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EDITOR'S NOTE: THE NEW YEAR
Victoria Prussen Spears

DEALING WITH BONDHOLDERS IN TROUBLED TIMES
Daryl B. Robertson, W. Lake Taylor, Jr., William H. McBride, and Nic O'Brien

FINANCING YOUR WAY OUT OF A PANDEMIC: HOW TWO AIRPORT COMPANIES RESTRUCTURED THEIR DEBT TO WITHSTAND AN ECONOMIC CRISIS
John R. Ablan and Douglas A. Doetsch

DEED IN A BOX: AN ADVANTAGEOUS LOAN WORKOUT METHOD IN THE TIME OF THE COVID-19 PANDEMIC
Rebecca Eschen

THE PROTECTING EMPLOYEES AND RETIREES IN BUSINESS BANKRUPTCIES ACT OF 2020: A SIGN OF THE TIMES
Shmuel Vasser and Eric Hilmo

SECOND CIRCUIT RULES THAT PROVISIONS IN LEHMAN CDOS SETTING PAYMENT PRIORITIES ARE PROTECTED BY SAFE HARBOR
Carmine D. Boccuzzi Jr., Lisa M. Schweitzer, Sean A. O'Neal, Emily J. Balter, and Brandon M. Hammer

THIRD CIRCUIT DECISION PROVIDES NEW GUIDANCE ON THE UNFAIR DISCRIMINATION STANDARD OF CRAMDOWN AND THE ENFORCEMENT OF SUBORDINATION AGREEMENTS WHEN CONFIRMING CRAMDOWN PLANS
Ronit J. Berkovich and Theodore S. Heckel

ELEVENTH CIRCUIT DEEPENS SPLIT ON STANDING IN FDCPA CASES
Jessica E. Salisbury-Copper, Scott A. King, and Joe Barton

COAL ACT PREMIUMS ARE NONDISCHARGEABLE TAXES RATHER THAN DISCHARGEABLE CLAIMS
Shmuel Vasser and Casey Norman

HOUSTON BANKRUPTCY COURT DETERMINES THAT A MAKE-WHOLE CLAIM IS NOT DISALLOWED BY THE BANKRUPTCY CODE AND THE SOLVENT DEBTOR EXCEPTION STILL EXISTS UNDER THE BANKRUPTCY CODE
Jim Prince, Luke A. Weedon, and Fareed Kaisani

THE ADVANTAGES OF "DIRECT DEBT" SECURITIZATION STRUCTURES
Jim Cotins and Matt Lyons

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Editor's Note: The New Year
Victoria Prussen Spears 1

Dealing with Bondholders in Troubled Times
Daryl B. Robertson, W. Lake Taylor, Jr., William H. McBride,
and Nic O'Brien 4

Financing Your Way Out of a Pandemic: How Two Airport Companies Restructured Their Debt to Withstand an Economic Crisis
John R. Ablan and Douglas A. Doetsch 10

Deed in a Box: An Advantageous Loan Workout Method in the Time of the COVID-19 Pandemic
Rebecca Eschen 14

The Protecting Employees and Retirees in Business Bankruptcies Act of 2020: A Sign of the Times
Shmuel Vasser and Eric Hilmo 18

Second Circuit Rules That Provisions in Lehman CDOs Setting Payment Priorities Are Protected by Safe Harbor
Carmine D. Boccuzzi Jr., Lisa M. Schweitzer, Sean A. O'Neal, Emily J. Balter,
and Brandon M. Hammer 23

Third Circuit Decision Provides New Guidance on the Unfair Discrimination Standard of Cramdown and the Enforcement of Subordination Agreements When Confirming Cramdown Plans
Ronit J. Berkovich and Theodore S. Heckel 30

Eleventh Circuit Deepens Split on Standing in FDCPA Cases
Jessica E. Salisbury-Copper, Scott A. King, and Joe Barton 36

