COMMENTARY

THE TRUST INDENTURE ACT OF 1939 IN CONGRESS AND THE COURTS IN 2016: BRINGING THE SEC TO THE TABLE

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Distressed firms with publicly issued bonds often seek to restructure the bonds' payment terms to better reflect the firm's weakened repayment capabilities and thereby avoid a bankruptcy. But Depression-era securities law bars the bondholders from agreeing via a binding out-of-bankruptcy vote to new payment terms, thus requiring individualized consent to the new payment terms, despite that such binding votes are commonplace now in bankruptcy and elsewhere. Recent judicial application of this securities law rule to bond recapitalizations has been more consistent than it had previously been, with courts striking down restructuring deals that twisted bondholders' arms into consenting to unwanted deals. These coercive bond exchanges first became common in the 1980s, when many hostile tender offers for public companies had a similarly coercive deal structure. The coercive deal structure in these takeover offers was brought forward then to justify wide managerial countermeasures, but this structure disappeared in takeovers. However, it persisted in bond exchange offers. While these court decisions striking down the coercive bond exchanges faithfully apply Depression-era securities law to thwart issuers from twisting bondholders' arms into exchanging, the bond market and distressed firms would be better served by exempting fair votes that bind all bondholders to new payment terms. The Securities and Exchange Commission now has authority to exempt fair restructuring votes from this now out-of-date securities law.

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INTRODUCTION

This short Commentary examines broad aspects of recent controversies and ongoing litigation arising from the Trust Indenture Act of 1939's[1] (Act's) requirement that no bondholder can see his or her payment terms change without the bondholder's own consent. The court in *Marblegate Asset Management, LLC v. Education Management Corp.*[2] persuasively showed how and why the Act applies to so-called exit-consent transactions, ruling that coercive exit-consent transactions run afoul of the Act.[3] But, I argue here, no judicial interpretation can construct a stable, appropriate policy framework for the bond market because the prohibition — a New Deal reaction to 1930s perceived insider-driven irregularities in the bond market — unwisely disrupts sensible, out-of-court distressed company restructurings, as well as coercive ones.

Marblegate and related decisions, the underlying transactions, and the potential impact both of these can have on distressed debt have garnered an unusual amount of mainstream media attention for what would normally be a technical matter for securities and bankruptcy lawyers.[4] Indeed, in last-minute congressional budget negotiations in 2015, affected parties are reported to have nearly succeeded in sharply amending the Act, with retroactive effect.[5]

I show here what tools can be used to build a sensible legal framework governing out-of-bankruptcy restructurings of public bond issues. I make four points, ending with the need to bring the SEC to the table to facilitate efficient restructurings:

1. Recent Southern District of New York decisions struck down exit-consent transactions — whose structure will be explained and

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[1] Pub. L. No. 76-253, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa–77bbbb (2012)).

[2] 111 F. Supp. 3d 542 (S.D.N.Y. 2015), *appeal docketed*, Nos. 15-2124 & 15-2141 (2d Cir. Jul. 2, 2015).

[3] *Id.* at 556.

[4] *See, e.g.*, Gretchen Morgenson, *Obscure Law Is Getting Its Sexy On*, N.Y. TIMES (Jan. 24, 2015), http://nytimes.com/2015/01/25/business/25gret.html. The *Wall Street Journal* published a roundtable of academic and lawyer comment on the issue. *See* Jenny Choi, *WSJ The Examiners — Trust Indenture Act*, HARV. L. SCH. BANKR. ROUNDTABLE (Oct. 6, 2015), http://blogs.harvard.edu/bankruptcyroundtable/2015/10/06/wsj-the-examiners-trust-indenture-act [http://perma.cc/R4KP-4HCM] (summarizing the *Journal*'s roundtable posts); *cf.* Mark Roe, *The Examiners: End the Trust Indenture Act's Bondholder Voting Ban*, WALL ST. J. (Sept. 29, 2015, 11:04 AM), http://blogs.wsj.com/bankruptcy/2015/09/29/the-examiners-end-the-trust-indenture-acts-bondholder-voting-ban (briefly stating the thesis analyzed here).

[5] *See* Matt Jarzemsky, *Caesars Takes Aim at Law Aiding Creditors*, WALL ST. J. (Dec. 6, 2015), http://www.wsj.com/articles/caesars-takes-aim-at-law-aiding-creditors-1449445319; Liz Moyer, *Wall Street's Debt Restructuring Fight Heads to Washington*, N.Y. TIMES: DEALBOOK (Dec. 7, 2015), http://www.nytimes.com/2015/12/08/business/dealbook/wall-streets-debt-restructuring-fight-heads-to-washington.html.

analyzed below.[6] The transactions underlying these decisions were structured as coercive exchange offers, which the courts held the Trust Indenture Act prohibited.

2. The decisions eliminate one difficulty for restructurings: coercive exit-consent offers. But they leave in place a second, equally difficult problem: how to prevent holdouts (or earnest dissenters) from destroying a good deal that most bondholders sincerely want. In today's institutionalized bond market, there is little reason to bar uncoerced voting for restructurings. A fair vote could resolve the holdout problem well.

3. The court decisions are not the cause of these two distortions; section 316(b) of the Trust Indenture Act itself is because it unwisely bars binding votes on payment terms. Hence, courts interpreting section 316(b) cannot reach the best policy result, which must deal with *both* distortions — other lawmakers need to come to the table.

4. The best result for the bond market is a legal framework that ends both degradations. There is a way, previously unrecognized, to construct sensible rules for bond workouts, even in the absence of wise legislation from Congress. Since 1990, the Securities and Exchange Commission (SEC) has had broad authority to exempt indentures and bond transactions from the full force of section 316(b). Thus, the SEC can, say, permit binding bondholder votes on payment terms by a two-thirds dollar majority (mimicking but not replicating the Bankruptcy Code standard[7]), perhaps conditioned on the vote not being forced via an exit-consent transaction and not otherwise coerced.

