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Expert Analysis

Limits of Out-of-Court Debt Restructurings

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One remedial statute enacted as a result of the Great Depression in the 20th century is the Trust Indenture Act of 1939 (TIA), designed to protect "investors in notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, which are offered to the public…."[1] These publicly offered debt securities are issued under trust indentures that protect the rights of security holders to enforce payment of the debt.

One abuse the TIA was enacted to prevent is forcing individual holders of debt to surrender their rights to payment under an indenture in restructuring the debts of a financially troubled company. For example, a company unable to pay its debts might reach an agreement with a majority of its bondholders to restructure its debts under which an objecting security holder would receive no payment.

Section 316(b) of the TIA (15 USC §77ppp(b)) protects objecting holders of debt securities by prohibiting any compromise of their rights without their consent and states in relevant part:

> Notwithstanding any other provision of the indenture to be qualified, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, *shall not be impaired or affected without the consent of such holder*…. (Emphasis added.)

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Because no holder rights to enforce payment may be compromised without consent, where there is dissent to restructuring the debts of a company, a bankruptcy may result in which the fairness to all creditors is subject to requirements of the Bankruptcy Code.

After 77 years, the unanimous consent requirement for restructuring TIA-qualified debt is being challenged in court by financially distressed companies owned by private equity firms.

After 77 years, the unanimous consent requirement for restructuring TIA-qualified debt is being challenged in court by financially distressed companies owned by private equity firms who also are lobbying Congress to amend §316(b) to jettison unanimous consent.

This article analyzes recent decisions in two cases in the U.S. District Court for the Southern District of New York addressing whether lack of unanimous holder consent in an out-of-court debt restructuring violates §316(b). Courts outside New York in two cases have held that §316(b) protects only the legal right to commence an action for payment of debt securities and not the practical right to payment of principal and interest itself, but without addressing the purpose of the statute or legislative history.[2] The Southern District decisions take the opposite view, concluding that the legal right to payment protects the practical right to recover payment under a TIA-qualified indenture.

'Marblegate'

Education Management Corporation (EDMC), a for-profit education company, sought to restructure $1.5 billion of debt, including $1.3 billion in secured debt and $217 million in unsecured debt qualified under the TIA that was issued by a subsidiary company and guaranteed by the parent company. Marblegate Asset Management[3] is an investment management firm that held an interest in the unsecured debt of approximately $20 million.

After suffering financial difficulties, EDMC entered into a restructuring plan with a majority of its creditors which provided that unsecured creditors would receive one-third the value of their unsecured debt by EDMC's conversion of the debt into equity. If EDMC did not obtain unanimous consent for the restructuring, the restructuring plan provided a parent guarantee on the unsecured debt that would be released leaving unsecured creditors with a Hobson's choice: accept the equity in exchange for debt or receive nothing. Marblegate rejected this choice and sued EDMC.

Marblegate initially moved to enjoin the restructuring because it impaired its ability to receive payment in violation of §316(b). The district court denied an injunction finding Marblegate would be worse off financially if EDMC declared bankruptcy or became insolvent. However, the district court held Marblegate had shown a likelihood of success on the merits that the restructuring violated §316(b), stating "where a debt reorganization that seeks to involuntarily disinherit the dissenting minority is brought about by a majority vote, that violates the fundamental purpose of the Trust Indenture Act."[4] EDMC proceeded with the restructuring, but without removing the parent guarantee. EDMC subsequently filed an answer and counterclaim for removal of the parent guarantee.

In a second opinion, the district court conducted an exhaustive review of the legislative history of §316(b) and concluded that the TIA protects a holder's practical right to recover payment in the event of a nonconsensual out-of-court debt restructuring. The district court stated the "purpose of the [TIA], as expressed consistently throughout the legislative history, was to prevent precisely the nonconsensual majoritarian debt restructuring that occurred here, even if the Act's authors did not anticipate precisely the mechanisms through which such a restructuring might occur."[5] EDMC appealed the decision, and oral argument was held in May before the U.S. Court of Appeals for the Second Circuit.

'Caesars'

In *MeehanCombs Global Credit Opportunities Funds v. Caesars Entertainment*,[6] the district court again analyzed an out-of-court restructuring of TIA-qualified debt and sided with *Marblegate*, holding that the TIA protects a non-consenting noteholder's practical ability to payment of principal and interest.

Caesars Entertainment Corporation (CEC) owns, manages and operates casinos throughout the United States. Caesars Entertainment Operating Company (CEOC and together with CEC, Caesars) is a direct operating subsidiary of CEC. Pursuant to two TIA-qualified indentures, CEOC issued $1.5 billion in notes in 2005 and 2006 that were unconditionally guaranteed by CEC. However, the unconditional guarantees could be released under certain limited circumstances, including if CEOC ceased to be wholly owned by CEC. The Caesars plaintiffs are holders of some of the debt.

