The Implication of Recent Court Decisions for Issuers of Debt Securities

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Introduction

The oil and gas sector is highly capital-intensive. Much of that capital is raised in the public debt market. The oil and gas sector is by far the largest issuer of high-yield debt securities. Consequently, legal developments in the public debt markets are of particular concern for oil and gas companies. Recent court decisions regarding two different legal issues have created significant uncertainty for debt issuers and have increased the legal risk of issuing such debt. As described below, one of these issues has recently been resolved in favor of re-introducing stability to the market. The other issue appears to have become a new permanent obstacle for issuers.

Marblegate: Ability of Bondholders to Challenge Out-of-Court Debt Restructurings

The precipitous 70% decline in oil prices beginning in 2014 triggered significant financial distress in the oil and gas sector. Declining borrowing bases and breaches of financial covenants led oil and gas companies to seek amendments, waivers and restructuring of their debt. Hundreds of companies in the sector were driven into bankruptcy, while others sought to restructure their debt outside of bankruptcy.

In the case of registered debt, the ability of issuers to restructure their debt out-of-court is subject to Section 316(b) of the Trust Indenture Act (the "TIA"), which provides that:

> "Notwithstanding any other provision of the indenture . . . 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…."

Out-of-court debt restructuring negotiations by dozens of oil and gas companies undertaken in response to the oil price decline were suddenly and unexpectedly made much more uncertain by the decision on June 2014 in *Marblegate Asset Management, LLC v. Education Management Finance Corp.*[1] ("Marblegate") by the U.S. District Court for the Second Circuit (the "District Court"). The Marblegate decision unsettled how the legal bar and debt markets interpreted Section 316(b) for decades. Fortunately, this decision was reversed on January 17, 2017 by the U.S. Court of Appeals for the Second Circuit (the "Appeals Court")[2].

Education Management Corporation ("EDMC") was a for-profit educational company that relied heavily upon federally funded student loans. In 2014, EDMC faced significant financial difficulty. A debt restructuring in bankruptcy would terminate its ability to enroll federally funded students, making any such restructuring financially impossible. Consequently, it sought a voluntary debt restructuring with its creditors – a bank group holding approximately $1.3 billion of secured debt, and bondholders holding approximately $217 million of unsecured bonds. The debt was issued by two of EDMC's subsidiaries (the "EDMC Borrowers"). The debt was guaranteed by EDMC, but the guarantee of the unsecured bonds was contingent upon the guarantee of the secured debt. That is, a release of the guarantee by the secured creditors would automatically release the guarantee of the unsecured bonds.

[1] *Marblegate Asset Management v. Education Management Corp*., 75 F. Supp. 3d 592 (S.D.N.Y. 2014); *Marblegate Asset Management v. Education Management Corp*., 111 F. Supp. 3d 542 (S.D.N.Y. 2015).
[2] *Marblegate Asset Management v. Education Management Corp*., 75 F. Supp. 3d 592 (S.D.N.Y. 2014).

An *ad hoc* creditors' committee of EDMC proposed two alternative restructurings:

- Unanimous Consent Structure. Subject to the consent of all lenders and bondholders, lenders would receive new secured debt and equity of the EDMC Borrowers and the bondholders would receive only equity of the EDMC Borrowers.
- Alternative Structure. This structure would be implemented if EDMC failed to obtain unanimous consent from all creditors to the first structure. Under this structure, (i) the secured debt guarantee would be released, thus terminating EDMC's guarantee of the unsecured bonds and (ii) the secured lenders would foreclose on the assets and immediately sell all the assets of the EDMC Borrowers to a newly created EDMC subsidiary ("Newco"). Consenting creditors would receive new debt and equity of Newco, but non-consenting creditors would be left with their existing debt (including their legal right to the payment of principal and interest on the debt), which would now be owed by a shell obligor and would not benefit from an EDMC guarantee.

It should be noted that although majority consent was obtained for the second restructuring alternative out of an abundance of caution, the terms of the indenture did not require bondholder consent for such restructuring transactions. That is, the release of the EDMC guarantee and the foreclosure on the proposed restructuring were explicitly permitted by the indenture without any amendment for waiver.

