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The Examiners: Practical Impairment Leads to Chapter 11

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How does bondholders' use of the Trust Indenture Act affect companies' ability to complete out-of-court restructurings?

The Trust Indenture Act of 1939 was enacted to protect investors and applies to notes, bonds, debentures and other debt instruments that have been qualified by the Securities and Exchange Commission. At its inception, the TIA was designed to prevent abuses by indenture trustees that had adversely affected the national public interest. The TIA was also meant to protect holders of minority positions in those debt instruments from insiders of a company who may have or acquire majority positions.

Section 316(b) of the TIA is mandatory and specifically promulgated to protect a bondholder's right to receive payment of both principal and interest. Its terms cannot be prohibited by the terms of an indenture: "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… shall not be impaired or affected without the consent of such holder."

As such, an issuer cannot alter its obligation to pay bonds without the consent of each bondholder, outside of a bankruptcy proceeding. In this way, the TIA was designed to protect investors by providing judicial scrutiny of debt-restructuring plans.

This has been black letter law for 75 years and was without controversy until recently. However, a few recent and well-publicized opinions by the U. S. District Court for the Southern District of New York have given holdout noteholders the power to preclude negotiated out-of-court restructurings supported by a vast majority of number and amount of other noteholders in those matters. At the heart of the issue is whether section 316(b) of the TIA protects more than the explicit legal right to receive payment and should be expanded to protect the noteholder's practical ability to receive payment when due. A noteholder's practical ability to be paid can be impaired by the transfer of assets by the issuer, the release of guarantees by a parent of the issuer or in a number of other ways which would allow a sophisticated issuer to bypass the TIA's protections. These recent cases are contradictory to other district-court and bankruptcy-court decisions that have held that impairment must be a breach or amendment of a core term of the debt instrument that precludes payment.

The recent cases in New York make it impossible to conduct an out-of-court restructuring without the consent of 100□ of the affected noteholders. The only alternate to override the holdout noteholder is to have the issuer file for chapter 11 bankruptcy and restructure the debt through a plan of reorganization where 100□ noteholder approval is not required. The recent decisions in New York recognize this result and reason that the SEC always meant to require judicial oversight in order to impair a noteholder's protections under the TIA□ whether an impairment to payment or the practical ability to receive payment when due.

□hile the reasoning of these decisions may be a stretch, it makes sense that a noteholder's practical ability to receive payment when due constitutes impairment just as a breach or amendment to a core term of the debt instrument that precludes payment does. Many have called these decisions activist interpretations, broad misreading of settled law, etc., but the impact is clear□ there will be fewer indentures issued and more chapter 11 filings while this issue remains unresolved. The Second Circuit Court of Appeals will decide, and perhaps the issue will reach the U. S. Supreme Court.

□hich group of investors is the TIA meant to protect□ the original issue noteholders or activist investors that buy even the smallest position in an indenture, or both□Unfortunately, the result of expanding the TIA's protections to practical impairment now provides a potential windfall to holdout noteholders who can demand a hefty price for their consent and leave the issuer and the majority of consenting noteholders with chapter 11 as the only option. That is a bad outcome and inconsistent with the original intent of the protections provided by the TIA. Out-of-court restructurings must always be a viable first option before chapter 11.

The TIA must be fixed to prevent activist investors from holding up an out-of-court restructuring. A simple amendment to section 316(b) to allow a 75□ supermajority in number and amount of noteholders to effectuate out-of-court restructurings without the necessity of a chapter 11 filing, provided that the indenture itself supports the restructuring, would alleviate the leverage that activist investors now enjoy under these recent cases. Such an amendment leaves the original intent of the TIA intact and would allow, and encourage, more out-of-court restructurings.

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