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The Trust Indenture Act Has Reemerged as a Powerful Tool for Objecting Bondholders Outside of Bankruptcy

Out-of-Court debt restructurings may face greater hurdles to success in light of two recent federal court decisions out of New York broadly expanding dissenting bondholders' rights under the Trust Indenture Act

The United States District Court for the Southern District of New York has recently issued two decisions that could give dissenting bondholders a potential edge in their efforts to hold out for greater concessions or forestall or prevent restructurings outside of bankruptcy. In both the Education Management Corp. ("EMC") bankruptcy case[1] and in a civil action involving Caesars Entertainment Corp. ("Caesars"),[2] the court injected new life into a 75-year-old provision of the Trust Indenture Act of 1939, as amended (the "TIA")[3] and, in particular, Section 316(b) which places limitations on collective action clauses in bond indentures so that a majority of holders cannot implement certain changes to indenture terms to the detriment of the minority.

Section 316(b) of the TIA

The TIA provides that bonds or notes to which it applies must be issued under an indenture that has been qualified by the Securities and Exchange Commission (the *"SEC"*). Indentures so qualified afford investors in bonds or notes with a variety of protections. Prior to the TIA's enactment in 1939, majority bondholders – often controlled by insiders – used collective or majority action clauses to change the terms of an indenture to the detriment of the nonconsenting minority. Designed to prevent a company, outside of bankruptcy, from altering its obligation to pay notes without the consent of each noteholder, Section 316(b) of the TIA was enacted to ensure against evasion of judicial scrutiny of debt readjustment. It specifically provides that "**the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security … shall not be impaired or affected without the consent of such holder**…." Prior court decisions and most practitioners historically interpreted this provision as a narrow protection against majority bondholders' attempts to amend certain "core terms" of an indenture relating to the holder's *legal* right to receive payment of principal and interest or to demand or seek payment when due (*e.g.,* Section 316(b) would bar an extension of a maturity date absent the holder's consent). Few bondholders and courts invoked Section 316(b) to challenge out-of-court restructurings for the simple reason that the restructurings did not attempt to extend maturity dates or other core payment terms.

The recent Caesars and EMC decisions, however, have expanded the scope of Section 316(b) to protect dissenting holders' *ability*, and not merely just the legal right, to receive payment on their bonds in circumstances where proposed restructurings seek to transfer assets out of the issuer (leaving it with no ability to pay the notes) or strip certain credit enhancements supporting the bonds, such as a parent guarantee. Importantly, these decisions will embolden dissenting bondholders to wield Section 316(b) as a potentially potent weapon against the majority and issuers that have agreed to a restructuring and have the practical effect of forcing bond restructurings into bankruptcy where unanimous consent is not required.

The Proposed EMC and Caesars Out-Of-Court Restructurings

The EMC Case: EMC is one of the country's largest for-profit providers of college and graduate education and derived over 78% of its revenue from federal student aid programs under Title IV of the Higher Education Act of 1965. EMC began facing deteriorating cash flows and sought to restructure over $1.5 billion in outstanding debt of its primary subsidiary, Education Management LLC ("*EM Sub*"). That debt consisted of $1.15 billion in secured term loans, $150 million in revolving loans and $220 million in unsecured notes governed by the TIA. All of this debt was guaranteed by EMC. EMC's parent guaranty of the notes could be waived (i) voluntarily by majority vote, or (ii) automatically if the secured lenders chose to waive the parent guaranty of their own debt (which guaranty had been given only one month prior to the proposed debt restructuring). EMC's substantial Title IV revenue stream was dependent on EMC's remaining in compliance with United States Department of Education oversight and other regulatory requirements. If EMC were to file for bankruptcy, it would lose its eligibility for Title IV funds. Faced with the potential wholesale loss of its primary source of revenue, bankruptcy, at least of the outset of negotiations, was not a preferred option.

EMC and a group representing a large majority of its secured debt and unsecured notes negotiated a proposed out-of-court restructuring that would involve the conversion of EMC's debt into a smaller amount of debt and equity, with the exact ratio varying by the type of debt held. The proposed restructuring contemplated an exchange offer for the notes and presented two options depending on the level of creditor consent.