SEC exemptive rulemaking thus provides a viable path to facilitate out-of-bankruptcy restructurings of bond issues going forward. Quick, efficient, noncoercive restructurings that save a company from an unnecessary bankruptcy serve both the public interest and the interest of the parties to the deal. The appellate courts can and should affirm the lower court decisions that the Trust Indenture Act bans exit-consent degradation, and the SEC can and should then use its exemptive power to carve out uncoerced votes on payment terms from section 316(b). Uncoerced binding votes would allow sound out-of-court restructurings to bind holdouts — but would disallow exit-consent restructurings. Two degradations would be eliminated and sound restructurings could go forward. Win-win.

In Part I, I illustrate how even one large holdout can stymie an otherwise sound restructuring. In Part II, I show how the exit-consent

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[6] *See* BOKF, N.A. v. Caesars Entm't Corp., Nos. 15-cv-1561 (SAS) & 15-cv-4634 (SAS), 2015 WL 5076785 (S.D.N.Y. Aug. 27, 2015); *Marblegate*, 111 F. Supp. 3d at 556; MeehanCombs Glob. Credit Opportunities Funds, LP v. Caesars Entm't Corp., 80 F. Supp. 3d 507, 515–16 (S.D.N.Y. 2015).

[7] *See* 11 U.S.C. § 1126(c) (2012).

transaction can overcome the holdout, by inducing it to participate. I also show how it can induce consent from bondholders who otherwise think a proposed deal is unwise. In Part III, I briefly examine the recent court decisions that conclude exit consents are inconsistent with the Trust Indenture Act's bar to changing payment terms without an affected bondholder's consent. While the cases are correctly decided, a tighter standard ought to be articulated to more clearly distinguish coercive from beneficial restructurings. In Part IV, I show how the SEC can and should resolve the persistent holdout difficulties via its modern exemptive power. In Part V, I discuss recently proposed legislation which could improve the restructuring setting we now have, but would be largely unnecessary if the SEC acts. Lastly, in Part VI, I conclude and recapitulate.

I. THE HOLDOUT PROBLEM

Section 316(b) of the Trust Indenture Act states:

> *(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 . . . shall not be impaired or affected without the consent of such holder . . . .[8]

Section 316(b) introduces a fundamental problem: holdouts, depending on how the numbers break, can benefit from a restructuring at the expense of participating bondholders. After a restructuring is completed with some but not all bondholders accepting weaker terms, lower-ranking securities, or a decreased loan amount, the firm can better pay off the nonexchanging bondholders. The following example illustrates:

BALANCE SHEET 1: FIRM-TO-BE-RESTRUCTURED

Assets	Liabilities and equity	
$150M	$125M	Market value of debt ($200M face value)
	$25M	Common stock[9]

[8] 15 U.S.C. § 77ppp(b) (2012).

[9] The $25 million for stockholders could come from the stockholders' hold-up value or from the possibility that the firm's prospects give it a 50% chance of being worth $250 million and a 50% chance of being worth $50 million. For further examples showing how and when efficiency gains can be large enough that a deal can succeed despite the holdout, see Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987).

Bonds were issued at $200 million when the firm was healthier. If the firm were to be restructured, it would be worth more than its current $150 million, because management could turn its full attention to operating issues, while suppliers and customers would be less fearful of dealing with an insolvent firm.

Posit five bondholders, each owed $40 million but each of whose bonds are worth only $25 million. The firm offers to exchange all bonds for stock. The current stockholders have, say, 100 shares of stock; each bondholder with $40 million in face value of bonds is offered 100 shares of new stock. If all of the bondholders accepted the deal, all would be better off. They would retain their $25 million in value, plus share in the benefit from any improved operational capacity due to the firm's reduced financial stress.

BALANCE SHEET 2: POST-RESTRUCTURING,
IF ALL FIVE BONDHOLDERS ACCEPT

$150M + gains	$150M stock	Five exchangers and old stockholders each get $150M/6, or $25M, plus one-sixth of any operational gains

Four of the five bondholders think the deal is worthwhile for the bondholders overall. One bondholder rejects the deal, either because it hopes to hold out and do better than the $25 million of stock plus 1/6 of the gains, or because it sees the deal as bad for bondholders. The holdout cannot be bound to the exchange, as section 316(b) precludes a binding vote on payment terms. Moreover, the holdout's nonparticipation will lead the four willing-to-participate bondholders to reconsider, because if they exchanged, the post-restructuring balance sheet would look like this:

BALANCE SHEET 3: POST-RESTRUCTURING, IF FOUR
BONDHOLDERS ACCEPT AND ONE DOES NOT

$150M	$40M	Nonexchanging bondholder
	$110M	Four exchangers and old stockholding group (each owning one-fifth of the stock)

Before the potential exchange, the four willing bondholders had bonds worth $100 million in total. If they exchanged, the nonexchanger could be paid in full and the exchangers would find their $100 million of bonds turned into $88 million of stock. The holdout bondholder stymies a deal that the others consider worthwhile. This is the first potential distortion emanating from section 316(b) — the failed but worthwhile workout. Exchangers go forward without the holdout only if the exchange would increase the firm's operating value by enough to compensate for the shift in value to the holdout.

Behind the Act was a sense, widely held in the 1930s, that many such deals would be corrupt, run by insiders to the detriment of outsiders, and that a bankruptcy proceeding, overseen by a capable and fair-minded judge, would be inexpensive and quick.[10] But this first proposed transaction is not coercive; a vote that bound all bondholders would lead to a better-capitalized company and more value for the bondholders themselves. Yet, because the Trust Indenture Act bars any binding vote on payment terms, a single holdout can stymie a deal that the issuer and most bondholders consider sound.

