American Bankruptcy Institute

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Decisions, Decisions: Investment Strategy

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CONCURRENT SESSION

2017

Trust Indenture Act

Section 316(b) of the TIA states:

"(b) 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***…"

Issue Presented

Does a debt restructuring violate Section 316(b) of the TIA when the restructuring does not modify any of the explicit payment terms of the Indenture or impair the ability of a bondholder to pursue remedies to received the contractually obligated payments?

Marblegate Asset Management LLC v. Education Management Corp

- EDMC pursued an out-of-court restructuring that was designed to ensure any dissenting bondholder would not receive a payment on its bonds
  - Restructuring provided for an "Exchange Offer" of the bonds for equity so long as 100% of holders elected to participate in exchange
  - If *all* did *not* holders participated in the exchange, the restructuring provided for an "Intercompany Sale", essentially a foreclosure by the lenders, that would not modify the terms of the bonds or the indenture but would leave EDMC with virtually no assets by which to satisfy the bonds
- Marblegate, a bondholder, sued for a preliminary injunction to stop the restructuring asserting violates of Section 316(b) of the TIA.
- SDNY denied the preliminary injunction because Marblegate would not be irreparably harmed since it had adequate remedies at law but did find that it would likely succeed on the merits of its TIA claim but the court also found that Marblegate would likely succeed on the merits of its claims under the TIA.
- EDMC proceeded with the "Intercompany Sale" but refrained from removing the parent guarantee from Marblegate's notes.
- The suit continued after the Intercompany Sale and the District Court found, after an extensive review of the legislative history of the TIA, that the purpose of the TIA was to ensure that minority bondholders would not "be forced to relinquish claims outside of the formal mechanisms of debt restructuring."
- While the Intercompany Sale did not specifically amend the indenture it gave "dissenting bondholders a Hobson's choice: take the common stock, or take nothing." The threat of total deprivation was outside a formal restructuring process (i.e. a bankruptcy), and thus, violated §316(b) .

BOKF, N.A. v. Caesars Entertainment Corp.

- Caesars Entertainment Corp. ("CEC"), the parent to the operating company ("CEOC"), effectuated a series of transactions that removed CEC's guarantees of CEOC's notes. As a result, CEOC's noteholders were left with a worthless claim against an insolvent company while the solvent parent, CEC, was let off the hook.
- The indenture trustee sued CEC after the commencement of CEOC's bankruptcy and argued that the release of the guarantee resulted in a nonconsensual change to payment terms of the indenture, which violated § 316(b) of the TIA.
- The SDNY, largely tracking the reasoning of *Marblegate*, adopted a broad reading of § 316(b) and found 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, such action constitutes an impairment" under section 316(b) of the TIA.
- The District Court, however, denied the noteholders summary judgment because there was a genuine issue of material fact as to whether an out-of-court restructuring occurred that resulted in a violation of § 316(b) of the TIA.
- The case settled before the District Court answered the question of whether a "restructuring" occurred.

Marblegate Reversed -- Second Circuit Adopts Narrow Interpretation of TIA Section 316(b)

- The Second Circuit found that the "Intercompany Sale" at issue in *Marblegate* did not violate the TIA because it left "core" payment terms of the Indenture unchanged.
- The Court held that "Section 316(b) prohibits only non-consensual amendments to an indenture's core payment terms."
- Disregarding the noteholders arguments that a court should look to the practical result of the transaction at question, the Court held that TIA only prevented an issuer from modifying the actual terms of an indenture regarding payment without the consent of all holders.
- Per the Second Circuit, notwithstanding the Intercompany Sale, the noteholders retained their "legal" right to payment and could pursue State and federal remedies if payment was not made in accordance with the terms of the Indenture.
- In reaching this ruling, the Court also examined the TIA's legislative history, which it interpreted as requiring a narrow reading of the statute in contrast to the District Court's broad reading.
- The Court rejected the District Court's interpretation of § 316(b) as unworkable because it would require that courts determine in each case whether a challenged transaction constitutes an "out-of-court debt restructuring . . . designed to eliminate a nonconsenting holder's ability to receive payment."

