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Country Question and Answer Chapters:

Similar But Not The Same: Some Ways in Which Bonds and Loans Will Differ in a Restructuring

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Introduction

Much ink has been spilled over the last several years about the ongoing convergence of the U.S. institutional Term Loan B market with the high-yield bond market, including by our firm.[1] The attention has been justified and the predictions of a continuing trend have been borne out. Changes in market practice, sometimes gradual and occasionally sudden, have resulted in increasing similarity of covenants and other deal terms found in these debt instruments that were once quite distinct and – partly as a result of this greater common ground – of the sales, trading and distribution processes for these two products and the groups of buyers who hold them. However, market participants should not allow this convergence to blind them to the reality that bank loans and debt securities (and the associated credit agreements and indentures) remain different in important respects. Some of those differences may come to the fore in the crucible of a restructuring, workout or other distressed credit situation.

With the leveraged loan default rate at a two-year high (measured by number of defaults) at the beginning of 2016 – and no shortage of predictions of credit troubles in multiple industries – now is a good time to think about some of these differences and how they may impact tomorrow's restructurings.

The purpose of this article is not to undertake an exhaustive review of the legal differences between loans and securities. Instead, we will highlight certain differences that can impact (and, in certain cases, have effectively blocked) attempted "out-of-court" restructuring transactions. As out-of-court restructurings themselves become more and more prevalent, providers and buyers of bank and bond financing (as well as borrowers/issuers) would be well advised to understand how these differences can affect their legal rights and shape the form and terms of, or impose limits on the ability to effectuate, certain transactions.

The key differences that we will discuss are:

- the Trust Indenture Act, applicable to many indentures (but not credit agreements or loans), which provides certain protections to "hold-out" bondholders;
- the differing contractual roles and responsibilities between a trustee under an indenture and an administrative agent under a credit agreement;
- the impact of *pro rata* "sharing" provisions that are common in term loans, but generally non-existent in bond indentures; and
- the use of "material non-public information" and the related role of U.S. securities laws governing insider trading.

Impact of the Trust Indenture Act

The Trust Indenture Act of 1939 (the "TIA") supplements the U.S. Securities Act of 1933 (the "Securities Act") in its application to certain debt securities. With certain exceptions, the TIA prohibits the sale of bonds unless they have been issued under a qualified indenture, which must contain various provisions and for the most part cannot be contracted around. Although bonds subject to an exemption from registration under the Securities Act need not be issued under a qualified indenture, investors and issuers should be aware that many non-qualified indentures incorporate the TIA by reference, or explicitly import certain provisions of the TIA or track the language of the TIA into the contractual provisions of the indenture, which leads to the same outcome as if the TIA had been incorporated by operation of law.

In the context of out-of-court restructurings, Section 316(b) of the TIA ("Section 316(b)") has been the subject of two recent decisions out of the U.S. Federal District Court for the Southern District of New York ("S.D.N.Y."). Section 316(b) provides in relevant part:

> 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, 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…

In published case law prior to the recent S.D.N.Y. decisions, judges interpreting Section 316(b) had generally found that it was intended to protect a bondholder's legal right to payment, but not the bondholder's substantive ability to get paid. For example, transactions or indenture amendments permitted on the face of the indenture that imposed subordination and payment block provisions,[2] or that permitted the issuer to transfer substantially all of its assets without assuming the bond obligations,[3] have been held to not violate the TIA. The two recent S.D.N.Y. decisions, *Marblegate*[4] and *Caesars Entertainment*,[5] however, have cast doubt on the limited "legal right" view of Section 316(b), providing a more expansive interpretation of that clause of the TIA to protect a bondholder's substantive right to payment, or the issuer's financial ability to make payments due on the bonds.

