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Client Alert

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Indenture Reporting Covenants and Section 314(a) of the Trust Indenture Act

"*Affiliated* is the second federal appeals court decision to declare this type of reporting covenant to be effectively 'broken,' joining the court decision in *UnitedHealth Group.*"

Beginning in the middle of this decade, a number of public companies were forced to delay the filing of their regular quarterly and annual reports while they grappled with accounting issues such as restatements and the heightened scrutiny of internal controls driven by Sarbanes-Oxley. Looking to protect their interests (or as some companies saw it, sensing a chance to extract monetary concessions), bondholders scrutinized the reporting covenants in their indentures, and asserted that an event of default had occurred whenever an issuer was late in making a required periodic filing under the Exchange Act. In some cases, issuers paid a consent fee to obtain a waiver of a claimed covenant default resulting from a late filing; in other cases, issuers disputed whether any covenant default existed.[1]

High-yield style bond indentures, which almost always contain an explicit requirement that an issuer file Exchange Act reports with the SEC within the time periods specified in the SEC's rules and regulations (whether or not those rules and regulations are applicable), were easy targets for bondholders. Other covenants, however, do not make it crystal clear when an issuer needs to file its Exchange Act reports. Investment grade and convertible note indentures often contain an ambiguous version of the reporting covenant, which many thought should be read to require only a ministerial filing with the indenture trustee of any Exchange Act reports that the issuer actually files with the SEC, if and when those reports are actually filed with the SEC. All of the recent litigation surrounding reporting covenant violations has focused on interpreting the ambiguity in these "broken" reporting covenants.

In light of the Fifth Circuit's recent decision in *Affiliated Computer Servs. Inc. v. Wilmington Trust Co.* (April 16, 2009),[2] we think this matter is now reasonably well settled. These ambiguous reporting covenants are indeed "broken" and should not be read to create a default simply because a quarterly or annual SEC filing is delayed. Every federal court that has addressed this issue has ruled similarly, and only one, lone decision by a New York State trial court—the *BearingPoint* case—has found differently. It is time to flash the "game over" light and move on.

Background

What do these "broken" reporting covenants look like? There is a surprisingly wide variety of reporting covenants in the market, but most of the troublesome varieties are found in investment grade and convertible note indentures. One common version of this type of reporting covenant reads as follows:

> "The Company shall file with the Trustee, within 15 days after it files the same with the SEC, copies of the annual reports and the information, documents and other reports (or copies of those portions of any of the foregoing as the SEC may by rules and regulations prescribe) that the Company is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act. The Company shall also comply with the provisions of TIA 314(a)."[3]

Many bondholders read the phrase "reports...that the Company is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act" to imply that the issuer is contractually obligated to file Exchange Act reports *in a timely manner* with the SEC. The issuer community takes the view that this formulation only requires a filing with the trustee if and when a filing is actually made with the SEC.

In a series of cases commencing in September 2006 with the ruling by a New York State trial court in *Bank of New York v. BearingPoint Inc.* (September 2006),[4] bondholders claimed these types of reporting covenants require that Exchange Act reports be filed with the SEC on a timely basis. They also argued that Section 314(a) of the Trust Indenture Act of 1939 (TIA)[5] imposes a similar requirement. Section 314(a) of the TIA requires issuers of public debt to "file with the indenture trustee copies of the annual reports and of the information, documents, and other reports… which such obligor is required to file with the Commission pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934." (Note that this provision does not explicitly specify a time period in which a company must file copies of the Exchange Act reports with the indenture trustee.)

TIA Section 314(a) automatically applies to all public debt indentures, whether or not it is expressly stated in the indenture, since it is a mandatory provision that cannot be contracted away.[6] The bondholders argued that their reporting covenant would be rendered meaningless if neither the explicit text of the reporting covenant nor TIA Section 314(a) required timely (or any) SEC filings. Not surprisingly, the issuers in each of these cases took a different view.

The question presented to the courts in each of the litigations seeking an interpretation of these "broken" covenants is simple: should a substantive timing requirement be read into Section 314(a) of the TIA or similarly drafted reporting covenants, or does TIA Section 314(a) and the reporting covenants patterned after that section require nothing more than the ministerial act of forwarding copies of Exchange Act reports (if filed, at all) to an indenture trustee?

Case Law

The following is a discussion of each of the court decisions that has addressed this issue.

