Simpson Thacher

Memorandum

Two SDNY Decisions Hold that the Termination of a Parent Guarantee in an Out-of-Court Restructuring Violates Section 316(b) of the Trust Indenture Act

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Introduction

In a pair of recent decisions, the courts in the Southern District of New York held that the transactions eliminating parent guarantees in connection with out-of-court restructurings were impermissible under Section 316(b) of the Trust Indenture Act of 1939, as amended ("**TIA**") because the elimination of such guarantees impaired the nonconsenting noteholders' right to receive payment. The first decision, *Marblegate Asset Management et al. v. Education Management Corp.*, -- F. Supp. 3d --, No. 14 Civ. 8584, 2014 WL 7399041 (S.D.N.Y. Dec. 30, 2014) ("**Marblegate**"), was issued on December 30, 2014 and the second decision, *Meehancombs Global Opportunities Funds, L.P., et al. v. Caesars Entertainment Corp., et al.*, -- F. Supp. 3d --, No. 14 Civ. 7091 (SAS) (S.D.N.Y. Jan. 15, 2015) ("**Caesars**"), was issued on January 15, 2015.

Background

In *Marblegate*, the dispute related to an out-of-court restructuring of Education Management LLC ("**EM**") that had $1.553 billion of debt outstanding, consisting of $1.305 billion in secured credit agreement debt and $217 million of unsecured notes due in 2018 (the "**Notes**"). The Notes were guaranteed by Education Management Corp. ("**EDMC**"), the parent of EM (the "**EDMC Parent Guarantee**"). The indenture for the Notes provided that the EDMC Parent Guarantee could be released if a majority of the noteholders consented or if the secured creditors released EMDC's guarantee of the secured credit agreement, which guarantee was granted during the course of the restructuring negotiations, some months after the Notes had been issued.

Facing financial distress, EDMC negotiated with creditors and entered into a Restructuring Support Agreement pursuant to which a consensual restructuring would occur if it was supported by 100% of the creditors. As only holders of 90% of the Notes and 99% of the debt under the secured credit agreement consented, the parties supporting the restructuring were obligated to enter into an alternate restructuring to be effectuated through three transactions: (a) the secured lenders would release their recently issued guarantee of the secured credit agreement, thereby triggering the release of the EDMC Parent Guarantee of the Notes[1]; (b) the secured lenders would foreclose on substantially all of the assets of EDMC and its subsidiaries; and (c) the secured lenders would immediately convey the foreclosed-upon assets back to a new subsidiary of EDMC, which would distribute new debt and equity to the consenting creditors. Under the terms of this out-of-court restructuring, non-consenting creditors would not receive a distribution and would be left with claims against the original issuer, which would have no material assets by virtue of the foreclosure and asset transfer, and no claim against EDMC by virtue of the release of the EDMC Parent Guarantee. The plaintiff noteholders sought a preliminary injunction to block the proposed restructuring.

In *Caesars*, the dispute can be traced back to the 2008 leveraged buyout of Caesars in connection with which Caesars Entertainment Operating Company, Inc. ("**CEOC**") issued $750 million of notes due in 2017 and $750 million of notes due in 2016 (collectively, the "**CEOC Notes**"). The CEOC Notes originally were supported by a payment guarantee issued by Caesars Entertainment Corporation ("**CEC**"), the publicly-traded parent company of CEOC (the "**CEC Parent Guarantee**"). In August 2014, through a supplement to the CEOC indenture, a majority of the noteholders were bought out at par plus accrued interest and fees and costs, which the opinion states was a price representing a 100% premium over market, and consented to (a) support any future restructuring of CEC and CEOC, (b) the removal and termination of the CEC Parent Guarantee, and (c) the modification of 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 (the "**2014 Amendment**"). Certain noteholders who did not consent to the 2014 Amendment filed suit against CEOC and CEC alleging that the 2014 Amendment violated the TIA and breached the indentures and the implied covenant of good faith and fair dealing.