II. THE EXIT-CONSENT PROBLEM

The prior "clean" transaction is not the only way for an issuer to structure its exchange offer, and since the attempted transaction readily fails due to the holdout, the issuer finds it unattractive. Prior to the actual exchange, the issuer could ask the bondholders to vote to strip the bond indenture of protective covenants, such as those according the bondholders seniority, security, and sinking fund protections, or those limiting the debtor from incurring debt, paying dividends, or transferring assets. If done outside the context of an exchange offer that aims to change payment terms, such a request would be unremarkable and would not directly implicate section 316(b) (since no payment terms would change). Bondholders would decide whether the overall terms offered were beneficial or not. If accompanied by a belief that payment from the weakened firm would be more likely, there's little reason to second-guess the deal, and section 316(b) would not be in play.

But when the request to strip the bond indenture of protective covenants is tied to an exchange offer for bonds with new payment terms, under which the issuer limits participation to those bondholders voting to strip the indenture of protective covenants, the analytics become more complex. Three Southern District of New York judges have analyzed the applicability of section 316(b) to such deals, and all called section 316(b) into play to invalidate the transactions.[11]

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[10] *See Marblegate*, 111 F. Supp. 3d at 556–57; U.S. SEC. & EXCH. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PART I: STRATEGY AND TECHNIQUES OF PROTECTIVE AND REORGANIZATION COMMITTEES 1 (1937); *cf.* George W. Shuster, Jr., *The Trust Indenture Act and International Debt Restructurings*, 14 AM. BANKR. INST. L. REV. 431, 438 (2006) (reporting the preference for bankruptcy).

[11] *See BOKF*, 2015 WL 5076785; *Marblegate*, 111 F. Supp. 3d at 556; *Caesars*, 80 F. Supp. 3d at 515–16.

The exit-consent exchange offer could induce unwilling bondholders to accept changes in payment terms that they dislike. They could dislike the deal but nevertheless exchange because they fear being left on the back end without the protective covenants.

The following analytics exemplify: Suppose that the bond indenture in the prior hypothetical in Part I (with one holdout and four consenters) bars the firm from issuing debt senior to the existing bonds and has no subordination covenant. The exit-consent offer seeks to strip the indenture of that protection and to add a subordination clause. If the protections are stripped away, and a subordination clause is added, the approving bondholders will exchange their old bonds for a package of some stock and $75 million of a new senior bond issue, one that in this restructuring will mature before the unexchanged bond. The new bonds will hence become senior to the holdout bondholder and will be paid before the holdout's maturity.

If the firm does well and everybody is paid, good. But this company might become insolvent again because, we'll assume for this hypothetical, there is a 50% chance that bad results next year will render the firm worth only $75 million operationally. If the firm's value deteriorates to $75 million, then all of that value will belong to the exchanging bondholders in an absolute priority bankruptcy. The holdout will get nothing, instead of sharing pro rata out of that $75 million (as it would if there were no exchange).

BALANCE SHEET 4: POST-RESTRUCTURING, WITH EXIT CONSENTS

$150M ($75M or $225M)	$75M	Senior debt (face value and financial value) maturing a year earlier than the original maturity
	$20M	Real financial value of old debt (now subordinated). That is, its market value is $20M, despite a face value of $40M
	$20M	New stock issued to the four exchanging bondholders
	$35M	Common stock

This deal structure for the exchange could induce the holdout bondholder to consent to a change in the bond's payment terms. After all, the holdout has a multi-million-dollar incentive to change its mind: If it continues to hold out, the exchanging bondholders jump ahead in seniority, the covenants are stripped, and the holdout becomes subordinated. Its bond is worth $25 million before and only $20 million after the exchange. It thus has the incentive to consent to the deal as long as the exchange offer's value is more than $20 million. It will do so here even if it views the deal as leaving the bondholders worse off than before.

The holdout's calculation is not whether the deal is better than what it has before the exchange ($25 million), but whether the deal is better than what value it would have after the exchange ($20 million). While the issuer's intention is not relevant to whether or not there's compliance with section 316(b), the issuer's intention to force an exchange is often clear, as law firms attest.[12]

This exchange structure now implicates section 316(b) because the bondholder's right to payment is "impaired . . . without the consent of such holder" and the statute's words seem to bar the impairing transaction without the holdout's consent. Three Southern District of New York judges have reviewed such transactions, and all three have held that exit-consent structures like the above run afoul of section 316(b).[13]

Notice something deeper here. The exchanging bondholders had bonds with a financial value of $25 million before the exchange. (While the company had promised to repay the bondholders $40 million, the company's value thereafter declined such that each bondholder became worth only $25 million. One cannot get blood from a stone, and there was only $25 million of blood, per bondholder, left in the company.) But after any exchange, they would have a package of a new bond and new stock that would be worth less than their original, pre-deal $25 million.

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[12] *See, e.g.*, CLEARY GOTTLIEB, EXIT CONSENTS IN RESTRUCTURINGS — STILL A VIABLE OPTION? 1 (2013), https://www.clearygottlieb.com/~/media/cgsh/files/publication-pdfs/exit-consents-in-restructurings-still-a-viable-option.pdf [http://perma.cc/75PL-86HR] ("[Covenant-stripping] incentivises bondholders to participate in the exchange: accepting the new bonds (even though they will usually have a lower face amount than the existing bonds) may be preferable to being 'left behind' in the old bonds, which will cease to have any meaningful covenant protection."); LINKLATERS, DEBT REPURCHASES AND AMENDMENTS: U.S. SECURITIES LAW CONSIDERATION 6 (2008), http://www.linklaters.com/pdfs/Insights/capitalmarkets/DebtTendersClientBriefing.pdf [http://perma.cc/QX9F-E9ZM] ("As part of tender or exchange offers, issuers often seek 'exit' consents for stripping out restrictive covenants from the terms of the notes. Such consents act as an incentive to participate in the offer *because they adversely modify the notes that remain in the hands of holdouts.*" (emphasis added)).

[13] *Marblegate*, 111 F. Supp. 3d at 556 ("Nevertheless, the restructuring gave dissenting bondholders a Hobson's choice: take the common stock, or take nothing. In effect, Marblegate bought a $14 million bond that the majority now attempts to turn into $5 million of stock, with consent procured only by threat of total deprivation, without resort to the reorganization machinery provided by law."); *Caesars*, 80 F. Supp. 3d at 516.

