

Client Alert

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Appeal Watch: Judge Scheindlin Sets Trial Parameters and Certifies Appeal Over Clash Between Release of Guarantee and Trust Indenture Act in Caesars' Noteholder Case

When does an out-of-court restructuring of a company with bond debt violate the Trust Indenture Act (the “TIA”)? The Second Circuit will soon visit this issue in the case of *BOKF, N.A. v. Caesars Entertainment Corp.* To protect minority bondholders, the TIA prohibits actions that impair bondholders’ rights to receive payment when due. Not clear is whether impairment speaks only to a legal right to payment, or whether it also extends to a somewhat amorphous “practical” ability to be repaid. In *Caesars*, the Second Circuit will decide whether an arguably authorized collateral release of a parent guarantee violates the TIA as a practical impairment of a bondholder’s right to payment. The holding should offer guidance in terms of board decision making and credit risk analysis in a multitude of transactions that may be deemed reorganizations and will hopefully clarify when an out-of-court reorganization is achievable or when a chapter 11 case is necessary.

Facts

In *Caesars*, Caesars Entertainment Operating Company (the “Issuer”) issued approximately \$7 billion in notes pursuant to a series of indentures. The Issuer’s corporate parent, Caesars Entertainment Corporation (“CEC”), guaranteed the obligations arising under the indentures until payment in full of all of the Issuer’s obligations. The documents contained a provision that CEC’s guarantee would be released upon the occurrence of certain events. In 2014, CEC took certain actions, including issuance of new debt and transferring certain stock of the Issuer, that triggered the release of the parent guarantee.

In January 2015, the Issuer and 172 of its subsidiaries (but *not* parent CEC) filed petitions under chapter 11 of the Bankruptcy Code – an event of default that accelerated the maturity of payment under the notes. Pursuant to a proposed reorganization plan, holders of the notes at issue

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would have been unable to recover principal and interest due under the indentures.

The note indenture trustee brought suit in the United States District Court for the Southern District of New York, claiming that in the wake of the Issuer's bankruptcy filing, the 2014 release of CEC's parent guarantee was void under the TIA in that it impaired the noteholders' right to payment.

Analysis

The TIA contains provisions meant to protect minority bondholders against majority actions. On summary judgment consideration, the trial judge, federal District Judge Shira A. Scheindlin, focused on section 316(b) of the TIA that protects minority bondholders from a non-unanimous action that would hinder enforcement and right to payment. In pertinent part, section 316(b) provides "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 . . . shall not be impaired or affected without the consent of such holder." As the court observed, "as a result of section 316(b), an issuer cannot – outside of bankruptcy – alter its obligation to pay bonds without the consent of each bondholder." The court further noted that this subsection of the TIA is "mandatory," meaning that an indenture cannot alter or waive the TIA's prohibition against it.

The court next turned to whether a transaction that technically complied with the TIA, but defeated its purpose, was allowable. Clearly, the TIA prohibits non-unanimous alteration of payment dates and amounts, i.e., the "legal right" to payment. Less clear is whether the TIA prohibits certain transactions (here the guarantee release) that effectively gut the payment right (i.e., a "practical ability"). Citing previous decisions including her own, Judge Scheindlin began her analysis by dispensing with the narrower "legal right" view. Rather, she continues "to adhere to the view that section 316(b) protects a noteholder's practical ability, as well as the legal right, to receive payment when due." In short, quoting a previous decision within the Southern District, the court held that mere technical compliance or crafty drafting would improperly allow "a sufficiently clever issuer to gut the [TIA's] protections."

How is a practical right implicated? To Judge Scheindlin, an alleged impairment must be either "an amendment to a core term of debt, or an out-of court reorganization." In other words, if a transaction was a "reorganization," then bondholder protections under the TIA were triggered. Moreover, the court found that the alleged impairment "must be evaluated as of the date that payment becomes due."

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The court needed no trial to find impairment. It held that payment was required upon the date of the Issuer's chapter 11 filing and noted that the payment would not in any event be made in light of the chapter 11 plan. So the Issuer's bankruptcy filing date was the date for determining impairment. The case would need to go to trial, however, for the plaintiffs to prove that the release of CEC's guarantee constituted a "reorganization." To Judge Scheindlin's credit, understanding the commercial implications of the issue, she certified her ruling for immediate appeal, making it more likely that the Second Circuit will rule before a trial is completed.

Takeaways

Does the TIA protect against "practical impairment?" Other lower courts have struggled with this issue in a variety of contexts. If the Second Circuit says no, then the issue becomes straightforward. Even if yes, however, the Second Circuit's ruling should offer guidance to borrowers and bondholders alike by clarifying what constitutes impairment. If the Second Circuit affirms the District Court's analysis, it would clarify that an out-of-court reorganization could simply be unworkable in certain situations – making chapter 11 an alternative that may not have been considered previously – and perhaps the only option short of unanimous noteholder approval. The Second Circuit's decision should provide guidance to borrowers and corporate boards as to whether potential practical impairment is determined upon a maturity date or some other date. Potential guarantors who thought they could rely on the occurrence of a contingency to obtain a release may have second thoughts. Lenders who rely upon the release of a guarantee when issuing debt to the former guarantor of bonds also have a stake in the decision. Olshan will be watching the case as it progresses.

For more information about the Caesars' noteholder case or restructuring issues generally, please contact the Olshan attorney with whom you regularly work or any of the attorneys listed below.

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