In the first transaction, Education Management – a provider of post-secondary education – had secured bank debt of $1.3 billion and unsecured notes in the principal amount of $217 million. The unsecured notes were guaranteed by the parent holding company, though the disclosure document used to initially offer the notes stated that this parent guarantee was solely to satisfy reporting requirements by the parent and was not meant to provide value to

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creditors. The bond indenture provided that the parent guarantee could be released by a majority vote of the bondholders, or automatically in the event that the secured bank debt released its own parent guarantee.[6]

Education Management began facing financial distress but was effectively unable to file for an in-court Chapter 11 bankruptcy proceeding, which would have removed its eligibility for federal student loan funding. Education Management therefore negotiated an out-of-court restructuring with holders of more than 80% of the secured loans and unsecured bonds. The transaction involved (i) the secured lenders (i.e., the bank debtholders) releasing the parent guarantee, thereby releasing the parent guarantee of the bonds, (ii) those secured lenders foreclosing on Education Management's assets and selling those assets to a new subsidiary of the parent, and (iii) distributing new debt and equity to consenting creditors. Non-consenting creditors, in effect, would be left as creditors of an empty shell company and without a parent guarantee. This transaction technically complied with the terms of the bond indenture, but holders of more than a majority of the bonds also consented to the transaction, providing an independent path to releasing the guarantee.

Holdout bondholders, representing less than 10% of the bonds, sued, arguing that the transaction violated Section 316(b). To the surprise of most practitioners, the court agreed. Breaking from most past court opinions on the topic, the court held that Section 316(b) prevented not only the modification of an indenture's payment terms on the basis of a majority vote, but also protected a bondholder from any impairment of such bondholder's right to payment through a non-consensual majority restructuring otherwise expressly permitted by the applicable contractual terms. In effect, the court held that the holdout bondholders had to be paid off, or the restructuring would have to be effectuated through an in-court bankruptcy proceeding – again, not an economically viable alternative for Education Management. In contrast, had one of Education Management's secured bank lenders objected to this same restructuring, it would have had no right to comparable protection under Section 316(b), since the TIA does not apply to loans or other bank debt.

If more courts adopt the broad reading of Section 316(b) of the TIA, out-of-court restructurings of companies with SEC-registered bonds – or unregistered bonds issued under indentures that incorporate the provisions of the TIA by their terms – will become more challenging to structure. The court in *Caesars Entertainment* adopted the same substantive analysis of the *Education Management* decision, and that decision is subject to continuing litigation and appeals. If nothing else, these recent decisions may provide holdout bondholders with additional leverage to extract consideration from a company in financial distress and undertaking a restructuring (and, given the limited pool of resources available for debt holders implicit in the typical restructuring, increasing their share at the expense of other creditors of the company).[7]

It is interesting to note that a growing practice is emerging in newly issued unregistered notes transactions to expressly avoid incorporating Section 316(b) of the TIA by contractual reference and not tracking such wording in the indenture governing such notes, in an attempt to prevent such recent case law from applying to these unregistered notes by analogy.

Trustee or Administrative Agent – Why It Matters

A customary indenture for an offering of debt securities will include the appointment of an institution – generally a trust company with a substantial "indenture trustee" business – to act as "Trustee" for the holders of the underlying securities. Similarly, a credit agreement for a syndicated term loan will customarily include the appointment of a bank or trust company to act as "Administrative Agent" for the lenders.[8] Customary "boilerplate" language will invest the Trustee or Agent with the authority to act on behalf of the "holders of the notes" or the "lenders", and will provide the Trustee or Agent with customary indemnification (by the company and by the holders/lenders). While the Trustee/Agent acts on behalf of the group of holders/lenders as a whole, it is generally the case that the Trustee/Agent is authorised to take direction from – and is fully protected in relying on – instructions given by a majority of the holders/lenders.

However, as between a Trustee and an Agent, it is generally understood that the Trustee's role is more passive – after all, the Trustee generally has no separate relationship with the noteholders for whom it acts, nor has the Trustee usually had any role in arranging the financing in question. Rather, the Trustee's function is almost exclusively ministerial in nature, and largely involves collecting payments from the issuer and disbursing funds to the holders of the notes. The Agent, however, is often an affiliate of one of the arrangers of the bank loan facility in question and, if the facilities include a revolving credit facility that was arranged at the same time as a term loan and as part of the same documentation (as is often the case), the Agent itself or one of its affiliates will typically hold commitments under that revolving credit facility. Because of its relationship with the syndicate lenders and its holdings of revolving credit facility debt, and because credit agreements typically require more in the way of ongoing consents and deliverables than indentures (convergence notwithstanding), the Agent is typically more involved in day-to-day administration of the facility and will generally have one or more employees that monitor the credit and interface with the borrower and the lender syndicate on a regular basis.

