A New Weapon in Mega-Bankruptcy Cases: The Trust Indenture Act

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I. Introduction to Trust Indenture Act of 1939 ("**TIA**"), 15 U.S.C. §§ 77aaa-77bbbb

A. The TIA supplements the Securities Act of 1933 (the "**Securities Act**") and Securities Exchange Act of 1934 (the "**Exchange Act**") with respect to, among other things, public bond issuances under indentures involving more than $10,000,000 in aggregate principal amount of debt. TIA § 304(a)(9); Rule 4a-3. The TIA requires that such indentures be "qualified" by the inclusion of certain disclosure in the associated registration statement as to the proposed indenture trustee's qualifications to serve as a trustee under Section 310, events of default and release of collateral (if applicable). TIA §§ 305(a) and 309(a); *see also* TIA §§ 306(a) and 307(a) (covering qualification of indentures governing securities not registered under the Securities Act). Qualified indentures are deemed to include certain terms, which are incorporated by operation of law into the indenture itself. TIA § 318(c).[1] One of these mandatory indenture provisions is the protection against nonconsensual modification of a bondholder's right to receive payments of principal and interest.

B. Statutory Language of TIA Section 316

1. Section 316(a) requires that a vote of not less than a majority of bondholders is required to direct remedies and waive defaults, and also provides an optional supermajority voting provision for limited postponements of interest payments.

2. Section 316(b), which prohibits the impairment of a bondholder's right to payment, states:

[1] In addition to the trustee requirements in Section 310, these terms include procedures governing trustee claims against an obligor (Section 311); information rights of the trustee and bondholders (Sections 312 and 313); periodic reporting obligations of the obligor regarding financial status, indenture compliance and status of collateral (Section 314); duties of the trustee (Section 315); restrictions on certain amendments and waivers that are the subject of this outline (Section 316); and the trustee's standing to recover payment from the obligor upon maturity of or default on the debt (Section 317).

> 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 . . . .

3. The protections in Section 316(b) are subject to two express exceptions. The first is the right of a 75% supermajority to postpone interest payments under Section 316(a)(2) for no more than three years after such payments are due. The second recognizes that a bondholder has a right to receive and sue for payment but not to foreclose on collateral if doing so would cause a release of the trustee's lien. This second exception is necessary because in a number of jurisdictions (domestic and international), instituting suit for payment of a secured debt without also bringing a parallel claim to realize on the collateral constitutes a waiver of the security. George W. Shuster, Jr., The Trust Indenture Act and International Debt Restructurings, 14 ABI L. REV. 431, 436 (2006) (citing 84 Cong. Rec. 9073, 9528 (1939)).

4. A third, unstated exception to Section 316(b) protections is for nonconsensual restructuring implemented through a federal bankruptcy proceeding. Argo Fund Ltd. v. Bd. of Dirs. of Telecom Arg., S.A. (*In re* Bd. of Dirs. of Telecom Arg., S.A.), 528 F.3d 162, 172 (2d Cir. 2008) (Sotomayor, J.) (quoting *In re* Delta Airlines, Inc., 370 B.R. 537, 550 (Bankr. S.D.N.Y. 2007) and citing *In re* Bd. of Directors of Multicanal S.A., 307 B.R. 384, 388 (Bankr. S.D.N.Y. 2004)); Shuster, 14 ABI L. REV. at 437.

   (a) The modern Bankruptcy Code does not contain any express override of the TIA, except with respect to debt securities issued in connection with a chapter 11 plan of reorganization that mature no

later than one year after the effective date of the plan. 11 U.S.C. § 1145(d).

(b) At least one court has held that the filing of an involuntary petition under Section 303 the Bankruptcy Code against a bond issuer is a valid exercise of a bondholder's right under Section 316(b) to bring suit to collect payment of past due interest. Envirodyne Indus., Inc. v. Conn. Mut. Life Co. (*In re* Envirodyne Indus., Inc.), 174 B.R. 986, 996 (Bankr. N.D. Ill. 1994).

5. Obligors seeking more options in restructurings may argue that Section 316(b) only protects a bondholder's *legal* right to payment and not the *practical* ability to be paid.

(a) This argument is allegedly supported by the statutory text of Section 316(b), which only speaks to the "right" of a bondholder to receive payment of principal and interest when due and to sue for the enforcement of such payment. Thus, narrowly read, the argument is that Section 316(b) merely prohibits a majority of bondholders from modifying an indenture to alter the amount owed or the payment due date, and from stripping bondholders of standing to sue for payment upon the due date.

