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Client Alert

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THE REALOGY CASE: NOTEHOLDERS BLOCK AN EXCHANGE OFFER

In the current economic climate, corporate borrowers in highly leveraged LBOs and their private equity sponsors are seeking creative ways to restructure outstanding debt in order to revive value for shareholders. In cases where existing debt is trading at a significant discount, the conditions may be ripe for exchange offers of new debt, in a lower principal amount, to retire existing debt. Exchange offers can be particularly attractive to borrowers and sponsors if no lender consents are required for the exchange offer to proceed.

Lender consent requirements can become a pitfall in such liability management transactions, as occurred in the recently decided Realogy case¹. Realogy Corporation, a real estate services company controlled by Apollo Management, the private equity firm, owns such real estate mainstays in the United States as Century 21 and Coldwell Banker. Its business has been deeply impacted by the downturn in

the real estate market, coupled with a relatively high debt burden as a result of its leveraged takeover by Apollo in 2007.

In November 2008, Realogy announced an exchange offer for approximately \$1.2 billion of its existing debt. Certain noteholders sued to enjoin the offer. The Delaware Chancery Court held that the offer was not permitted under the relevant financing documents, effectively forcing the company to reconsider its plans for liability management.

Proposed Restructuring

At the time it launched the exchange offer (the “**Exchange Offer**”), Realogy had \$3.157 billion of unsecured debt securities (the “**Notes**”) comprised of (a) \$1.7 billion of 10.5% Senior Notes due 2014 (the “**Senior Cash Pay Notes**”), (b) \$582 million of Toggle Notes due 2014 (the “**Toggle Notes**”), and (c) \$875 million of 12.375%

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¹ *The Bank of New York Mellon and High River Limited Partnership v. Realogy Corporation*, Court of Chancery of the State of Delaware, C.A. No 4200-VCL, Memorandum Opinion, December 18, 2008.

Senior Subordinated Notes due 2015 (the “**Senior Subordinated Notes**”). The Senior Subordinated Notes were subordinated to the Senior Cash Pay Notes and the Toggle Notes, which ranked *pari passu* to each other. Realogy also had a secured senior credit facility (the “**Credit Agreement**”) in place with a \$3.17 billion secured term loan facility, a \$750 million revolving credit facility and a \$525 synthetic letter of credit, each of which were secured by substantially all of Realogy’s assets and those of its parent company and subsidiary guarantors.

Under the terms of the Exchange Offer, Realogy proposed to exchange approximately \$1.2 billion of the outstanding Notes for up to \$500 million of additional term loans (the “**Second Lien Term Loans**”). These new loans would be incurred under an “accordion” feature of the Credit Agreement that allowed for additional loans. Although the exchange ratios on offer would crystallize significant discounts in the value of the outstanding Notes, the main appeal of the exchange was that the new Second Lien Term Loans would be secured on a second lien basis, whereas the existing Notes were unsecured.

The terms of the Exchange Offer set a priority as to which holders were entitled to accept the offer: first, holders of the Senior Subordinated Notes, then holders of the Senior Cash Pay Notes and then holders of the Toggle Notes. Given the exchange ratios offered and the principal amount of Senior Subordinated Notes and Senior Cash Pay Notes expected to be tendered in the Exchange Offer, all \$500 million of the Second Lien Term Loans were expected to be allocated to holders of the Senior Subordinated Notes and the Senior Cash Pay Notes. As a result, holders of the Toggle Notes would be unable to participate in the Exchange Offer. These holders, in effect, faced a situation in which holders of junior debt (the Senior Subordinated Notes),

including a shareholder², and *pari passu* debt (the Senior Cash Pay Notes) who accepted the offer would end up with a secured position (albeit second ranking) under the Second Lien Term Loans, ahead of the unsecured Toggle Notes.

Noteholder Allegations

High River LP, an investment vehicle controlled by Carl Icahn that held Toggle Notes, and The Bank of New York Mellon, as trustee under the indenture governing the Toggle Notes (the “**Indenture**”), brought suit against Realogy in the Delaware Chancery Courts, seeking declaratory relief and an injunction to prevent the Exchange Offer from going forward, on the basis, among other things, that the Exchange Offer would violate the terms of the Indenture.