As a result, an Agent will generally be actively involved in a credit facility and will spend time understanding the implications of any action it is being asked to undertake on behalf of one party or another under the facility. In recognition of the more limited role of a Trustee and of the practical reality that Trustees tend to seek clear, mandatory instruction rather than discretion, indentures generally provide that it is a condition to the taking of any action by the Trustee that the issuer provide it with an officer's certificate (and often an opinion of counsel) to the effect that the requested action is authorised under the indenture. And the exculpatory provisions of the indenture usually provide that the Trustee will incur no liability for any action it takes in reliance on such a certificate and/or opinion.[9] No such parallel provision authorising an Agent to act based on a certification/opinion from the borrower exists in a typical syndicated credit agreement.[10] Rather, when asked to take actions – which can range from execution of simple amendments or acknowledgement of joinder documents to approving the forms of new intercreditor agreements or the form and substance of additional permitted financings and amendments effecting a complicated restructuring – the Agent will typically review the credit agreement (often with its counsel) and then make its own determination as to whether the action in question is permitted and/or required. In close cases, the Agent may seek input from the lenders to bring itself within exculpation provisions that expressly apply to actions taken "with the consent of" or "at the direction of" a majority of the lenders.

The converse to the general principle that an Agent can act with the consent of or direction from the majority of the lenders is that it would be rare for an Agent to act *against* the express wishes of a majority of the lenders.[11] Given the Agent's role as a representative of the lenders, an Agent acting contrary to the majority of the lenders would likely risk removal or other consequences. However, in today's environment of increasingly complex capital structures and diverse lender bases, it can sometimes be difficult or even impossible

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to get a majority of lenders to agree on anything, including a distressed borrower's proposed amendments. Consequently, the Agent might be stuck in a precarious position between conflicting sub-groups of lenders. One can easily envision such a contentious scenario, where a substantial minority of lenders wants the Agent to undertake a certain action, such as executing an amendment or joinder agreement, but a majority group of lenders stands in opposition. Stuck between opposing lenders, even in cases where the Agent would be permitted to act in its own discretion, the Agent might err on the side of inaction. In extreme cases, an Agent could even resign to avoid any consequences under such a scenario.

The example above underscores the tension between the Agent's role as administrator and the requirement of its participation – again, often styled as ministerial or confirmatory – in effecting a substantive amendment or permitting the borrower to issue new debt or take other consequential actions, which can become manifest when the action in question is the subject of lively disagreement within the lender group. On the other hand, a similar scenario involving a Trustee would seem unlikely in practice, since – as noted before – the signature of the Trustee on any required documentation could likely be procured on the basis of a certification from the issuer that the transaction was authorised (potentially with an opinion of counsel). While existing noteholders could perhaps instruct the Trustee otherwise, an indenture does not typically afford discretion but does specify where a clear right to indemnity lies. Thus, such a scenario sheds light on a key difference between the roles of a Trustee and an Agent.[12]

The *Pro Rata* Sharing Provision and its Effect on Syndicated Term Loan Restructurings

Buried away in most syndicated credit agreements is the "*pro rata* sharing" provision, a provision that is not found in bond indentures.[13] A customary formulation – taken from the Loan Syndication and Trading Association's "Model Credit Agreement Provisions" – is as follows:

> If any Lender shall, by exercising any right of setoff or counterclaim or otherwise, obtain payment in respect of any principal of or interest on any of its Loans or other obligations hereunder resulting in such Lender receiving payment of a proportion of the aggregate amount of its Loans and accrued interest thereon or other such obligations greater than its pro rata share thereof as provided herein, then the Lender receiving such greater proportion shall (a) notify the Administrative Agent of such fact, and (b) purchase (for cash at face value) participations in the Loans and such other obligations of the other Lenders, or make such other adjustments as shall be equitable, so that the benefit of all such payments shall be shared by the Lenders ratably in accordance with the aggregate amount of principal of and accrued interest on their respective Loans and other amounts owing them.[14]