Key Take Aways

- For Noteholders:
  - Noteholders will continue to retain their State and federal causes of action such as breach of contract claims if the indenture is violated as well as protections under fraudulent conveyance, foreclosure and other state laws protecting creditors and, in the case of insolvent issuers, potential claims against officers and directors for breach of fiduciary duty.
  - Noteholders, however, should be vigilant and monitor issuer and guarantor transactions to ensure that rights are not impinged and when such transactions do occur, the noteholders should take necessary steps to protect their interests.
  - Noteholders can also seek to protect against the type of out-of-court restructuring that occurred in *Marblegate* by requiring the inclusion of specific protective convents in the indenture.
- For Issuers/Debtors:
  - Issuers/Debtors should work with noteholders when "restructuring" transactions are contemplated so as to avoid unnecessary litigation.
  - Issuers/Debtors, however, should still be able to take actions that are reasonable and necessary to protect the company and its assets so long as such transaction do not modify or alter the specific terms payment terms of the indenture.

Hogikyan 6/28/2017

Advising Lenders and Borrowers on Make-Whole Claims in Bankruptcy

Basic Framework

Make-whole obligations are more uncertain in bankruptcy because the Bankruptcy Code adds a layer of additional complexity on top of the typical state law analysis. The concept of a make-whole itself (the lender getting the full benefit of its bargain) is also in tension with some objectives of bankruptcy (fair treatment of all creditors and maximizing recovery; freedom to accept/reject contracts; second chance/opportunity to reorganize). However, as outlined below, bankruptcy does not increase the uncertainty of make-whole obligations all that much.

Since interest rates remain relatively low, refinancing may be particularly attractive for debtors subject to make-wholes. Discussing recent developments on make-wholes is timely.

- There are two basic steps of analysis for make-wholes:
  - 1. Was the make whole triggered? Is it enforceable under state law?
  - 2. Is the valid state law claim enforceable under federal bankruptcy law?
- A contractual make-whole claim in bankruptcy is secured under 506(b). A general "breach of contract" claim to recover the present value of outstanding coupons is an unsecured 502(b) claim.

Debt Document Negotiation Points

The bottom line at this stage is that lenders should be extremely specific that the premium is due upon acceleration for any reason including bankruptcy, and that maturity does not affect the premium obligation. Debtors, on the other hand, should minimize specificity in applicable provisions, especially maturity and acceleration, since the majority view in the case law is that once debt has accelerated a premium is no longer due (unless the contract very specifically says so).

Below is a breakout of key terms to review when negotiating a debt instrument or assessing likelihood that a make-whole will be enforced. The section for each term includes advantageous language for a debtor and a lender.

Definition of Make-Whole

- Pro-debtor: "pre-payment premium"
- Pro-lender: "pre-payment premium" plus specification that maturity does not affect enforceability of pre-payment
  - Alternative: "redemption premium"
    - This is a new untested distinction as of *EFH* in late 2016 and breaks with the prior market standard. The decision on the *Momentive* appeal may split with this distinction. That is particularly significant since *Momentive* is a 2nd Circuit case (which applies to New York), whereas *EFH* is a 3rd Circuit case (which applies to Delaware, New Jersey and Pennsylvania).
      - "Redemption" is a term also generally used only in indentures and notes (not credit agreements).
  - Lenders should also ensure that the yield maintenance formula used to calculate the premium is a reasonable estimate of actual expected damages.
    - E.g., a premium >10% of principal and where lender could not show any actual damages suffered as a result of prepayment disallowed (*In re Schwegmann*)
  - Lenders should avoid calling the premium a penalty.
  - Lenders should include a representation that borrower agrees the premium is a reasonable estimate of actual expected damages suffered from pre-payment.