Although the plaintiffs made a number of arguments that were rejected by the Court, they prevailed on the argument that Realogy’s incurrence of new second liens would violate the Indenture’s negative pledge clause³. The clause prohibited Realogy from securing indebtedness unless the Toggle Notes were granted liens either senior to (in the case of new liens securing subordinated debt) or *pari passu* with (in the case of new liens securing *pari passu* senior debt) the new liens, with the exception of Permitted Liens, as defined in the Indenture.

Accordingly, the case focused on whether the second liens were “Permitted Liens”. In relevant part, the defined term permitted liens securing indebtedness incurred under the Credit Agreement. This led the Court to frame the dispute as a question of whether the new debt in the Exchange Offer could be incurred under the Credit Agreement. If it could not, the second lien would not be a Permitted Lien.

² Notably, from the perspective of the holders of Toggle Notes, Apollo owned approximately \$69 million in principal amount of the Senior Subordinated Notes and had advised Realogy of its intention to participate fully in the Exchange Offer.

³ None of the other Indenture covenants, including the limitations on indebtedness and restricted payments, prohibited the Exchange Offer.

Outcome

The restricted payments clause of the Credit Agreement expressly prohibited payments of principal and interest or other distributions of property in redemption or exchange for any of the Notes, except for refinancings permitted under the debt covenant of the Credit Agreement. The debt covenant allowed “Permitted Refinancing Indebtedness” to refinance the Notes, provided that the refinancing indebtedness had no greater security than the debt being refinanced. Given that the new Second Lien Term Loans were secured (on a second lien basis) and the existing Notes being refinanced under the exchange offer were unsecured, the Court concluded that the Second Lien Term Loans were not Permitted Refinancing Indebtedness.

This exercise in contract interpretation had one additional twist. Realogy argued that the prohibition on greater security for Permitted Refinancing Indebtedness was qualified by a carveout stating that “other . . . security may be added to the extent then permitted” by the Credit Agreement. Since the Credit Agreement allowed for liens to secure debt incurred under the Credit Agreement, Realogy argued that the Second Lien Term Loans could be secured. The Court, however, was not persuaded, noting that Realogy’s interpretation would make the carveout an “exception that swallows the rule” by eliminating any restriction on greater security as long as the Permitted Refinancing Indebtedness was incurred under the Credit Agreement. The Court accepted the more narrow reading by the plaintiffs, specifically that “other security” could be granted to the extent that the debt being refinanced was entitled to additional security. Given that the Notes being refinanced were not entitled to additional security, the Court concluded that the Second Lien Term Loans did not qualify as Permitted Refinancing Indebtedness.⁴

Since the restricted payments clause in the Credit Agreement had no other exceptions allowing

redemptions or exchanges in respect of the Notes, the Court held that the Second Lien Term Loans (and the second liens supporting them) were prohibited by that clause. The Second Lien Term Loans therefore could not constitute indebtedness under the Credit Agreement. Accordingly, liens supporting the Second Lien Term Loans could not constitute “Permitted Liens” under the Indenture for the Toggle Notes.

Realogy could not point to other types of Permitted Liens applicable to the second liens in question. Given that the exchange offer did not provide for the Toggle Notes to be secured as required by the negative pledge clause of the Indenture, the Court ruled that the offer, if consummated, would constitute a breach of the Indenture.

The Court granted summary judgment in favor of the plaintiffs.

* * *

At one level, the Realogy case represents a fact-specific case of contract interpretation. At another level, however, it illustrates how shareholders and their leveraged companies may seek creative ways to use provisions that allow for the incurrence of additional debt. While it may be appealing for sponsors and corporate borrowers to use new debt to retire a larger amount of existing debt that is trading at a significant discount, the resulting new capital structure can disadvantage existing lenders who elect not to, or cannot, participate in an exchange offer.

The relevant provisions of the financing agreements in Realogy served to protect the holders of Toggle Notes from such a fate. While this may seem a logical result, it may not be the outcome under all complex financings structures. The issue should be considered closely in new financings.

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⁴ In essence, then, the terms of the Credit Agreement were imported into the Indenture, with the effect of prohibiting the Exchange Offer. Realogy, of course, could ask its lenders under the Credit Agreement to waive the restriction on greater security for Permitted Refinancing Indebtedness, with the result that those lenders, holding first ranking security, could decide the fate of the Exchange Offer by permitting the second lien feature.

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