(b) Moreover, obligors may argue that Section 316(b) can be read as a restriction on the majority control provisions permitted by Section 316(a) and that this is an allocation of power between majority and minority bondholders that does not purport to govern the conduct of the obligor.

6. Bondholders seeking to prevent restructurings may point to the use of "or" in Section 316(b) to argue that the statute prohibits the impairment of either the right to "receive payment" or the right to "institute suit for the enforcement of any such payment" absent consent. This argument has found traction with at least one court. Marblegate Asset Mgmt., LLC v.

Educ. Mgmt. Corp., No. 14 Civ. 8584 (KPF), 2015 WL 3867643, at *11 (S.D.N.Y. June 23, 2015) (discussed below).

C. Legislative History of TIA Section 316(b)

1. 1936 Securities Exchange Commission Report (the "**SEC Report**")

(a) William O. Douglas, later chairman of the Securities Exchange Commission (the "**SEC**") and associate justice of the U.S. Supreme Court, was the principal author of an extensive study by the SEC pursuant to Section 211 of the Exchange Act (the "**1936 SEC Report**") that focused on the need for judicial or administrative oversight of reorganizations to protect minority bondholders during reorganizations.

(i) The report noted that minority dissenting bondholders are at their most vulnerable when faced with foreclosure sales outside the supervision of a judicial or administrative process, where a consenting majority would have little incentive to offer accommodations to the holdouts. The 1936 SEC Report asserts that the solution is to have more active indenture trustees in reorganizations. SEC, Report on the Study and Investigation of the Work, Activities and Personnel and Functions of Protective and Reorganization Committees, Part VI: Trustees Under Indentures 63-64 (1936).

(ii) The 1936 SEC Report also highlighted a fear that provisions allowing majorities to amend collateral and payment obligations would become commonplace and, without proper constraints, debt reorganizations would take place on that basis without supervision of any court or administrative agency. Id. at 150. Nevertheless, the 1936 SEC Report acknowledged the problems associated with

> requiring unanimous consent of bondholders to reorganize outside bankruptcy, stating that "reorganizers would be faced with the necessity of dealing with a dissenting minority, with the consequences that foreclosure proceedings (and later on, [bankruptcy] proceedings) would be necessary." Id. at 145.

(b) Obligors may argue that the report only reflects a concern about indenture provisions that would allow a majority of noteholders to (i) deprive other noteholders of the ability to sue on their notes and (ii) modify payment terms by waiving or delaying an issuer's obligations, both of which are addressed in Section 316(b). On the other hand, those arguing for a broader interpretation of Section 316(b) may say that the proponents of the TIA were more broadly concerned about the abuse of majority-control provisions to the detriment of the minority's right to payment.

2. The Trust Indenture Act of 1937 (the "**1937 Bill**")

(a) The proposed Trust Indenture Act of 1937 gave the SEC broad regulatory authority to require qualified indentures to contain terms regarding:

> [t]he rights, powers, and remedies of the indenture security holders and the manner in which and conditions upon which such rights, powers and remedies may be exercised, including the right and power of the indenture security holders with respect to . . . bringing action to collect the principal of and interest upon the indenture securities at their respective due dates.

Trust Indenture Act of 1937, S. 2344, 75th Cong. § 7(m)(5) (1st Sess.1937). The language of the 1937 Bill, which focuses on the

right to bring an action to recover principal and interest, is much narrower than the contemporary Section 316(b).

(b) Still, in congressional testimony, Douglass expressed concern that obligors of securities might seek to withdraw collateral and sell pledged property to the detriment of bondholders, and Senator Robert Wagner worried whether the 1937 Bill would sufficiently prevent the substitution of worthless collateral for collateral on which a security holder had relied.

3. The Trust Indenture Act of 1938 (the "**1938 Bill**")

(a) The 1938 Bill largely tracked the 1937 Bill minority bondholder protections, giving the SEC the power to require indenture provisions narrowly tailored to the right to bring suit. Section 7(m)(3) read:

> The indenture to be qualified shall contain provisions which the Commission deems adequate . . . with respect to the following matters . . . (3) The rights, powers, and remedies of the indenture security holders and the manner in which and conditions upon which such rights, powers, and remedies may be exercised, including the rights, powers, and remedies of the indenture security holders with respect to . . . (B) bringing action to collect the principal of and interest upon the indenture securities upon their respective due dates. . . . The indenture to be qualified may contain provisions authorizing the holders of not less than a majority in principal amount of the indenture securities at the time outstanding to consent to the postponement of any interest payment for a period not exceeding one year from its due date, or to the waiver of any default and its consequences, except a default in the payment of the

> principal of any indenture security upon the date of maturity specified therein . . . .

