Indenture Breach Ruling Leads to Windstream Bankruptcy

February 26, 2019

On February 15th, in a much-anticipated decision, a federal district court issued a $310 million judgment in favor of Aurelius Capital in *U.S. Bank National Association v. Windstream Services, LLC v. Aurelius Capital Master, Ltd.* The court noting that Windstream's "financial maneuvers–and many of its arguments here–are too cute by half," found that Windstream's 2015 spin-off of its telecommunications assets, and subsequent "lease" of such assets was a sale-leaseback that violated its indenture. The decision, which provides evidence of courts' willingness to see past the form of a transaction and evaluate its substance, raises some key compliance considerations for sponsors and corporate issuers as discussed below. As a result of the decision and the corresponding cross-default to Windstream's other indebtedness, Windstream filed for Chapter 11 bankruptcy protection on February 25, 2019.

Debevoise & Plimpton

BACKGROUND

In January 2013, Windstream issued $700 million of senior unsecured notes. The indenture contained a negative covenant restricting Windstream and its restricted subsidiaries from entering into certain sale and leaseback transactions. A mere eight months later Windstream's board of directors embarked on a process to transfer critical telecommunications assets owned by certain of Windstream's restricted subsidiaries to a REIT. The REIT would then lease such assets back to Windstream's holding company (Holding), which is not subject to the indenture covenants, for use by those subsidiaries. In 2014, in order to obtain regulatory approval for the proposed transaction, Windstream confirmed to various regulators that under the terms of the lease between Holding and the REIT, the transferor subsidiaries would continue to have "long-term exclusive control of the assets" and would lease the assets back from the REIT.

In March 2015, Windstream completed the proposed transaction. Under the terms of the lease, Holding had the exclusive right to use the transferred assets. Holding could assign such right to the transferor subsidiaries and cause such subsidiaries to discharge its obligations under the lease. While the subsidiaries were not parties to the lease, they were the only ones who could, and did, facilitate Holding's "performance" under the lease. In particular, in addition to funding Holding's monthly rental payments, the

subsidiaries used the assets, entered into subleases as the lessor of the assets, paid all maintenance, insurance and taxes and made all necessary capital improvements.

In September 2017, Aurelius, which owned greater than 25% of the outstanding notes, gave notice to Windstream that the 2015 transactions violated the indenture. Windstream relied on the indenture language in its response stating that for there to be a sale leaseback the party that transferred its assets had to be the same party to the subsequent lease of those assets. Because the transferors were the subsidiaries and the sole lessee was Holding (which was not party to the indenture), there was no sale and leaseback under the indenture.[1]

THE COURT'S OPINION

The court rejected Windstream's argument. According to the court, just because the subsidiaries were not party to the lease, did not mean there was no sale and leaseback within the meaning of the indenture. Citing principles set forth in *Sharon Steel Corp*, the court ruled that to say that the subsidiaries did not lease the transferred assets would be to "elevate form over substance" because it was clear that the objective of the lease was for the subsidiaries to discharge the obligations under the lease and have exclusive use and control over the assets. The court also noted that Windstream's accountants classified payments by the transferor subsidiaries to Holding as long-term lease obligations in the subsidiaries' financial statements and as lease income in Holding's financial statements, even though such classifications were not consistent with Windstream's compliance position under the indenture that there was no leaseback by the subsidiaries.

Relying on the doctrine of judicial estoppel, which prohibits a person from taking a position that is contrary to a position that the entity previously took in connection with an administrative or quasi-judicial proceeding, the court also held that, as a result of explicit representations made by Windstream to various regulators, Windstream could not deny that the transferor subsidiaries leased the assets back from the REIT.

FINAL THOUGHTS

While the outcome of the *Windstream* decision is perhaps not surprising, the decision presents a number of practical lessons:

- Issuers and their counsel should negotiate at the outset to ensure flexibility for future transactions.

[1] The court's decision also ruled in Aurelius's favor on the invalidity of subsequent transactions Windstream executed in an attempt to neuter Aurelius's claim. This alert does not address that part of the decision.

- Issuers should be wary of taking positions (e.g., for accounting purposes in its financial statements or vis-à-vis regulators and other third parties) that are inconsistent with their interpretation of the indenture covenants.

- Coordination both among internal departments within an issuer and among an issuer's advisors is key to ensuring inconsistent positions are not taken.

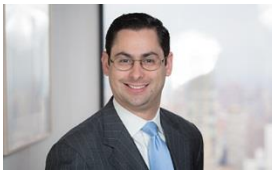
- Strict covenant compliance is key. Activist creditors, including those with larger short positions, will seek to find covenant defaults.

* * * * *

Please do not hesitate to contact us with any questions.

NEW YORK

Jeffrey E. Ross
jeross@debevoise.com



Scott B Selinger
sbselinger@debevoise.com

Ramya S. Tiller
rstiller@debevoise.com

Ryan T. Rafferty
rtrafferty@debevoise.com