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Court Rejects Windstream's Defenses and Awards Aurelius $310.5 Million

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Not since *Marblegate* has a decision in a bondholder litigation been awaited with as much anticipation as the February 15, 2019 post-trial decision in *U.S. Bank National Association v. Windstream Services, LLC*, No. 17-cv-7857 (S.D.N.Y. 2017). The dispute arose out of the 2015 spin-off and subsequent leaseback of Windstream's fiber optic and cable business (the "2015 Transaction"). Two years later, after acquiring long (bonds) and short (credit default swaps) positions in Windstream's debt, Aurelius issued a notice of default and directed the trustee to file an action challenging the 2015 Transaction on the ground that it violated the sale-leaseback covenant in Windstream's indenture. In an effort to moot the claim after the trustee filed an action, Windstream sought to obtain the consent of a majority of note holders to waive the alleged default in exchange for entry and exit consent fees and the issuance of new notes of the same series to effectively dilute Aurelius' ownership (the "2017 Transaction").

Following a trial, the Court agreed with Aurelius that the 2015 Transaction was a sale- leaseback prohibited under the Indenture and that the consent solicitations were invalid and did not cure the default. The Court awarded Aurelius $310.5 million plus interest. The decision hinges, in part, on one fatal admission by Windstream. While the Court held that Aurelius is entitled to judgment on its notes, its finding that the New Notes issued in connection with the exchange offer are not invalid has given rise to confusion over their status.

The 2015 Transaction

In 2015, Windstream Holdings, Inc. ("Holdings") spun-off its fiber optic and cable business into a publicly traded REIT, the Uniti Group ("Uniti"). In exchange for those assets, Uniti issued common stock, transferred $1 billion in cash, and transferred $2.5 billion in debt to Windstream Services LLC ("Services"), a direct subsidiary of Holdings. Services then distributed roughly 80% of the Uniti common stock to Holdings, which in turn distributed the Uniti shares to its stockholders. After the spin-off, Holdings and Uniti entered into a master lease agreement which provided for Holdings to lease the spun-off cable assets from Uniti. Rent for the assets was funded by subsidiaries of Services that had transferred the assets.

Services defended the action on the grounds that the 2015 Transaction complied with the literal terms of the Indenture: the 2015 Transactions did not fall within the Indenture's definition of Sale and Leaseback Transaction

because that definition covers only transactions where one "Person" transfers the assets and that *same Person* leases those assets back. Here, the entity that made the transfer—Services—and the entity that leased the assets—Holdings—are different entities.

The 2017 Transaction

Two months into the litigation, the Company sought to moot the trustee's action by conducting consent solicitations and exchange offers in which it issued additional, new notes (the "New Notes"), intended to be of the same series as the 6¾% 2023 Notes (the "2023 Notes"), held by, among others, Aurelius, to holders of its 2021, 2022 and 2023 notes. The exchanging noteholders received consideration in the form of New Notes in connection with the exchange and consent fees for agreeing to amend the Indenture and waive the default. To compensate exchanging noteholders for entering into the transactions, the Company incurred an additional $40 million of debt. The exchange and consents enabled the Company to, among other things, combine portions of three tranches of notes into one class and obtain a sufficient majority not only to waive the default, but also dilute Aurelius below the 25% note ownership it needed to maintain its action. After Services certified that it had received the requisite consents from the noteholders, the trustee signed the Third Supplemental Indenture governing the New Notes and declined to pursue Aurelius' claims that the consent solicitation was invalid.

Notwithstanding the trustee's refusal, Aurelius issued a new notice of default alleging that the exchange violated the Indenture and the waivers and consents were thus invalid. Specifically, Aurelius argued that (i) Services did not have the capacity to incur $40 million of additional debt, (ii) equivalent consideration was not offered to holders of the old notes, and (iii) the liens used to secure the new notes do not fit into any of the categories of Permitted Liens as required under the Indenture. Services responded that the claims were moot because a majority of the noteholders waived any default related to the 2015 Transaction and, since the issuance of the New Notes diluted Aurelius' ownership to less than 25%, it lost standing to maintain its action under the Indenture's no action clause.

The Post-Trial Findings of Fact and Conclusion of Law

With respect to the spin-off and sale-leaseback, the Court found that the economic substance of the transaction was a lease: there was a transfer of the right to use property for a specified term in exchange for rent. The transferor retained exclusive control of the transferred assets and paid $54 million per month to rent the assets. In other words, Services' "use and enjoyment of the Transferred Assets walks like a lease and talks like a lease. That is because it is a lease." (Op. at 41).

Alternatively, the Court held that Services was judicially estopped from denying the existence of the lease because, in obtaining approval for the 2015 Transaction, the Windstream entities made explicit representations to nine state regulators that the transferor entities would lease the assets back "on an exclusive, long-term basis." (Op. at 34). The Court held that having "benefited from repeated statements to state regulators that the Transferor Subsidiaries would lease back the Transferred Assets, Services is estopped from now denying that the Transferor Subsidiaries did in fact lease those assets[.]" (Op. at 35).

With respect to the exchange offer, the Court held that the New Notes did not qualify as "Additional Notes" within the meaning of the Indenture because they were issued in violation of an Indenture covenant that restricted the amount of additional indebtedness Services could incur. As such, the holders of the New Notes did not have the right to vote the notes and Services did not have the requisite consents to waive the default.

The Company conceded that if the 2015 Transaction constituted a Sale and Leaseback Transaction, its Consolidated Leverage Ratio before the 2017 Transaction would exceed the 4.5-to-1 threshold and, consequently, it did not have the capacity to issue the New Notes unless the additional $40 million of debt

qualified as “Permitted Debt” issued to refinance the exchange of debt. The Court chose not to “delve into” the question of whether the $40 million was “premium” within the meaning of the Indenture for “the simple reason that Services admitted” in its interrogatory answers “that it paid no premium at all.” (Op. at 46). Thus, the New Notes did not qualify as “Permitted Debt,” “were not valid Additional Notes” within the meaning of the Indenture and, accordingly, the “Third Supplemental Indenture, which purported to waive any default or Event of Default arising from the 2015 Transaction, was and is invalid.” (Op. at 47). The Court separately held that a condition precedent to closing a large part of the exchange offer was not effectively waived, and that that part of the exchange did not close.

Take Away

The Court’s reliance on Windstream’s admissions is a reminder for counsel to consider not just whether a proposed transaction fits within the literal terms of the debt documents, but also whether it is: (1) consistent with the company’s public statements; (2) supported by the contemporaneous factual record; and (3) whether the economic substance of the transaction is consistent with its characterization.

While the court held that the notes issued under the Indenture—*i.e.* any notes outstanding prior to the exchange offers—are accelerated, it specifically declined to hold that the New Notes issued in the 2017 exchange are invalid, giving rise to confusion over their status. (*See* Op. at 51). Because the Court held that the Third Supplemental Indenture containing the waiver of default was invalid, it follows that all holders of the 2023 Notes at the time of the exchange—not just Aurelius—should be entitled to a judgment. At least some of this confusion could have been obviated by a finding that all holders of the New Notes are to be restored to their *status quo ante* as it existed prior to the exchange offers. While this ruling would also raise complex issues, it would better accord with the operation of the Indenture.

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