Trust Indenture Act of 1938, H.R. 10292, 75th Cong. § 7(m)(3) (3rd Sess. 1937).

(b) During testimony in the House on the 1938 Bill, Douglass testified that he did not believe that the 1938 Bill would impose a unanimity requirement on indenture amendments. Rather, he stated that

> The effect of this exception is merely to prohibit provisions authorizing such a majority to force a non-assenting security holder to accept a reduction or postponement of his claim for principal, or a reduction of his claim for interest or a postponement thereof for more than 1 year. In other words, this provision merely restricts the power of the majority to change those particular phases [sic] of the contract.

Trust Indentures: Hearing on H.R. 10292 Before a Subcomm. of the Comm. on Interstate and Foreign Commerce, 75th Cong. 35 (1938). The Senate Report on the 1938 Bill offers a similar view. S. Rep. No. 75–1619, at 19 (1938).

(c) In an address to the American Bar Association on the 1938 Bill, Edmund Burke, the Assistant Director of the Reorganization Division of the SEC, expressed his concern that the bill as drafted would prevent indenture provisions permitting majorities to waive principal and interest defaults and that this prohibition would force issuers into bankruptcy. Edmund Burke, Jr., Asst. Dir. Reorg. Div., SEC, before the ABA, *Aims, Purposes and Philosophy of the Barkley Bill* (July 25, 1918).

4. The Trust Indenture Act of 1939

(a) The initial draft of the 1939 version of the TIA remained largely the same as the 1938 Bill. However, after senators expressed concern about the enormous discretion left to the SEC, the statute was revised with the regulatory powers rewritten as statutory requirements. The TIA has been amended only once since its enactment, and Section 316 was unaffected. *See* Trust Indenture Reform Act of 1990, Pub. L. No. 101-550, 104 Stat. 2713, 2721.

(b) Comparison of the final text of Section 316(b) with the prior versions reveals two significant distinctions. First, while previous iterations of the TIA prescribed a more active indenture trustee and SEC as the remedy for minority bondholder disenfranchisement, the enacted TIA provides that protective indenture provisions are mandatory rather than contingent upon SEC designation. Second, the minority protection is no longer expressed only as the right to bring an action, but now also as a separate right "to receive payment."

(c) In his testimony on behalf of the SEC, Assistant Director Burke stated:

> All that the section does is preserve the individual holder's right to bring an action at law to collect his interest and principal in accordance with the terms of his contract, unless he himself has consented to a variation from that contract. . . . When an investor buys a bond, he buys a right to get a thousand dollars on a particular date. All that this subsection [316(b)] says is that he shall not be deprived of that individual right without his consent.

Trust Indentures: Hearing on H.R. 2191 & H.R. 5220 Before the Subcomm. of the Comm. On Interstate & Foreign Commerce, 76th Cong. (1939) 284-85. Burke went on to make clear that majorities

could renegotiate their own rights and agree to reduce or postpone their claims; they simply could not bind a nonconsenting security holder.

(d) House and Senate Reports on the TIA were identical to SEC testimony finding that the security holder must receive his principal when due. H.R. Rep. 76–1016, at 56 (1939); S.Rep. No. 76–248, at 26–27 (1939).

5. The 1958 SEC Manual

(a) The only other material legislative history available on Section 316(b) is a 1958 SEC manual prepared for internal use, which states: "In view of the emphasis upon the right to sue for principal and interest in the legislative history of Section 316(b), the staff has acquiesced in the view that it relates solely to a suit on the bonds and does not accord any right to pursue a remedy under the indenture." SEC, Manual on Trust Indenture Act of 1939, at 145 (1958).

D. Other Potentially Applicable Laws

1. Obligors may argue that a bondholder's practical ability to recover payment is protected by the following, which would be preempted by a broad interpretation of Section 316(b):

(a) Contract law and express negotiated provisions of indentures;

(b) Fraudulent conveyance law; and

(c) Judgment enforcement mechanisms under state law, such as restrictions on the disposition of the judgment debtor's assets and turnover proceedings.

II. Case Law Interpreting TIA Section 316(b)

A. Federated Strategic Income Fund v. Mechala Group Jamaica Ltd., No. 99 Civ. 10517 (HB), 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999)

1. Mechala suffered financial setbacks as a result of a general decline in the Jamaican economy—its home jurisdiction and locus of operations. Mechala conducted a cash tender offer for two series of outstanding notes, which included a consent to significant indenture amendments, including the elimination of subsidiary guarantees and of covenants limiting affiliate transactions and requiring the maintenance of Mechala's corporate existence—all of which would have limited a subsequent planned corporate reorganization that would have resulted in the transfer of substantially all of Mechala's assets to its subsidiaries. Holdout noteholders sought a preliminary injunction to block the deal, arguing that such amendments required unanimous consent under the TIA.