Even before the recent decisions, the Southern District of New York had struck down exit-consent transactions as violating section 316(b). *See* Federated Strategic Income Fund v. Mechala Grp. Jam. Ltd., No. 99 CIV 10517 HB, 1999 WL 993648, at *7 (S.D.N.Y. Nov. 2, 1999). The U.S. District Court for the District of Kansas and the U.S. Bankruptcy Court for the District of Delaware held to the contrary, however. *See* YRC Worldwide Inc. v. Deutsche Bank Tr. Co. Ams., No. 10-2106-JWL, 2010 WL 2680336, at *6–8 (D. Kan. July 1, 2010); *In re* Nw. Corp., 313 B.R. 595, 600 (Bankr. D. Del. 2004).

Here's the calculation: After the exchange, each bondholder has a package worth only $23.75 million (from one-fourth of $75 million, which is the value of the new bonds, plus one-fourth of $20 million, which is the value of the new stock in the exchange package). If each of these four bondholders calculates that it would rather take the exchange and get $23.75 million instead of the $20 million that the holdout gets, then they all will consent to a (slight) degradation of their bonds' financial value. They too may have reason to complain under section 316(b).

To whom did the bondholders lose value? Five million dollars of value shifted from the one holdout bondholder to the issuer's stockholders, and $1.25 million from each of the four exchanging bondholders (totaling $5 million overall) shifted to the stockholders as well. This $10 million shift in value can explain why the issuer structured the exchange offer as it did: for stockholders' benefit. The exchange is one type of the coercive shifts that the statute was presumably aimed to thwart.

The exit-consent planners can engineer even more complex transactions. In the above example, the asset side of the balance sheet remains intact in the exchange, but the liability side and the protective covenants change. The exiting bondholders could consent to asset transfers out from the debtor that would otherwise have violated the original bond indenture. Such asset-stripping transfers in addition to covenant-stripping terms were in play in the exit consent transactions underlying the recent Southern District of New York decisions.[14]

This asset-stripping could also be a voidable fraudulent transfer. One could dispute whether that makes the exit-consent transaction more egregious — because the fraudulent conveyance is the classic bête noir of bankruptcy — or less so — because there's an alternative remedy. But the fraudulent conveyance remedy is shrinking because it is now largely safe harbored from avoidance due to section 546(e), which insulates from avoidance as a fraudulent conveyance transactions that favor securitized debt.[15]

The two-tiered tender offer to buy a public company, which was common in the 1980s, has similar financial properties. In a 1980s two-tiered offer to buy up the stock of a target company, the offeror offered to pay the first 51% of stockholders $100 per share if they tender to the offeror, but the offeror promised (or threatened) to squeeze out the remaining 49% at $50 per share, averaging about $75 per share. (That

[14] *Marblegate*, 111 F. Supp. 3d at 544, 556; *Caesars*, 80 F. Supp. 3d at 511. And, hence, one could imagine continued litigation if the decisions are upheld, as some issuers may choose to limit the exit consent arm-twisting to covenant deletions without asset transfers, arguing that their transaction is distinguishable on its facts from those in play in the recent litigation.

[15] 11 U.S.C. § 546(e) (2012).

is, the offeror would buy just over half of the shares for $100 per share and the rest for $50 per share, thereby paying about $75 per share on average). Shareholders may well have thought that the average price should be $90 per share, but fearful of getting $50 on the back-end, they stampeded into the $100/$50 offer and would be coerced to take $75 on average, which is less than they thought proper. The two-tiered distortions provided a major early justification for the poison pill and antitakeover legislation. The two-tiered offer has since disappeared from real-world takeover transactions.

III. THE EXIT-CONSENT TRANSACTION UNDER THE TRUST INDENTURE ACT: FORMAL LEGAL RIGHTS VS. PRACTICAL RIGHTS TO PAYMENT

In the Southern District litigation, the court has three times held that exit-consent transactions, by effectively giving the bondholder no choice but to accept a change in payment terms, violate the Trust Indenture Act's "prohibition of impairment of holder's right to payment," as the section is partially entitled, and cannot proceed given the statutory text's requirement that the "right of any holder . . . to receive payment of the principal . . . *shall not be impaired or affected without the consent of such holder*."[16] Consent formally given after arms are twisted in an exit-consent transaction is presumably not real consent.

The argument contra is that the Act does not protect bondholders from losing practical rights to payment even if the transactional structure forces them to consent to payment terms worse than what they have.[17] Judge Failla in *Marblegate* investigated the legislative history extensively and precisely, showing how it evolved in Congress, with the original proposal susceptible to the formal-rights-only interpretation and with the subsequent text explicitly amended to protect both real and practical rights.[18] Restructurings were controversial in the

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[16] 15 U.S.C. § 77ppp(b) (2012) (emphasis added).

[17] Proponents of the formal-right-is-enough view focus on section 316(b)'s first part, which protects a bondholder's "*right* . . . to receive payment." *Id.* (emphasis added). *E.g.*, Brief for Education Management Appellants at 1, 19, Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Fin. Corp., No. 15-2124 (2d Cir. Sept. 9, 2015). Opponents look at the consent requirement (no bondholder can be "impaired or affected without [its] consent") — in other words, if the deal terms give no meaningful alternative to acquiescing in changing payment terms, then the statute appears violated.

[18] As Judge Failla stated:

> The legislative history weighs in favor of Plaintiffs' reading of Section 316(b) in two regards. First, the textual changes to what became Section 316(b) over the course of its legislative history demonstrate that the Act's protections were broadened from a mere right to sue into a more substantive right. Second, the purpose of the Act, as expressed consistently throughout the legislative history, was to prevent precisely the nonconsensual majoritarian debt restructuring that occurred here, even if the Act's authors did not anticipate precisely the mechanisms through which such a restructuring might occur.

Marblegate, 111 F. Supp. 3d at 554.

