Reorg Research

Panel Recap: Out-of-Court Restructurings After Marblegate: Trust Indenture Act Section 316(b) and Beyond

Last week at the New York office of Davis Polk & Wardwell LLP, Reorg Research, along with Davis Polk, Drinker Biddle and Wilmer Hale, held a panel event titled "Out-of-Court Restructurings After Marblegate: Trust Indenture Act Section 316(b) and Beyond." The panelists addressed the future of out-of-court restructurings and refinancings in light of litigation between Marblegate Asset Management and Education Management Corp., which just resulted in a major ruling from the Second Circuit. A video recording of the panel discussion can be found HERE.

The panelists were:

- **James H. Millar**, partner, Drinker Biddle, corporate restructuring
- **Mark J. Roe**, David Berg Professor of Law, Harvard Law School
- **Byron B. Rooney**, partner, Davis Polk, capital markets
- **George W. Shuster Jr.**, partner, WilmerHale, bankruptcy and financial restructuring
- **Jude M. Gorman**, general counsel, Reorg Research (moderator)

The panelists discussed the policy rationale for Section 316(b) of the TIA, how the statute might best serve the capital markets, the practical application of 316(b) for market participants after the Second Circuit's ruling and the prospect for the legal landscape to change in the near future. Of note in particular, the panelists discussed how guarantees of bonds may be treated independently from the underlying bond under the TIA and how the Second Circuit's decision may increase involuntary chapter 11 cases and fraudulent transfer actions against issuers. The effects that the decision may have on legal opinions and on the role of indenture trustees were also discussed.

Background

The *Marblegate* decision addressed purported violations of Section 316(b) of the Trust Indenture Act of 1939, a statute that provides that:

> "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).

The issue in dispute in *Marblegate* related to the meaning of the words "right ... to receive payment."

The District Court for the Southern District of New York had found that the "right ... to receive payment" should be read as a practical right to receive payment. Accordingly, under that court's interpretation, actions taken by an issuer that impair a bondholder's practical ability to get paid could violate TIA Section 316(b), even if those actions don't affect the bondholder's legal right to pursue payment. However, the Second Circuit overturned the District Court's decision, ruling that the TIA "prohibits only non-consensual amendments to an indenture's core payment terms."

Panel Discussion

The Decision

As laid out by Mr. Shuster, the interpretation of section 316(b) of the TIA seeks to alleviate the tension between issuers of bonds - who generally desire flexibility to restructure their debt obligations - and bondholders - who generally desire to protect their likelihood of being repaid. At least on the facts before it, the *Marblegate* court ruled that an issuer could restructure its obligations without violating the TIA as long as the restructuring did not impair bondholders' "legal right to payment." This was true in *Marblegate* even though the issuer in essence stripped the bondholders' collateral and guarantee packages and arguably left certain bondholders without a practical remedy for being repaid.

According to Mr. Millar, one interpretation is that the *Marblegate* court ruled that a secured creditor could foreclose on its security interests without offering any value to unsecured creditors, which is no different from what secured creditors do out of court on a regular basis. However, Mr. Millar discussed how a guarantee of a bond stands on different footing under the TIA, noting that a guarantee should be treated as a separate security that is afforded protections that are independent of those provided to the underlying bond.

Policy Rationale of Section 316(b) of the TIA

Mr. Roe discussed the purpose of the TIA, noting that it was derived from a "New Deal mindset" that arose from the Great Depression, when insiders were said to have too often taken control of restructurings and taken value from investors. Part of the New Deal mindset at the SEC, evinced over the 1930s in statements from William Douglas (the principal SEC architect of the TIA), Abe Fortas, and Jerome Frank was a general notion that bondholders ought to be protected from losing their core payment rights unless they consented or a judge approved. Whether the SEC got this across in the TIA to Congress is another issue. The Second Circuit said no, they did not, dismissing a Douglas statement to this effect in the TIA's legislative history as a "shard," in the court's word, to be discarded as too weak to upset other legislative history pointing elsewhere.

Mr. Millar suggested similarly that the TIA was enacted in 1939 to protect the "mom and pop" retail investors. However, he noted that while investors may be more sophisticated today, there is good reason for the TIA to continue to protect bondholders who may hold minority positions in a bond issuance, particularly because of the conflicts of interest that can arise with respect to voting incentives when

the same entities hold debt or equity in different parts of the capital structure.

Mr. Rooney pointed out that bondholders - especially large institutional bondholders - have the ability to push back on language in indentures in new issuances, which affords them protection. Also, the panelists discussed the fact that chapter 11 could serve as the "hammer" that would enable minority bondholders to enforce their rights, and Mr. Roe suggested that it might benefit the capital markets for there to be a voting process outside of court that was similar to the chapter 11 voting process and that a voting mechanism would be a better platform on which to build protection than section 316(b).