BearingPoint— First, but not Followed

The first court to tackle the issue was the New York State trial court in *BearingPoint.* During 2005, BearingPoint failed to timely file its annual report on Form 10-K and two of its quarterly reports on Form 10-Q. According to its notifications of late filings, the delays were due in part to the need to perform significant substantive procedures to compensate for the material weaknesses in its internal control over financial reporting and its efforts to complete management's assessment of its internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act.

The trustee, on behalf of the holders of BearingPoint's convertible bonds,

sought to accelerate the bonds, arguing that BearingPoint had violated the reporting covenant in the indenture. That covenant required BearingPoint to file with the trustee copies of its SEC reports "within 15 days after it files such … reports … with the SEC." In an unpublished decision in September 2006, the New York court ruled that BearingPoint's failure to timely file its reports with the SEC violated Section 314(a) of the TIA and breached the indenture's reporting covenant, reasoning that making timely "SEC filings optional under the terms of the Indenture vitiates the clear purpose of the Indenture to provide information to the investors so that they may protect their investment." After the decision was rendered, the judge took the uncommon step of granting the parties leave to reargue the case, but the matter was settled before it could be retried.

The *BearingPoint* decision sent a shock wave through the debt markets as it was the first decision on this point, and stood for the proposition that failure to timely file Exchange Act reports with the SEC equaled an event of default for failure to comply with TIA Section 314(a) (and the many reporting covenants patterned after TIA Section 314(a)).

Federal Courts Enter the Fray

In 2007 and 2008, federal district courts weighed in,[7] and each of the four federal district courts addressing the issue in published decisions found that a failure to timely file Exchange Act reports with the SEC *does not* violate either TIA Section 314(a) or a reporting covenant patterned on the language of TIA Section 314(a).[8] Those district courts (and the Eighth and Fifth Circuits on appeal, as discussed later) soundly rejected the reasoning of the New York trial court in *BearingPoint* and held that TIA Section 314(a) (and related reporting covenants) do not impose a timing requirement within which to file Exchange Act reports with the SEC.

In *UnitedHealth Group v. Wilmington Trust Co.* (December 2008),[9] the Eighth Circuit became the first federal appeals court to address this issue. UnitedHealth Group was one of the many companies that came under public scrutiny during the middle of this decade for allegedly backdating stock options to reflect more favorable historical market values. While in the midst of an internal investigation, UnitedHealth Group failed to timely file a quarterly report on Form 10-Q. It filed a notification of late filing on Form 12b-25, explaining the reasons for the delay, together with a 44-page appendix containing information that was substantially similar to the information that would ultimately be in the Form 10-Q that it filed late. It also filed Form 8-Ks over the next several months reporting on the status of the investigation and the late filing.

A notice of default was sent on behalf of certain hedge funds that held the company's bonds, claiming a violation of TIA Section 314(a) and a violation of the related indenture reporting covenant,[10] which read:

> "the Company shall cause copies of all current, quarterly and annual financial reports on Forms 8-K, 10-Q and 10-K, respectively, and all proxy statements, which the Company is then required to file with the Commission pursuant to Section 13 or 15(d) of the Exchange Act to be filed with the Trustee …. within 15 days of filing with the Commission. The Company shall also comply with the provisions of the TIA [Section] 314(a)."

The Eighth Circuit affirmed the district court's ruling, and found that UnitedHealth Group did not have an independent obligation to timely file Exchange Act reports with the SEC under either TIA Section 314(a) or the reporting covenant under its indenture. The court held that the indenture language imposed only a "ministerial" obligation to forward to the trustee copies of the required Exchange Act

reports within 15 days of the actual filing of such reports. That language, and TIA Section 314(a), did not "independently impose any particular timetable for filing nor does it incorporate the SEC's regulatory deadlines."

The trustee argued that TIA Section 314(a) should be read to impose something more substantive than a ministerial obligation. The trustee urged the court to find an obligation to provide copies of Exchange Act reports to the trustee on a timely basis, particularly in light of the current world of instant Internet availability. The court soundly rejected this argument, stating that "[t]he development of more efficient electronic alternatives is no reason to expand [the company's] duties under the TIA."

The Fifth Circuit's Turn—*Affiliated Computer Services Inc.*

On April 16, 2009, the Fifth Circuit in *Affiliated* similarly ruled that Affiliated Computer Services Inc.'s late filing of a Form 10-K did not violate TIA Section 314(a) or the related reporting covenant in its indenture. Like UnitedHealth Group, Affiliated was unable to timely file its Form 10-K, initially due in September 2006, because of an ongoing internal investigation into its historical stock option granting practices. As with UnitedHealth Group, Affiliated filed a Form 12b-25 explaining the reasons for its late filing.