Analysis

In Marblegate, the court's opinion related to a motion for a preliminary injunction, requiring the court to analyze whether the plaintiffs had satisfied the standard to obtain a preliminary injunction, which includes plaintiffs establishing (i) a likelihood of irreparable harm, (ii) a balance of the equities tipping in the plaintiffs' favor, (iii) a public interest favoring an injunction, and (iv) a likelihood of success on the merits (or sufficiently serious questions as to the merits plus a balance of hardships that tips decidedly in plaintiffs' favor). After concluding that the plaintiffs failed to meet the first three prongs of the preliminary injunction analysis, the court nevertheless went on to state that it believed that the plaintiffs were likely to succeed on the merits because of the issuer's violation of the TIA's protections for nonconsensual debt restructurings.

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1 Under the terms of the indenture governing the Notes, the EDMC Parent Guarantee may also have been subject to release or waiver by virtue of consents obtained from holders of a majority of the outstanding Notes.

The court began its analysis of the merits of plaintiffs' claims by reviewing Section 316(b) of the TIA, which provides, in relevant part:

> 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 . . . .

The court reviewed the legislative history and the statutory purpose of Section 316(b) of the TIA and rejected the defendants' view that Section 316(b) "is limited to preventing formal majority modification of an indenture's payment term". The court stated that the applicable standard was as follows: "[p]ractical and formal modifications of indentures that do not explicitly alter a core term 'impair[] or affect[]' a bondholder's right to receive payment in violation of the Trust Indenture Act only when such modifications effect an involuntary debt restructuring." Under this standard, a majority of noteholders could still amend "a significant range of indenture terms, including many that can be used to pressure bondholders into accepting exchange offers." However, in the court's view, which might be characterized as dicta given the court's conclusion that the other prerequisites for injunctive relief were not met, the termination of the EDMC Parent Guarantee, coupled with the foreclosure and immediate transfer of the assets back to the issuer, likely violated the TIA. The court did not define what constitutes a "core term" for purposes of its analysis.

In *Caesars*, the court stated that pursuant to Section 316(b) of the TIA, "a company cannot—outside of bankruptcy—alter its obligation to pay bonds without the consent of each bondholder." CEC argued in its motion to dismiss the complaint, which is the subject of the *Caesars* opinion, that CEOC was not in payment default and that the TIA only protected a noteholder's legal right to receive payment.

The court disagreed and rejected the "narrow reading" of the TIA advanced by CEC and instead concluded that "it is possible for a right to receive payment to be impaired prior to the time payment is due." Noting that there is little case law on the point, the court favorably cited the reasoning in *Marblegate* and *Federated Strategic Income Fund v. Mechala Grp. Jam. Ltd.*, No. 99 Civ. 10517, 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999) and rejected CEC's attempt to "gut the [TIA's] protections through a transaction such as the one at issue here." The court held that the stripping away of the valuable CEC Parent Guarantees, which left the plaintiffs with an empty right to assert a payment default against an insolvent issuer, was sufficient to state a claim under Section 316(b) of the TIA. The court also took note of the fact that CEOC would be filing for Chapter 11 relief shortly, and thus the stripping away of the noteholders' guarantee claim against a solvent guarantor was "exactly what TIA section 316(b) is designed to prevent." The court concluded that, as alleged in the complaint, the removal of the CEC Parent Guarantees was an impermissible out-of-court restructuring achieved through collective action in violation of Section 316(b) of the TIA.

Conclusion

The *Marblegate* and *Caesars* opinions are important decisions as they may limit some of the means by which an issuer and the majority of its noteholders may seek to effectuate non-consensual out-of-court restructurings. While the *Marblegate* opinion supports the ability of noteholders to consent to certain indenture amendments including covenant modifications, these decisions are important reminders that care must be taken in structuring consent solicitations and transactions that could be characterized as out-of-court reorganizations or restructurings to ensure that the "core terms" of debt securities subject to the protections of the TIA, including the right to receive payment, are not impaired. Parties should monitor the issue as it continues to develop in the courts.

You can download a copy of the *Marblegate* opinion by clicking here and the Caesars opinion by clicking here.

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