Practical Application of the Marblegate Decision

Mr. Rooney said that the understanding in the capital markets of how section 316(b) of the TIA operates did change substantially as a result of the original *Marblegate* ruling. Before the ruling, market participants understood that an issuer could restructure its debt obligations as long as the bondholders' legal right to repayment was not interrupted. This understanding was affirmed by the Second Circuit ruling, such that the market practice is now largely the same as prior to the original *Marblegate* decision.

Mr. Rooney did note that, before the Second Circuit's ruling, in 144A bond offerings (offerings not registered with the SEC and therefore not afforded the protections of the TIA as a matter of law), indentures included language that attempted to make it clear that an issuer could amend the indenture in any way as long as it did not affect a bondholder's legal right to payment. This language was designed to make it clear that, despite any court ruling to the contrary and absent egregious circumstances, a restriction on impairing a bondholder's "right to receive payment" should not prohibit an issuer from impairing a bondholder's practical right to receive payment as long as it did not impair a legal right to receive payment.

Mr. Rooney, referencing a white paper that several law firms signed before the Second Circuit's ruling, said that the *Marblegate* ruling significantly affected legal opinion practice while such ruling was in force – due to the broad language used in the original *Marblegate* decision, any transaction that could be deemed to be a "debt restructuring" had to be supported by evidence that principal and interest on affected bonds would be able to be paid when due. Since the Second Circuit's decision, as long as a bondholder's legal right to payment is not affected in connection with a proposed transaction, absent egregious circumstances involving indenture amendments granted by less than all holders, law firms will likely be able to give a clean opinion with respect to section 316(b) of the TIA.

Mr. Shuster discussed how the role of indenture trustees could potentially be expanded as a result of the *Marblegate* ruling, noting the possible shift in emphasis that might occur if bondholders cannot seek protection under an expanded version of the TIA. In that scenario, they may resort to leaning on the indenture trustee more than they have done in the recent past.

Mr. Shuster also noted that because the *Marblegate* decision limited recourse for bondholders, bondholders may be inclined to file more involuntary bankruptcies against issuers. As a practical matter, filing an involuntary case against a company requires that the company generally not be paying its debts as they come due (among other requirements), but bondholders may nevertheless be able to pursue involuntary chapter 11 cases against issuers in certain instances when they may have otherwise looked to section 316(b) of the TIA for recourse.

Additionally, Mr. Shuster noted that bondholders may increase fraudulent transfer actions, which they can most likely bring without alleging a TIA violation, and the panelists debated the merits and probability of fraudulent transfer actions being brought by minority bondholders.

Mr. Shuster also suggested that as a result of the Second Circuit's *Marblegate* ruling, the scope of "no action" clauses in indentures may be expanded by issuers. "No action" clauses, which appear frequently in indentures, generally preclude noteholders from pursuing remedies directly against the issuer. Instead, because of the clauses, remedies against the issuer are to be pursued by the indenture trustee on the noteholders' behalf, and only if a certain percentage of noteholders request such relief. Mr. Shuster suggested that, as a result of the *Marblegate* ruling, which highlighted the possibility of certain types of individual bondholder suits as an alternative to expanded TIA protection, issuers may try to increase the scope of no action clauses and further curtail those types of suits..

The panelists also debated whether out of court debt exchange offers that target only "QIBs" (Qualified Institutional Buyers) to the exclusion of retail and other investors should implicate the TIA. Among other things, the panelists debated whether an issuer could target particular holders in a bond issuance - by repurchasing their bonds with cash or debt - without having to make the same offer to all the holders in the issuance.

The Prospect of Marblegate Being Changed

Mr. Roe noted that he thought legislative change to the TIA was unlikely, adding that there had been a lot of pressure for change to the statute before the *Marblegate* decision, but that no change had occurred and there are unlikely to be influential motivated players now to push for change.

Mr. Roe also noted that the SEC has largely unused "exemptive authority," obtained in 1990, with respect to issues concerning the TIA - and that it could be petitioned by bondholders or an issuer to invoke that authority on a case-by-case basis, or even for bond market players to request conditional exemption from section 316(b) for upcoming bond issues. Mr. Millar noted, however, that the SEC has taken a "hands off" approach with respect to TIA issues in the past. Mr. Shuster noted that in terms of regulation, equityholders may have more protections than bondholders since the SEC intervenes in matters concerning rights of equity holders. Mr. Gorman added that shareholder activism doesn't necessarily have a counterpart in the debt capital markets.

Mr. Millar said that he thought it was unlikely that a different circuit court would rule in a way contradictory to the Second Circuit if given the facts of *Marblegate*, but he again discussed that there may be room for a circuit court to rule differently with respect to guarantees of bonds. The guarantee of the bonds was not before the *Marblegate* court, he noted, because the indenture in that case provided that the guarantee of the bonds would be stripped automatically upon the stripping of the bank debt guarantee, and in connection with the restructuring, the bank debt guarantee had been stripped. The panelists debated when a guarantee could be stripped without violating section 316(b) of the TIA and discussed language in different indentures.

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