Client Update
Expansive Trust Indenture Act Interpretation May Negatively Affect Bond Restructurings

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In two recent decisions, the United States District Court for the Southern District of New York adopted an interpretation of Section 316(b) of the Trust Indenture Act of 1939 (the "TIA") that may complicate future exchange offers and, in some cases, force bond restructurings that might otherwise have been completed out-of-court to be effectuated through a bankruptcy filing.[1] In *Marblegate Asset Management v. Education Management Corp.*,[2] the court denied a preliminary injunction sought by holdout noteholders to block an out-of-court restructuring forcing holders to convert their notes to equity or risk the elimination of their practical ability to receive payment, but went on to argue that the transaction violated the TIA. In *MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entertainment Corp.*, the court quoted at length from the *Education Management* decision in denying Caesars' motion to dismiss noteholder claims that the release of a parent guarantee violated the TIA even though it was allegedly permitted under the indenture's amendment provision.[3] While the court's reading of the TIA was mere dicta in *Education Management*, it was core to the holding in *Caesars Entertainment*.

EDUCATION MANAGEMENT

Education Management Corporation ("EDMC") is a large for-profit provider of college and graduate education. Faced with deteriorating finances, EDMC sought to restructure approximately $1.522 billion in secured loans and unsecured notes, both issued by its subsidiary Education Management LLC ("EM") and guaranteed by EDMC. Because EDMC would lose its entitlement to funds under federal student aid programs available under Title IV of the Higher

[1] Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb.
[2] *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, Case No. 14 Civ. 8584(KPF), 2014 WL 7399041 (S.D.N.Y. Dec. 30, 2014).
[3] *MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entm't Corp.*, No. 14-CV-7091 SAS, 2015 WL 221055 (S.D.N.Y. Jan. 15, 2015).

Education Act of 1965 if it filed for bankruptcy, the restructuring had to be accomplished out-of-court.

To this end, EDMC negotiated a restructuring support agreement ("RSA") with its creditors that contemplated two possible transactions, neither of which required a bankruptcy proceeding. If 100% of EDMC's creditors consented, holders of secured debt would receive a combination of cash, new debt and preferred stock convertible into approximately 77% of EDMC's common stock, and noteholders would receive preferred stock convertible into at least 19% of EDMC's common stock. If 100% consent was not obtained: (i) the secured lenders would release EDMC's guarantee of their loans, which under the indenture governing the unsecured notes would automatically release EDMC's guarantee of the notes; (ii) the secured lenders would exercise their right under the credit facilities to foreclose on substantially all of EDMC's assets; and (iii) the secured lenders would in turn sell the assets back to a new subsidiary of EDMC in exchange for new debt and equity to be distributed only to consenting creditors. Non-consenting holders of unsecured notes would lose the benefit of the EDMC guarantee and would be left with claims against an entity that no longer held any assets.

While 99% of the secured lenders and over 90% of the noteholders consented to the first option, EDMC was forced to pursue the second nonconsensual alternative. The *Education Management* plaintiffs were among the holdouts and sought a preliminary injunction to enjoin the restructuring, alleging that it violated the TIA and the terms of the TIA-qualified indenture governing the unsecured notes.

CAESARS ENTERTAINMENT

Caesars Entertainment Corporation ("CEC"), along with its subsidiaries, including Caesars Entertainment Operating Company, Inc. ("CEOC"), own and manage dozens of casinos in the United States. CEOC issued $750 million in senior unsecured notes due in 2016 and $750 million in senior unsecured notes due in 2017. The notes were guaranteed by CEC.

In August 2014, with a restructuring on the horizon, CEOC and CEC purchased a substantial portion of the notes at par plus accrued interest in a private transaction. In exchange, the holders of these notes agreed to: (i) support a future restructuring of CEOC; (ii) release CEC's guarantees; and (iii) modify the covenant restricting the disposition of "substantially all" of CEOC's assets to measure future asset sales based on CEOC's assets as of the date of the amendment of the indentures. The plaintiffs were noteholders that were not invited to participate in the deal. Due to the amount of CEOC's secured debt, with the release of the guarantee by CEC, the plaintiffs faced losing the only source for repayment on the unsecured notes. The plaintiffs sued CEC and CEOC on the theory that the release of the parent guarantee violated the TIA and the TIA-qualified indentures.

