Bankruptcy

Reid to support efforts to change Trust Indenture Act

By Kelsey Butler Updated 04:12 PM, Dec-09-2015 ET

A change to the 76-year old Trust Indenture Act could send shockwaves through the restructuring community.

According to a source familiar with the situation, a special interest group is attempting to insert an amendment into omnibus appropriations legislation this week that would tweak the law with the support of Sen. Harry Reid (D-Nev.).

This person, and others, wouldn't confirm the identity of the special interest group, but the act, meant to protect debt investors, has been a hot button issue in the restructurings of **Caesars Entertainment Operating Co. Inc.** and **Education Management Corp.** (EDMC).

The same special interest group attempted to include a similar proposed change into transportation legislation just before Thanksgiving, but that language didn't make it into the final bill. No current language of the proposed change that may be included in the omnibus bill is available at this time, but some critics say it could roll back crucial investor and creditor protections, while others contend it clarifies the original intent of the act.

The legislation, enacted in 1939, provides that "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."

There are a few exceptions included in the act, including the temporary postponement of interest payments, a Chapter 11 filing and an indenture that contains a provision limiting or denying the right of a bondholder to sue.

Sources say the change would alter a key definition. Currently, a bondholder's right to payment and right to sue for nonpayment can't be impaired without the consent of the bondholder. But the proposed amendment would make the definition of impaired more narrow. It would only consider a bondholder impaired if there was a reduction in principal or interest rate or a change in a maturity date. All other instances would be fair game for changes without needing bondholder approval.

Judge Katherine Polk Failla of the U.S. District Court for the Southern District of New York in Manhattan issued a 30-page opinion on June 23, stating that Education Management, a private equity-backed for-profit education company, had violated the act during its out-of-court restructuring.

In the opinion, Failla wrote, "the question put before the court is straightforward: does a debt restructuring violate Section 316(b) of the Trust Indenture Act when it does not modify any indenture term explicitly governing the right to receive interest or principal on a certain date, yet leaves bondholders no choice but to accept a modification of the terms of their bonds? Examining the test, history and purpose of the Trust Indenture Act, the court concludes that the answer is yes."

Noteholder Marblegate Asset Management LLC, a Greenwich, Conn.-based asset management firm, and New York-based hedge fund Magnolia Road Capital LP filed a lawsuit with the Manhattan court on Oct. 28 to stop the out-of-court restructuring of the owner of colleges branded as Art Institutes, Argosy University and Brown Mackie Colleges.

In the lawsuit, Marblegate and Magnolia Road argued that **Pittsburgh**-based Education Management violated the Trust Indenture Act by leaving them out of the restructuring negotiations and only talking with the larger firms holding its debt, among other things.

(The matter is currently being heard on appeal before the **U.S. Court of Appeals** for the Second Circuit.)

The act has also been a pain point for **Caesars Entertainment Corp.** (CZR) unit CEOC.

Numerous lawsuits have been filed against Caesars Entertainment for alleged fraudulent transactions that occurred before CEOC entered bankruptcy.

One recent example is that of **Wilmington Trust NA**, indenture trustee for $479 million in 10.75% notes due 2016, which on Oct. 20 sued Caesars Entertainment in the U.S. District Court for the Southern District of New York in Manhattan. **Wilmington Trust** wants the parent to pay $51.45 million in outstanding interest owed on the notes that remains unpaid.

In the lawsuit, the bank also contends that Caesars Entertainment violated the Trust Indenture Act of 1939 by voiding a guarantee of the operating unit's obligations before CEOC's bankruptcy filing.

In August, Caesars Entertainment had attempted to rescind its guarantee on some of CEOC's prepetition debt without consulting the debtholders. A group of these creditors sued Caesars Entertainment and CEOC in the Manhattan district court, alleging the action violated the Trust Indenture Act.

Judge Shira A. Scheindlin on Jan. 15 ruled the parent's stripping of its guarantee was "an impermissible out-of-court debt restructuring achieved through collective action."

Scheindlin wrote that the parent's actions "impaired plaintiffs' right to payment under the notes." Caesars has maintained that it disagrees with the ruling.

Exactly what any change to the act could mean, however, depends on one's viewpoint of what the act is meant to do.

In a Tuesday memo, **California Institute of Technology** professor Bradford Cornell said an amendment to the act "would change financial rules governing public debt that have been in effect for 75 years. Investors will be less willing to purchase securities, if they fear their rights can be expropriated without warning."

But Ted Gavin, a managing director and founding partner at bankruptcy and restructuring consulting firm **Gavin/Solmonese LLC**, offered a rebuttal.

"Institutional bondholders and buyers are much more sophisticated than that," he said by phone. "Interest is an assessment of risk. If they're getting interest on the bonds, there's a tacit acknowledgement...that there is a risk of nonpayment."

A collection of law professors in a Tuesday letter to Reid, Sen. Mitch McConnell (R-Ky.), Rep. Nancy Pelosi (D-Calif.) and Rep. Paul Ryan (R-Wis.), expressed disagreement with the back-door approach to any change to the act.

"Recently, several members of **Congress** have been lobbied to amend this longstanding law, first through a rider to the highway bill and now through a rider to the omnibus appropriations legislation," the letter said. "The proposed amendment would narrowly define impairment of the right to payment and the right to institute suit for nonpayment. The proposed amendment would also be retroactive and apply to litigation that is presently on appeal before the Second Circuit Court of Appeals."

The group continued, "Several of us believe that the Trust Indenture Act should be amended, but not in the way proposed. We agree, however, that any amendment of the Trust Indenture Act should take place only after legislative hearings and opportunity for public comment. The proposed amendment has not been subjected to the customary vetting through public hearings and other mechanisms that are critical to improving the public confidence in Congress' ability to govern. There have been no hearings on the matter, no opportunity to hear from a diverse group of experts or the public, and no attempt to establish a legislative record."

Kenneth N. Klee, founder member of **Klee, Tuchin, Bogdanoff & Stern LLP**, countered that any amendment would simply "clarify the original intent of the act" and "establish a bright line" that if you're seeking to amend principal or interest on a bond, you need unanimous consent, but otherwise you don't.

Klee said that any characterizations that the marketplace would suffer due to adjustments to the legislations are unfair.

"Right now the marketplace has been suffering because judicial determinations of fairness is a variable that makes it uncertain for bondholders to invest," Klee said.

He later noted that "there's always been a tension between judges who interpret laws as they're written, and those who are more activists." Klee pointed to the cases of Caesars and Education Management as examples of the latter.

As far as the criticism of the path a potential amendment could take, Klee said that "no hearings are necessary for Congress to clarify its original intention."

For his part, Gavin/Solmonese's Gavin said, "An activist judge is only an activist judge when [someone] disagrees with the opinion reached. There's going to be two sides of every argument."

Spokesmen for Caesars and Education Management declined to comment for this story. A spokeswoman for Marblegate also declined comment.

Reid's office didn't return calls.

Seth H. Lieberman and Patrick Sibley at **Pryor Cashman LLP** and J. Christopher Shore, Harrison L. Denman, Jason Zachary Goldstein, Thomas E. Lauria and Jason Zakie at **White & Case LLP** are advising Wilmington Trust in the district court lawsuit. Lauria and Shore couldn't be reached for comment Wednesday.
--Jamie Mason contributed to this report.