A quick bit of history might be helpful. It is generally understood that the *pro rata* provision was incorporated into credit agreements (when loans tended to be provided almost exclusively by relationship banks) to address the risk that a borrower would – if faced with financial difficulties – attempt to consummate transactions that would favour one or more of its lenders under a particular facility with which it has a better or economically more important relationship at the expense of other lenders under that facility. This concern makes sense if the lending syndicate is viewed as being collectively exposed to the Borrower, and if the syndicated loans are viewed as a single loan that has been divided up among multiple lenders (as opposed to multiple loans having, at least initially, the same terms).[15]

The effect of this provision – which often requires a 100% vote (or a vote of all affected lenders) to amend – is to require any lender that benefits from receiving a payment (or other consideration) on account of its loans that exceeds its *pro rata* share of all payments in respect of loans made by the Borrower to purchase participations in the loans of other lenders, so as to ensure that all payments are received by the lenders on a ratable basis. Importantly, the "or otherwise" language brings into the ambit of the *pro rata* sharing provision many transactions that to the casual observer might not appear to be a "payment", including the exchange of a loan for some other consideration.

Indeed, when finance lawyers are asked to structure an exchange offer involving term loans under a syndicated credit agreement, one of the first things they think about is whether the proposed transaction requires only the consent of the exchanging lenders, or whether an amendment to the credit agreement to address any potential issues under the *pro rata* sharing provision will be required. As noted above, it is generally understood that the exchange of loan principal for other consideration is a "payment" in respect of that loan principal and, as a result, implicates the *pro rata* sharing provision. If the exchange offer is structured so that each existing lender (or each existing lender of the applicable class) participates and exchanges the same proportion of existing loans of the applicable class, then issues under the *pro rata* sharing provision will generally not arise.

However, particularly in a distressed context (a common scenario for exchange offers), there is often a sub-group of creditors that negotiate for the right to exchange their own debt for some other consideration – in other words, the deal itself is structured so as to permit the participation of only a chosen few creditors. Over the past year or so, there have been a number of exchange offers, with creditors generally being offered the opportunity to exchange existing debt at a discount (i.e., creditors have been offered the right to exchange 100% of unsecured or junior debt for a lesser principal amount of a new obligation that ranks higher in the capital structure, with the effect of improving the exchanging creditor's prospects of recovery, albeit on a smaller principal amount, while simultaneously diminishing the borrower/issuer's overall debt burden). These "up-tier" exchanges, involving the repurchase of existing notes and the issuance of new notes, have in most cases been permitted by the express provisions of the indenture without the need for consents to amend the restrictive covenants.

It is interesting, and not coincidental, that in all of the recent up-tier exchanges sponsored by a sub-group of the creditors of which we are aware, the existing debt obligation that was exchanged was a security and not a term loan, as a *pro rata* sharing provision is not a customary feature of indentures. Companies (and debtholders) have substantially less flexibility to structure and effectuate such an exchange offer where the obligation being exchanged is a term loan. Because of the *pro rata* sharing provision, such a transaction involving only a sub-group of lenders will likely only be permissible if the *pro rata* provision could be amended, which, as noted, would require the consent of at least a majority (and often 100%) of the lenders, thus effectively eliminating the ability of the borrower to negotiate only with the chosen few.

MNPI and the Public/Private Split

The U.S. securities laws impose restrictions on the use of "material nonpublic information" ("MNPI") in the purchase or sale of securities by parties in the market, with certain types of trades viewed as "insider trading" under Rule 10b-5.[16] For those restrictions to apply, however, the instruments being traded must be "securities" under the U.S. securities laws.

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Interests in bank loans have typically not been considered securities. Although this assumption is not free from doubt – and has generated some scepticism around institutional bank loans of the sort considered in this article, particularly as convergence moves this market closer to the bond market in many respects – it continues to be the operating assumption of market participants that Rule 10b-5 will not apply to trading in loans. This does not mean, however, that a lender receiving MNPI in its capacity as a lender will be free to use that MNPI in trading bonds or other securities that the borrower may have outstanding. The tension inherent in this distinction has been the subject of loan market responses but also a continuing degree of uncertainty, enhanced in the context of a workout or restructuring where even small differences in information about an issuer can create significant differences in the price of its debt.

