SEWARD & KISSEL LLP

Global Banking and Institutional Finance & Restructuring Practice Group

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Subordination: The Power of Punctuation

In the world of subordinated debt, senior means senior, and junior means junior, or at least that's the general understanding. In other words, senior debt gets paid in full before the juniors receive any payment at all. However, holders of the junior debt of the parent corporation in the Adelphia bankruptcy attempted in a litigation to upend this general understanding, using an argument based on a rarely invoked and little understood provision in the trust indenture – the X-Clause.

Seward & Kissel LLP, representing Law Debenture Trust Company of New York, the trustee for the holders of $5.2 billion in senior debt, successfully litigated the question of whether Adelphia's Senior Noteholders were required to share ratably – *pari passu* – with Subordinated Noteholders in the bankruptcy distributions made pursuant to Adelphia's Plan of Reorganization. The Adelphia bankruptcy, which followed one of the most significant corporate scandals of the past decade, presented numerous complex issues for creditors, including holders of corporate debt of many of the Adelphia entities and their trustees.

In the case, in attempting to share in the distributions made to the Senior Noteholders, the Subordinated Noteholders invoked the X-Clause. X-clauses in Subordinated Indentures commonly provide a narrow exception to subordination ("X" is for "exception") which enables junior debt holders to retain securities issued in connection with a plan of reorganization, as long as the subordination scheme remains intact, i.e., that the seniors get paid first.

Judge Robert E. Gerber of the United States Bankruptcy Court for the Southern District of New York concluded that, as argued by Seward & Kissel on behalf of the Senior Notes Trustee, the Senior Noteholders were not required to share distributions with the Subordinated Noteholders and therefore the Senior Noteholders were entitled to sole distribution rights on their aggregate principal amount of Senior Notes.

The case turned on two provisions in the trust indentures: First, the definition of "Permitted Junior Securities":

> Permitted Junior Securities, which can be distributed to holders of the subordinated notes in a reorganization, are: (1) shares of stock of any class of the Company other than Disqualified Stock; or (2) securities of the Company other than Disqualified Stock that are subordinated in right of payment to all Senior Debt that may be outstanding at the time of issuance or delivery of such securities to substantially the same extent as, or to a greater extent than, the Notes are so subordinated pursuant to the terms of this Indenture.

The "X-Clause" in the indentures stated that:

> The holders of all Senior Debt shall first be entitled to receive payment in full of the principal thereof, the interest thereon and any other amounts due thereon before the Holders [of Subordinated Notes] are entitled to receive payment on account of the principal of or interest on or any other amounts due on the [Subordinated] Notes, **except payments comprised solely of Permitted Junior Securities.** . . . (emphasis added).

An *Ad Hoc* Convertible Notes Committee, representing the Subordinated Noteholders, presented two questions for resolution by the Bankruptcy Court, the significance of which will be seen below. The first

question was whether Time Warner Cable, Inc. (one of the purchasers of Adelphia assets under a $17 billion Asset Purchase Agreement, which provided the groundwork for the Plan of Reorganization) was the "successor" to the Adelphia parent corporation, and therefore the "Company" within the definition of Permitted Junior Securities. Assuming the answer to the first question was yes, the second question was whether the distributions under the Plan were Permitted Junior Securities that, they argued, must be shared pari passu with the Subordinated Noteholders pursuant to the X-Clause.

Based on the language of the indentures, legal precedents, common industry understanding, and basic common sense, Seward & Kissel argued that the answer to both questions must be "No."

Judge Gerber agreed on both points. First, he determined that the X-Clause in the Subordinated Indentures was not triggered, with the principal reason being that the Time Warner Stock to be issued under the Plan was not stock "of the Company" because Time Warner did not assume the obligations of the Company (defined as Adelphia's parent corporation). Also, the indentures prohibited a merger, and therefore eliminated the possibility of a successor in a case which a default had occurred and was continuing. Obviously, Adelphia was still in default. Thus, Time Warner could not be considered the successor to Adelphia, and the Time Warner shares to be distributed under the Plan could not possibly be shares "of the Company" and could not be "Permitted Junior Securities" that holders of junior debt would be able to retain under the X-Clause.

The Judge could have stopped there, but went on to determine that even if Time Warner was a successor, and therefore was issuing Permitted Junior Securities, the Subordinated Noteholders were not entitled to share in any such distributions. Judge Gerber found that the "core promise" of subordinated indentures required that subordinated noteholders remain subordinated, and that this was the general understanding of subordinated indentures in the financial community.

Although Judge Gerber found that the X-Clause in this case was ambiguous and poorly drafted, the term "Permitted Junior Securities" must be read in the context of the entire agreement, and the parties must assume that the word junior means junior, and implies subordination. If the parties desired to override the "core promise", then they would have had to manifest a clear intent to draft the X-Clause to effect that purpose, which the parties did not do. Much of the argument turned on the meaning of the semi-colon placed between the two clauses in the definition of Permitted Junior Securities, and whether the placement of that semi-colon demonstrated the intent of the drafters of the indentures to have the Juniors share with the Seniors in any distribution of securities in connection with a plan of reorganization.

Finally, the court held that existing case law interpreting X-Clauses, which was well-known within the community, supported the conclusion that if the parties intended to draft an X-Clause that negated subordination, then the parties would have drafted the language to express such an intent much more clearly than they did – subordination simply would not be undermined based on the clever placement of a semi-colon.

The Senior Noteholders, therefore, were awarded full distribution rights on their approximately $5.2 billion in aggregate principal amount of senior notes.

Bruce Paulsen, who, with Michael Woolley, tried the X-Clause case on behalf of Seward & Kissel LLP, contributed to this article. Special thanks to Arlene Alves who helped in pre-trial preparation.

If you have any questions, please feel free to contact any of the attorneys in the Global Banking and Institutional Finance & Restructuring Practice Group via telephone at (212) 574-1200 or email generally by typing in the attorney's last name @sewkis.com

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