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Ambiguous Remark Threatens Kodak Bonds With Collateral Damage

--CEO comment prompts concerns company may violate covenants

--Sale of patents backing secured bonds worries some creditors

--Company declines to discuss plans for patent-sale proceeds

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NEW YORK (Dow Jones)--A remark from Eastman Kodak's (EK) chief executive on the company's earnings call last month has sparked questions from distressed-debt investors about whether the company might stiff some bondholders by selling a portfolio of patents.

A loophole in the company's "junk" bond paperwork could allow the struggling film and camera maker to sell its intellectual property. That could hurt creditors who rely on the patents as security for their bonds, according to bond lawyers.

Worse, the terms or "indentures" of Kodak's secured bonds could allow the company to use proceeds from the patents sale to indirectly repay unsecured debt maturing in 2013, effectively moving them ahead of secured bonds ranked higher in the capital structure, the lawyers say.

Using asset sale proceeds to repay unsecured debt isn't permitted by the indentures of the secured bonds.

"It absolutely was part of the investment decision for bondholders to be able to grab the patents in the worst-case scenario; too bad the bond documents didn't do a great job of ensuring that," said Adam Cohen, founder of Covenant Review, a research firm that advises asset managers on how to interpret bondholder protections, known as "covenants."

The controversy began on July 26, during Kodak's quarterly earnings call. Shannon Cross of Cross Research asked chief executive Antonio Perez what limitations surround Kodak's use of patent sale proceeds and whether any money would be available to shareholders. Kodak suspended dividend payments in 2009.

"We have enough freedom," Perez said, without elaborating. Kodak's stock has fallen about 40% over the last 12 months and traded near a record low Friday.

Then Perez added: "There might be obligations that we might have to have. We might have to buy the debt of 2013 -- we don't know."

Referring to debt obligations in response to the question about shareholders is what prompted concerns about how well the company understands its indentures amid mounting pressure to show growth.

The $250 million of unsecured 7.25% bonds due 2013 is the most significant near-term maturity in Kodak's debt stack, a spokesman said. That gives the company a big incentive to pay the 2013 bonds before the later-maturing, secured debt due 2018 and 2019.

But the spokesman declined to say whether the 2013 debt is a priority and the company hasn't explicitly said it wouldn't pay back secured debt with proceeds from the sale of patents.

The spokesman said Perez's point on the call was that the company has "flexibility," adding: "We are still early in the process of exploring strategic alternatives for our digital patent portfolios. It would be premature to speculate about the nature of any transaction beyond that."

Kodak has $1.26 billion of debt maturing through 2018 and beyond, including the 2013 bonds, which were yielding 17.29% when last traded on Tuesday, according to MarketAxess data. Its secured debt is less expensive: $500 million of 9.75% notes due 2018 yield around 14.1%, and $250 million of 10.625% bonds due 2019 yield 14.4%.

"Whenever you have a credit that is more speculative, the near-term debt will be higher risk and will yield more," said Adrian Miller, senior vice president for fixed income strategy at Miller Tabak Roberts Securities LLC. "If they can make it past the immediate funding issue, the credit outlook becomes better."

Kodak's secured bond indentures limit the company to using any asset-sale proceeds to permanently repay secured debt, acquire "permitted" or reasonably related businesses, or buy additional assets -- including inventory.

The provision is meant to protect secured creditors' collateral. But it falls short because the company could sell the patents and use proceeds to buy inventory or invest in its new businesses, freeing up cash to repay the unsecured 2013 bonds, Cohen notes.

"The indenture raises substantial questions about, if this asset sale occurs, what the company can do with the money," said Sigmund Wissner-Gross, partner at Brown Rudnick. "If the company takes steps other than to pay down secured debt or buy related business assets, it is at risk of being in breach of its obligations to bondholders."

Kodak had $957 million in cash on June 30 and forecasts it will have as much as $1.7 billion by year end. It also owns the 1,200-acre Eastman Business Park in Rochester, N.Y., but it isn't pledged as collateral to secured bondholders. Kodak has $97 million in outstanding letters of credit and $68 million to secure other banking arrangements.

The company said in July that it was considering selling 10% of its patent portfolio, citing "heightened market demand for intellectual property." Nortel Networks Corp. (NRTLQ) netted $4.5 billion in a recent auction of patents.

Kodak's portfolio is focused on digital imaging technology and contains patents that have led to blockbuster licensing deals, such as agreements with Samsung Electronics Co. (005930.SE, SSNHY) and LG Electronics Co. (066570.SE) that netted Kodak $964 million.

The company is suing Apple Inc. (AAPL) and Research in Motion Ltd. (RIMM, RIM.T), alleging their smartphones violate a Kodak patent. Perez has said those suits could fetch $1 billion in licensing revenue.

Kodak's spokesman said the company has not itemized its patents, nor estimated their value. Rafferty Capital Markets analyst Mark Kaufman said they could be worth $2 billion -- far more than Kodak's $650 million equity market capitalization.

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