1930s, and Congress, the SEC, and William O. Douglas (the SEC Chair and principal architect of the provision) sought to regulate them. They presumably thought they were doing something seriously substantive, not merely formalistic, via section 316(b). To interpret the law to not protect real rights to payment would presumably have surprised them.

The court's practical rights standard would be better implemented, however, with a more narrowly defined standard than protecting every "practical right" to receive payment — a quite broad standard. Instead, the appropriate standard for the courts to settle on is whether an immediate consequence of a transaction, such as an exit-consent transaction, would be to give bondholders no real economic incentive other than to accept a change in payment terms. It's that standard that emanates from section 316(b)'s emphasis on individualized bondholder consent: could the bondholders realistically and rationally decide not to participate in the exchange, or must any aware bondholder exchange to protect itself, even if it dislikes the terms of the offer? If that lack of real choice is the result, then the transaction violates section 316(b).[19] The Southern District at times restricted the practical-versus-formal distinction in its opinion,[20] and that narrowing part of the opinion should be the basis for the standard.

While that is the best conclusion, strands of the history fit awkwardly. William O. Douglas, the SEC Chair and proponent of the Act, testified that section 316(b)'s sought to bar provisions allowing payment term changes. *Trust Indentures: Hearings on H.R. 10,292 Before a Subcomm. of the Comm. on Interstate and Foreign Commerce*, 75th Cong. 35 (1938) [hereinafter *Hearings*] (testimony of William O. Douglas, Chair, Securities and Exchange Commission). But Douglas was responding to the criticism that no amendment of the bond indenture would be possible. He replied by setting out the basics: votes on nonpayment covenants were freely allowed, votes on payment terms were not; that is, in that incomplete domain for the legislation's scope on which he commented, he emphasized the distinction between nonpayment (freely amendable) and payment terms (not freely amendable), without focusing on the ban's broader impact on protecting payment terms once they were agreed to. Douglas immediately went on in the 1938 testimony to make the broader functional claim for the language: it aimed to prevent "[e]vasion of judicial scrutiny of the fairness of debt-readjustment plans." *Id.*

[19] Thus, for example, a distressed issuer that offered superior-ranking debt at a lower principal amount for exiting junior debt with a higher principal amount, under a bond indenture that permitted it to issue new superior debt, would not ordinarily run afoul of the standard. Without exit consents, each bondholder would have the same loan terms after the transaction as before and each could determine on its own whether the riskier promise of more money was worth keeping or whether to take the lower-risk, superior-ranking promise of less. While some financial configurations of such an offer could be coercive, if votes were permitted, many issuers would choose to solicit a bondholder vote, because it would be more efficacious and bind all bondholders.

[20] As Judge Failla stated:

> [T]here is no reason to think that the Trust Indenture Act was targeted only at a particular method of restructuring — [that is, by] straightforward amendment [of the payment terms] — as opposed to an undesirable result: allowing "a majority to force a non-assenting security holder to accept a reduction or postponement of his claim."

Marblegate, 111 F. Supp. 3d at 555–56 (quoting *Hearings*, *supra* note 18, at 35 (Douglas's statement)).

In contrast, a free-standing solicitation to amend bond covenants without exit consents would not normally run afoul of section 316(b), because it would not immediately affect payment terms. But if the proposed immediate covenant changes are coupled with an immediate exchange offer seeking to change payment terms, the deal normally should not get past section 316(b). The *Marblegate* decision ought to be upheld on appeal, but its articulated standard should be sharply tightened. There's much that can affect the real prospects of repayment (closing a factory, declaring a dividend), but the statute is not focused on distant threats to repayment: it instead focuses on immediate changes in payment terms. Appellate (or lower court) clarification with a standard such as that articulated above would greatly help lawyers guiding bond restructurings to know what is permissible and what is barred.[21]

Appellate reversal of the Southern District's decision due to policy considerations would not be the first time that an appellate court chose its preferred policy outcome over a statute's words, legislative history, and a strong lower court analysis.[22] Here that preferred market outcome might be to facilitate out-of-court restructurings that make a bankruptcy filing unnecessary. But if ruling on policy grounds alone is ever justifiable, doing so under section 316(b) is particularly inappropriate because the court cannot obtain a stable, appropriate policy result. The appropriate policy override available to the courts (in contradistinction to the range available to other lawmakers) is hard to discern. *Either way* the court will have to allow transactional degradation: either allowing holdouts who stymie a deal, *or* allowing exit-consent transactions that coerce minority bondholders. There's no clear, complete policy result available to the courts.

Hence, courts acting alone in interpreting section 316(b) cannot reach the best, or even an overall good, policy result. Other lawmakers — Congress or the SEC — need to come to the table.

IV. BRINGING THE SEC TO THE TABLE

The institutional setting here is more propitious for good policy resolution than it often is. If the Southern District's opinions stand, as should result from statutory fealty, and even if Congress does not act, then the SEC can complete the task of handling both distortions (those

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[21] *28 Law Firms Publish White Paper Addressing Trust Indenture Act Complications in Debt Restructurings*, DEBEVOISE & PLIMPTON (Apr. 25, 2016), http://www.debevoise.com/insights/publications/2016/04/28-law-firms-publish-white-paper [http://perma.cc/5QT4-66SS].

