

Client Alert

A report
for clients
and friends
of the Firm May 2007

All's Fair In Love, War and Restructuring: *Solutia* Bondholders Denied “Equal and Ratable” Lien Status—Implied Covenant of Good Faith Does Not Trump Explicit Indenture Provisions

On May 1, 2007, the Southern District of New York Bankruptcy Court in the Chapter 11 case of *Solutia, Inc., et al.*, Case Nos. 03-17949 (PCB), denied an attempt by certain bondholders to elevate their claims to secured status notwithstanding the release, ten weeks prior to *Solutia*'s Chapter 11 filing, of the bondholders' “equal and ratable” lien. The Court was not swayed by the argument that *Solutia*'s deliberate triggering of indenture provisions that released the bondholders' lien was a bad faith action.

In 1997, *Solutia* issued bonds that were initially unsecured. The bond indenture, however, required that the bondholders obtain an “equal and ratable” lien if *Solutia* incurred indebtedness secured by collateral exceeding 15% of its “Consolidated Net Tangible Assets”. In 2002, the Company amended its secured credit facility in a manner that triggered the “equal and ratable” lien clause. However, in late 2003 (just prior to its chapter 11 filing), *Solutia* refinanced that facility with a new secured loan that brought it below the “equal and ratable” lien threshold, reverting \$680 million of secured bonds back to their original unsecured status. After it filed for bankruptcy, *Solutia* obtained debtor-in-possession financing in an amount,

and secured by a collateral package, that, absent the bankruptcy, would have once again triggered the “equal and ratable” clause.

In *Solutia*'s bankruptcy case the bondholders argued that *Solutia* violated the covenant of the good faith and fair dealing implicit in all contracts by deliberately structuring the pre-petition refinancing in order to deprive them of their lien. Accordingly, the bondholders sought to reinstate their “equal and ratable” lien. *Solutia* countered that it acted properly under the express terms of the indenture. Ultimately, although the court indicated some sympathy for the bondholders' plight, it ruled in favor of *Solutia*. The court held that the specific terms of the indenture governed, not broad concepts such as equity, and that the implied covenant of good faith and fair dealing cannot impose duties and obligations on a party that would be inconsistent with the specifically bargained for indenture provisions. As a result, the bondholders, now relegated to unsecured status, face the prospect of diminished recoveries.

As the *Solutia* decision demonstrates, all provisions of debt documents should be carefully reviewed and negotiated, as arguments that a literal reading of such documents will cause an injustice may very well fall on deaf ears, even when raised in a court of equity such as the federal bankruptcy court. If you would like more information about the *Solutia* decision or the steps you can take to protect against a similar result, please contact one of the attorneys in our Bankruptcy and Reorganization Practice Group.

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