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New York Court of Appeals Splits from Second Circuit on Minority Bondholders' Rights in Out of Court Restructurings

By Benjamin D. Feder*

The author of this article discuses a recent New York Court of Appeals opinion on out of court restructurings involving bond debt, which will result in fewer consensual out of court restructurings and require more Chapter 11 filings for the implementation of such deals.

New York's highest court, the New York Court of Appeals, recently handed down an important opinion on out of court restructurings involving bond debt. In *CNH Diversified Opportunities Master Account, L.P., v. Cleveland Unlimited, Inc.*, the Court of Appeals, in a 4-3 ruling, diverged from the U.S. Court of Appeals for the Second Circuit's ruling a few years ago in *Marblegate Asset Mgt., LLC v. Education Mgt. Fin. Corp.* and resuscitated rights of minority bondholders under the Trust Indenture Act which were limited under *Marblegate*.

The *CNH* decision, by making it easier for minority bondholders to impede remedial action taken by an indenture trustee at the direction of a majority of bondholders under a trust indenture and related documents, will result in fewer consensual out of court restructurings and require more Chapter 11 filings for the implementation of such deals.

MARBLEGATE

Section 316(b) of the Trust Indenture Act provides that "the right of any Holder to receive payment of principal . . . and interest . . . on a Note . . . or to bring suit for the enforcement of any such payment . . . shall not be impaired or affected without the consent of such Holder." The Second Circuit in *Marblegate* rejected a challenge under Section 316(b) to an out of court restructuring that stripped nonconsenting minority unsecured bondholders of their practical ability to collect payment on their bonds.

The transaction at issue in *Marblegate* consisted of an intercompany sale of the issuer's assets to a new subsidiary, effectuated through a foreclosure by the holders of senior secured bank debt together with certain other steps. Unsecured bondholders were given the choice of (i) exchanging their bonds for

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equity in the new subsidiary, or (ii) retaining their bonds and their rights against the issuer, which no longer held any assets and was effectively an empty shell. The Second Circuit held that Section 316(b) was not violated with respect to the nonconsenting bondholders because there had been no formal amendment of the payment terms of the indenture that governed the bonds.

CNH

In *CNH*, following the issuer's default, a group of bondholders representing 96.3 percent of the bonds negotiated a settlement which would have provided for the issuer's parent company to distribute 100 percent of the issuer's equity, which had been pledged in support of the bond debt, to a new holding company to be owned by all of the bondholders on a pro rata basis.

The deal failed when the holders of the remaining 3.7 percent of the bonds refused to consent. As a workaround, the majority bondholders directed the indenture trustee (which was also the collateral agent) to undertake a foreclosure of the pledged equity under the Uniform Commercial Code and distribute the equity to all bondholders in full satisfaction of the debt and to cancel the bonds.

The minority bondholders commenced an action against the issuer and its affiliated guarantors to enforce the remaining amounts owed under the bonds, citing Section 316(b) and identical language incorporated in the indenture. The lower courts in *CNH*, relying in part on *Marblegate*, ruled in favor of the defendants. Those courts found that, as in *Marblegate*, there had been no amendment to any terms of the indenture that impaired the minority bondholders' rights.

THE COURT OF APPEALS DECISION

However, the New York Court of Appeals reversed, holding that the rights of the minority bondholders to seek payment under the bonds survived the foreclosure. Although there was no question about the authority of the indenture trustee, under the security documents that governed the pledge of the issuer's equity, to undertake the actions it did at the direction the majority bondholders, the Court of Appeals held that the Section 316(b) language incorporated in the indenture meant that the rights of the minority bondholders to enforce the bonds could not be extinguished.

The majority opinion determined that in *Marblegate*, even though the practical ability of nonconsenting bondholders to recover had been impaired because they were left with rights against a shell company with no assets, the legal right of such holders to enforce the bonds had remained intact. By contrast, in *CNH*, the bonds were cancelled.

The dissenting opinion disagreed with the majority's interpretation of the Section 316(b) language, and expressed concern about the confusion likely to ensue from having a split between the Second Circuit and the New York Court of Appeals on such an important issue and its likely impact on the corporate debt markets: "The majority strikes at the consistency between the law of this Court and that of the United States Court of Appeals for the Second Circuit with respect to the rules by which disputes related to an indenture of this nature are to be resolved."

The dissent also argued, among other things, that the majority opinion failed to consider the security documents and whether those documents, which were expressly incorporated by reference in the indenture, effectively evidenced the consent of the minority bondholders for the actions taken by the indenture trustee, including the cancellation of the bonds.

CONCLUSION

The Second Circuit in *Marblegate* limited the ability of nonconsenting minority bondholders to block a consensual arrangement between an issuer and majority bondholders. The *CNH* decision, in contrast, by empowering recalcitrant minority bondholders, will make consensual out of court restructurings more difficult to achieve.

More issuers will need to resort to Chapter 11 filings and the provisions of the U.S. Bankruptcy Code which override Section 316(b) and prevent a small minority of bondholders from impeding restructuring transactions which have the support of at least 66 percent of a class of bondholders.

The New York Court of Appeals' determination to distinguish *Marblegate* may be justifiable based on a technical reading of the language of Section 316(b). As a practical matter, however, the *CNH* dissent is correct that the difference in outcomes of the two rulings will create uncertainties and complicate the calculations of distressed issuers, bondholders, and indenture trustees that are seeking to engage in out of court restructurings.