Large financial institutions have developed and maintain elaborate internal procedures to allow certain of their employees to receive MNPI while effectively insulating employees in other groups. So, for example, an agency group of a bank may receive MNPI in the ordinary course of its discussions with a borrower and the administration of its loan, while traders working at that same bank or an affiliate make and maintain trades in its bonds without sharing that MNPI. But not all institutional investors in loans want or are able to implement these sorts of controls – in fact, it may be the case that the same person making the decision to purchase loans on one day will decide to purchase or sell that same company's bonds tomorrow. These loan investors will typically opt to be "public-side" lenders, specifically waiving any right to receive MNPI sent to other, "private-side", lenders and the Agent. A public-side lender receives assurance that it is not in possession of MNPI that could compromise its ability to trade in the company's securities.

Absent information walls and similar procedures of the type described above, a private-side lender will generally avoid trading in bonds absent reliable assurance that it is not in possession of MNPI at the time of the trade. However, there is no Rule 10b-5 restriction on buying or selling from a public-side lender;[17] when trading with a lender that may be at an informational disadvantage, a private-side lender will rely on protections and waivers in the operative documents or on separate "big boy" letters in which the public lender acknowledges and waives any right to complain about any superior information that its counterparty possesses. While it is beyond the scope of this article to address the efficacy of these waivers, trading of this sort does occur among sophisticated parties.

Even in the context of bonds – clearly viewed as securities – the law of insider trading can introduce some confusion into the restructuring process. A company engaged in restructuring its debts will often engage in discussions with representative committees of its creditors, testing possible ideas and giving information in advance of release to a broader group. These discussions often are done under the protection of a non-disclosure agreement that provides both that the debt holder will not trade in the company's securities for a specified period and that, at the end of that period, the company will "cleanse" any MNPI that the creditor obtained in those discussions by making the information public. Debt holders have typically been willing to rely on a company's view that any information divulged by the company to the creditor is no longer MNPI with respect to the company.

In 2011, however, in a decision denying confirmation of a Chapter 11 bankruptcy plan of Washington Mutual, Inc. ("WaMu"), the United States Bankruptcy Court for the District of Delaware gave investors engaging in these sorts of discussions reason to reevaluate this practice.[18] In the *WaMu* decision, the bankruptcy court determined that even creditors who might not be classic "insiders" of WaMu could be "temporary insiders" with MNPI as a result of their participation in prospective settlement discussions, and could not rely, without a duty of further inquiry, on WaMu's commitment to disclose all MNPI at the end of an agreed confidentiality period, or on WaMu's judgment that the information actually disclosed comprised all MNPI that those creditors possessed.

The intersection of the law of insider trading; the asymmetry of information between different groups of lenders (on the one hand) and between lenders and bondholders (on the other); and the possibility that the bankruptcy process may impose equitable requirements more stringent than those of Rule 10b-5 are all contributing to continuing uncertainty for traders in distressed debt, and to different ways in which a company in distress can interact with its lenders and bondholders.

Conclusion

Despite the convergence between the terms and markets for high-yield bonds and Term Loan B bank debt, differences in contractual and other legal rights remain. These differences have shown themselves to be important during out-of-court restructurings. Given recent decisions in the S.D.N.Y. regarding the scope of the TIA, non-consenting bondholders will have relatively more leverage than their bank lender counterparts during certain types of out-of-court restructurings. The role of the bank Agent *versus* a bond Trustee could impact the restructuring a company can implement out of court, if the company requires the signature of the Agent or Trustee on even a seemingly innocuous document. *Pro rata* sharing provisions in bank loans could effectively prohibit a non-*pro rata* deal that might be achievable if the debt were issued under a standard high-yield indenture, and sensitivities surrounding access to MNPI and differences between the standards governing communication among and between "public-side" and "private-side" creditors impose their own challenges to restructuring negotiations. Investors in distressed companies should carefully consider these differences (and the impacts they could have) when weighing possible restructuring solutions.

