Notes

A Renewed Need for Collective Action: The Trust Indenture Act of 1939 and Out-of-Court Restructurings*

I. Introduction

Spurred on by near-zero interest rates, U.S. companies have issued corporate bonds at a record pace.[1] The amount of outstanding corporate debt now exceeds $8.2 trillion, marking a 50% increase since the subprime mortgage collapse.[2] As U.S. policy makers intended, the corporate-bond market grew to meet the capital needs of the U.S. economy.[3]

Unfortunately, the statute that governs the issuance of corporate bonds, the Trust Indenture Act of 1939 (TIA), may inadvertently raise the cost of borrowing for corporate-bond issuers. In particular, § 316(b) of the TIA limits how corporate issuers can renegotiate with bondholders,[4] which may needlessly push some financially distressed companies into Chapter 11 bankruptcy. Since it is difficult to predict which companies will run into financial trouble, this leads bondholders to demand higher rates of interest from *all* corporate issuers.

To see the problem, it is important to recognize that many financially distressed companies are able to avoid bankruptcy altogether. In fact, a considerable number manage to privately restructure their obligations without ever going to court. This is called a "workout": a company with a temporary

---

* I would like to thank the *Texas Law Review* for all its work in editing this Note. I am also immensely grateful to Professor Henry T.C. Hu, whose thoughtful comments and questions greatly improved the early drafts and helped guide me through the entire writing process. Lastly, and most importantly, I wish to thank my wife, Catherine Lucchesi. This Note would not have been possible without her support and love. All errors are my own.

1. Owen Davis, *Fed Rate Hike: Why Seven Years of Near-Zero Interest Rates Failed to Boost Wages*, INT'L BUS. TIMES (Sept. 16, 2015, 7:14 AM), http://www.ibtimes.com/fed-rate-hike-why-seven-years-near-zero-interest-rates-failed-boost-wages-2098447 [https://perma.cc/F8YW-WC95].

2. SEC. INDUS. & FIN. MKTS. ASS'N, US BOND MARKET ISSUANCE & OUTSTANDING, at tbl.2 (2016), http://www.sifma.org/uploadedfiles/research/statistics/statisticsfiles/cm-us-bond-market-sifma.xls?n=92029 [https://perma.cc/CA3M-BTC8].

3. HONG XIE & AYE M. SOE, S&P 500 BOND INDEX: SIMPLIFYING THE U.S. CORPORATE BOND MARKET 2 & ex. 2 (2015), https://us.spindices.com/documents/research/research-sp-500-bond-index-simplifying-the-us-corporate-bond-market.pdf [https://perma.cc/2B6Y-ZNYV]; *see also* OLIVER WYMAN, WORLD ECON. FORUM, ACCELERATING EMERGING CAPITAL MARKETS DEVELOPMENT: CORPORATE BOND MARKETS 16–20 (2015), http://www3.weforum.org/docs/WEF_Capital_Markets_Report_2015.pdf [http://perma.cc/M5ES-E7T5] (explaining the importance of corporate bond markets on the financial system and economy).

4. Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp(b) (2012).

shortage of cash, for example, might offer to make larger payments to its bondholders in the future in exchange for not having to pay anything now.[5] And its bondholders might take that deal to avoid the hassle of a default. When these negotiations are successful, workouts provide a relatively quick and inexpensive solution.

Granted, for complex financial problems Chapter 11 bankruptcy may be the only solution.[6] In these challenging cases, the troubled corporate issuer files a bankruptcy petition, and once the petition is filed, a court will oversee the entire process and scrutinize every step of the reorganization in accordance with the U.S. Bankruptcy Code.[7] But Chapter 11 bankruptcy is generally regarded as a lengthy, expensive process—one that issuers and bondholders want to avoid; the average bond workout, for instance, takes three months, "while a bankruptcy reorganization typically takes two or three years."[8]

So it is troubling that the TIA favors Chapter 11 bankruptcy by placing restrictions on how workouts can be negotiated. Under § 316(b), specifically, corporate issuers cannot restructure their obligations by obtaining the approval of a majority of their bondholders.[9] Rather, they must obtain the consent of each bondholder individually.[10] This makes renegotiating with bondholders as a class quite challenging.

Moreover, these restrictions appear to be almost unique in modern corporate law. A majority of shareholders can approve an amendment to a corporation's certificate of incorporation and bind all owners of the corporation.[11] Similarly, a two-thirds majority of creditors, which includes bondholders, can "cramdown" a reorganization plan under Chapter 11 bankruptcy, overriding the minority's claims.[12] But a majority of bondholders cannot alter the interest and principle owed under an indenture; § 316(b) bars collective action.[13]

Nonetheless, the TIA has not stopped workouts altogether. In the last several years, numerous issuers have restructured corporate debt outside of bankruptcy because enterprising lawyers and bankers have developed suit-

5. Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 316, 321 (1990).