Coal Act Premiums Are Nondischargeable Taxes Rather Than Dischargeable Claims
Shmuel Vasser and Casey Norman 39

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Houston Bankruptcy Court Determines That a Make-Whole Claim Is Not Disallowed by the Bankruptcy Code and the Solvent Debtor Exception Still Exists Under the Bankruptcy Code
Jim Prince, Luke A. Weedon, and Fareed Kaisani 42

The Advantages of "Direct Debt" Securitization Structures
Jim Cotins and Matt Lyons 47

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Dealing with Bondholders in Troubled Times

By Daryl B. Robertson, W. Lake Taylor, Jr., William H. McBride, and Nic O'Brien*

Care must be taken by a public company in dealing with bondholders and their indenture trustee. There are numerous important legal considerations, which the authors summarize in this article.

Most public companies have outstanding one or more series of bonds (or notes) that are held by third party, mostly institutional, investors. Any of these companies that are experiencing financial difficulties may wish, or may be forced, to deal with the holders of their outstanding bonds in order to reorganize the company's debt structure, to reduce its debt, to permit an acquisition or disposition transaction to occur or to amend restrictive covenants.

In addition, during troubled economic times, bonds are often traded at deep discounts from their face principal amounts as a reflection of the market's view of the financial condition and future prospects of the issuing company. Sometimes the bonds are acquired by opportunistic investors (a/k/a "vulture funds") that are intent on forcing declarations of default and acceleration of the bonds or otherwise realizing quick profits on their investments in the bonds.

As is often the case, dealing with individual bondholders can be difficult because of their number. The indenture trustee appointed pursuant to the trust indenture governing the bonds will usually act on behalf of the bondholders in their interactions with the issuer. However, the nominal annual fee paid for standard trust services provides little incentive for an indenture trustee to spend much time in representing the bondholders in troubled situations. As a result, the initial bond trustee will often resign, and a substitute trustee must be located to serve in that capacity.

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MARBLEGATE

A 2017 U.S. Court of Appeals for the Second Circuit decision illustrating some of the issues that can occur in dealing with bondholders is found in *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*[1]

In 2014, Education Management Corporation ("EMDC") found itself in severe financial distress with $1.5 billion in debt that was issued by EMDC's subsidiaries and guaranteed by EMDC. Of this debt, roughly $1.3 billion was secured debt governed by a credit agreement, and the remaining $217 million was issued in the form of unsecured notes pursuant to a trust indenture agreement. EMDC determined that restructuring through bankruptcy was not a realistic option, so, instead, EMDC negotiated consensual foreclosure and debt restructuring transactions with its secured creditors. These transactions were then approved by all of the holders of the unsecured notes with the exception of the plaintiff, which held $14 million of the unsecured notes.

Pursuant to the negotiated restructuring transactions, the secured creditors exercised their rights under the credit agreement to foreclose on the assets of EDMC's subsidiaries and sold the assets to a newly formed subsidiary of EMDC. The newly formed subsidiary issued new debt and equity securities to all of the secured creditors and to those noteholders who approved the transactions in exchange for their unsecured notes.

The secured creditors also released EMDC's guarantee under the credit agreement, which triggered an automatic release of EMDC's guarantee of the unsecured notes pursuant to the trust indenture. After the transactions, the plaintiff, which held the sole remaining unsecured note, was left with no practical ability to be repaid because the subsidiaries obligated to repay the note no longer held assets and its note was no longer backed by EDMC's guarantee.

The unsecured holdout noteholder sued EMDC and its subsidiaries arguing that the restructuring transactions violated the restrictions in Section 316(b) of the Trust Indenture Act of 1939, as amended (the "TIA"),[2] and the district court agreed with the holdout noteholder.

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[1] *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 846 F.3d 1 (2d Cir. 2017), *reh'g denied*, No. 15-2124 (2d Cir. Mar. 21, 2017).