EDMC failed to obtain unanimous consent for the fist structure and the second restructuring alternative was implemented. Only Marblegate Asset Management, LLC and its affiliate (collectively, "Marblegate"), holders of less than 10% of the unsecured bonds, did not consent to the first structure. Moreover, Marblegate filed suit to enjoin the "alternative structure" on the grounds that it violated Section 316(b) of the TIA.

The District Court concluded that EDMC could not release its guarantee because to do so would violate Section 316(b) of the TIA. According to the District Court, the TIA's legislative history indicated a desire to protect dissenting minority debt holders' rights by favoring debt restructurings in bankruptcy. In keeping with this policy interpretation, the District Court concluded that Section 316(b) broadly protected a bondholder's "practical" right to receive principal and interest, not just the "legal" right. It stated that "where ***a debt reorganization*** that seeks to involuntary disinherit the dissenting minority is brought about by a majority vote, that violates the fundamental purpose of the Trust Indenture Act." [emphasis ours] The court further stated that: "Practical 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***." [emphasis ours]

However, the District Court failed to explain what constitutes a "debt reorganization" or "debt reorganization."

Perhaps smelling blood in the water, within weeks of the Marblegate decision, minority bondholders sought injunctions to other restructuring transactions. In a case with fairly similar facts to Marblegate, in *Meehancombs Global Credit Opportunity Funds L.P. v. Caesar's Entertainment Corp.*,[3] the District Court again halted the implementation of a majority-approved bond restructuring. The court stated that Section 316(b) protects the "substantive/practical right" to repayment, and any revision which left the plaintiff with a "worthless" legal right to payment

[3] *Meehancombs Global Credit Opportunity Funds, L.P. v. Caesars Entertainment Corp*., 80 F. Supp. 3d 507 (S.D.N.Y. 2015).

as part of an "out-of-court debt restructuring" was prohibited. No further helpful explanation was forthcoming in the Court's next decision in *BOKF, N.A. v. Caesars Entertainment Corp*. on August 27, 2015[4]. There, the Court added further confusion by stating that whether an impairment has occurred must be evaluated as of the date the payment becomes due. Therefore, issuers and their lawyers must make a factual determination as to the probability of a consequence that may be years in the future.

Class-action law firms lined up as further lawsuits were filed in favor of minority dissenting bondholders[5]. Law firms pondered how to give clean opinions that bond amendments or refinancings did not violate the TIA. Issuers found it much harder to reach agreement on restructuring terms with creditors as creditors flexed their new-found bargaining strength. Trustees were uncertain if they would face liability for signing amendments that appeared to be specifically permitted by the governing indentures, but were being entered into in order to permit a transaction which could arguably be deemed to impair the noteholders' practical right to payment on their notes at some point in the future. Some issuers sought to avoid the application of Section 316(b) by issuing bonds on a 144A-for-life basis, which are not subject to the TIA.

EDMC appealed the District Court's decision to the Appeals Court. On January 17, 2017, the Appeals Court overturned the District Court's decision, stating that Section 316(b) protects "only non-consensual amendments to an indenture's core payment terms," which are limited to the "amount of payment and interest owed and the date of maturity." The Appeals Court further concluded that Section 316(b) applied to only "formal" amendments to an indenture affecting the

[4] *BOKF, N.A. v. Caesars Entertainment Corp*., 144 F. Supp. 3d. 459 (S.D.N.Y. 2015)
[5] *See: Waxman v. Cliffs Natural Resources, Inc*., No. 16-CV-1899 (S.D.N.Y. 2016); *In re Vanguard National Resources, Bondholder Litigation*, No. 16-CV-01578 (S.D.N.Y. 2016).

“right . . . to receive payment” rather than preventing other corporate actions that might “impair a bondholder’s practical ability to recover payment.”