6. *See id.* at 316, 324–25, 345 (explaining many reasons workouts might be successful).

7. *Id.* at 317–18; *Process – Bankruptcy Basics*, U.S. COURTS, http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/process-bankruptcy-basics [https://perma.cc/Y4J7-5CJR].

8. Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 236 (1987).

9. George W. Shuster, Jr., *The Trust Indenture Act and International Debt Restructurings*, 14 AM. BANKR. INST. L. REV. 431, 433–34 (2006).

10. *Id.* at 434.

11. *E.g.*, DEL. CODE ANN. tit. 8, § 242(b)(1) (2014).

12. 11 U.S.C. §§ 1126(c), 1129(a)(8)(A), 1129(b)(1) (2012).

13. Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp(b) (2012).

able, although less efficient, alternatives.[14] But despite their efforts, they likely have not overcome the statutory bias against out-of-court restructurings.

Recent developments in the case law have likely made the problem worse. Two federal district court decisions—*Marblegate Asset Management v. Education Management Corp.*[15] and *MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entertainment Corp.*[16]—have further curtailed the use of workouts, which raises the question: Are workouts still a viable means of restructuring? Congress may need to finally amend § 316(b) of the TIA to allow for reorganizations through collective action.

In this Note, I argue that Congress should repeal § 316(b). In its place, a new Securities and Exchange Commission (SEC) rule that requires all out-of-court restructurings with bondholders to be negotiated by an uncoerced majority vote should be implemented. Mandating collective action in reorganizations would finally bring the TIA in line with other areas of corporate law and eliminate crucial problems with the current statutory approach. Part II of the Note briefly reviews the legislative history and original purpose of the TIA. Part III addresses the two federal district court cases that recently interpreted the scope of § 316(b)'s prohibition on collective action. Part IV details my proposal for repealing the prohibition against majority voting and realizing a new SEC rule. Finally, Part V summarizes this Note's recommendations.

II. Regulating Workouts: The Trust Indenture Act of 1939

A. The Trust Indenture Act's Purpose: Protection from Backroom Deals

With support from the SEC, Congress passed the TIA during the Great Depression, largely to protect retail investors from backroom deals.[17] Specifically, § 316(b) states that "the right . . . to receive payment of the principal of and interest on [an] indenture security . . . shall not be impaired or affected without the consent of [the] holder."[18] When the Senate and House subcommittees debated the law, each felt that § 316(b)'s prohibition against collective action was integral to their aim:

14. *See, e.g.*, MeehanCombs Glob. Credit Opportunities Funds, LP v. Caesars Entm't Corp., 80 F. Supp. 3d 507, 512 (S.D.N.Y. 2015) (using side payments to induce bondholders to participate in the out-of-court restructuring); Marblegate Asset Mgmt. v. Educ. Mgmt. Corp., 75 F. Supp. 3d 592, 597 (S.D.N.Y. 2014) (making an exchange offer conditioned on exit consents).

15. 75 F. Supp. 3d 592 (S.D.N.Y. 2014).

16. 80 F. Supp. 3d 507 (S.D.N.Y. 2015).

17. *See* S. REP. NO. 76-248, at 4–8 (1939) (highlighting inadequate disclosure as a primary danger to bondholders in trust indentures); Roe, *supra* note 8, at 234 (detailing the SEC's rationale for supporting the TIA).

18. Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp(b) (2012).

> Evasion of judicial scrutiny of the fairness of debt-readjustment plans is prevented by this prohibition. . . . This prohibition does not prevent the majority from binding dissenters by other changes in the indenture or by a waiver of other defaults, and the majority may of course consent to alterations of its own rights.[19]

Notably, these Congressional reports, along with comments made by the SEC, reflect a belief that recapitalizations demand the supervision of judges.[20] In practice, Congress and the SEC sought to nudge insolvent organizations into bankruptcy.[21]

Congress's skepticism toward out-of-court restructurings was likely due to the perceived financial improprieties of the decades leading up to the New Deal, one example being the suspect use of railroad receiverships around the turn of the twentieth century.[22] A receivership was a form of out-of-court restructuring roughly analogous to Chapter 11 bankruptcy, but unlike Chapter 11, the original shareholders of these insolvent firms often managed to maintain their equity stakes despite many creditors not being paid.[23] In effect, debt was subordinate to equity and critics of receiverships saw this as nothing more than large shareholders (or insiders) profiting at the expense of retail investors.[24] Congress passed the TIA, in part, to ensure that workouts would not be abused in a similar manner.[25]