DISTRICT COURT DECISIONS

While the *Education Management* court declined to grant equitable relief to the plaintiffs, it went on to explore in dicta (ultimately adopted by the *Caesars Entertainment* court) the merits of their case, concluding that the plaintiffs had demonstrated a likelihood of success on their claim that the proposed restructuring violated the TIA.

Section 316(b) of the TIA provides that "the right of any holder of any indenture security to receive payment of the principal of an interest on such indenture security … shall not be impaired or affected without the consent of such holder…."[4] Read narrowly, and as generally understood,[5] the TIA only protects a legal right to *seek* payment by protecting each holder against amendments of certain "core terms" not implicated in either decision, such as the indenture's payment terms, that are consented to by a majority of holders. After a review of an unpublished district court decision[6] and the TIA's legislative history, the *Education Management* court reasoned that the TIA should be read as "a broad protection against non-consensual debt restructurings" protecting each noteholder's "substantive right to actually obtain" payment, and not merely the "legal entitlement to demand payment."[7]

Applying this expansive interpretation of the TIA, the court found that the non-consensual restructuring contemplated by the RSA would "effect a complete impairment of dissenters' right to receive payment" and therefore was illegal under the TIA.[8] The court further stated that Section 316(b) of the TIA "was intended to force bond restructurings into bankruptcy where unanimous consent could not be obtained."[9]

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4 15 U.S.C. § 77ppp(b).

5 *See, e.g.*, *In re Northwest Corp.*, 313 B.R. 595, 600 (Bankr. D. Del. 2004) ("[The TIA] applies to the holder's legal rights and not the holder's practical rights to the principal and interest itself."); *Brady v. UBS Fin. Servs., Inc.*, 538 F .3d 1319, 1326 n.9 (10th Cir. 2008) (quoting the language from *In re Northwest Corp.* cited above with approval).

6 *Federated Strategic Income Fund v. Mechala Grp. Jam. Ltd.*, 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999).

7 *Marblegate*, 2014 WL 7399041, at *15-19.

8 *Id.* at *20.

9 *Id.* at *18.

Relying on the reasoning in the *Education Management* decision and quoting from it extensively, the *Caesars Entertainment* court concluded that the plaintiffs' allegations were sufficient to state a claim under Section 316(b) of the TIA.[10] The court held that, as alleged, the removal of the parent guarantee was "an impermissible out-of-court debt restructuring achieved through collective action. This is exactly what TIA section 316(b) is designed to prevent."[11]

PRACTICAL IMPLICATIONS

The implications of these decisions are potentially significant. While their facts are extreme, involving involuntary releases of guarantees and attempts to strip a borrower of assets without requiring the new owner to assume liability for the notes, the stated rationale of these decisions is extraordinarily broad and could reach transactions involving far less dramatic modifications to noteholder rights. Both courts stated that Section 316(b) prohibits out-of-court debt restructurings achieved through collective action. Although the decisions do not clearly define what constitutes a debt restructuring for these purposes, they could suggest that any modifications of an indenture – and even automatic guarantee releases and other actions provided for or permitted under an indenture – that actually impair a dissenter's ability to obtain payment might be prohibited. Exchange offers, however, commonly involve exit consents whereby exchanging noteholders consent to indenture amendments stripping certain covenants and events of default under typical majority-rule amendment provisions. These alterations of the debt terms are designed to discourage noteholders from holding out in order to free ride on concessions made by majority holders. While the *Education Management* court states that exit consents will be permissible in some cases, the *Education Management* and *Caesars Entertainment* decisions call into question the continued viability of this restructuring tool, at least if coupled with other steps such as guarantee releases and transfers of assets out of the reach of dissenting bondholders. In so doing, these decisions may force more companies into bankruptcy or, at minimum, increase the execution risk and related costs of out-of-court bond restructurings. In addition, companies may have another disincentive to register their bonds with the Securities and Exchange Commission and thereby subject their bond indentures to the TIA.

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Please do not hesitate to contact us with any questions.

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[10] *Caesars Entertainment*, 2015 WL 221055, at *4-5.

[11] *Marblegate*, 2014 WL 7399041, at *5.