

Clients & Friends Memo

Second Circuit Interpretation of “Absolute and Unconditional” Clause May Limit the Effectiveness of Limited Recourse and Similar Provisions Common to Structured Finance Indentures

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On June 1, 2010, the U.S. Court of Appeals for the Second Circuit decided a case with broad implications for issuers of limited recourse notes. This is particularly applicable in the context of structured finance transactions and notes issued by special purpose entities. In *The Bank of New York v. First Millennium, Inc.*,¹ the Second Circuit found that the holders of notes issued by a trust of which The Bank of New York (BNY) was trustee, in favor of NextBank, N.A. (NextBank) had a valid claim to all assets held in the trust despite a limited recourse provision in the indenture. At issue in *First Millennium* was whether the limited recourse provision in the indenture, which limited the noteholders' right to payment to certain assets held in the trust, conflicted with provisions in the indenture and the notes granting noteholders an “absolute and unconditional” right to payment of principal and interest upon maturity of the note. The Second Circuit concluded that the indenture's “notwithstanding clause” and the express terms of the notes conflicted with, and trumped, the limited recourse provision in the indenture. Thus, noteholders could enforce their right to payment of principal and interest against all assets held in the trust.

The Subject Securitization: Credit Card Receivables

In 1999, NextBank began issuing consumer credit cards to sub-prime borrowers. To finance this consumer credit card business, NextBank entered into a securitization transaction where it established a trust at BNY and sold the right to be paid interest and principal on the credit cards to the trust. The trust then issued four classes of notes to investors (class a, class b, class c and class d) in alphabetical order of priority of payment collateralized by the cash flows generated from the credit card receivables. Cardholders' payments of fees and interest were used to make interest payments on the notes and excess cash flow was divided into two pools. One pool was intended for the payment of principal on the notes (Trust Collateral) and the other pool was intended to fund regular payments to NextBank (Transferor Interest Collateral). Pursuant to the terms of the transaction documents, if the cardholders defaulted on their credit card payments the defaulted

¹ *Bank of New York v. First Millennium, Inc.*, No. 09-1628-cv (2d Cir. June 1, 2010).

amount would be deducted from the Trust Collateral while the Transferor Interest Collateral was unaffected by such default. This distinction proved to be significant when a large number of NextBank's cardholders defaulted on their payments causing the Trust Collateral to be reduced to zero. In 2002, the Federal Deposit Insurance Corporation (FDIC) was appointed as NextBank's receiver and closed all NextBank credit card accounts.² The class a and class b noteholders were fully paid principal and interest due on their notes. The class c noteholders received partial payment of principal and interest and the class d noteholders received some interest payments but their investment principal was not paid.

“Notwithstanding” Language Trumps Other Conflicting Contract Provisions

Relying on the indenture's “limited recourse provision,”³ the FDIC argued that the noteholders' claim to the trust's assets were extinguished when the Trust Collateral was reduced to zero since the noteholders did not have a valid claim to the Transferor Interest Collateral. The Second Circuit, however, found that the limited recourse provision in the indenture conflicted with certain provisions contained in the indenture and the class c notes, each of which provided noteholders with an “absolute and unconditional” right to payment of principal and interest upon the notes' maturity. The Second Circuit found that the plain language in the “notwithstanding clause”⁴ in the indenture did not limit the noteholders' right to payment of principal and interest upon the notes' maturity to the Trust Collateral and conflicted with the limited recourse provision in the indenture.⁵ Relying on New York law, the Second Circuit noted that clauses similar to the “notwithstanding clause” in the indenture trump conflicting contract provisions. The Second Circuit concluded that the noteholders could enforce their “absolute and unconditional” right to payment against all assets held in the trust, including the Transferor Interest Collateral.

The FDIC argued that the “notwithstanding clause” in the indenture did not conflict with the limited recourse provision because the “notwithstanding clause” constituted boilerplate language that was included in the indenture solely based on the Trust Indenture Act of 1939 (TIA). The “notwithstanding clause” in the indenture is similar to Section 316(b) of the TIA,⁶ which requires bond indentures to protect minority bondholders by prohibiting majority bondholders from

² As NextBank's receiver, the FDIC succeeded to all of the bank's “rights, titles, powers, and privileges.” 12 U.S.C. § 1821(d)(2)(A)(i).

³ The limited recourse provision states, “The obligation of the Issuer to make payments of principal of, and interest on and other amounts with respect to, the Notes is limited by recourse only to the Collateral.” *First Millennium*, at 19.

⁴ The notwithstanding clause states, “Notwithstanding any other provision in this Indenture, each Holder of a Note shall have the right which is absolute and unconditional to receive payment of the principal and interest in respect of such note as such principal and interest becomes due and payable and to institute suit for the enforcement of any such payment.” *Id.*

⁵ *Id.*, at 20.

⁶ 15 U.S.C. § 77ppp(b).

collusively agreeing to modify the bond's payment terms. The FDIC argued that the "notwithstanding clause" in the indenture was included for the limited purpose of preventing the oppression of minority noteholders by the majority noteholders. The Second Circuit, however, rejected this argument concluding that extrinsic evidence concerning the purpose of contract provisions was inadmissible as there were no ambiguities with respect to the pertinent language of the indenture. Additionally, the Second Circuit noted that nothing in the TIA required the indenture to provide noteholders with an "absolute and unconditional" right to payment, and there was no basis to disregard the plain language as drafted.

The Second Circuit also found that the "absolute and unconditional" right to payment provision on the reverse side of the class c notes trumped the limited recourse provision in the indenture.⁷ Relying on New York law again, the Second Circuit noted that where there is a conflict between the terms of the note and the ancillary documents, the terms of the note control. Thus, the class c noteholders had an "absolute and unconditional" right to payment of interest and principal upon the notes' maturity and were not limited to the Trust Collateral.

Preserving the Integrity of the Indenture

Issuers should carefully consider the ramifications of the court's decision in *First Millennium* on their future note issuances. In light of this decision, issuers should review broad boilerplate language that may conflict with, and trump, limited recourse provisions and similar provisions (such as customary provisions limiting enforcement, non-petition, extinguishment of obligations and non-recourse). Limitations on the applicability of "notwithstanding clauses" should be clearly expressed in indentures, particularly with respect to provisions granting noteholders an "absolute and unconditional" right to payment of principal and interest. In addition, issuers must also take care to insure that the terms of the notes themselves do not override the terms of the indenture.

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⁷ The class c notes state, "No reference herein to the Indenture and no provision of this Class C Note or of the Indenture shall alter or impair the obligation of the Issuer, which is absolute and unconditional, to pay the principal of and interest on this Class c note at the times, place, and rate, and in the coin or currency prescribed." *First Millennium*, at 19.