Moreover, New York's Negotiable Instrument Law, which in practice governed the issuance of almost all bonds at the time, already prohibited collective action.[26] For a bond to be negotiable, the instrument had to be "a sum certain, due on a date certain."[27] In 1928, the New York Court of Appeals ruled that this requirement meant that core terms of a bond could not be amended by majority vote.[28] Hence, § 316(b) did not upset the industry custom for recapitalizations because the statute simply mirrored New York's existing law.[29]

19. H.R. REP. NO. 76-1016, at 56 (1939); S. REP. NO. 76-248, at 26–27.

20. Roe, *supra* note 8, at 234.

21. *Id.*

22. *See* Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420, 1444–45 (2004) (explaining that many suspected collusion among bankers to keep out outside bidders in railroad restructuring).

23. *Id.* at 1445.

24. *Id.* at 1445–46.

25. Roe, *supra* note 8, at 251.

26. Mark J. Roe, Commentary, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 661 (1996).

27. *Id.*

28. Enoch v. Brandon, 164 N.E. 45, 47 (N.Y. 1928).

29. *See* H.R. REP. NO. 76-1016, at 56 (1939) (specifying that the right of any indenture holder to receive principal and interest amount "may not be impaired without his consent").

B. *The Need for Recapitalizations by Vote*

The Congress and SEC that passed the TIA undoubtedly favored restructurings through bankruptcy.[30] However, changing views among legal commentators, as well as changes in federal and state law, have undercut this strict policy preference for judicial supervision.[31] Notably, many financial and legal scholars now regard bankruptcy as a relatively expensive form of restructuring.[32] They contend that if a troubled issuer could avoid insolvency without incurring the additional expense of Chapter 11, then it should.[33] Moreover, in 1978 Congress passed the Bankruptcy Reform Act that allowed for so-called "prepackaged" bankruptcies: now if more than two-thirds of a firm's creditors consent to a reorganization plan, the bankruptcy judge must confirm the plan, thus removing all judicial scrutiny from the process.[34] In part then, the "raison d'etre [for § 316(b)] is now gone."[35] Finally, § 316(b)'s prohibition against collective action significantly distorts the bargaining process between issuers and their creditors.[36] And these bargaining hurdles consume time and capital that should otherwise be put to more productive uses like research and development.

1. Holdouts and the "Buoying Up" Effect.—To understand the bargaining dynamics of a workout, it is essential to first grasp how workouts come about, and this is best illustrated by an example. Suppose that a company issues $2 billion in bonds and that you and I are its only bondholders, each owning $1 billion of the company's debt. At the time we purchased the

30. *See* William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. 1, 53 n.182 (2004) ("The purpose of [§ 316] was . . . to force the parties into the then new Chapter X bankruptcy procedure, where strong judicia[l] supervision was provided for."); Roe, *supra* note 8, at 251 ("The SEC wanted trust indenture legislation that would bring contractual recapitalizations under the jurisdiction of the federal bankruptcy court."); Shuster, *supra* note 9, at 438 n.27 ("[I]n passing the TIA Congress wanted to force bond debt restructurings into court proceedings under bankruptcy law . . . .").

31. Roe, *supra* note 8, at 234.

32. *See* Edith S. Hotchkiss et al., *Bankruptcy and the Resolution of Financial Distress*, *in* 2 HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 235, 251 (B. Espen Eckbo ed., 2008) ("[T]he direct restructuring costs are likely to be substantially lower for an out-of-court restructuring than for a court-supervised bankruptcy."); Roe, *supra* note 8, at 235–36.

33. Roe, *supra* note 8, at 236.

34. 11 U.S.C. §§ 1126(c), 1129(a)(8)(A), 1129(b)(1) (2012).

35. Roe, *supra* note 8, at 255.

36. *See* John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1224 (1991) (noting that the risk of incurring bankruptcy costs raises uncertainty, which causes bondholders to demand a higher rate of return and issuers to pay more for capital).

bonds, the company was in a strong financial position and had a good credit rating; it had healthy cash flows from which to make bond payments and was valued at well over $20 billion.

But all of a sudden, the company runs into financial trouble; its cash flows dry up, and its valuation drops to $1 billion. Even the safest investments come with risk, and this turns out to be especially true in our case.

Under these circumstances, the company most likely cannot afford to pay us. Our bonds have also probably lost a significant amount of their value. Let us say they are trading at a 50% discount to their face value, leaving us each holding bonds worth $500 million. So we have both lost $500 million on paper and might reasonably fear that we are going to lose our entire investment.