Hogikyan 6/28/2017

Definition of Maturity

- Pro-debtor: "maturity"
- Pro-lender: fixed date
  - This decreases ambiguity around whether the debt has matured early, for example due to automatic acceleration.

Acceleration

The bottom line here is that *EFH* and *Momentive* agree that acceleration clauses must expressly state that a premium is still due upon acceleration in order for a premium to be valid.

- Pro-debtor: explicitly state that no premium is due upon acceleration due to an event of default.
  - This is likely unrealistic as most debt automatically accelerates upon bankruptcy filing.
- Pro-lender: automatic acceleration upon an event of default or bankruptcy event of default does not affect obligation to pay the Makewhole Premium.
  - This is the strongest type of acceleration clause for make-wholes, and the only one that has been consistently allowed in recent case law.
  - Lenders should use a capitalized definition of the premium to avoid ambiguity (e.g. "Makewhole Premium").
  - Lenders may also wish to expressly state that the make-whole is due upon any unscheduled prepayment whether voluntary or not since some courts interpret lenders who accelerate payment to be giving up their make-whole.
  - Lenders should sufficiently cross-reference between applicable provisions (maturity, premium, acceleration, default) to avoid ambiguity on whether premium is due upon acceleration caused by interaction between provisions.
- Middle ground: silence on whether the premium is due upon an event of default.
  - All other things being equal, this has approximately 50/50 odds.

Rescission

Lenders should be aware that rights of rescission of acceleration are generally invalidated in bankruptcy due to 362(a)'s automatic stay on additional claims against the borrower. This is important because if the debt document does not clearly state that acceleration does not affect obligation to pay the premium, without a valid rescission right, lenders may be unable to recover their premiums.

- In order for a lender's rescission right to survive 362(a), the lender has to show "cause," which is very difficult. The standard a court uses to evaluate whether a lender has "cause" to keep its rescission right is basically whether the harm to the lender caused by maintaining the stay "greatly outweighs" the harm to the debtor of lifting the stay and having to pay the premium.
  - The full "cause" standard is: 1) whether any great prejudice to either side will result from lifting the stay, 2) whether the hardship to the non-bankrupt party by keeping the stay considerably outweighs the hardship to the debtor, 3) the probability of the lender prevailing on the merits.
    - Solvency a big factor here, but even solvent debtors can keep the protection of the stay as occurred in *EFH*.

No-Call

No-call provisions preventing debtors from pre-paying are not specifically enforceable in bankruptcy. However, damages caused by breaching a no-call provision may be recoverable as an unsecured damages claim.

- There is a risk that a court will determine that such a recovery is barred by 502(b)(2)'s prohibition on recovery of unmatured interest. This is a large risk if the debtor is insolvent, and a minor risk if the debtor is solvent.

- If the debtor is insolvent, courts generally do consider such damages barred by 502(b)(2).

Other
- Pro-debtor: maintain a workable level of ambiguity. Ambiguities tend to run in debtor's favor because judges are not supposed to read additional terms into contracts.
  - For example, make whole triggered if notes are "redeemed" or repaid prior to "maturity."
- Pro-lender: include a cumulative remedies provision, which serves as a back-up plan to recover all outstanding coupon payments as an unsecured damages claim.

Navigating Filing & Post-Petition Refinancing

The bottom line in bankruptcy is that the debt document controls. If the links between filing, automatic acceleration, maturity and premium payment are watertight, filing will generally not protect a debtor from paying the make-whole. But if the debtor can introduce sufficient ambiguity, or the links are not watertight to begin with, then triggering automatic acceleration by filing for bankruptcy may be a way to avoid paying the make-whole.

Debtors may also benefit from results-oriented judgements, in other words, courts backing into conclusions in order to reach a certain overall outcome for all creditors. Lenders should be aware of this potential risk when pursuing make-whole claims after filing.