[22] For one such bankruptcy interpretive opinion, see *In re Chateaugay Corp.*, 961 F.2d 378, 382 (2d Cir. 1992): "The bankruptcy court's reasoning [under the statute] . . . may seem irrefutable[,] . . . [but not] if one takes into account the strong bankruptcy policy in favor of speedy, inexpensive, negotiated resolution of disputes, that is an out-of-court [settlement]," *id.* at 382.

from holdouts and those from exit-consent transactions). The SEC now has very broad exemptive authority, unlike when the Trust Indenture Act was passed in 1939 and even unlike when exit consent first became common in the late 1980s. Its section 304 was amended in 1990 to provide:

> *(d) Exemptions in public interest*
>
> The Commission may, by rules or regulations upon its own motion . . . exempt conditionally or unconditionally any person, . . . indenture, security or transaction, or any class or classes [thereof] . . . from any one or more of the provisions of this subchapter, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by this subchapter.[23]

The SEC should exempt bond indentures from section 316(b) if they (1) provide for a binding vote on payment terms approved by two-thirds of the bondholders, without the vote of any conflicted bondholder, and (2) bar coercive transactions such as exit-consent exchange offers.[24] Such restructurings are in the public interest, comport

[23] 15 U.S.C. § 77ddd (2012). The SEC's rulings show it is open for exemptive business under § 304(d). 17 C.F.R. § 260.4d-7 (2012) (SEC instructions on how to apply for a § 304(d) exemption). And it has granted 304(d) exemptions from § 316(b). *E.g.*, Securities and Exchange Commission, Order Granting Application for Exemption: Petroleos Mexicanos and the Pemex Project Funding Master Trust, Trust Indenture Act Release No. 2430, 2004 WL 2347881 (Oct. 13, 2004), https://www.sec.gov/divisions/corpfin/cf-noaction/pemex101304.pdf [http://perma.cc/JV64-6TR6].

[24] Allowing a vote will in and of itself cut issuers' incentives to use exit-consent transactions. Issuers today have reason to resist banning exit-consent transactions in their bond indentures because they are unable to restructure outside bankruptcy via a vote. But if a clean restructuring vote were allowed, the issuer would have less need for an exit-consent transaction. More issuers would willingly constrict exit consents in the indenture and some issuers, even if they did not, would find the vote as good and voluntarily choose it over the coercive transaction. Moreover, I have here emphasized the coercive character of exist consents. But many exit-consent transactions fail, in that they do not successfully restructure the firm's debts. A straight, binding vote should facilitate more successful and more thorough restructurings.

Full bondholder choice would allow bondholders to subject themselves to exit-consent offers, even if the issuer could get a fair vote. Hence, fully respecting bondholder choice would militate for item (1) (a vote) alone, and not require item (2) (a ban on exit consents). Still, (1) plus (2) may be needed for statutory fidelity. Although the SEC can exempt matters "in the public interest," 15 U.S.C. § 77ddd(d), item (1) alone would read section 316(b) out from the statute. Congress barred potentially coercive votes in 1939, hence, overturning section 316(b) alone may not be a valid SEC action. But combining (1) and (2) incorporates this congressional "finding" by pointing to modern exit-consent transactions as a prime source of coercion, which the packaged exemption would eliminate.

Exit consents could be evaluated under contractual good faith standards and under indenture provisions barring the issuer from voting a treasury bond (that is, a bond that it sold and then bought back). Because the bondholder in an exit-consent transaction has no continuing economic interest in the bond, the bond is being de facto voted by the issuer, which de jure the indenture typically bars. The leading American decision did not accept that view. Katz v. Oak Indus. Inc., 508 A.2d 873, 881 (Del. Ch. 1986). A British court recently and prominently held to the contrary, explicitly criticizing *Katz v. Oak Industries, Inc. See* Assénagon Asset Mgmt. S.A. v. Irish Bank Resolution Corp., [2012] EWHC (Ch) 2090 [5], [61]–[62], [85]–[86] (Eng.).

with the Act's purposes (barring coerced and insider deals), and can be exempted as a class under the SEC's section 304 authority. Since the Act's overall purpose was to protect bondholders, and since the exit-consent offers end-run section 316(b)'s protective vote ban, an SEC rulemaking exemption to allow issuers to package a vote with a ban on coercive transactions seems to be within the Act's policy parameters.[25] Much of this can be done by rulemaking with prospective impact, so that companies contemplating a bond issue could have pre-approved loan terms to consider using.[26]

V. LEGISLATION AND RETROACTIVITY

I have thus far not discussed legislative solutions because in today's congressional environment it is hard for Congress to legislate and because the combination of the judicial interpretation of section 316(b) and SEC exemptive action can resolve the two core distortions going forward.[27]

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[25] The SEC has separate authority under section 14 of the Securities Exchange Act of 1934, Pub. L. No. 73–271, 81 Stat, 884 (codified as amended at 15 U.S.C. §§ 78a–78pp), which prohibits "any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer," 15 U.S.C. § 78n(e), including exchange offers of publicly issued debt. But the section 14 exemptive authority is not as broad as section 304(d)'s. A two-tiered tender offer for a target company's stock is designed to manipulate stockholders into participating in a transaction that they dislike, just as an exit-consent proposal is designed to manipulate bondholders into consenting. But the Supreme Court ruled that, to run afoul of section 14, a material misrepresentation or nondisclosure was needed. Coercion is not enough. Schreiber v. Burlington N., Inc., 472 U.S. 1, 12 (1985). However, the SEC's exemptive authority under section 304 is much broader, extending beyond deceptive practices to permit exemptions that are in the public interest.

Exit consents work effectively without deception, so there's little basis for bondholders to turn to section 14. Indeed, to coerce the bondholders into tendering, issuers have reason *to emphasize and not hide* the bondholder's poor position if it holds out. Hence, deception is not integral to the exit-consent offer.

This corporate analogue to the exit-consent transaction — the two-tiered tender offer for a target company's stock — cannot today readily go forward for a firm with a poison pill, which Delaware and other states have validated. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985).

[26] To make some restructurings fully viable, the covenants themselves are important to change. Arm-twisting to change payment terms is not the only motivation for votes to alter covenants. If the vote on covenants is combined with a vote on changed payment terms, each bondholder can ordinarily decide whether the deal is overall good enough; no coercion need be involved and, hence, such combined votes should pose little problem.

[27] While I have assumed Congress is paralyzed and the SEC is agile, that contrast is not black and white. The SEC now lacks its full five members, often cannot command a majority vote for new action, and itself has a long agenda ahead of section 316(b) reform. *See* Jesse Eisinger, *Once Powerful, Mary Jo White's S.E.C. Is Seen as Sluggish and Ineffective*, N.Y. TIMES: DEALBOOK (Aug. 13, 2014, 12:00 PM), http://dealbook.nytimes.com/2014/08/13/once-powerful-the-s-e-c-is-seen-as-sluggish-and-ineffective; Ashley Kindergan, *The SEC Has Packed Agenda in 2014*, THE FINANCIALIST (Nov. 18, 2013), https://www.thefinancialist.com/the-sec-has-packed-agenda-in-2014 [http://perma.cc/2RT8-CYH9].