This is the point when the troubled issuer will try to renegotiate with us. Often, the issuer will make what is called an "exchange offer": in return for all of the bonds that we each hold, the company will offer to give each of us half of the company. That is, we would each receive 50% of its common stock, which is also valued at $500 million, if we hand over our bonds and give up our rights to future bond payments. And remember, neither of us would necessarily lose money on the exchange; the value of our bonds has fallen to $500 million and even if we kept the bonds, the issuer might not be able to make the payments. Rather, we would be making an even trade of debt for equity. And this shift in the company's capital structure is the key feature. The troubled issuer can stop making bond payments that it cannot afford, and the bondholders are able to trade in bad debt for the chance to profit from the company's eventual turnaround.

But, unlike our example, a typical workout involves far more than two bondholders, and this creates a serious problem because nearly all of the bondholders have to accept an exchange offer for it to be successful. Otherwise, the concessions made by those who consent will not benefit the insolvent company but, instead, become the gains of (or "buoy up") those bondholders who held out. This is referred to as a "holdout" problem, and at its most pernicious, a holdout problem can entirely undermine an out-of-court restructuring.[37] To see this, let us return to the example.

Suppose that I agree to the exchange offer discussed above, but you do not. Under these circumstances, I am in trouble: the entire value of the corporation has shifted to you, the nonconsenting bondholder. Although we both initially had competing claims as bondholders, you will now be paid before me because you are still a creditor while I have become an owner. Recall that the corporation is still valued at $1 billion dollars and you, the holdout, are still owed $1 billion as a bondholder, which leaves no residual

37. Roe, *supra* note 8, at 236.

value for me. Hence, this hypothetical restructuring amounts to a transfer of wealth from one bondholder to another, and does nothing to shore up the troubled issuer.[38]

Put another way, holding out in a restructuring can be viewed as a strategic attempt to gain "priority"; before the restructuring, the two investors had competing rights to payment, but when one bondholder participates in the exchange without ensuring that the other follows suit, the consenting bondholder allows the holdout to jump to the front of the line.[39] Because equity is subordinate to debt, the consenting bondholder will always be paid last, and often there will not be anything left once those in front of him have been paid.[40] Even if a workout does not involve an exchange of debt for equity—but rather an exchange of old bonds for new ones, which typically have terms that are more favorable to the issuer—the same principle applies. The holdouts that kept the old bonds will typically have stronger contractual rights than those who consented to the exchange.[41] This also gives the holdouts a kind of priority where the capital that the restructuring frees up flows to them rather than the troubled issuer.

Granted, the effect of a holdout will not typically be so severe as to dissuade the other creditors from agreeing to a deal.[42] However, the fear of holdouts can make bondholders wary of out-of-court restructuring in general. Even when issuers and bondholders can overcome these bargaining frictions, the negotiated solution is still likely to be inefficient.[43] For instance, in the best-case scenario, all the bondholders participate in the workout. The only additional expense is the higher transaction cost of convincing other creditors that there will not be holdouts. Then, except for this higher cost of bar-

38. This example is based off one provided by Professor Roe in *The Voting Prohibition In Bond Workouts*. *Id.* at 233 n.3.

39. *Id.* at 236–37.

40. *See* CHRIS ROUSH, SHOW ME THE MONEY: WRITING BUSINESS AND ECONOMICS STORIES FOR MASS COMMUNICATION 296 (2d ed. 2011) (explaining that "in most bankruptcy cases, the stockholders [equity] typically get nothing"); Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1457 (1990) (noting that, under the traditional rule, the proceeds of a bankruptcy are used to pay off senior creditors' debt in full, then junior creditors' debt in full, and lastly the shareholders' equity—if anything remains); Roe, *supra* note 8, at 237 n.13 (reminding readers of "the bondholder's [debt] right to be paid before stockholders [equity] in a bankruptcy").

41. *See, e.g.*, Marblegate Asset Mgmt. v. Educ. Mgmt. Corp., 75 F. Supp. 3d 592, 616 (S.D.N.Y. 2014) (holding that debtholders who refused to trade in their bonds likely had a claim against the company because "they were not told that they could be forced to accept a wholesale abandonment of their right to receive payment").