Under the first option, if 100% of creditors consented, secured lenders would receive full cash payment of $150 million on the revolving loan and debt and equity worth $631 million, for a recovery of roughly 55%, on their $1.15 billion of secured term loans. Holders of the unsecured notes would receive between 19 and 23.5% of EMC's common stock for an estimated 33% recovery value. Under the second option, if less than 100% consent was received, then (1) the secured lenders would release EMC's parent guaranty of the secured loans (which, under the note indenture, would automatically trigger the release of EMC's parent guaranty of the notes), (2) the secured lenders would foreclose on substantially all of the assets of EMC and EM Sub under Article 9 of the Uniform Commercial Code, and (3) the secured lenders would immediately sell such assets back to a new subsidiary of EMC. The new subsidiary would then distribute debt and equity on the same terms to the consenting secured lenders and noteholders. Nonconsenting noteholders would be left holding notes against an issuer that had been stripped of all of its assets and with no parent guarantee. EMC did not anticipate that such holders would receive any payment of principal or interest after the transaction closed since the issuer was left assetless. A minority of noteholders declined to participate in the exchange offer causing the consenting parties to pursue the second restructuring option.

Certain dissenting noteholders sued for an injunction to block the transfer of assets out of the issuer, claiming, among other things, that the proposed restructuring violated Section 316(b) of the TIA. Specifically, the noteholders argued that the foreclosure and sale of substantially all of EM Sub's assets and the removal of the EMC parent guaranty impermissibly impaired or affected their right to receive payment of their notes. The Court declined to issue an injunction, but importantly concluded in *dicta* that the noteholders demonstrated a reasonable likelihood of success on their Section 316(b) claim. The court, in reaching that conclusion, was particularly persuaded by the unique facts that the EMC parent guaranty of the secured loans had been conferred only one month prior and that EMC had assured regulators that the asset transfer was purely a formality and not designed to change EMC's ownership, debt structure, board, management or governance.

The Caesars Case: This case involved $1.5 billion of unsecured notes maturing in 2016 and 2017 issued subject to the TIA by Caesars Entertainment Operating Company ("*CEOC*") and unconditionally guaranteed by its parent, Caesars Entertainment Corporation ("*CEC*"), owners and managers of dozens of casinos throughout the United States. The indentures further included provisions prohibiting CEOC from divesting its assets. Recognizing that a restructuring was imminent, CEOC and CEC purchased a large portion of the notes at par value in a private transaction. In exchange, the noteholders agreed to (i) support a future restructuring of CEOC, (ii) consent to the removal of CEC's parent guarantee, and (iii) consent to modification of a covenant restricting the disposition of substantially all of CEOC's assets.

Noteholders who were not invited to participate in the transaction sued CEC and CEOC claiming that the release of the CEC parent guaranty violated Section 316(b) of the TIA.[4] They further alleged that the combination of releasing the CEC parent guarantee coupled with transferring assets out of CEOC left them with no source for recovery of payment on their notes. CEOC and CEC moved to dismiss the noteholders' complaint. The court denied the motion to dismiss and concluded that the noteholders had plausibly stated a claim under Section 316(b), expressly adopting the rationale set forth in its prior ruling one month earlier in the EMC case. The court specifically found that the removal of the parent guaranty was "an impermissible out-of-court debt restructuring achieved through collective action. This is exactly what TIA section 316(b) is designed to prevent."[5] The court was further not persuaded by CEOC that its imminent bankruptcy filing should make the court view the proposed transaction as not being "out-of-court." The ruling was not a determination of the merits of the claim but procedurally cleared the noteholders to proceed with fact discovery against CEOC and CEC to gather evidence to support their claims.

The Courts' Interpretation of Section 316(b) of the TIA

In both cases, the court rejected the issuer's contentions that the proposed asset sale or the removal of the parent guaranty complied with Section 316(b) because the actions did not prevent the noteholders "from asserting a legal claim to payment against a soon-to-be judgment-proof" issuer.[6] The court instead chose to rely heavily on a fifteen-year-old unpublished decision out of the same district entitled *Federated Strategic Income Fund v. Mechala Group Jamaica Ltd*.[7] In that case, the court found that acts similar to those complained of in EMC and Caesars "would eliminate the noteholder's ability to recover and remove the holder's 'safety net' of a guarantor, which was obviously an investment consideration from the outset." That court further found under such circumstances that "a holder who chooses to sue for payment at maturity would no longer, as a practical matter, be able to seek recourse from an assetless [issuer] or from the discharged guarantors."

