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Recent Decisions Concerning the Trust Indenture Act Underline the Limits on Out-of-Court Restructurings

Jason W. Harbour and Matthew Mannering*

In this article, the authors explain two recent decisions from the United States District Court for the Southern District of New York which have indicated that the Trust Indenture Act of 1939 requires unanimous consent for out-of-court restructurings that impair bondholders' practical ability to receive payments, even if the bondholders' technical, legal ability to receive payments remains intact.

In two recent cases, the United States District Court for the Southern District of New York has indicated that Section 316(b) of the Trust Indenture Act of 1939[1] (the "TIA") requires unanimous consent for out-of-court restructurings that impair bondholders' practical ability to receive payments, even if the bondholders' technical, legal ability to receive payments remains intact.[2]

EDUCATION MANAGEMENT

In *Marblegate Asset Management et al. v. Education Management Corp.*, Marblegate Asset Management, LLC, Marblegate Special Opportunities Master Fund, L.P. (collectively, "Marblegate"), Magnolia Road Capital LP, and Magnolia Road Global Credit MasterFund L.P. (collectively, "Magnolia," and with Marblegate, "Plaintiffs") sought a preliminary injunction to block a

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[1] Section 316(b) of the TIA reads 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[.]"

[2] *See Marblegate Asset Management et al. v. Education Management Corp.*, (S.D.N.Y. Dec. 30, 2014) ("*Education Management*") and *MeehanCombs Global Opportunities Fund LP et al. v. Caesars Entertainment Corp. et al.*, (S.D.N.Y. Jan. 15, 2015) ("*Caesars*").

proposed out-of-court restructuring of the debt of Education Management LLC, Education Management Finance Corporation and Education Management Corporation ("EDMC," and collectively, "Defendants") that would require Plaintiffs to convert their debt to equity or potentially lose their practical ability to receive principal and interest payments.

EDMC had approximately $217 million in unsecured notes, some of which were held by the Plaintiffs. The notes are governed by a March 5, 2013, Indenture (the "Indenture") and are covered by the TIA.[3]

In May 2014, EDMC informed creditors and investors that it was experiencing financial difficulties. As EDMC was negotiating with its creditors to resolve its financial distress, it entered into a Proposed Restructuring Agreement (the "Proposed RA") with certain of its creditors; the Proposed RA was governed by the Restructuring Support Agreement.

The Proposed RA provided two options for EDMC to restructure its debt. Under the first option, if EDMC was able to secure consent of 100 percent of its creditors,

> $150 million of the revolving loans would be repaid and made available for re-borrowing; certain letters of credit drawn from the revolver would be extended until March 2019; and the remainder of EDMC's secured debt (constituting $1.155 billion), including the term loans, would be exchanged for $400 million in new secured term loans and preferred stock convertible into roughly 77% of EDMC's common stock.

The Defendants issued an exchange offer for the notes on October 1, 2014 (the "Exchange Offer") in order to attempt to consummate the first option for this voluntary restructuring. The Defendants, however, received less than 100 percent creditor acceptance. The Defendants' failure to receive 100 percent consent to the Exchange Offer triggered the second option for restructuring the debt—an Intercompany Sale, which was accomplished through a number of contemporaneous steps:

> (i) the secured lenders would release EDMC's parent guarantee of their loans (which the secured lenders recently obtained in the Third

[3] In addition, Section 6.07 of the Indenture reads in relevant part, "*Rights of Holders of Notes to Receive Payment.* Notwithstanding any other provision of this Indenture, the right of any Holder of a Note to receive payment of principal, premium, if any, and Additional Interest, if any, and interest on the Note, on or after the respective due dates expressed in the Note. . . or to bring 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."

> Amended and Restated Credit and Guaranty Agreement (the "2014 Credit Agreement")), thus triggering the release of EDMC's parent guarantee of the Notes under Indenture § 10.06;
>
> (ii) the secured lenders would exercise their rights under the 2014 Credit Agreement and Article 9 of the Uniform Commercial Code to foreclose on 'substantially all of the assets' of Defendants; and
>
> (iii) the secured lenders would immediately sell these assets back to a new subsidiary of EDMC. This new subsidiary would then distribute debt and equity to the creditors who had consented to the Restructuring Support Agreement. . .