42. *See, e.g.*, JASMINE BALL ET AL., DEBEVOISE & PLIMPTON, CLIENT UPDATE: EXPANSIVE TRUST INDENTURE ACT INTERPRETATION MAY NEGATIVELY AFFECT BOND RESTRUCTURINGS 2 (2015), http://www.debevoise.com/~/media/files/client%20updates/expansivetrustindentureactinterpretationmaynegativelyaffectbondrestructurings.pdf [http://perma.cc/P2JM-C93P] (noting that although there were creditor holdouts for a restructuring agreement, the rest of the creditors continued with a "nonconsensual alternative").

43. Roe, *supra* note 8, at 238–39.

gaining, all of the money that is freed up in the workout goes towards shoring up the troubled issuer.[44] Often though, the best-case scenario is not feasible and there will not be universal participation among the bondholders.[45] As a result, the benefits of the workout are diminished in two ways—first by the higher transaction costs associated with convincing the other creditors to participate and second by the portion of the deal that is lost to the holdouts.[46] In either instance, a workout is partially thwarted because a portion of the benefits is lost.

Collective action clauses, however, can solve the holdout problem. When a majority can bind all bondholders—and act as a class—the risk of holdouts is eliminated. The requisite majority consents to the out-of-court restructuring and all the bondholders are bound by the terms of the deal, or they do not, in which case all bondholders retain their rights to payment of principal and interest under the original indenture.[47] There will simply never be a holdout. But § 316(b) of the Trust Indenture Act prohibits majority voting.[48] The section forces issuers to renegotiate indentures one by one, giving rise to unavoidable bargaining frictions, such as holdouts, that destroy value.

2. Exit Consents and Coercive Debt Tender Offers.—Barred from using collective action clauses, creative lawyers and bankers have developed alternative methods to facilitate workouts, most notably exchange offers conditioned on "exit consents."[49] There, an issuer offers to exchange new bonds for the old ones, but makes the offer contingent on a vote (commonly referred to as an exit consent): before a bondholder can accept the exchange offer, she must vote to remove the financial covenants from the original indenture.[50] While § 316(b) states that "the right . . . to receive payment of the principal . . . and interest . . . shall not be impaired," it does not preclude altering other non-core provisions of the indenture by collective action.[51] So the terms of an indenture that do not directly address the right to principal and interest—but may significantly affect the substance of those rights—can be amended by collective action.[52] For example, a majority of bondholders could vote to allow a borrower to issue senior debt, but such a vote would be

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.* at 239.

48. Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp(b) (2012).

49. *See* Coffee & Klein, *supra* note 36, at 1224–25 (discussing the exit consents and the prisoner's dilemma that it creates for bondholders).

50. *See id.* (assessing the key provisions common in exit consents).

51. 15 U.S.C. § 77ppp(b).

52. *See id.* (restricting any changes to the bond indenture as it relates to principal and interest, unless there is consent from each holder).

prohibited if it concerned the maturity date of a bond.[53] Hence, § 316(b) creates an asymmetry in the law: the terms of an indenture that brush up against the formal rights to principal and interest may be amended by collective action, whereas any vote that would alter the "substance" of the right to payment of principal and interest is prohibited.[54]

This asymmetry affords bondholders and issuers a needed degree of flexibility in negotiating and amending the non-core terms of indentures. Unfortunately, it also creates the problem of coercive exchange offers.[55] Bondholders who would not do so otherwise may participate in exchange offers and consent to strip old bonds of their covenants solely because of the structure of an offer: bondholders can either accept a deal on the issuer's terms or risk being stuck with potentially worthless bonds.[56] Understandably, many holders tender their bonds despite having objections.[57]

Formally, the structure of such an exchange offer can be modeled as a prisoner's dilemma.[58] In effect, these offers pressure bondholders into reorganizations that may not be in their best interests. Again, an overly simplified example best illustrates how this works. Similar to the earlier example, assume that you hold bonds with a total face value of $1 billion, which are trading at 50% of their face value ($500 million) because the corporate issuer is in financial trouble. But unlike before, let us suppose that you are only one of many bondholders, and you think the corporation's troubles are only temporary. In fact, you expect the value of your bonds to soon rise to $700 million.

Now, further assume that the corporation does not make a straightforward exchange offer. Instead, it makes an exchange offer with an exit consent: in return for its old bond, the company will again give you common stock, valued at $500 million. But unlike before, your acceptance will depend on the majority of all bondholders agreeing to strip the old bonds of

53. *See* Coffee & Klein, *supra* note 36, at 1224–25 (noting that although the TIA does not allow bondholders to alter certain core provisions of publicly issued debt obligations, bondholders may eliminate other important protective covenants, such as those "prohibiting the firm from incurring debt senior in any respect in right of payment to the debt for which the exchange offer is made").