Solvency of the debtor is key. The balance sheet determines solvency in bankruptcy court. If the debtor is solvent, a bankruptcy court generally cannot redistribute rights to payments, so a valid contractual make-whole claim is likely to be honored. But if the debtor is insolvent, the make-whole is generally not enforced, unless the lender can show that the unfairness to the lender greatly outweighs the unfairness to the debtor of enforcing the make-whole. In this situation, a lender seeking a make-whole should be prepared to show the evidence in court of its actual damages.

The closer the debtor gets to insolvency, the greater likelihood that the fairness considerations of bankruptcy will start to influence recovery on a make-whole. Additionally, if enforcing the make-whole will prevent reorganization, it will generally not be enforced.

Proactive Steps for Lenders When Debtor is Headed for Filing
- Lenders considering accelerating the debt should do so pre-bankruptcy to increase control over recovery. Waiting until after filing increases three risks:
  - Risk that the premium is held to be unmatured interest since at time of filing the premium was not due.
  - Risk of premium being held a penalty that just punishes debtor and junior creditors for filing instead of redressing lender's losses.
  - Risk debtor becomes insolvent which significantly decreases probability that court will allow recovery for a make-whole.
- Lenders should review other provisions to identify additional avenues to seek equivalent value to the make-whole in damages (e.g. specific performance, cumulative remedies provision).

General Defenses for Debtors against Make-Whole Claims
- 502(b)(2): Debtors can argue that the claim is barred by 502(b)(2)'s prohibition on claims for unmatured interest.
- No valid state law claim: Debtors can argue that the claim is grossly disproportionate to actual damages suffered and therefore unenforceable under state law because it is a penalty.
- No valid state law claim: Debtors can argue that the make-whole has not been triggered based on the language of the contract.

Refinancing

- Debtors should understand that filing bankruptcy to trigger an automatic acceleration can be a way to avoid a make-whole payment, but only if the debt document says so. Bankruptcy is not automatic protection against the make-whole.
  - EFH tried to avoid a $431M make-whole by filing bankruptcy and triggering automatic acceleration. However, filing was held in the 3rd Circuit to be an Optional Redemption, which meant that even though the automatic acceleration triggered maturity of the debt, EFH was still contractually obligated to pay the make-whole because maturity does not affect redemption.
  - Besides *EFH*, however, if the debt document does not specify that a make-whole is still due after automatic acceleration in bankruptcy, courts do not enforce make-wholes. But again, that is really just dependent on the words of the contract and not on bankruptcy.

Mitigating Damages

- Lenders do not have to mitigate damages on make-whole claims (unlike many other creditors in bankruptcy).

General "Breach of Contract" Claims in Bankruptcy

- A claim for breaching another provision of the debt document such as a no-call is a promising avenue for lenders to recover the equivalent of a make-whole premium as an unsecured claim for damages. The keys for success with this strategy are an enforceable no-call provision, a cumulative remedies provision (which is market) and a solvent debtor.
  - A lender can generally recover the present value difference between the market interest rate and contract interest rate. This is calculated as of the time the debt was pre-paid.

Conclusions

Bankruptcy does not substantially affect contractual make-whole obligations. The value of a make-whole is really set at the drafting stage. Bankruptcy Code generally only overrides make-whole obligations in a few places: on rescission of acceleration rights, upon insolvency of the debtor, and certain post-filing actions.

- *EFH* may increase the value of make-wholes to lenders. It introduces a possible strategy for further solidifying a make-whole obligation in the event of automatic acceleration. It holds that where a make-whole is called a "redemption premium," absent contractual language stating otherwise, the premium is due regardless of acceleration or maturity. However, the significance of this decision is likely overstated right now. First, *EFH* is a 3rd Circuit decision, so it is controlling in Delaware but not New York. Second, many recent precedents including the most recent 2nd Circuit decision on this topic treat "redemption" premiums no differently than regular "pre-payment" premiums. The 2nd circuit case is on appeal, so investors should check its outcome to remain up-to-date.

Evaluation of any debt document should include reference to precedent in the controlling jurisdiction. This summary focuses primarily on 2nd and 3rd Circuit appellate and district court level case law.