Chapman and Cutler LLP

Chapman Client Alert

March 24, 2016 Current Issues Relevant to Our Clients

The Aftermath of EMC and Caesars: Trust Indenture Act Claims Brought by Objecting Bondholders

Two Recent Exchange Offers Are Challenged in Federal District Court

In an earlier Client Alert,[1] Chapman noted that in light of the decisions in Education Management Corp. (*"EMC"*)[2] and Caesars Entertainment Corp. (*"Caesars"*),[3] two recent cases interpreting the Trust Indenture Act of 1939, as amended (the *"TIA"*),[4] minority holders may be more emboldened to challenge exchange offers. This month, reflecting those predictions, retail bondholders filed two class action suits in the United States District Court for the Southern District of New York challenging exchange offers under the TIA.

Section 316(b) of the TIA

As we noted in our earlier alert, Section 316(b) of the TIA was designed to prevent a company, outside of bankruptcy, from altering its obligation to pay notes without the consent of each noteholder. It specifically provides that "**the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security … shall not be impaired or affected without the consent of such holder**…."

This provision was historically interpreted as a narrow protection against majority bondholders' attempts to amend certain "core terms" of an indenture relating to the holder's *legal right* to receive payment of principal and interest or to demand or seek payment when due.

The Caesars and EMC decisions, however, expanded the scope of Section 316(b) to protect dissenting holders' *ability*, and not merely just the legal right, to receive payment on their bonds.

We predicted that these decisions (i) could embolden dissenting bondholders to wield Section 316(b) as a weapon against issuers which conduct out-of-court restructurings without their participation and (ii) could encourage issuers to avoid registering bonds with the SEC where possible to avoid subjecting such bonds to the TIA.

Earlier this month, retail bondholders which were bypassed in the exchange offers of Vanguard Natural Resources and Cliffs Natural Resources did just that, filing separate class actions against the issuers in the United States District Court for the Southern District of New York.[5]

The Cliffs Natural Resources and Vanguard National Resources Class Actions

These class actions, involving the same law firms representing the plaintiffs in both cases, have very similar characteristics. Both Cliffs Natural Resources (a mining company) and Vanguard Natural Resources (a developer of natural gas and oil properties) experienced declining revenues because of significant drops in commodities prices. Both sought to alleviate their public debt burden through private placement exchange offers for their existing public unsecured bond debt which were offered exclusively to "qualified institutional buyers" (*"QIBs"*) under Rule 144 of the Securities Act.[6] Neither Cliffs nor Vanguard permitted non-QIB bondholders to participate in their exchange offers because they did not qualify for participation under Rule 144.

In the case of Vanguard, the exchange offer was made to QIBs holding Vanguard's TIA qualified 7.875% senior unsecured notes due 2020 (the *"Vanguard Class Notes"*). Of the approximately $550 million of the Vanguard Class Notes outstanding, QIBs exchanged approximately $168 million (approximately 30.6%) for new 7.0% second priority secured notes due 2023. For each $1,000 of the Vanguard Class Notes tendered, QIBs received between $400 and $450 (depending on the date tendered) of the new 7.0% second priority secured notes.

In the case of Cliffs, the exchange offer was made to QIBs holding its TIA qualified 5.90% senior unsecured notes due 2020 and 6.25% senior unsecured notes due 2040 (the *"Cliffs Class Notes"*), as well as four additional series of unsecured notes not held by the putative plaintiff class representatives. Of the approximately $783 million of the Cliffs Class Notes outstanding, QIBs exchanged approximately $259 million (approximately 33%) for new 8% secured notes (of varying priority), guaranteed by Cliffs' subsidiaries, due 2020. For each $1,000 of the Cliffs Class Notes, QIBs received between $340 and $500 (depending on the date tendered) of the new 8.0% secured notes.

In both class action cases, the plaintiffs are non-QIB holders of TIA qualified Class Notes and seek to certify a class of all non-QIB holders of the Class Notes which were not permitted to participate in the exchange offers.

Plaintiffs in both cases argue that the exchange offers wrongfully separated the QIBs and the non-QIBs into the "haves" and the "have nots" by permitting only the QIBs to participate in the exchange offers. They allege violations of the TIA because the exchange offers allegedly impaired their rights under the existing indentures, without their consent, to receive interest and principal. The impairment, they argue, arises by virtue of their notes now being subordinated to the new notes with respect to assets of the issuers against which the new notes have liens. Plaintiffs also assert that the TIA was violated because the exchange offers were concealed from them as non-QIBs, violating their right under the indentures to file suit to compel payment.

The TIA impairment alleged in the class actions is different in character than that involved in the EMC and Caesars cases, where the existing bondholders' ability to collect was compromised by asset transfers and the elimination of guaranties. Nevertheless, the plaintiffs in the class actions do allege a virtual subordination of their bond claims to the new secured notes and the potential for a negative impact on the issuer's ability to repay them on account of the exchange offers.[7]

The Potential Impact of the Class Actions

While these class actions are at a very early stage, and we do not comment on the merits of the cases, their mere filing represents a predicted uptick in the use of TIA Section 316(b) by debtholders aggrieved by out-of-court restructurings.

Moreover, with respect to new debt issuances, these class actions, together with the EMC and Caesars decisions, could cause issuers to consider avenues to avoid the application of the TIA to their bond indentures. For example, just this month it has been reported that GameStop (NYSE: GME) issued bonds under Rule 144A (to which the TIA would not apply) and proposed an amendment provision in the indenture which did not include the customary provision that each holder's consent is required for any amendment that would impair its right to institute suit for the enforcement of any payment — a provision which would have violated the TIA.

It therefore appears that, at least in the near term, it will be more difficult for financially troubled bond issuers with outstanding debt subject to the TIA to achieve out-of-court restructurings through exchange offers. In addition, we may see issuers attempt to avoid subjecting their new bonds to the TIA by issuing privately placed notes subject to Rule 144A.

For More Information

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1 *The Trust Indenture Act Has Reemerged as a Powerful Tool for Objecting Bondholders Outside of Bankruptcy* (March 13, 2015), available at http://www.chapman.com/media/publication/492_Chapman_Trust_Indenture_Act_Powerful_Tool_Objecting_Bondholders_Outside_Bankruptcy_031315.pdf.

2 *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, Case No. 14 Civ. 8584 (KPF), 2014 WL 7399041 (S.D.N.Y. Dec. 30, 2014).

3 *MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entm't Corp.* No 14 Civ. 7091 (SAS), 2015 WL 221055 (S.D.N.Y. Jan. 15, 2015).

4 Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb.

5 *Gary Waxman and Leonard Hammerschlag, individually and on behalf a proposed class v. Cliffs Natural Resources Inc.*, Case No. 16 Civ. 1899 (S.D.N.Y), filed March 14, 2015, and *Gregory Maniatis, individually and on behalf a proposed class v. Vanguard Natural Resources, LLC and VNR Finance Corp.*, Case No. 16 Civ. 1578 (S.D.N.Y), filed March 1, 2016.

6 17 C.F.R. §230.144A.

7 Defendants in the class action can be expected to argue that because the QIBs exchanged the Class Notes for a reduced principal amount of the new notes with (in some cases) longer maturity dates, their ability to repay the non-QIBs was not impaired.

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