In 2008, Caesars was acquired in a leveraged buyout by two private equity firms, TPG Capital and Apollo Global Management, through the issuance of $24 billion in debt that was used to acquire CEC's publicly traded shares. Following the leveraged buyout, Caesars entered into a series of transactions that transferred assets away from CEOC, depriving CEOC of assets it needed to pay its debts.

In an attempt to rid itself of the unconditional guarantee, in May 2014, CEC announced it sold 5 percent of CEOC's common stock to institutional investors and on that basis claimed CEOC was no longer wholly owned by CEC. In August 2014, CEC announced a private refinancing transaction with certain noteholders where CEOC purchased the noteholders' notes for par plus accrued interest representing a 100 percent premium return over market value.

In exchange, these noteholders agreed to: amend and remove the unconditional guarantees from the 2005 and 2006 indentures; consent to future restructurings proposed by Caesars; and remove provisions in the indentures that restricted disposition of CEOC's assets. Noteholders who objected to this restructuring filed suit against Caesars alleging violations of §316(b) because the ability to collect principal and interest due was impaired by transferring its assets to other entities.

Measures have been proposed in Congress to amend §316(b) by narrowing the definition of a security holder's right to payment and to sue for nonpayment of amounts owed.

Relying largely on *Marblegate*, the district court held plaintiff stated a claim under §316(b) to survive a motion to dismiss. It rejected CEC's argument that the TIA protects only a noteholder's legal right to receive payment and that actions taken to make a debtor unable to pay its debts violated §316(b). The district court, however, noted there was scant case law on point and in a subsequent opinion certified an interlocutory appeal to the Second Circuit regarding the scope of §316(b).

Proposed Amendment to TIA

Measures have been proposed in Congress to amend §316(b) by narrowing the definition of a security holder's right to payment and to sue for nonpayment of amounts owed. The proposed legislation would retroactively apply to the Marblegate and Caesars litigation, effectively mooting the district court's interpretation of §316(b).

The proposed legislation was attached as a rider to a 2015 federal highway bill and also to an omnibus appropriations bill. In response, 18 law professors wrote Congress urging it to reject the rider noting in a letter that it had not been vetted through public hearings and "could have broad negative unintended consequences in the securities markets."[7] The letter was followed by a letter from the nation's largest public debt investors expressing the "strongest possible opposition" to the proposed legislation and warning of "adverse consequences to the economy and to capital markets" if the legislation were adopted.[8]

Ultimately, the rider was abandoned, but the Chamber of Commerce and other trade associations have submitted new letters urging Congress to "act swiftly to clarify congressional intent with respect to the TIA" claiming "marketplace confusion" caused by the Marblegate and Caesars decisions.[9]

Conclusion

The Marblegate and Caesars holdings reflect the district court's understanding that statutory protection of a right to payment of debt securities is worthless unless assets and guarantees that back them are available to pay the debts. The Second Circuit will decide whether this understanding is correct.

1. TIA §302(a), 15 U.S.C. §77bbb.
2. See *In re Northwestern Corp.*, 313 B.R. 595 (Bankr. D. Del. 2004); *YRC Worldwide Inc. v. Deutsche Bank Trust Co. Am.*, No. 10 Civ. 2106 (JWL), 2010 WL 2680336 (D. Kan. July 1, 2010).
3. *Marblegate Asset Management v. Education Management Corp.*, 75 F.Supp.3d 592 (2014) (*Marblegate I*); *Marblegate Asset Management v. Education Management Corp.*, 111 F.Supp.3d 542 (2015) (*Marblegate II*).
4. *Marblegate I*, 75 F.Supp.3d at 615.
5. *Marblegate II*, 111 F.Supp.3d at 554.
6. *MeehanCombs Glob. Credit Opportunities Funds v. Caesars Entm't Corp.*, 80 F.Supp.3d 507 (SDNY 2015); *BOKF, N.A. v. Caesars Entm't Corp.*, No. 15-CV-1561 SAS, 2015 WL 5076785 (SDNY Aug. 27, 2015); *Meehancombs Glob. Credit Opportunities Master Fund v. Caesars Entm't Corp.*, No. 14-CV-7091(SAS), 2015 WL 9478240 (S.D.N.Y. Dec. 29, 2015).
7. Georgetown University Law Center sponsored letter dated Dec. 8, 2015.
8. Letter sent by BlackRock, Inc., DoubleLine Group LP, Oaktree Capital Management, L.P., Pacific Investment Management Company LLC (PIMCO), T. Rowe Price Associates, Inc. and Western Asset Management Company dated Dec. 14, 2015.
9. Letter sent by Chamber of Commerce dated March 31, 2016.