54. *See* Marblegate Asset Mgmt. v. Educ. Mgmt. Corp., 75 F. Supp. 3d 592, 613 (S.D.N.Y. 2014) (holding that a contrary interpretation would "gut the [TIA's] protections").

55. *See* Coffee & Klein, *supra* note 36, at 1224–25 (contending that although § 316(b) permits bondholders to amend some provisions in the indenture, the potential power of the corporate issuer to strip the bonds of their protective covenants places bondholders in a kind of prisoner's dilemma "which coerces the bondholders to accept an exchange offer they would not otherwise accept").

56. *See id.* at 1227–29 (illustrating the various choices bondholders have in the context of coercive exchange offers being proposed by the corporate issuer).

57. *See id.* at 1229 & n.62 (illustrating that a coercive exchange offer leads bondholders to accept a deal on the issuer's terms because there is no situation where the bondholder is worse off by tendering, but the bondholder is worse off by not tendering "if a sufficient number of others tender and the offer is successful").

58. *Id.* at 1228 n.58.

their financial covenants. Supposing that the old bonds will only be worth $300 million without the covenants, this exchange offer—with exit consents—creates the following payoff structure for you.[59]

Figure 1

		You	
		Do Not Exchange	*Exchange*
Majority of other Bondholders	*Do Not Exchange*	$700 million	$700 million
	Exchange	$300 million	$500 million

So what is your best course of action? If the majority of bondholders choose not to exchange their bonds, then the entire transaction fails, and all of the holders will keep their bonds. This scenario is shown in the top row of the diagram.

Figure 2

		You	
		Do Not Exchange	*Exchange*
Majority of other Bondholders	*Do Not Exchange*	$700 million	$700 million
	Exchange	$300 million	$500 million

As the diagram shows, if the transaction fails, then you would receive $700 million regardless of your choice (remembering that you expect the value of the bonds to rise in the near term).

However, if the majority agrees to exchange its bonds and provides exit consents, then you should always participate in the exchange offer. This is made clear by the bottom row of the diagram.

Figure 3

		You	
		Do Not Exchange	*Exchange*
Majority of other Bondholders	*Do Not Exchange*	$700 million	$700 million
	Exchange	$300 million	$500 million

59. This example borrows heavily from the one provided by Professors Coffee and Klein in *Bondholder Coercion: The Problem of Unconstrained Choice in Debt Tender Offers and Recapitalizations*. *See id.* at 1227–29 (providing a similar example to the one used here).

If you do not exchange your bond when the majority has, you will be left holding bonds that have been stripped of their covenants and are only worth $300 million, while you would have received common stock valued at $500 million if you had participated.

Thus, if the majority participates, you are indifferent, but if the majority does not, you would be strictly better off by exchanging your shares. So you will always choose to participate in the exchange offer conditioned on exit consents. Looking at the diagram, this can be seen by observing that the payoffs in the right-hand column are all greater than or equal to the payoffs in the left-hand column.

Figure 4

		You	
		Do Not Exchange	*Exchange*
Majority of other Bondholders	*Do Not Exchange*	$700 million	$700 million
	Exchange	$300 million	$500 million

Every bondholder will face this exact decision, and assuming they are rational, they will all decide to exchange their shares—just as you did. So when presented with this exchange offer that is conditioned on exit consents, all holders will participate. Note, however, that this is not the efficient outcome. From the beginning, all bondholders would have been better off had they rejected the exchange: they would have been left holding bonds valued at $700 million instead of common stock worth only $500 million. The structure of the offer pushed them to accept an unwanted deal.

Not surprisingly, there is potential for abuse in the current system.[60] Issuers may be tempted to use these bargaining tactics to gain the upper hand in workout negotiations.[61] And such coercive methods are problematic. They create another kind of inefficiency. Instead of a holdout soaking up the benefits of a workout, there is the problem of issuer overreach.[62] On its face,

60. *See id.* at 1232–33 (providing a "real-world" example of the prisoner's dilemma in the current system that could easily have resulted in the incurrence of debt superior to that of the bondholders).

61. *See id.* at 1242–43 (contending that a reduction in the claim of the debt holders may be essential to the creation or preservation of value for a corporation in financial trouble and in need of new capital but incumbent management may "take advantage of the need for recapitalization by offering the debtholders too little").

62. *See id.* (noting that corporate issuers that are tempted to offer debt holders "too little" when recapitalization is needed can do so by either offering an amount that is "less than the value of the debt in bankruptcy" or that is simply an "inadequate share of the gains from cooperation").

this may seem preferable to holdouts since troubled issuers—the parties who actually need the capital—are benefiting; after all, any loss to the bondholders is the issuer's gain. But, ultimately, coercive exchange offers destroy potential value because they likely have a chilling effect on corporate-bond issuances.[63] While the resulting transfer of wealth from the bondholders is not inefficient per se, it discourages purchasers of corporate debt or at least makes them demand higher interest rates to compensate for the risk.[64] And once again this places an unneeded drag on the economy.