But what about bonds already in the market? Because we usually prefer not to retroactively apply new substantive rules, the holdout problem could persist for bonds already issued. This is not a large long-run problem: over time, already-issued bonds would mature and be retired, and then replaced with new bonds with modernized restructuring terms. But legal change frequently cannot happen unless it immediately and substantially benefits current players and facilitates current transactions.

Three possibilities could handle the holdout problem for current bonds. First, Congress could apply the change retroactively after all, if it thought that's what today's bond market wants.[28]

Second, the SEC could facilitate exchange offers that put in the new terms (yes on votes; no on exit consents), as long as no restructuring under the new terms occurred for, say, two years. Such a proposal would not be without some retroactive tone, but it would be modest.

Third, Congress could amend the Bankruptcy Code to facilitate a quick bondholder restructuring. The National Bankruptcy Conference, an organization of prominent bankruptcy lawyers, proposed such a bankruptcy solution to the restructuring problem. It suggested adding a new chapter 16 to the Bankruptcy Code, which would allow binding votes on payment terms in a short, rapid bankruptcy similar to a traditional chapter 11.[29] If the anti-exit-consent judicial rulings stand, the legislative proposal would complete the termination of the two distortive consequences of section 316(b) going forward, without SEC action. The judicial rulings would end the exit-consent distor-

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[28] Proponents of exit-consent transactions sought retroactive legislation to validate exit-consent transactions struck down by lower courts. The proposal, which for a time was reported to have a good chance of passage, not only had retroactive qualities that plausibly worked against its passage, but also went substantively in the wrong direction: the legislative rider would have continued to ban votes (and, hence, holdout distortions) and allow exit-consent transactions. *See* Jarzemsky, *supra* note 5; Liz Moyer, *Law Professors Ask Congress to Delay Changes in Debt Law*, N.Y. TIMES: DEALBOOK (Dec. 8, 2015), http://www.nytimes.com/2015/12/09/business/dealbook/law-professors-ask-congress-to-delay-changes-in-debt-law.html; Liz Moyer, *Under Fire, Debt Restructuring Amendment Is Pulled*, N.Y. TIMES: DEALBOOK (Dec. 15, 2015), http://www.nytimes.com/2015/12/16/business/dealbook/under-fire-debt-restructuring-amendment-is-pulled.html; Moyer, *supra* note 5. Such efforts may recur. *See* U.S. Chamber of Commerce, Letter on Recent Case Law on Sec. 316 of the Trust Indenture Act of 1939 (Mar. 31, 2016), https://www.uschamber.com/sites/default/files/documents/files/160331_trustindentureact_hensarling_shelby_goodlatte_grassley.pdf [http://perma.cc/95VE-XP7W].

[29] Richard Levin, *National Bankruptcy Conference Proposed Amendments to Bankruptcy Code to Facilitate Restructuring of Bond and Credit Agreement*, HARV. L. SCH. BANKR. ROUNDTABLE (Feb. 9, 2016), http://blogs.harvard.edu/bankruptcyroundtable/2016/02/09/national-bankruptcy-conference-proposed-amendments-to-bankruptcy-code-to-facilitate-restructuring-of-bond-and-credit-agreement-debt [http://perma.cc/5DJS-3Y9A]. The full proposal and transmission letter to Congress are available at http://newnbc.wpengine.com/wp-content/uploads/2015/07/Proposed-Amendments-to-Bankruptcy-Code-to-Facilitate-Restructuring-of-Bond-and-Credit-Agreement-Debt.pdf [http://perma.cc/VAJ4-ETJ6].

tion, and the National Bankruptcy Conference's proposed new chapter 16 would end the holdout problem, by making a bankruptcy vote[30] even more viable than it is now.

The proposed statute deserves brief discussion. Standing alone it would be incomplete: First, it would not itself handle exit-consent distortions. Second, the issuer would have to enter bankruptcy, which firms often do not want to do. Third, there's a philosophical issue, in that the statute effectively tells bondholders that they cannot contract to have a voting ban. Even if bondholders preferred the voting ban of section 316(b) (which some bondholders could want anyway), they cannot have the ban, because it could be overridden by a vote at any time for an issuer willing to use a new chapter 16.[31]

The issue is a philosophical one in that if one interprets the proposed chapter 16 as merely bringing forward the Bankruptcy Code's basic voting features, then chapter 16 is basic bankruptcy, which always overrides contract. Hence, no problem. But if we instead view the proposed chapter 16 as just a targeted contract right for bondholders (because nothing else besides this contract right would be affected in a chapter 16), then it would de facto do just what William O. Douglas and Congress did to bondholders in 1939 via section 316(b): telling bondholders what their contract rights must be and barring them from deciding for themselves.

Since the chapter 16 result is in my view much closer to the right package that most bondholders and issuers would negotiate toward, it is a better set of nonnegotiable rights than is now in the Trust Indenture Act. But that view is debatable, and it still would be a nonnegotiable set of rights.[32]

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[30] 11 U.S.C. § 1126 (2012).

[31] Why might they want to bar voting on payment terms anyway? They might mistrust the issuer or other bondholders, seeing the vote ban as their best protection. Traditional bank syndications allowed each bank to decide on whether to accept changes in payment terms.