The Plaintiffs filed a motion for a temporary restraining order and preliminary injunction. The Plaintiffs asserted the Intercompany Sale and the removal of the parent guarantee impaired their right to receive payment in violation of the TIA. The Plaintiffs contended they would be left with no practical ability to receive anything for their claims because the original issuer would have no assets to satisfy the claims due to the Intercompany Sale, and the release of the parent guarantees would preclude the Plaintiffs from any recovery against the parent.

In analyzing the merits of the Plaintiffs' claims, the court concluded that the Plaintiffs could not obtain a preliminary injunction[4] due to their inability to demonstrate irreparable harm, failure to show that the balance of equities weighed in their favor, and failure to demonstrate that an injunction would be in the public interest. The court noted, however, in *dicta*, that the Plaintiffs had demonstrated a likelihood of success on the merits of their claim that the Intercompany Sale violated the TIA.

The court considered whether the protections of the TIA against nonconsensual debt restructurings were to be read broadly or narrowly—in other words, "whether the 'right. . . to receive payment' is to be read narrowly, as a legal entitlement to demand payment, or broadly, as a substantive right to actually obtain such payment." The court noted that in an earlier Southern District of New York ruling, in *Federated Strategic Income Fund v. Mechala Grp.*

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[4] In the Second Circuit the standard for obtaining a preliminary injunction is that the plaintiff demonstrates "(i) 'irreparable harm,' and (ii) either (a) 'a likelihood of success on the merits' or (b) 'sufficiently serious questions going to the merits of its claims to make them fair ground for litigation, plus a balance of the hardships tipping decidedly in favor of the moving party.'" *Education Management*, citing, *Otoe-Missouria Tribe of Indians v. N.Y. Dep't. of Fin. Servs.*, 769 F.3d 105, 110 (2d Cir. 2014) (quoting *Lynch v. City of N.Y.*, 589 F.3d 94, 98 (2d Cir. 2009)).

Jam. Ltd.,[5] that court had concluded that the TIA "protects the *ability*, and not merely the formal right, to receive payment in some circumstances." The court also observed that other courts and commentators who have considered the legislative history and purpose of the TIA have concluded that Section 316(b) of the TIA was enacted to encourage bankruptcy filings in the absence of unanimous consent to out-of-court bond restructurings.[6]

Although the Plaintiffs were unable to secure an injunction or temporary restraining order, the court stated that "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," and that "the Intercompany Sale is precisely the type of debt reorganization that the Trust Indenture Act is designed to preclude."

CAESARS

A few weeks after the decision in *Education Management*, the United States District Court for the Southern District of New York again analyzed the TIA in connection with an out-of-court bond restructuring in *Caesars* and held that the TIA protects non-consenting bondholders' practical ability to receive payment and not merely a technical right to payment.

The Caesars Plaintiffs[7] hold certain of the notes issued by Caesars Entertainment Operating Co. Inc. ("CEOC") and guaranteed by Caesars Entertain-

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[5] *Federated Strategic Income Fund v. Mechala Grp. Jam. Ltd.*, (S.D.N.Y. Nov. 2, 1999) ("*Federated*"). The *Federated* court held "By defendant's elimination of the guarantors and the simultaneous disposition of all meaningful assets, defendant will effectively eliminate plaintiffs' ability to recover and will remove a holder's 'safety net' of a guarantor, which was obviously an investment consideration from the outset. Taken together, these proposed amendments could materially impair or affect a holder's right to sue. A holder who chooses to sue for payment at the date of maturity will no longer, as a practical matter, be able to seek recourse from either the assetless defendant or from the discharged guarantors. 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 for its debt, that such action does not constitute an 'impairment' or 'affect' the right to sue for payment." *See Federated Strategic Income Fund*.

[6] *Education Management*, citing *Brady v. UBS Fin. Servs., Inc.*, 538 F.3d 1319, 1325 (10th Cir. 2008) ("Section 316(b) was adopted with a specific purpose in mind—to prevent out-of-court debt restructurings from being forced upon minority bondholders . . . . Specifically, § 316(b) was designed to provide judicial scrutiny of debt readjustment plans to ensure their equity.").