Exchange offers conditioned on exit consents, however, are also an important means of overcoming the problem of holdouts.[65] Without them, issuers may face insurmountable negotiating barriers.[66] As a result, § 316(b) distorts the out-of-court restructuring market and can make bondholders worse off.[67]

C. *Why Has § 316(b) Not Been Repealed?*

Despite the concerns about holdouts and coercive exchange offers, the "organizational costs" of repealing § 316(b) are regarded as too high.[68] Today, most lawyers and bankers who disagree with § 316(b)'s ban of collective action cannot justify advocating for change: "Although financiers and firms would be better off[,] . . . the value of [amending § 316(b)] is small and discounted by its future incidence."[69] Only a fraction of bond issuances are restructured, and when they are, the benefits often accrue well into the future.[70] Comparing these distant benefits to the immediate costs, most financiers, firms, and practitioners rationally choose to tolerate the status quo.[71]

---

63. *See* Andrew Laurance Bab, Note, *Debt Tender Offer Techniques and the Problem of Coercion*, 91 COLUM. L. REV. 846, 853 (1991) (contending that "by 'stripping' . . . covenants through the exit consent mechanisms, issuers aim to reduce substantially the value of bonds held by holdouts, since bonds without covenants are ordinarily extremely difficult to sell").

64. *See id.* (noting that through the exit consent mechanism, the issuer's "hope is that no reasonable investor [would] hold out if by doing so [the investor] runs the risk of being stuck with an obligation that has none of the contractual protections that bondholders regularly demand").

65. Coffee & Klein, *supra* note 36, at 1241.

66. *See* Roe, *supra* note 8, at 250 (discussing the substantial bargaining frictions associated with recapitalization).

67. *See id.* at 233 (noting that current bond regulation exacerbates the costs of financial collapse and can make "the task of recapitalization—raising new capital, renegotiating terms with creditors, or merging with another firm—more difficult").

68. Roe, *supra* note 26, at 660.

69. *Id.* at 662.

70. *See id.* (noting that only one out of fifty bond issuances in 1996, the year the article was published, became defective and needed recapitalization).

71. *See id.* (contending that the combination of adaptive mechanisms that have resulted from § 316(b), such as coercive debt, and the costs associated with changing the law and then the practice leads to the persistence of a less than optimal, but satisfactory, system).

Moreover, amending the law may have no immediate effect; courts would be unlikely to disturb the terms of existing contracts between issuers and bondholders that routinely include § 316(b)'s prohibition against majority action.[72] Although new indentures would reflect the change, the delay further dilutes the incentive to act.

Finally, the availability of other means to facilitate workouts (e.g., coercive exchange offers) also undercuts the need to cure the inefficiencies of § 316(b).[73]

Thus, the result of the TIA "is a peculiar regulatory history,"[74] a peculiar history that may have actually made amending the TIA more difficult.[75]

III. Recent Developments

Nonetheless, two federal district courts, in *Marblegate Asset Management v. Education Management Corp.* and *MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entertainment Corp.*, may have provided the impetus to amend the TIA and allow for recapitalizations by bondholder vote that are outside of bankruptcy.

Each court ruled that the defendant–issuer's exchange offer violated § 316(b) of the TIA because the offer impaired the plaintiff–bondholders' right to principle and interest without their consent.[76] But the facts of each case are distinct and demonstrate the two most common bargaining tactics adopted by issuers in negotiating with creditors: exchange offers conditioned on exit consents and the use of side payments.

A. *Marblegate Asset Management*

The federal district court in *Marblegate* addressed a $1.523 billion out-of-court restructuring attempt by Education Management Corporation (EDMC) and its subsidiaries.[77] At the time, the company's obligations consisted of $1.1 billion in term loans and a $220 million revolving line of

72. Roe, *supra* note 8, at 275.

73. *See id.* at 250 (discussing the use of "clever reorganization techniques" and their limitations).

74. *Id.* at 258.