[2] TIA Sec. 316(b) reads: "(b) *Prohibition of Impairment of Holder's Right to Payment.* 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, except as to a postponement of an interest payment consented to as provided in paragraph (2) of subsection (a), and except that such

However, EMDC and its subsidiaries appealed the ruling, and after analyzing the restructuring transactions, the trust indenture and the legislative history of Section 316(b), the majority opinion of the Court of Appeals concluded that, while the restructuring impaired any practical ability of the holdout noteholder to be repaid, the transaction did not violate Section 316(b) because the transaction did not amend the indenture's "core payment terms." Nor did it prevent the dissenting noteholder from initiating suit to collect payments due on its note.

The majority also determined that the TIA's legislative history for Section 316(b) indicated that it was intended to address formal amendments to indentures and to prohibit indenture provisions such as collective-action clauses, which would allow a majority of bondholders to amend core payment terms, or no-action clauses, which bar individual bondholders from suing to collect interest and principal payments.

At the outset, this may come across as providing a blanket protection to issuers, but the majority in *Marblegate* stated that its decision "will not leave dissenting bondholders at the mercy of bondholder majorities." The majority noted that bondholders may rely on state and federal laws to seek recourse from issuers. Dissenting bondholders may pursue remedies such as claims for successor liability or fraudulent conveyance, claims for violations of foreclosure laws or implied good faith covenants, or commercial tort claims. The majority further noted that sophisticated creditors can insist on credit agreements that forbid transactions like the debt restructuring in this case.

LEGAL CONSIDERATIONS

There are many legal considerations that need to be taken into account when an issuer deals with its bondholders and the indenture trustee.

- *Trust Indenture Governs*. The legal rights and obligations of the issuer, the trustee and the bondholders with respect to the bonds are generally governed by the trust indenture. If the indenture is ambiguous on an issue, a court may look to the description of the bonds in the bond offering documents for an interpretation of the indenture's provisions. However, discrepancies between the description of the bonds in the bond offering documents and actual clear provisions in the indenture

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indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien."

will usually be resolved in favor of the indenture.[3]

- *TIA Provisions*. Most indentures will be subject to the TIA, which applies even to debt securities issued in transactions otherwise exempt from registration under Section 3(a)(9) or (10) of the Securities Act of 1933, as amended (the "Securities Act"), as well as debt securities issued in connection with bankruptcy reorganizations. The TIA specifies that certain of its provisions will be deemed part of the indenture.
- *Rights of Bondholders and Issuers*. Other provisions of the trust indenture and the TIA may affect the rights of bondholders, such as rights to declare an event of default and to accelerate the maturity of the bonds, to instruct the trustee to exercise remedies against the issuer on behalf of the bondholders, and to waive defaults by the issuer, as well as the right of individual bondholders to directly sue the issuer for payment of the bonds. Trust indentures may also contain important restrictive covenants concerning the issuer's financial condition and results of operation that must be observed by the issuer. In addition, the document should detail the issuer's rights to replace the indenture trustee or to approve a new trustee if the original trustee is removed by the bondholders.
- *Amendments to Indenture*. The indenture may or may not be amended without any consent of the bondholders or without the consent of all of the bondholders in a manner that would alleviate the troublesome situation. If the indenture cannot be amended without consent of the bondholders, it is often true that fewer than all the holders need to consent to an amendment that will solve the problem. Therefore, consideration should be given to tendering for or otherwise reducing the outstanding amount of bonds or directly soliciting the necessary bondholder consent.
- *Tender or Exchange Offers*. Tender offers or exchange offers by an issuer for its debt securities will be impacted by a number of important securities laws. In particular, Rule 14e-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") has requirements for how long a tender offer must remain open, for the timing of payment for tendered securities after expiration of the offer, for any extensions of an open tender offer and other important rules that must be observed. An exchange offer must either (a) be exempt from registration under

[3] Of course, if the bonds were sold in a securities offering, such a resolution may result in a securities lawsuit against the issuer based on incorrect disclosure about the bonds.

the private offering exemption or the exemption for exchanges of securities under Section 3(a)(9) of the Securities Act, or (b) be registered on a Form S-4 or F-4 with the Securities and Exchange Commission ("SEC"). In the case of a registered exchange offer, the TIA will usually require the trust indenture for the new debt securities offered in the exchange offer to be registered with the SEC and meet the other requirements of that statute.