2. The court held that "[i]t 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 . . . constitute[s] an 'impairment' . . . [of] the right to sue for payment." *Id.* and *7. Accordingly, the plaintiffs had shown a likelihood of success on the merits of their TIA claim and, ultimately, the court granted the injunction.

B. Magten Asset Management Corp. v. Northwestern Corp. (*In re* Northwestern Corp.), 313 B.R. 595 (Bankr. D. Del 2004)

1. Northwestern acquired another company, which had issued its own bonds and became a subsidiary of Northwestern. After the acquisition, Northwestern transferred all of the subsidiary's assets to itself in exchange for assuming substantially all of the subsidiary's liabilities. In connection with the assumption, a supplemental indenture was executed subordinating the subsidiary's bonds to Northwestern's existing senior debt.

2. The plaintiffs held bonds issued by the subsidiary and asserted in the context of a fraudulent conveyance action that this subordination could not occur absent their consent. The relevant indenture contained TIA Section 316(b) language.

3. The court held that the transactions did not impair the plaintiffs' right to payment because the payment obligations had been assumed by Northwestern and, even though Northwestern ultimately filed for bankruptcy, "there is no guarantee against default." The court also stated that Section 316(b) "applies to the holder's *legal* rights and not to the holder's *practical* rights to the principal and interest itself. Plaintiffs' legal rights were not impaired. Again, there is no guarantee against default." *Id.* at 600.

C. YRC Worldwide Inc. v. Deutsche Bank Trust Co. Americas, No. 10 Civ. 2106 (JWL), 2010 WL 2680336 (D. Kan. July 1, 2010)

1. YRC Worldwide had issued bonds under two indentures and, as part of a restructuring effort, conducted an exchange offer in which holders would exchange their bonds for equity in YRC and consent to indenture amendments to delete, among other things, a bondholder put right and a covenant prohibiting YRC from merging or transferring substantially all of its assets absent assumption of YRC's obligations under the bonds.

2. More than 90% of each class of bondholders accepted the exchange offer and consented to the proposed amendments. The trustees, however, declined to sign the supplemental indentures effecting the amendments on the basis that, under Section 316(b), the deletions required unanimous consent of the holders. YRC sued for declaratory judgment to the contrary.

3. The court held that the trustee was justified in objecting to the deletion of the put right without unanimous consent because the exercise dates in the indenture constituted "due dates" for purposes of Section 316(b) and the

amendment revoked holders' right, upon exercise, to receive the principal amount of and interest on their bonds on or after those due dates.

4. In contrast, the court held that the deletion of the fundamental transactions covenant was proper under Section 316(b) and did not require unanimous consent because YRC's conduct would not affect the holders' legal rights "to receive payment from and to institute suit against" the borrower, "who would remain obligated under the notes and indentures if such a transfer did occur."

D. Marblegate Asset Management, LLC v. Education Management Corp., No. 14 Civ. 8584 (KPF), 2015 WL 3867643 (S.D.N.Y. June 23, 2015)

1. 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 bonds, both issued by its subsidiary Education Management LLC and guaranteed by EDMC. EDMC would lose its entitlement to funds under federal student aid programs available under Title IV of the Higher Education Act of 1965 if it filed for bankruptcy. Thus, EDMC negotiated a restructuring support agreement with its creditors that contemplated two possible out-of-court transactions. If 100% of EDMC's creditors consented, holders of secured debt would receive a combination of cash, new debt and convertible preferred stock, and bondholders would receive convertible preferred 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 ("**EDMC II**") in exchange for new debt and equity to be distributed only to consenting creditors (such transactions, the

"**Intercompany Sale**"). Nonconsenting 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.

2. Because 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 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. After the court denied a preliminary injunction because an adequate remedy existed at law in the form of money damages, EDMC consummated the Intercompany Sale steps other than releasing the EDMC guarantee and provided a new guarantee of the plaintiffs' notes by EDMC II, the combined effect of which was to preserve the status quo in the case of a final ruling in favor of the holdouts.

3. Ruling on the merits, the court held that the restructuring violated Section 316(b) even though there was no modification of an indenture term governing the right to receive interest or principal on a certain date because the practical effect of the transaction was to leave bondholders with no choice but to agree to the modification or receive nothing. The court relied on the fact that the text of what became Section 316(b) initially only provided for the mere right to sue but that the version that was ultimately enacted included the broader right "to receive payment." The court also relied on the testimony and reports relating to the TIA at the time it was being drafted to show "a broad concern with debtors taking advantage of creditors" and the "[e]vasion of judicial scrutiny of the fairness of debt-readjustment plans." *Id.* at * 6, 12.[2]

[2] The decision has been appealed to the Second Circuit and briefing is under way, as of the time of submission of this outline.

E. MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entm't Corp., 80 F. Supp. 3d 507 (S.D.N.Y. 2015)

1. 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, 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.

2. 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. A few months later, CEOC and 172 of its subsidiaries (but not CEC) filed for chapter 11 bankruptcy protection.

3. Sustaining the complaint against a motion to dismiss, the court relied heavily on the logic in *Marblegate Asset Management, LLC v. Education Management Corp.*, 75 F. Supp. 3d 592 (S.D.N.Y. 2014), where the injunction was ultimately denied because an adequate remedy existed at law despite the plaintiffs having shown a likelihood of success on the merits. The court held that the plaintiffs' allegations that the challenged transaction "stripped plaintiffs of the valuable . . . Guarantees leaving them with an empty right to assert a payment default from an insolvent

obligor are sufficient to state a claim under section 316(b)." Caesars, 80 F. Supp. 3d at 517.

F. BOKF, N.A. v. Caesars Entertainment Corp., Nos. 15 Civ. 1561 (SAS) and 15 Civ. 4634 (SAS), 2015 WL 5076785 (S.D.N.Y. Aug. 27, 2015)

1. This action also arises from certain pre-bankruptcy conduct of CEC and CEOC. BOKF, N.A. and UMB Bank are indenture trustees for, respectively, 12.75% second lien notes and first lien notes issued by CEOC and guaranteed by CEC. The governing indentures contain a release provision providing that the CEC guarantee will terminate upon the occurrence of certain events, including when CEOC ceases to be a "wholly owned subsidiary" of CEC. In May and June 2014, CEC sold 5% of CEOC's common stock to certain institutional investors and subsequently authorized CEOC to grant shares of CEOC stock to its directors and officers. CEC asserts that, following the transactions, CEOC was no longer a wholly owned subsidiary and its guarantee was released.

2. After a final decision was rendered in *Marblegate Asset Management, LLC v. Education Management Corp.*, No. 14 Civ. 8584 (KPF), 2015 WL 3867643 (S.D.N.Y. June 23, 2015), the court ruled on the trustees' motions for summary judgment. The court held that in order to prove an "impairment" under Section 316(b), bondholders must show either an amendment to a core term of the indenture or an out-of court debt reorganization. An amendment to a core term of the indenture includes the unilateral adjustment of the amount of principal or interest due or "renegotiating a debt obligation with a majority of noteholders to the detriment of a nonconsenting minority under the same indenture."

3. The transactions challenged did not involve an amendment of a core term of the indentures, and the court found that the trustees had not eliminated questions of fact related to whether the series of transactions "effected a nonconsensual debt restructuring," in particular whether these transactions

were routine deleveraging transactions or "undertaken as part of a plan to accomplish an out-of-court restructuring of all CEOC debt." *Id.* at *11.[3]

G. Phoenix Light SF Ltd. v. Bank of N.Y. Mellon, No. 14 Civ. 10104 (VEC), 2015 U.S. Dist. LEXIS 131206 (S.D.N.Y. Sept. 29, 2015)

1. Plaintiffs were investors in certificates issued by residential mortgage-back securities trusts. Plaintiffs alleged that Bank of New York Mellon, as trustee for the trusts, breached its contractual, fiduciary and statutory duties by failing, among other things, to review mortgage files for completeness and ensuring that document defects were remedied; to provide notice of breaches by the sellers of the loans held by the trusts; to provide accurate monthly reports to certificateholders; and to act prudently following events of default. The trustee's alleged failures caused plaintiffs to incur investment losses of approximately $270 million when several loans with document defects ultimately defaulted.

2. Plaintiffs alleged that their right to receive payment under Section 316(b) was rendered effectively meaningless because they were unable "to receive payment in connection with defective mortgage loans for which BNY Mellon failed to take action to correct." *Id.* at * 29 (citation omitted).

3. The court held that Section 316(b) only applies to a holder's legal right to receive payment, not the holder's ability to receive payment. "Although the Court is not unsympathetic to Plaintiffs' argument that BNYM's behavior hampered certificateholders' ability to receive payments to which they were otherwise entitled, the text of the statute is clear — Section 316(b) does not provide Plaintiffs a cause of action in this case." *Id.* at * 30.

[3] Trial preparation continues, as of the time of submission of this outline, while the court certified certain questions for interlocutory appeal

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