The Appeals Court reached these conclusions by a review of the legislative history of the TIA and reports by the Securities and Exchange Commission regarding the TIA. Based upon this analysis, the court concluded that Section 316(b) protects only the ***legal*** right to payment, and therefore forbids only amendments to core payment terms without unanimous consent. The decision was also heavily influenced by the uncertainty introduced by the District Court. The Appeals Court stated that the “broad reading of the term ‘right’ as involving the practical ability to collect payment leads to both improbable results and interpretive problems.” For example, the Appeals Court pointed to the uncertainty of what degree of “impairment” would be required by such an interpretation. Second, the TIA’s protection of a noteholder’s right to institute suit for payment would be rendered “superfluous” by such a reading. Third, the Appeals Court noted that such an “interpretation thus turns on the subjective intent of the issuer or majority bondholders” to engage in a “debt restructuring,” whatever that means.

Although the Second Circuit has overturned the Marblegate line of cases, several important considerations should be kept in mind. First, it is possible that the Marblegate case could be appealed for *certiorari* to the U.S. Supreme Court. Second, courts in other circuits are not bound to follow the Second Circuit’s decisions, and could therefore follow the reasoning of the Second Circuit District Court. Third, bondholders may be emboldened by these cases to try to negotiate additional “core terms” that require unanimity to amend. Similar to the amendment provisions in most credit agreements, parties are free to agree by contract that amendments to additional provisions in the indenture must be subject to unanimous consent and/or a threshold higher than a bare majority. Fourth, issuers should be aware that the Appeals Court’s decision will not render valid all restructurings or amendments just because they comply with the traditional understanding of Section 316(b). Such restructurings must also be undertaken in compliance with the state law's concepts of fraudulent conveyance and successor liability. Finally, it is interesting to note that even the Appeals Court found the phrase "right to receive payment" ambiguous, as it lends itself to interpretations that favor each side of the issue. For that reason, in non-TIA-governed indentures, issuers may want to clarify that unanimous consent is required for any amendment that impairs or affects the ***legal*** right of any holder to receive payment.

<u>Following the *Cash America* Decision, Investors Resist Efforts by Issuers to Include "No Premium on Default" Language in Indentures</u>.

In September 2016, the U.S. District Court for the Southern District of New York held in *Wilmington Savings Fund Society, FSB v. Cash America International, Inc.*[6] that, following a default resulting from the voluntary actions of the issuer, noteholders were entitled to sue for specific performance to enforce the indenture's optional redemption provisions in order to receive not only principal and accrued interest, but also the make-whole redemption premium on their notes. The Court found that Cash America had breached a covenant in its indenture that prohibited Cash America from selling or disposing of any of its properties when it spun off to its shareholders 80% of the shares of one of its subsidiaries. Prior to this decision, it was widely believed that the primary remedy for noteholders upon an event of default was for noteholders to accelerate the maturity of the notes, at which time the principal and interest on the notes (but not any redemption

[6] Case No. 15-cv-5027 (JMF), 2016 WL 5092594, 2016 BL 30797 (S.D.N.Y. Sept. 19, 2016).

premium) would be immediately due and payable. The reasons for this widely held belief were twofold.

First, except for sinking fund or other mandatory redemption obligations, redemption provisions in indentures are an option or right of the issuer (not the noteholders or the trustee) to redeem or prepay the notes prior to maturity at a specified price. This optional redemption right provides the issuer with the ability to prepay the notes if and when it chooses and, in return, the noteholders receive a premium (either a make-whole or a fixed percentage above par as specified in the indenture) designed to compensate the noteholders for the loss of the future stream of interest payments that they had expected to receive on the redeemed notes.

Second, the traditional language in indentures provides that, upon an event of default, the trustee or the holders representing at least 25% of the outstanding principal amount of the notes may accelerate the notes, at which time "the principal of, and accrued interest on" the notes become immediately due and payable. In some indentures, the acceleration provisions provide that upon acceleration "the principal of, *premium, if any*, and accrued interest" on the notes becomes immediately due and payable. However, unless the issuer has either called the notes for redemption or is obligated to make an offer to repurchase the notes at 101% due to the occurrence of a change-of-control event, the "premium, if any" language is not applicable in connection with an acceleration because at the time of acceleration no premium on the notes is then due. Presumably, if investors expected or demanded that noteholders receive a make-whole or other redemption premium upon an event of default, the acceleration provisions in the indenture would have been explicit in providing that the redemption premium that would be payable on the notes if the notes were redeemed by the issuer is payable upon acceleration in addition to principal and interest.[7]

The Court in *Cash America*, however, focused on the fact that under the indenture, the trustee's and the noteholders' right to accelerate the notes was "explicitly permissive and not exclusive of other remedies" and that the indenture specifically authorized the trustee to seek the remedy of specific performance of any provision of the indenture.[8] While acknowledging Cash America's argument that the redemption provisions of the indenture state that only Cash America may redeem the notes prior to maturity, the Court nonetheless concluded that since Cash America's default "was not due to bankruptcy, but to the company's voluntary actions," the trustee was entitled to seek enforcement of the redemption provisions of the indenture and payment of the make-whole premium.

