District Court Rules That Standard Private Debt-for-Debt Exchange Offer Limited to Institutional Investors Does Not Violate the Trust Indenture Act

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Court finds common debt refinancing transaction is not an involuntary out-of-court restructuring protected by Section 316(b) of the Trust Indenture Act and that there is no implied obligation to make an offer to all holders

Introduction

An issuer of high yield bonds won dismissal of claims brought by retail noteholders who claimed that a debt swap of new secured notes for unsecured notes, made available only to institutional investors to ensure compliance with the federal securities laws, violated their rights under the indenture and Section 316(b) of the Trust Indenture Act of 1939 (TIA). Recent decisions in the U.S. District Court for the Southern District of New York (SDNY) in *Marblegate* and *Caesars* (see our previous client memorandum) had suggested that arguments could be made that exchange offers could violate the TIA because they could have the effect of "impairing" the holders' right to principal and interest.[1] The December 6 *Cliffs Natural Resources* decision[2] by Judge Sweet of the SDNY applied a reading of the earlier decisions that was narrower than some have feared, and held that an exchange offer, in the absence of any majority action through consent and in the absence of any asset stripping or guarantee releases, would not fit within the earlier decisions or implicate the TIA. *Marblegate* has been appealed to the U.S. Court of Appeals for the Second Circuit, but in the meantime, the *Cliffs Natural Resource*s decision, if followed by other courts, should provide additional comfort to market participants that certain standard market transactions do not violate the TIA, in particular those that do not involve a solicitation of consent to amend the indenture through majority action.

The Exchange Offer

In early 2016, Cliffs conducted an offer to exchange six classes of its outstanding unsecured bonds for new notes that were secured and offered a higher interest rate, but with a substantial reduction in principal. The exchange offer was not registered with the SEC and, to comply with securities laws, was conducted as a private offering limited to qualified institutional buyers (QIBs) and holders that were not U.S. persons, meaning that U.S. retail holders were not entitled to participate. The exchange transaction did not involve any solicitation of consent to amend indenture terms or any payment of consent fees. Upon consummation of the exchange, Cliffs reduced the principal amount of its debt by $293 million and its annual interest expense by $14 million.

The plaintiffs were retail investors who were not eligible to participate in the exchange. None of the terms of their notes were changed as a result of the exchange offer. However, due to the secured position of the new notes, the notes of the non-exchanging holders were effectively subordinated to the new notes to the extent of the value of the collateral.

The plaintiffs claimed that their rights under Section 316(b) of the TIA were breached, and also claimed breach of contract, breach of the implied covenant of good faith and fair dealing, and unjust enrichment.

The Ruling

Judge Sweet granted Cliffs' motion to dismiss all claims and found that (i) the non-exchanging noteholders could not establish that they suffered an injury-in-fact and therefore did not have standing to challenge the exchange offer, (ii) the TIA protections for minority noteholders against impairment of principal and interest payment rights were not implicated and (iii) there is no implied duty in an indenture to make offers to all holders.

Effective Subordination of Notes Not a Harm in the Absence of an Imminent Bankruptcy

Judge Sweet examined the noteholders' claims that the new secured debt issuance caused injury by potentially reducing the plaintiffs' recovery on their notes in a bankruptcy, by subordinating the unsecured notes to new debt with an improved position in the capital structure, and by diminishing the value of their existing notes. He found that those alleged injuries did not meet the threshold standing requirement necessary to permit a case to proceed in federal court. He noted that the plaintiffs did not allege that a bankruptcy was imminent and therefore found that any worsening of the plaintiffs' claims in a bankruptcy proceeding was a hypothetical harm that might never occur. Judge Sweet also found no basis for the claims that the plaintiffs' notes diminished in value, observing that the trading price actually increased after the announcement of the debt exchange results, and roughly six months later showed increases in value of 500% to 650%.

Cliffs Debt Swap Falls Nowhere in Universe of a TIA Section 316(b) Impairment Claim

Judge Sweet concluded that the exchange offer was not prohibited by TIA Section 316(b), applying the criteria established by the opinions in *Mechala,*[3] *Marblegate* and *Caesars*, which he termed the "broad cases" interpreting Section 316(b). Those cases held that "impairment" under Section 316(b) included impairment of the *practical* ability to receive payment of principal and interest and did not require a formal amendment to a core payment term (which he described as what is required to show impairment in the "narrow cases"). According to Judge Sweet, as an initial matter, "practical impairment" under the broad cases requires an "involuntary, out-of-court pseudo bankruptcy" and at least: (1) a transfer of assets or (2) the elimination or material modification of intercorporate guarantees or security interests. As a policy matter, he noted that the broad cases emphasized that the purpose of Section 316(b) was to safeguard minority holders from debt reorganizations resulting from a majority vote without judicial supervision.

Judge Sweet found that all of those features were absent in the Cliffs exchange offer. In the Cliffs transaction, there was no bondholder vote or any majority action. The plaintiffs were not forced to relinquish any claims as a result of the debt exchange. No changes were made to the terms of the indenture underlying the plaintiffs' notes, and Cliffs did not dispose of any assets, modify or strip a guaranty or eliminate a security interest. Unlike *Mechala, Marblegate* and *Caesars*, where majority noteholders supported transactions that released guarantees or security interests or moved assets away from supporting debt of non-consenting noteholders, the Cliffs exchange offer did not leave the plaintiffs with a "worthless right to collect principal and interest." On the contrary, the trading price of those notes actually improved after the debt exchange offer.

Breach of Implied Covenant to Treat All Holders Equally

Judge Sweet dismissed the claim for breach of an implied covenant of good faith and fair dealing on the basis that no specific indenture violation was alleged. He rejected claims by the plaintiffs that an implied covenant was breached because non-QIBs could not participate in the exchange offer, as unsupported by the indenture. He observed that the indenture could have included an express provision that barred disparate treatment of noteholders in an exchange offer.

Observations

The opinion does not address whether the interpretation of TIA Section 316(b) under the "broad cases" is proper. This issue is pending before the Second Circuit, which heard oral arguments for *Marblegate* in May 2016. If other courts follow Judge Sweet's application of these "broad cases," his interpretation would suggest that exchange offers that are not accompanied by consent solicitations, including those that layer in debt higher in the capital structure, should withstand a TIA Section 316(b) challenge. The guidance set by this opinion, if followed, would reduce some of the concern in the market about the reach of *Mechala, Marblegate* and *Caesars*.

[1] See *Marblegate Asset Mgmt., LLC* v. *Educ. Mgmt. Corp.,* 75 F. Supp. 3d 592 (S.D.N.Y. 2014); *Marblegate Asset Mgmt., LLC* v. *Educ. Mgmt. Corp.,* 111 F. Supp. 3d 542 (S.D.N.Y. 2015); *MeehanCombs Global Credit Opportunities Funds, LP* v. *Caesars Entm't Corp.,* 80 F. Supp. 3d 507 (S.D.N.Y. 2015); *BOKF, N.A.* v. *Caesars Entm't Corp.*, 144 F. Supp. 3d 459 (S.D.N.Y. 2015).

[2] *Waxman* v. *Cliffs Natural Resources Inc.,* No. 16 CIV 1899 (S.D.N.Y. filed Dec. 6, 2016).

[3] *Federated Strategic Income Fund* v. *Mechala Group Jamaica Ltd.*, No. 99 CIV 10517 HB, 1999 WL 993648 (S.D.N.Y. 1999).

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