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TWO RECENT DISTRICT COURT DECISIONS GIVE NEW AMMUNITION TO NOTEHOLDERS OPPOSING NONCONSENSUAL OUT-OF-COURT RESTRUCTURINGS

Two recent decisions from the influential District Court for the Southern District of New York may have strengthened the hands of unsecured noteholders in efforts to oppose nonconsensual out-of-court restructurings. Whether these decisions signal the beginning of a nationwide trend is not yet clear. What is clear, however, is that these decisions empower dissenting noteholders to use the provisions of the Trust Indenture Act of 1939 (Act) in order to prevent the diminution of their financial positions.

The Trust Indenture Act

The Trust Indenture Act was adopted in 1939 for the protection of investors. The Act prohibits the sale of notes, bonds or debentures in interstate commerce unless the securities have been issued under an indenture that fully discloses the terms and conditions of the issuance. Most importantly, Section 316(b) of the Act prohibits a company, outside of bankruptcy, from altering its obligations to pay principal and interest arising under bonds without the consent of each bondholder:

> 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 ...

Nowhere does the Act define exactly what is encompassed by the "right . . . to receive payment." It is therefore unclear from the Act itself whether preserving the "right . . . to receive payment" prohibits only actions that interfere with a noteholders' legal entitlement to demand payment or also prohibits actions that interfere with a noteholders' ability to actually obtain payment.

The *Marblegate* Decision

In *Marblegate Asset Management v. Education Management Corp.*[1], the court denied a motion for a preliminary injunction which had been filed by two investment funds holding unsecured debt in Education Management LLC (EDML). The notes were guaranteed by EDML's parent, Education Management Corporation (EDMC), and were governed by an indenture which provided the noteholders the same protections provided by Section 316(b) of the Act.

In May 2014, EDMC announced to its investors and creditors that it was experiencing significant financial distress. EDMC began negotiating with an *ad hoc* committee comprised of secured creditors and creditors holding both secured and unsecured debt. The committee did not have lenders holding only unsecured debt. The negotiations resulted in a Restructuring Support Agreement (RSA) which provided for two potential restructuring paths. The first path required 100% creditor consent and would have left the secured creditors with a recovery of approximately 55% and a recovery for unsecured creditors of approximately 32%. Because 100% creditor consent was not obtained, the company sought to undertake the restructuring along the second path under which unsecured creditors could exchange their notes for notes in a new subsidiary of EDMC ("NewCo") and EDMC's guarantee would be released. However, because all assets would have been transferred to NewCo, the non-consenting noteholders who did not agree to exchange their notes would be left with claims against an asset-less entity. Accordingly, non-consenting noteholders were projected to receive no distribution on account of their notes.

Two noteholders, which together held only US$20 million of EDMC's US$1.5 billion in outstanding debt, did not consent to the proposed restructuring and did not exchange their notes. Instead, the noteholders filed a lawsuit seeking a preliminary injunction preventing the companies from moving forward with the proposed restructuring, arguing that the restructuring violated Section 316(b) of the Act. The court denied the noteholders' motion for preliminary injunction, finding that the noteholders could not establish irreparable harm. Nonetheless, the court expressed (albeit in non-binding *dicta*) a broad interpretation of the protections provided for in Section 316(b) of the Act. Specifically, the court rejected the companies' argument that the Act only prohibited impairment of the legal right to demand payment. Instead, the court opined that the Act prevented an impairment of the substantive right to actually obtain the payment. Accordingly, even though the preliminary injunction was not entered, the court found that the noteholders had demonstrated a likelihood of success on the merits because the proposed restructuring impaired their substantive ability to obtain payment on the notes.

The *Caesars* Decision

The *Marblegate* opinion was followed a month later by a decision by the same court in *Meehancombs Global Credit Opportunities Funds LP vs. Caesars Entertainment Corp.*.[2] In Caesars, Caesars Entertainment Operating Co. (CEOC) issued US$1.5 billion in notes, of which US$750 million was due in 2016 and US$750 million was due in 2017. The notes were subject to two separate indentures, both of which included unconditional guarantees by CEOC's parent, Caesars Entertainment Corp. (CEC), and provisions prohibiting CEOC from divesting its assets.

[1] 2014 U.S. Dist. LEXIS 178707 (Dec. 30, 2014 S.D. N.Y.)

[2] 2015 U.S. Dist. LEXIS 5111 (Jan. 15, 2015 S.D.N.Y.).

The noteholders alleged that in 2014, hedge funds in a controlling position instituted a plan ("2014 Transaction") to put CEOC into bankruptcy while protecting the owners from CEOC's creditors. As part of this plan, supplemental indentures were issued that effectively left CEC free to transfer CEOC's assets without any obligation to back CEOC's debts.

Under the 2014 Transaction, consenting noteholders would receive a 100% premium over market, in exchange for which they agreed to (1) support any restructuring proposed by the company, (2) consent to the termination of CEC's guarantees and (3) consent to the modification of the covenant restricting disposition of substantially all of CEOC's assets. The plaintiffs characterized this essentially as a payoff designed to get a sufficient number of noteholders to allow the company to modify the governing documents so as to permit a divestiture of CEOC's assets and the termination of CEC's guarantees. These actions, according to plaintiffs, violated Section 316(b) of the Act and breached the indentures.

Taking the complaint's allegations as true for purposes of the motions to dismiss, the court held that plaintiffs had sufficiently alleged a violation of Section 316(b) of the Act by CEC (because of CEOC's pending bankruptcy, the action against CEOC had been stayed). The court found that plaintiffs had adequately alleged that the 2014 Transaction was an impermissible impairment of plaintiffs' right to payment under the notes. Citing the *Marblegate* decision, the court found that transferring away CEOC's assets and eliminating CEC's guarantees to backstop the debt "constitutes an impairment of the right to sue for payment." According to the court, the notion that Section 316(b) was meant to protect only against formal modifications of the legal right to receive payment was "unsatisfying." Furthermore, removing the CEC guarantees through the 2014 Transaction was an impermissible out-of-court restructuring and was "exactly what TIA Section 316(b) was designed to prevent."

Implications

The *Marblegate* and *Caesars* decisions make it more difficult to implement out-of-court restructurings. These decisions increase the leverage of minority noteholders in restructuring negotiations and may, in fact, lead to an increase in bankruptcy filings since out-of-court restructurings can be held up by the objecting noteholders. Bankruptcy filings are comparatively more expensive and many companies that could afford out-of-court restructurings may not be financially able to incur the in-court restructuring costs. Accordingly, one byproduct of these cases, especially if the holdings are adopted by other courts, may be the liquidation of companies which might be better served by a restructuring. Both debt issuers and parties holding debt must consider the *Marblegate* and *Caesars* decisions should the need for a restructuring arise.

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