- *Consent Solicitations*. Consent solicitations of bondholders by the issuer are often effective to effect a change in the covenants in the trust indenture. These solicitations by themselves are not subject to Rule 14e-1 but are often combined with a tender or exchange offer that is subject to that rule. Consideration paid to consenting bondholders must be carefully structured to avoid potential liability under applicable court cases that require the consideration to be offered on the same terms to each holder of the affected debt security. Provisions in the trust indenture may also impact the ability to make consent payments to only consenting bondholders.
- *Anti-Fraud Securities Laws*. In the case of any consent solicitation, tender offer or exchange offer, the general anti-fraud rules of the securities laws will be applicable. The written disclosures provided to bondholders in connection with any of the foregoing transactions must be carefully prepared to avoid any possible claims of false or misleading disclosures that might be actionable under applicable securities laws.
- *Communicating with Bondholders*. Note that if the bondholder group is large, there can be real problems communicating with them through the book-entry system. DTC will not provide a list of holders of an issuer's bonds—only a list of the authorized contacts for each participant holding the securities. That list then has to be worked with to develop a bondholder list. There are private companies who, for a price, will supervise a bondholder solicitation.
- *Bondholder Committees and Direction by Bondholders*. The trust indenture may provide the indenture trustee the ability to offer interested bondholders the opportunity to form a committee and "advise" it on actions post-default or even prior to default in some situations. In addition, some trustees will allow a bondholder committee to be created even without clear mention in the indenture because the committee can provide a trustee some protection in a later bondholder suit against the trustee for misbehavior. Such a committee can also be of benefit to the issuer in at least providing a sounding board for alternatives in restructuring and analyzing the possibility of obtaining

the requisite percentage bondholder approval of amendments. An issuer may also be able to use such a committee, or a similar but not formally organized group of bondholders, to "direct" the trustee to take certain actions under the trust agreement, perhaps including actions that the trustee is not certain are in the best interest of all the bondholders but that the group of interested bondholders find acceptable.

- *Duties of Directors and Officers*. In general, the officers and directors of a corporation do not owe duties to bondholders, such as the duties of care, loyalty and good faith that they may owe to the corporation's shareholders. The relationship between bondholders and the issuing corporation is considered contractual in nature. However, when a corporation is in the "vicinity" or "zone" of insolvency, the duties of the corporation's officers and directors may shift and expand to include creditors and other stakeholders (e.g., employees) of the corporation. Creditors have a right to expect that the directors and officers will not divert, misappropriate or unduly risk the corporation's assets in an effort to avoid claims of creditors, including the bondholders. Officers and directors must consider the interests of the corporation's entire "community of interest." Obviously, these expanded duties may cause conflicting expectations and problems in planning the corporation's future.
- *Impediments to Extraordinary Transactions*. Extraordinary corporate transactions by the issuer will often trigger issues with respect to bondholders. The trust indenture usually has a provision that is triggered by a merger with another entity or the sale, transfer, lease or other disposition of all or substantially all of the issuer's assets to another entity. These provisions typically require that the issuer's obligations under the trust indenture must be assumed by the transferee or successor. Spin-offs of corporate assets to shareholders are often questioned by bondholders and can be an impetus for litigation concerning the purpose and effect of the spin-off. Likewise, sales of important assets may raise issues of successor liability. Bondholders and trustees might assert that the purchaser is liable for the indebtedness represented by the bonds. Caution should be exercised in connection with these kinds of transactions to make certain that bondholder rights are addressed.

Care must be taken by a public company in dealing with bondholders and their indenture trustee. As can be seen from the foregoing summary, there are numerous important legal considerations.