CLIENT MEMORANDUM

Court Holds Issuer Liable for a Make-Whole Based on Its Voluntary Breach of an Indenture

October 6, 2016

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Generally, if an issuer breaches its bond indenture and the indenture trustee or noteholders accelerate the notes thereunder, any make-whole premium intended to compensate a noteholder for prepayment would not be owing unless the indenture expressly provides otherwise. This exception has been strictly interpreted by various courts. As a result, one could argue that an issuer could be placed in a better position based on its breach, and noteholders in a worse position because they exercised remedies. In response, based on the Second Circuit's 1982 decision in *Sharon Steel*,[1] courts fashioned an exception keeping the issuer liable for the make-whole if it defaults "with the intention of forcing an acceleration" in order to evade the make-whole.[2]

In a recent case, *Wilmington Savings Fund Society, FSB v. Cash America International, Inc.* (the "Decision"),[3] the U.S. District Court for the Southern District of New York (the "Court") adopted a more expansive interpretation of this exception based on *Sharon Steel*. Specifically, the Court held that noteholders were permitted to recover the make-whole following

[1] *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039 (2d Cir. 1982).

[2] *See, e.g.*, *In re Granite Broadcasting Corp.*, 369 B.R. 120 (Bankr. S.D.N.Y. 2007).

[3] Case No. 15-cv-5027 (JMF), 2016 WL 5092594, 2016 BL 30797 (S.D.N.Y. Sept. 19, 2016).

any event of default that resulted from a voluntary breach by the issuer even in the absence of an intent to evade the make-whole.

Issuers and investors should take note of the Decision. The indenture provisions relied upon by the Court are common to most indentures. If followed, the Decision interprets these provisions in a way that could expand the remedies available to noteholders, providing them with a powerful right to force an issuer to redeem its notes at a premium above par.

A. Background

In May 2013, Cash America International, Inc. ("Cash America") – a provider of secured, non-recourse lending, including payday and pawn shop loans – issued $300 million in unsecured notes (the "Notes," and the holders thereof, the "Noteholders") pursuant to an indenture ("Indenture").

In November 2014, Cash America effectuated a spin-off transaction (the "Spin-Off"), pursuant to which the online lending business conducted by its wholly owned subsidiary Enova International, Inc. ("Enova") was spun off into a separate publicly traded company and 80% of Enova's shares were distributed to Cash America's shareholders as a dividend. According to Cash America, after the Spin-Off it had ample liquidity and capital resources for ongoing operations and repayment of the Notes, including over $250 million of available credit, with only $185 million in outstanding Notes.

In June 2015, Wilmington Savings Fund Society, FSB, the successor trustee (the "Trustee") under the Indenture, commenced the litigation before the Court for breach of contract seeking declaratory relief that an event of default occurred as a result of the Spin-Off and seeking specific performance in the form of redemption of the Notes in an amount not less than 113.65% of the principal amount of the Notes, plus accrued and unpaid interest (including default interest), and fees, costs and expenses of enforcement. The complaint did not seek to unwind the Spin-Off or avoid it as a fraudulent transfer.

B. The Decision

Upon cross-motions for summary judgment, the Court determined that Cash America had breached the Indenture's consolidation, merger and sale covenant by consummating the Spin-Off.[4] The Court then turned to the question of the Trustee's remedies, which, it stated, "turns on the interplay between the Indenture's prepayment and acceleration clauses."

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[4] Under this covenant, Cash America and its subsidiaries were generally prohibited from dissolving, liquidating, merging or consolidating with, or selling, assigning or disposing of its properties to, any other person, unless the transaction fell within one of several enumerated exceptions. One exception existed if "the aggregate book value of the properties disposed of" during the prior year does not exceed 10% of the total assets of Cash America and its consolidated subsidiaries. Cash America argued that the Spin-Off fell within this exception because the phrase "aggregate book value of the properties disposed of" should be interpreted as the book value of Enova's net assets – i.e., the book value of assets minus liabilities.