The EMC court concurred with the prior court's statement that "it is beyond peradventure that when a company takes steps to preclude any recovery by noteholders for payment of principal coupled with the elimination of the guarantors, that such action does not constitute an 'impairment' or 'affect' the right to sue for payment."[8] The EMC court reasoned that the Section 316(b) should be read as a "broad protection against non-consensual debt restructurings" protecting each noteholder's substantive right to actually obtain payment and not just the legal entitlement to demand payment.[9] The court found that Section 316(b) protects the *ability*, and not merely the legal right, to receive payment under the circumstances present in that case. The court further concluded that "Section 316(b) was intended to force bond restructurings into bankruptcy where unanimous consent could not be obtained."[10] Notwithstanding the hugely detrimental effects a bankruptcy of EMC would have on its creditors, employees and students, the court nevertheless insisted that the TIA simply does not allow the company to precipitate the proposed restructuring outside the bankruptcy process to effectively eliminate the rights of nonconsenting noteholders.[11]

Similarly, in the subsequent Caesars decision, the court adopted its prior rationale in EMC and found "unsatisfying the notion that Section 316(b) protects only against formal, explicit modification of the legal right to receive payment, and allows a sufficiently clever issuer to gut the [TIA's] protections through a transaction such as the one at issue here."[12] The court let stand the noteholders' allegations that the proposed restructuring would leave them with "an empty right to assert a payment default from an insolvent issuer" as sufficient to state a claim under Section 316(b).

Practical Effects of Rulings

While these decisions were limited to situations involving involuntary releases of parent guarantees and the intent to transfer assets out of an issuer (and leaving it without ability to pay the notes), they could nonetheless have broad implications on future efforts to achieve out-of-court debt restructurings. Certainly, dissenting bondholders now appear to have potentially gained leverage in future negotiations with issuers, secured lenders and majority holders and will likely argue that any proposed material modification to an indenture may impair or affect either their legal right to payment or their *ability* to be paid. As a result, we may see an uptick in the use of Section 316(b) claims by holders desiring to oppose or frustrate an out-of-court restructuring.

Other types of restructurings, such as an exchange offer coupled with an exit consent, will also likely face heightened scrutiny. In those transactions, consenting noteholders agree to indenture amendments stripping certain covenants and events of default under standard majority rule amendment provisions. In light of these decisions, this restructuring alternative could now face a Section 316(b) challenge by a constituency of hold-out bondholders, especially where such consents contemplate releases of guarantees or transfers of assets out of the issuer.

It is also too early to tell to what extent, if at all, these decisions will affect pricing of future deals or cause issuers to choose to forego subjecting their bond indentures to the TIA, either at the outset of a deal or in connection with any exchange offer, by registering the securities with the SEC.

At a minimum, as result of these decisions, issuers and consenting constituencies of creditors will likely find it increasingly difficult to achieve out-of-court restructurings through collective action, whether through concerns of execution risk or concerns about cost due to increased litigation from dissenting noteholders. Time will tell whether these decisions will actually result in more companies filing bankruptcy cases to effectuate their restructurings.

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1 *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, Case No. 14 Civ. 8584 (KPF), 2014 WL 7399041 (S.D.N.Y. Dec. 30, 2014).

2 *MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entm't Corp.* No 14 Civ. 7091 (SAS), 2015 WL 221055 (S.D.N.Y. Jan. 15, 2015).

3 Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb.

4 This lawsuit was commenced and the decision was issued prior to CEOC's bankruptcy filing.

5 *Caesars,* 2015 WL 221055 at * 5.

6 *See ENA,* 2014 WL 7399041 at *17.

7 *See ENA,* 2014 WL 7399041 at *19, *citing Federated Strategic Income Fund v. Mechala Grp. Jam. Ltd.,* No.

99 Civ. 10517 (HB), 1999 WL 993648, at * 7 (S.D.N.Y. Nov. 2, 1999).

8 *ENA,* 2014 WL 7399041 at *17.

9 *Id.,* at *15.

10 *Id.,* at *18.

11 The court did note that Section 316(b) does not prevent the majority from binding dissenters by other changes in the indenture or by waiver of defaults, and the majority may of course consent to alterations of it own rights.

12 *Caesars,* 2015 WL 221055 at * 4.

For More Information

For more information, please contact Mark D. Rasmussen (312.845.3276), Hannah M. Wendling (312.845.3910) or your primary Chapman attorney, or visit us online at chapman.com.