Affiliated's reporting covenant required that it:

> "shall file with the Trustee, within 15 days after it files the same with the SEC, copies of the annual reports and the information, documents and other reports (or copies of those portions of any of the foregoing as the SEC may by rules and regulations prescribe) that [it] is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act. [It] shall also comply with the provisions of TIA 314(a)."

The court expressly agreed with the reasoning of the Eighth Circuit in *UnitedHealth Group*, and in affirming the decision of the district court below declared that "§314(a) of the TIA does not impose an independent obligation timely to file reports with the SEC. Rather, §314(a) requires [Affiliated] to provide copies of reports that are *actually filed* with the SEC." [Emphasis added.] With respect to the indenture language, the court stated that the "unambiguous language … does not impose an independent obligation … timely to file reports with the SEC."

Implications and Conclusions

These decisions raise several important concerns for issuers, bondholders and trustees when negotiating new bond indentures and interpreting existing bond indentures.

Looking Backward: Is it "Game Over" for Bondholders?

The prevailing case law in the federal courts holds that TIA Section 314(a) and similarly drafted reporting covenants do not impose an independent obligation to file Exchange Act reports with the SEC on a timely basis. *Affiliated* is the second federal appeals court decision to declare this type of reporting covenant to be effectively "broken," joining the Eighth Circuit's decision in *UnitedHealth Group*. Although it is important to note that *Affiliated* and *UnitedHealth Group* are not binding outside of the Fifth and Eighth Circuits, respectively (for example, New York is located in the Second Circuit, which has not yet opined on this issue), we think these cases are likely to be viewed by most as persuasive authority.[11]

Looking Forward: For New Issuances—Say What You Mean

If bondholders wish to impose an independent obligation on an issuer to file reports timely with the SEC and to have delinquency rise to the level of

a covenant default that could trigger acceleration, express and clear language to that effect must be included in the indenture.[12] Needless to say, bond issuers—who desire to avoid defaulting on their bonds (and cross-defaulting other debt) because of a delay in filing Exchange Act reports—may see things very differently, and resist this type of language.

If the parties intend for Exchange Act reports to be timely filed with the SEC, we recommend that investment grade and convertible note issuers and bondholders adopt the model covenant proposed by the Credit Roundtable, in association with the Fixed Income Forum, in its 2007 white paper on "Improving Covenant Protections in the Investment Grade Bond Market."[13] The model covenant is reproduced in full text in Appendix A to this *Client Alert*. The Credit Roundtable's model provides the issuer is required:

> (a) to furnish its bondholders with copies of its Exchange Act reports "*within the time periods* specified in the SEC's rules and regulations"; and (b) in the event that the issuer ceases to be subject to Exchange Act reporting requirements, to publish financial information on its web site "substantially similar to that which would have been required" in Exchange Act reports "*within the time periods* that would have been applicable to filing such reports with the SEC." [Emphasis Added.][14]

Conclusion

Words matter. Reporting covenants only work when they are properly drafted. Consider the reporting covenant language and the related events of default carefully in your indentures and make sure you understand the implications.

Appendix A

Model Reporting Covenant for Investment Grade Issuers

Reports. The Indenture provides that so long as any Notes are outstanding, if the Company is subject to the periodic reporting requirements of the Exchange Act, the Company will file with the SEC and furnish to the Holders of Notes (or cause the trustee to furnish to the Holders of Notes), within the time periods specified in the SEC's rules and regulations:

(1) all quarterly and annual reports on Forms 10-Q and 10-K required to be filed by companies that are subject to the periodic reporting requirements of the Exchange Act; and

(2) all current reports on Form 8-K required to be filed by companies that are subject to the periodic reporting requirements of the Exchange Act.

Each annual report on Form 10-K will include a report on the Company's consolidated financial statements by the Company's certified independent accountants. In addition, the Company will post a copy of each of the reports referred to in clauses (1) and (2) above on its website for public availability within the time periods specified for filing such reports with the SEC in the rules and regulations applicable to such reports.