Endnotes

1. Meyer C. Dworkin & Monica Holland, "Recent Trends in U.S. Term Loan B", 2 *The International Comparative Guide to Lending & Secured Finance 2014* 26 (2014).
2. *UPIC & Co. v. Kinder-Care Learning Ctrs*., 793 F. Supp. 448 (S.D.N.Y. 1992).
3. *YRC Worldwide Inc. v. Deutsche Bank Trust Co. Americas*, 2010 U.S. Dist. LEXIS 65878 (D. Kan. July 1, 2010).
4. *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 2015 U.S. Dist. LEXIS 81395 (S.D.N.Y. June 23, 2015).
5. *Meehancombs Global Credit Opportunities Funds, LP v. Caesars Entm't Corp.*, 80 F. Supp. 3d 507 (S.D.N.Y. 2015).
6. At the time the bonds were issued, the parent did not guarantee the secured bank debt. However, as part of a later amendment to that credit agreement, a parent guarantee was put in place.
7. Holders of bank debt, however, have no TIA rights to appeal to, so their rights are governed exclusively by the contractual language of the relevant agreements. In response to these decisions, attempts have recently been made to introduce legislation in the United States Congress to amend and expressly narrow Section 316(b) to its understood meaning.
8. The "Administrative Agent" or "Trustee" will also typically act as "Collateral Agent" if the relevant financing is secured. For purposes of this article, references to "Administrative Agent" or "Trustee" include the collateral agent role. In addition, we use the term "Agent" rather than "Administrative Agent" for simplicity.
9. The indenture will also typically provide that the Trustee can refuse to take any action that, in the opinion of its counsel, would expose it to liability.

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10. As noted below, the Agent will typically be exculpated and be entitled to indemnification for any action taken with majority lender consent.
11. While this is also true for a Trustee, bank lenders are much better positioned to coordinate and communicate with each other than bondholders are, due largely to the existence of Intralinks and similar websites that facilitate lender communication. So it is more difficult to get a majority of noteholders to agree to anything, absent an express solicitation by the issuer.
12. It is worth noting that this issue is by no means limited to a restructuring context. For example, what if a borrower wanted to incur new term loans in a "plain-vanilla" exercise of the "incremental facilities" (or accordion) option that is common to many credit agreements, outside a restructuring context, in a transaction where the conditions to issuance were clearly met, but the Agent was directed by a majority of the lenders not to sign the relevant documentation? In such a case, it would seem that the borrower would have difficulty (or at least a delay) in getting the transaction executed. Do borrowers that have expressly bargained for the flexibility inherent in an accordion exercise (specifically, the right to NOT have to get the consent of the Required Lenders) really expect that the Required Lenders could nonetheless join together to frustrate that transaction? Litigation would almost certainly follow if such a situation was to arise, and the borrower might ultimately prevail. But we wonder whether borrowers in general understand that they are exposed to this potential hold-up risk merely because the Agent is required to perform what has generally been assumed to be the largely ministerial task of executing a joinder.
13. Bond indentures sometimes, but not always, have a "payment for consent" provision prohibiting non-*pro rata* payments in return for consents under an indenture. Such a provision is far more limited in application than a *pro rata* sharing provision as repurchases of notes do not necessarily involve solicitation of consents.
14. The provision goes on to set forth a few exceptions, none of which are relevant for our purposes.
15. One of our colleagues at Davis Polk has taken to referring to this view as the "shared taxicab model," i.e., we are all heading to the same destination and will get there (or not) at the same time and with the same economic return.
16. Rule 10b-5 under the United States Securities Exchange Act of 1934, as amended (the "Exchange Act"). Although other provisions of the Exchange Act can be relevant to questions of insider trading, 10b-5 is the centrepiece of the thinking and case law on the subject.
17. Note that the absence of 10b-5 liability does not mean absence from *all* liability. A buyer or seller of loans could still allege common law fraud, just to use the simplest example, against its counterparty.
18. *In re Wash. Mut., Inc.*, 442 B.R. 314 (Bankr. D. Del. 2011).

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