The Court disagreed, concluding that the Indenture was "unambiguous" and that the book value should be determined based on assets alone, which resulted in the 10% threshold being exceeded. The relevant provisions made no mention of liabilities or "net" assets and instead stated that

Generally, an issuer cannot redeem notes prior to maturity absent a clause in the indenture that allows for early prepayment. Section 3.01 of the Indenture allowed for the early redemption of the Notes upon payment of the make-whole premium.[5] The Court recognized that the purpose of the make-whole premium was to compensate the Noteholders for the expected series of payments that they would not receive through the maturity of the loan.

Sections 6.02 and 6.03 of the Indenture addressed the remedies available to Noteholders upon a breach. Section 6.02 of the Indenture stated that upon an event of default, the Trustee or Noteholders holding 25% in principal amount of the Notes "may" accelerate the Notes, and declare that the principal and interest thereon due immediately. In addition, Section 6.03 of the Indenture permits the Trustee, upon an event of default, to "pursue … any available remedy … to enforce the performance of any provision of the Notes or the Indenture." The Court described these provisions as "permissive" because acceleration was not listed as the exclusive remedy.

Relying on the Second Circuit's 1982 *Sharon Steel* decision,[6] the Court held that because the Indenture did not mandate acceleration as the exclusive remedy, and the default was not due to bankruptcy, but rather Cash America's "voluntary actions" (i.e., the Spin-Off), the Noteholders could seek specific performance of the redemption provisions of the Indenture, including the payment of the make-whole premium.

The Court rejected Cash America's argument that the prepayment provision merely provided Cash America with a right that it "may" redeem the Notes, rather than a remedy for Noteholders. In addition to noting that the indenture in *Sharon Steel* contained the same type of optional prepayment provision, the Court concluded that because the Indenture, in effect, provided Cash America with the option to prepay in advance in order to avoid the breach, Cash America's voluntary breach gave rise to the Noteholders' right to enforce prepayment. Enforcing the prepayment provision, the Court concluded, led to the more equitable result because it prevented Cash America from placing itself in a better position by breaching the Indenture and gave effect to the bargained-for agreement among the parties.

Lastly, Cash America argued that *Sharon Steel* limited enforcement of the redemption provision to circumstances where the issuer acted in bad faith. The Court conceded that several cases since *Sharon Steel* have interpreted the case to require that the issuer have acted in a tactical way, or with the intention of creating a default. However, the Court

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the book value of properties disposed of "shall be deemed to be the aggregate book value of all assets." Moreover, the Court noted that, while liabilities are relevant when valuing a company or equity, they do not generally attach to assets.

5 The make-whole premium was calculated based on the present value of the remaining principal and interest payments, using a discount rate equal to a reference treasury rate plus 50 basis points.

6 In *Sharon Steel*, the Second Circuit concluded that the issuer breached the indenture by attempting to liquidate the corporation on a piecemeal basis, and then, in connection with the sale of the remaining business, invoke the merger/successor obligor provision of the indenture to force the noteholders to accept successor notes. The Second Circuit concluded, based on such breach, that the noteholders could sue for the make-whole payment.

concluded that this narrow interpretation imposed limitations that were nowhere to be found in the Second Circuit's reasoning itself. Furthermore, the Court was reluctant to write a subjective intent requirement into the case law, not only due to the inherent difficulty in determining such intent, but also because contract remedies are generally designed to compensate the non-breaching party and not to punish the breaching party.[7]

C. <u>Observations</u>

If the Decision is followed, it provides a potentially powerful tool for noteholders. The prepayment and acceleration provisions relied upon by the Court are generally not uncommon for indentures governing high yield bond issuances. By reading *Sharon Steel* to apply where there is any voluntary default, and not merely those where some form of bad faith can be proven, the Court's interpretation of *Sharon Steel* could allow noteholders to require their issuers to redeem their notes with the make-whole intact, thereby providing another cause of action that may be pursued in litigation and potentially allowing noteholders to preserve the right to a make-whole premium in lieu of, or notwithstanding, acceleration.

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[7] The Court also rejected Cash America's argument that the Noteholders' only remedy was acceleration, and not redemption, since Section 6.03 expressly provided for other remedies, including enforcing performance.