The decision in *Cash America* was not unprecedented. Beginning with the Second Circuit U.S. Court of Appeals' decision in *Sharon Steel*[9] in 1982, a few courts have held that noteholders were entitled to receive the redemption premium in addition to principal and interest following the issuer's default under the indenture. However, either due to the explicit wording of these decisions or the egregious facts of the case demonstrating the issuer's obvious bad faith, these decisions were generally viewed by many practitioners as only applying in instances where the issuer

[7] Interestingly, the Court in *Cash America* took the exact opposite approach explaining that Cash America could have made acceleration the exclusive remedy or bar other remedies, such as specific performance, under the indenture following an event of default, but it didn't.

[8] The relevant language from the *Cash America* indenture that the Court cited is the traditional language found in most indentures. Section 6.13 of the indenture read "No right or remedy conferred or reserved to the Trustee or to the Holders under this Indenture is intended to be exclusive of any other right or remedy." Section 6.03 "*Other Remedies*" of the indenture explicitly authorized the trustee to pursue "any available remedy by proceeding at law or in equity… to enforce the performance of any provision of the Notes or the Indenture."

[9] *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d. 1039 (2d Cir. 1982). The Court in *Cash America* based its holding primarily on the *Sharon Steel* precedent.

intentionally breached the indenture covenants with the design of triggering acceleration to take out the notes at par and thereby avoid the more expensive alternative of redeeming the notes and paying the related redemption premium.[10]

What was noteworthy about the *Cash America* decision was that the Court expressly stated that its ruling was not based upon any finding that the issuer acted in bad faith or that the subjective intent of the issuer was to circumvent the prepayment provisions of the indenture and avoid paying the redemption premium.[11] Instead, the Court stated that its holding was based solely on the fact that the default resulted from the issuer's voluntary actions (the spin-off of the subsidiary) versus involuntary actions (the Court giving examples such as bankruptcy or inability to make debt-service payments). Since the *Cash America* decision, the Third Circuit Court of Appeals, in *In Re Energy Future Holdings Corp*.,[12] held that an issuer that voluntarily filed for bankruptcy could not avoid paying the make-whole premium upon a post-filing refinancing of the notes.[13] As in Cash America, the Third Circuit did not consider the issuer's bad faith or subjective intent, but rather focused on the voluntary or optional nature of the issuer's actions.

[10] See, e.g. *In re Granite Broadcasting Corp*., 369 B.R. 120, 144 (Bankr. S.D.N.Y. 2007), describing Sharon Steel as applicable to "an intentional default by a borrower, with the intention of forcing acceleration."

[11] The Court stated: "And even if this Court were writing on a blank slate, it would be reluctant to introduce the issue of subjective intent into the analysis, given the inherent difficulty of deciphering the 'intent' of a company and the fact that contract remedies are generally designed to compensate the non-breaching party, not punish the breaching party for bad intent."

[12] *In Re Energy Future Holdings Corp*., No. 16-1351 (3d. Cir. Nov. 17, 2016).

[13] Energy Future Intermediate Holding Company LLC, the issuer, had disclosed in securities filings its proposal to voluntarily file for bankruptcy and refinance its outstanding notes without paying the make-whole premium that would be due in a refinancing outside of bankruptcy.

In response to the Cash America decision, beginning in the fall of 2016, a number of issuers began inserting specific language into their indentures providing that a redemption premium would not be payable upon an event of default.[14] The following is an example of the language:

> "For the avoidance of doubt and notwithstanding any other provision of this Indenture or the Notes, the Holders shall not be entitled to specific performance of the optional redemption provisions applicable to any Notes described in [the Optional Redemption Section], and no premium will be due or available as a remedy, in each case in connection with (i) any default or Event of Default, (ii) any acceleration of the Notes or (iii) any other payment, distribution, satisfaction or other recovery in respect of any Notes."