The evidence indicates that bondholders and issuers would often want votes. Voting clauses were common before the Act. *See* Case v. L.A. Lumber Prods. Co., 308 U.S. 106 (1939); Aladdin Hotel Co. v. Bloom, 200 F.2d 627 (8th Cir. 1953); U.S. SEC. & EXCH. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES: TRUSTEES UNDER INDENTURES, PART VI, at 143 (1936). In Britain, publicly issued bonds are often restructured via a vote; Britain has no equivalent to section 316(b). *See* Assénagon Asset Mgmt. S.A. v. Irish Bank Resolution Corp., [2012] EWHC (Ch) 2090 (Eng.). Preferred stock, whose financial terms resemble risky bonds, typically uses a vote, despite the fact that it is not required to do so. And private deals often handle the holdout/exit-consent problems without a vote, but designate syndicate leaders who can agree to change payment terms on behalf of all the creditors in the deal.

[32] My principled preference would be to respect the antiretroactivity principle and have new voting rules only apply for new bonds. That solution though may not be practical; if exit consents are banned, some issuers will immediately want a nonbankruptcy mode for restructuring. If applicability to current bonds were needed, I would prefer option 2 — a vote to allow a vote, but with delayed effectiveness — or option 3 — a charged-up quick bankruptcy but with a sunset

* * *

There's a second timing issue that I mention here, only for completeness. The Act was passed in 1939. Here we are in 2016, with the courts still interpreting its basic scope. Why the long delay?

The basic explanation for the delay is probably market-driven. The junk bond market did not become a major economic institution until the 1980s, with the rise of Michael Milken and Drexel Burnham's high-yield, junk bond underwriting.[33] When some of these bonds went sour later in the 1980s, out-of-bankruptcy restructuring measures were sought, including the exit-consent transaction. It's plausible that the exit-consent possibility was vivid to lawyers and bankers in the 1980s because of its obvious analog in the 1980s takeover wave — the two-tiered tender offer.

That market development can explain the delay until the 1980s, not the delay from the 1980s to today. But exit-consent litigation did not wait from the 1980s until now: the exit-consent exchange offer was quickly challenged and decisively upheld in 1986 in *Katz v. Oak Industries, Inc.*[34] with an opinion from the country's leading, highly respected business judge of the time, William Allen. Perhaps that respectability led the exit-consent offer to be considered fair game.

Yet there are lawyering and jurisprudential oddities behind that decision. *Oak Industries* never mentions the Trust Indenture Act, perhaps because the section 316(b) issue was not put before the court. The decision validated exit-consent transactions, but not under the Trust Indenture Act. About a dozen years later, the Southern District confronted an exit-consent transaction and struck it down as inconsistent with section 316(b).[35] Yet much restructuring practice seems to have ignored this Southern District decision on point and followed the path lit by *Oak Industries*, which validated exit-consent transactions generally, but never reached, discussed, or ruled on the section 316(b) issue.[36]

provision of a decade after which chapter 16 would disappear. Once the old generation of straight-316(b) bonds is retired, issuers and bondbuyers can negotiate over whether they want votes on restructuring payment terms.

[33] Robert A. Taggart, Jr., *The Growth of the "Junk" Bond Market and Its Role in Financing Takeovers*, *in* MERGERS AND ACQUISITIONS 5, 5, 9–10 (Alan J. Auerbach ed., 1988); *Stars of the Junkyard: Drexel Burnham Lambert's Legacy*, THE ECONOMIST (Oct. 21, 2010), http://www.economist.com/node/17306419 [http://perma.cc/C5CX-3GLW].

[34] 508 A.2d 873 (Del. Ch. 1986).

[35] Federated Strategic Income Fund v. Mechala Grp. Jam. Ltd., No. 99 CIV 10517 HB, 1999 WL 993648, at *7 (S.D.N.Y. Nov. 2, 1999).

[36] *See* 508 A.2d at 881. Other reasons help explain why exit-consent deals were not more regularly challenged. Small holders often lack an incentive to challenge the deal. Bigger holders can often force payment change terms that they then accept. And the Trust Indenture Act is not at the forefront of many securities litigators' consciousness.

Whatever the explanation for the delay, the issue is here now in major restructurings and major litigation. So decisions have to be made. I have here outlined a strong structure for future restructurings: no exit consents that give bondholders no realistic choice but to accept an immediate change in payment terms, with SEC exemptive action to allow restructurings by an uncoerced fair vote a major part of that framework.

CONCLUSION

The Southern District's decisions, both from the past year[37] and 1999,[38] fit well with the Trust Indenture Act's purpose and history in striking down exit-consent restructurings. There's almost a basis for a plain meaning interpretation of section 316(b) that bars transactions that immediately impair a bondholder's right to payment, unless the affected bondholder has freely given its consent. But even if the text is seen as unclear, Judge Failla's precise review of the legislative history militates against any alternative outcome.[39]

The Trust Indenture Act induces two distortions in bond restructuring decisionmaking. It can induce holdouts to stymie a deal, and it can induce exit-consent coercion that twists bondholders' arms into taking a deal that some and, conceivably many, bondholders dislike. They accept the exit-consent offer for fear of being on the losing back end of a bad deal that decreases the bond's value by stripping protective covenants from the indenture. Yet courts alone cannot solve both the holdout and the coercion problems via a policy-oriented trump.

The best overall policy solution is to bar exit-consent transactions (as similar two-tiered tender offers cannot go forward in takeovers), as the courts are now doing, and to allow bondholders to vote to restructure their bonds' payment terms via binding uncoerced votes. The courts, with the Trust Indenture Act in hand, can ban the first, but lack authority to permit the second. The SEC has that authority. It can and should allow for the vote, using its broad exemptive authority.

[37] Marblegate Asset Mgmt. v. Educ. Mgmt. Corp., 111 F. Supp. 3d 542 (S.D.N.Y. 2015), *appeal docketed*, Nos. 15-2124 & 15-2141 (2d Cir. Jul. 2, 2015); MeehanCombs Glob. Credit Opportunities Funds, LP v. Caesars Entm't Corp., 80 F. Supp. 3d 507, 515–16 (S.D.N.Y. 2015).

[38] *See Mechala*, 1999 WL 993648. I am aware of no earlier decisions, but since exit consents were not as far as I know used until the late 1980s, that absence is unsurprising.

[39] *See Marblegate*, 111 F. Supp. 3d at 547–51.