[7] The Caesars Plaintiffs are MeehanCombs Global Credit Opportunities Fund, LP; Relative Value-Long/Short Debt; A Series of Underlying Funds Trust; SB 4 CF LLC; CFIP Ultra Master Fund, Ltd.; and Trilogy Portfolio Company, LLC (collectively, "MeehanCombs"); and Fredrick Barton Danner, individually and on behalf of all others similarly situated.

ment Corp. ("CEC"). Supplemental indentures issued in August 2014 (the "August 2014 Transaction" or the "Amendments") removed the guarantee from the parent company, CEC, and left the Caesars Plaintiffs with an opportunity to collect only against the initial issuer, CEOC, which was divesting its assets and was laden with debt well in excess of its assets.[8]

The Caesars Plaintiffs alleged that the August 2014 Transaction was a nonconsensual change to their payment rights, which violated the terms of Section 316 of the TIA. The Caesars Defendants[9] moved to dismiss the complaints.

The court concluded that certain Caesars Plaintiffs sufficiently stated a claim under Section 316 of the TIA to survive the Caesars Defendants' motion to dismiss.[10] In making such a finding, the court rejected CEC's argument that the TIA "protects only a noteholder's *legal* right to receive payment when due." The court noted that such a narrow reading of the TIA is not mandated by the statutory text and cited *Education Management* and *Federated* courts with approval for the proposition that the TIA should be interpreted more broadly.[11]

CEC also attempted to distinguish *Caesars* from *Education Management* by informing the court that CEOC would soon be filing for bankruptcy and therefore the August 2014 Transaction was not a true out-of-court debt restructuring. The court, however, found this argument unavailing.

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[8] The court noted,"[i]n January 2008, Caesars was acquired in a leveraged buyout by two private equity funds, Apollo Global Management, Inc. and TPG Capital, LP. Caesars subsequently entered into a series of transactions aimed at transferring assets away from CEOC and leaving it (CEOC) holding company debt. CEC's ultimate plan is to push CEOC into bankruptcy while protecting Apollo and TPG from CEOC's creditors. The Amendments effectively left CEC free to transfer CEOC's assets without any obligation to back CEOC's debts."

[9] The Caesars Defendants include Caesars Entertainment Corp. and Caesars Entertainment Operating Co. Inc.

[10] The court held that MeehanCombs did not adequately allege the necessary beneficial ownership or control in order to establish a claim under Section 316(b) of the TIA; however, the court did not believe such an allegation was impossible based on the record before it. Consequently, the court granted the Caesars Defendants' motion to dismiss as to the Section 316(b) claim asserted by MeehanCombs without prejudice to MeehanCombs amending their complaint to assert the required beneficial ownership or control.

[11] "Specifically, 'the Court finds . . . 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 Act's protections through a transaction such as the one at issue here." *Caesars*, quoting, *Education Management*.

CONCLUSION

Education Management and *Caesars* clarify that in the Southern District of New York, unanimous consent is required if bondholders' practical right to receive payment is compromised in an out-of-court restructuring. As defendants in both *Education Management* and *Caesars* noted, however, courts in other jurisdictions have concluded that the TIA requires only that the technical legal right to receive payment remain undisturbed in a nonconsensual, out-of-court restructuring.[12] Further, as the *Caesars* court noted, "there is scant case law on point."

Thus, while there are numerous ways for creative debtors and creditors to restructure outside bankruptcy, *Education Management* and *Caesars* illustrate the limits of this ingenuity in the Southern District of New York. Specifically, under *Education Management* and *Caesars*, the TIA protects bondholders' practical right to receive payment, not merely their technical, legal right to receive payment from an issuer. In light of the paucity of case law on this issue, further developments are likely. Nevertheless, the different ways in which courts have addressed this issue may lead to forum shopping and, in particular, plaintiffs seeking to enforce the TIA in the Southern District of New York, if possible.

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[12] *See Magten Asset Mgmt. Corp. v. Northwestern Corp. (In re Northwestern Corp.)*, 313 B.R. 595, 600 (Bankr. D. Del. 2004) (Section 316(b) of the TIA "applies to the holder's *legal* rights and not the holder's *practical* rights to the principal and interest itself . . . there is no guarantee against defaults."); *YRC Worldwide Inc. v. Deutsche Bank Trust Co. Am.*, (D. Kan. July 1, 2010) ("TIA § 316(b) does not provide a guarantee against the issuing company's default or its ability to meet its obligations. Accordingly, the fact that the deletion of section 5.01 might make it more difficult for holders to receive payments directly from plaintiff does not mean that the deletion without unanimous consent violates TIA § 316(b)").