However, in November 2016, Covenant Review, a covenant review service geared toward buy-side investors, published a research article entitled "Beware of Language That Deprives Bondholders of the Payment Premium upon a Covenant Breach" in which it stated regarding the new "no premium upon a default" language appearing in a few offering documents, "we cannot state strongly enough how opposed we are to these types of provisions" and characterized the new language as a "radical change." On January 11, 2017, Covenant Review followed up its earlier warning with an article entitled "The End of Covenants: The 'No Premium on Default' Language is Spreading Like Wildfire – Your Future Covenant Enforcement is Being Destroyed" in which it stated that "now we are at a crisis – as of today we know of 18 deals that have been marketed with new language that works basically to 'opt-out' of the Court's ruling. This terrible language will vastly embolden issuers to consider breaching covenants… Investors must rapidly fight this." But

[14] See e.g., indentures for (i) CF Industries' 3.400% Senior Secured Notes due 2021, (ii) Communications Sales & Leasing's 7.125% Senior Notes due 2024; (iii) EP Energy's 8% Senior Secured Notes due 2024, (iii) American Honda Finance Corp.'s 0.75% Medium-Term Notes, Series A, due 2024, (iv) Nike Inc.'s 2.375% Notes due 2026, (v) Rackspace Hosting's 8.625% Senior Notes due 2024, (vi) The Service Master Company's 5.125% Senior Notes due 2024 and (vii) Toyota Motor Credit Corp.'s 1.7% Medium-Term Notes, Series B, due 2019.

in that article, Covenant Review also indicated that the tide was beginning to turn and investors were starting to push back on the inclusion of the "no premium upon a default" language, "But, good news! Bondholders have scored the first official victory with the elimination of this language from the Novolex deal, and as of the publication of this report we have multiple sources conveying that the language is being removed from Broadcom, Fibria, GM and Raizen." Finally, in another article published five days later on January 23, 2017 entitled "War on Covenants: Kramer Levin Sets the Trap We Predicted Law Firms Would Try Next – Just Say No!" Covenant Review proudly noted "The good guys are winning the War on Covenants. In the week before last, after we put out our alert, all five deals being marketed had to pull the offending provisions. The provision was even pulled from one deal that had already been priced. Last week, the provision disappeared entirely. None of the deals marketed last week included any version of the 'no premium on a default' language." On March 18, 2017, Covenant Review confirmed that since the publication of their article they were not aware of any further notes offering marketed with the "no premium upon default" language. Thus, while a few issuers were able to include the "no premium upon a default" language in the first few months following the *Cash America* decision, it appears that the "war on covenants" is over as issuers are no longer willing to try to include the language and take on the execution and pricing risk it would entail.

Issuers of capital markets debt securities and their counsel frequently struggle with the question of whether or not a proposed transaction or undertaking would comply with the covenants in their indentures. This struggle is due to the fact that the language in indenture covenants and related definitions is often ambiguous (sometimes intentionally) or, in some cases, drafted poorly or, when drafted, was not intended to apply to the particular situation at hand but nonetheless is arguably applicable. As a result, indenture compliance issues often involve a significant amount of judgment. The most obvious example is the customary language found in the merger covenant and the definition of change of control as to whether the sale or disposition of certain assets by the issuer involves the sale of "substantially all of the assets of the issuer and its subsidiaries taken as a whole." By excluding any consideration of bad faith or the subjective intent of the issuer and focusing exclusively on whether the default resulted from the issuer's voluntary actions, the Court in *Cash America* may have increased the risk of litigation for issuers and the cost of obtaining waivers or consents since the reward for noteholders challenging any questionable transaction now includes a redemption premium, in addition to principal and interest, even if the issuer has a good faith argument as to why its actions did not breach any of the indenture covenants. Accordingly, absent the inclusion of any "no premium upon a default" language in an indenture, the *Cash America* decision has increased the potential damages an issuer may have to pay if a court disagrees with the issuer's position that its actions did not breach the indenture's covenants.