If, at any time, the Company is no longer subject to the periodic reporting requirements of the Exchange Act for any reason, the Indenture requires that the Company will nevertheless continue to prepare the financial statements and a "Management's Discussion and Analysis of Financial Condition and Results of Operations" substantially similar to that which would have been required to be included in each of the reports specified in clause (1) of the preceding paragraph of this covenant had the Company been subject to such Exchange Act reporting requirements (with all such financial statements prepared in accordance with Regulation S-X promulgated by the SEC and all such annual financial statements including a report thereon from the Company's certified independent accountants) and post copies thereof to its website for public availability within the time periods that would have been applicable to filing such reports with the SEC in the rules and regulations applicable to such reports if the Company had been required to file those reports with the SEC; *provided, however*, that if the Company is no longer subject to the periodic reporting requirements of the Exchange Act, the Company will not be required to comply with Section 302 or Section 404 of the Sarbanes-Oxley Act of 2002, or related Items 307 and 308 of Regulation S-K promulgated by the SEC, or Item 10(e) of Regulation S-K (with respect to any non-GAAP financial measures contained therein).*

* Other exceptions to the SEC's specific reporting obligations may be negotiated on a case by case basis.

Endnotes

[1] Regardless of whether the dispute resulted in litigation or the payment of a consent fee, we noticed that many of these bonds jumped in price once the issuer was alleged to be in default, presumably on speculation that a consent or waiver fee could be extracted from the issuer. In addition, the cross-default provisions of senior secured debt would be implicated if the reporting covenant in one of these indentures were breached. Some bank lenders accordingly received consent fees as well, either directly because the issuer failed to file financials, or via a waiver of the cross-default.

[2] *Affiliated Computer Servs. Inc. v. Wilmington Trust Co.*, 2009 U.S. App. LEXIS 8011, slip op. (5th Cir. April 16, 2009).

[3] This is the reporting covenant that was at issue in *Affiliated*.

[4] *Bank of N.Y. v. BearingPoint, Inc.*, 2006 N.Y. Misc. LEXIS 2448 (N.Y. Sup. Ct. 2006) (unpublished table decision).

[5] The TIA is codified as 15 U.S.C. § 77aaa through 15 U.S.C. § 77bbbb; Section 314(a) is found at § 77nnn.

[6] *See* TIA § 318, 15 U.S.C. § 77rrr (2004).

[7] *See Finisar Corp. v. U.S. Bank Trust Nat'l Ass'n,* 2008 WL 3916050 (N.D.Cal. Aug. 25, 2008); *UnitedHealth Group, Inc. v. Wilmington Trust Co.,* 538 F. Supp 2d 1108 (D. Minn. Mar. 10, 2008)*; Affiliated Computer Servs., Inc. v. Wilmington Trust Co.,* 2008 WL 373162 (N.D.Tex. Feb. 12, 2008)*; Cyberonics, Inc. v. Wells Fargo Bank Nat'l Ass'n,* 2007 WL 1729977 (S.D.Tex. June 13, 2007).

[8] When the TIA was first adopted in 1939, the requirement to file certain reports with the trustee was significant. In many cases, it was the only way that bondholders could obtain current information about the bond issuer. Today, issuers publicly file their Exchange Act reports with the SEC electronically and these reports are immediately available to the public over the Internet on the SEC's Web site. Given this evolution, the requirement to file Exchange Act reports with the trustee is now mostly ministerial, and many indentures no longer require those reports to be separately provided to the trustee so long as they are publicly available on EDGAR.

[9] *UnitedHealth Group v. Wilmington Trust Co.*, 548 F.3d 1124 (8th Cir. 2008).

[10] The trustee also argued that the company breached an implied covenant of good faith and fair dealing on account of the delinquent filing. The court rejected this claim.

[11] The SEC has not adopted any rules under the TIA in the 70 years the Act has been law. And we do not expect the SEC to implement any TIA rules in the foreseeable future to clarify this issue.

[12] We note that a late filing does not necessarily need to result in a default under the terms of the indenture. In some formulations that we are aware of, a late filing only triggers an increase in the interest rate.

[13] The Credit Roundtable in association with the Fixed Income Forum, *Improving Covenant Protections in the Investment Grade Bond Market* (Dec. 17, 2007), *available at* http://www.iimemberships.com/downloads1/creditroundtable/Covenant%20White%20Paper%20revised%207-2-08.pdf.

[14] Another benefit to adopting the model covenant is that it would require the issuer to provide information substantially similar to that required in Exchange Act reports even if it is not subject to Exchange Act reporting requirements. Section 314(a) and similarly drafted reporting covenants do not independently require an issuer to file Exchange Act reports or similar information with the trustee if the issuer is not subject to Exchange Act reporting requirements. SEC Telephone Interpretation Question 107.01 (March 30, 2007) available at http://www.sec.gov/divisions/corpfin/guidance/tiainterp.htm.

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