



JONES DAY
COMMENTARY

EXCHANGE OFFER DEVELOPMENTS: DELAWARE COURT DECLARES DEBT EXCHANGE OFFER IN VIOLATION OF BOND INDENTURE

The Court of Chancery of the State of Delaware recently held in *The Bank of New York Mellon v. Realogy Corporation*¹ that a company's proposed debt exchange offer was impermissible under the terms of the documents governing its debt. Because debt exchange offers and tender offers are likely to continue to play a significant role in addressing financing needs and opportunities in today's market, this *Commentary* summarizes the Delaware court's opinion and considers its possible impact on future debt exchange offers.

THE DELAWARE COURT'S OPINION IN *REALOGY*

Realogy Corporation had the following debt outstanding: (i) a senior secured term loan facility and a senior secured revolving credit facility (the "Credit Facility"); (ii) senior notes (the "Senior Fixed Notes");

(iii) senior toggle notes (the "Senior Toggle Notes"); and (iv) senior subordinated notes (the "Senior Subordinated Notes"). Realogy sought to refinance its outstanding notes by offering to exchange a portion of them for term loans under a new \$500 million term loan facility. The new term loans were to be issued under an "accordion" feature of the Credit Facility and were to be secured by a second lien on substantially all of Realogy's assets.

Because the Senior Toggle Notes could be paid in kind (and thus were the cheapest debt element of the capital structure on a cash basis), Realogy structured the offer to allow holders of the Senior Toggle Notes to participate only after all interested holders of the other two tranches had participated. In light of the relatively small size of the offer and the expected degree of interest from the other two tranches, it was unlikely that any holders of the Senior Toggle Notes would be able to exchange their notes for new term

¹ C.A. No. 4200-VCL, 2008 Del. Ch. LEXIS 186 (Del. Ct. Ch. Dec. 18, 2008) (unreported opinion).

loans. As a result, because the new term loans were to be secured by second liens under the Credit Facility, the proposed exchange offer would have allowed the Senior Fixed Notes to effectively become senior to the Senior Toggle Notes and the Senior Subordinated Notes to “leapfrog” in priority over the Senior Toggle Notes.

The trustee under the indenture sued Realogy on behalf of holders of the Senior Toggle Notes, alleging that the exchange offer breached the indenture. Because certain terms of the indenture relied upon terms of the Credit Facility, the question before the court was whether the exchange offer was permissible under the Credit Facility.² The trustee maintained that the exchange offer was impermissible under the Credit Facility because (i) the exchange offer allowed holders of notes to fund their commitments for new term loans with exchanged notes, even though the Credit Facility required “loans” to be funded in cash, and (ii) the new term loans were not “Permitted Refinancing Indebtedness” as defined in the Credit Facility.

The Delaware Court of Chancery rejected the trustee’s first argument as “hyper-technical.”³ The court concluded that the use of the word “loan” in the Credit Facility was not necessarily limited to loans made for cash, observing that “[t]here are many commercial examples of loans which are not funded in cash.”⁴ The court was also unconvinced by the trustee’s narrower contention that the word “loan,” in the context of the Credit Facility’s other terms, implied funding only in cash.⁵

The court, however, agreed with the trustee’s second argument. As is typical of such facilities, the Credit Facility prohibited prepayment of the notes except, among other exceptions, with “Permitted Refinancing Indebtedness,” that is, indebtedness the proceeds of which are used to refinance the indebtedness in question. The definition of “Permitted Refinancing Indebtedness” had an exclusion, however, for any new debt with “greater ... security” than the refinanced debt. The proposed exchange offer, which contemplated

replacing unsecured notes with second lien term loans, would result in new debt with greater security than the refinanced debt and therefore be impermissible under the exclusion. But the exclusion itself had a carveout that allowed new security to be added to the refinancing indebtedness to the extent permitted under the Credit Facility’s negative covenants. While those covenants generally prohibited liens on Realogy’s property, they permitted liens created under the Credit Facility itself. Since the new term loans were to be issued under the “accordion” feature of the Credit Facility, Realogy contended that the liens were to be created under the Credit Facility and thus came within the carveout for additional security permitted by the definition of “Permitted Refinancing Indebtedness.” The trustee responded that Realogy’s interpretation would make the carveout so broad that the exclusion that it modified would itself be rendered meaningless.

The court observed that an interpretation of the exclusion to the definition of “Permitted Refinancing Indebtedness” that required nothing more than compliance with the covenants would add no substance to the definition. The exclusion would then be “mere surplusage.”⁶ Because courts generally try to give meaning to every term of an agreement, the court reasoned that Realogy’s interpretation should be disfavored. The court preferred the trustee’s interpretation, which permitted the refinancing indebtedness to be secured only if the debt being refinanced could itself have been secured pursuant to the terms of the Credit Facility.⁷

REALOGY’S IMPACT ON DEBT EXCHANGE OFFERS

Although the Delaware court did not allow Realogy to pursue its proposed refinancing structure and there is always a risk of litigation where one group of creditors may be adversely affected by a proposed transaction, the court’s reasoning may actually facilitate debt exchange offers by companies

2 One of the holders of Senior Toggle Notes also party to the complaint against Realogy contended that the exchange offer amounted to a fraudulent transfer. The court did not address that claim.

3 2008 Del. Ch. LEXIS 186, at *23.

4 *Id.*

5 *See id.* at *24-*33.

6 *Id.* at *40.

7 *See id.* at *41-*42.

in certain circumstances. The court's decision with respect to the trustee's second argument is likely to have little precedential impact because it was so fact-specific. But the court's decision on the first issue—allowing loans to be exchanged for debt securities under a credit facility—may have a wider impact. In today's climate, where liquidity is so hard to find, courts may be more willing to follow the Delaware Chancery Court's lead in rejecting "hyper-technical" arguments that would limit refinancing to new debt funded in cash.

However, no transaction should be undertaken until all documents governing outstanding debt are carefully reviewed, as the current market climate may also lead to more disputes over proposed financings as creditors attempt to obtain positions closer to a debtor's diminished capital. Because the alternative to refinancing can be bankruptcy, room for compromise is limited, and many of these disputes may proceed to litigation.⁸ The success of any debt exchange or tender offer, therefore, will depend on the terms of a debtor's debt instruments, and even slight differences in terminology can affect the outcomes of these transactions. For companies considering debt exchange offers or other refinancing transactions, careful review of those instruments is critical.

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⁸ Two other examples of exchange offers that have led to litigation may be found in *Murchison v. Harrah's Entertainment Inc.*, No. 09cv00020 (D. Del. filed Jan. 9, 2009) and *Springfield Assocs. v. Neff Corp.*, No. 08-603668 (N.Y. Sup. Ct. filed Dec. 15, 2008).

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