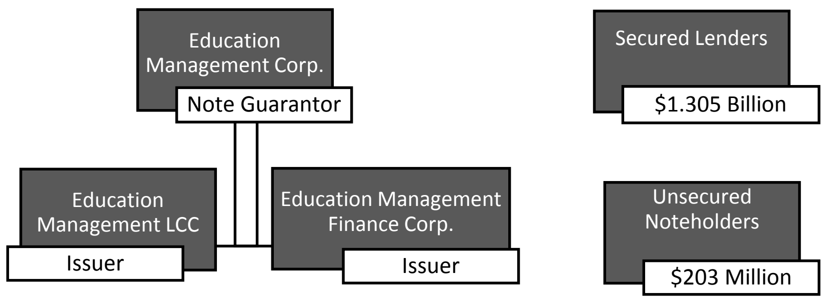
75. Roe, *supra* note 26, at 660–62 (contending that the legislative history of § 316(b) demonstrates "strong-form path dependence").

76. MeehanCombs Glob. Credit Opportunities Funds, LP v. Caesars Entm't Corp., 80 F. Supp. 3d 507, 515–16 (S.D.N.Y. 2015); Marblegate Asset Mgmt. v. Educ. Mgmt. Corp., 75 F. Supp. 3d 592, 615–17 (S.D.N.Y. 2014).

77. Marblegate Asset Mgmt. v. Educ. Mgmt. Corp., 75 F. Supp. 3d 592 (S.D.N.Y. 2014) (No. 14-CV-08584); Complaint for Declaratory and Injunctive Relief ¶¶ 17–18, 25–26.

credit—both of which were secured by substantially all of EDMC's assets.[78] Additionally, EDMC's subsidiaries had issued $203 million in unsecured notes.[79]

Figure 5



The plaintiffs—Marblegate Asset Management and Magnolia Road Capital, investing through their respective funds—owned $20.3 million of those unsecured notes and sought to enjoin the proposed restructuring.[80] From the outset, they were drawn to these investments for a unique set of characteristics:

First, they were guaranteed by the corporate parent, which had a strong balance sheet.[81] Although the guarantee was not unconditional, the plaintiffs were confident that it would protect them.[82] Under the indenture, the guarantee would be released automatically if EDMC and its subsidiaries' secured lenders agreed to waive their guarantee on the secured loan, but at the time, there was no secured loan guarantee in place.[83] So the plaintiffs assumed that EDMC could not be released from its obligation as guarantor for their investment.[84]

And second, the plaintiffs reasoned that EDMC and its subsidiaries would never undergo a Chapter 11 reorganization.[85] As one of the nation's largest for-profit college providers, EDMC derives most of its revenue from

78. *Marblegate*, 75 F. Supp. 3d at 597; Complaint for Declaratory and Injunctive Relief, *supra* note 77, ¶ 17.

79. Complaint for Declaratory and Injunctive Relief, *supra* note 77, ¶ 18.

80. *Marblegate*, 75 F. Supp. 3d at 596.

81. *Id.* at 597.

82. *Id.* at 597–98.

83. *Id.*

84. *Id.* at 598.

85. *Id.* at 596.

government-funded student loans.[86] If EDMC ever sought bankruptcy protection, the company would become ineligible to receive that funding.[87]

As anticipated by the plaintiffs, continued financial distress did force EDMC to renegotiate with all of its creditors, but the restructuring did not turn out as expected, and that gave rise to the litigation.[88]

Initially, the secured lenders agreed to waive the company's breach of financial covenants, giving EDMC time to pursue a full recapitalization.[89] In return, though, they insisted that the parent corporation of EDMC become a guarantor for the secured loans as well—just as it initially had for the notes.[90] To facilitate this long-term restructuring of its balance sheet, EDMC began negotiating with the "Ad Hoc Committee for Term Loan Lenders" (Ad Hoc Committee), which did not include the plaintiffs but was comprised of eighteen asset management firms that held 80.6% of the secured loans and 80.7% of the unsecured notes.[91]

Following these discussions, EDMC proposed an exchange offer that was conditioned on creditor participation and exit consents.[92] In effect, the creditors who accepted the exchange offer consented to two distinct restructurings—one if there was unanimous consent among creditors, and another if there was not. If there was unanimous consent, both the secured lenders and the noteholders would receive a mix of debt and equity.[93] The secured lenders would recover a little more than half the value of their loans, and the noteholders would recover roughly a third of the value of their notes.[94]

But without unanimous consent, it was an entirely different transaction: First, the secured lenders agreed to release the parent company from its guarantee of the secured loans, thus automatically releasing the guarantee on the notes as well.[95] Second, the secured lenders agreed to foreclose on "substantially all" of the assets in EDMC's subsidiaries.[96] And third, the secured lenders agreed to turn around and instantly resell the foreclosed assets back to a new subsidiary of EDMC that would issue new debt and equity in exchange for their participation.[97]

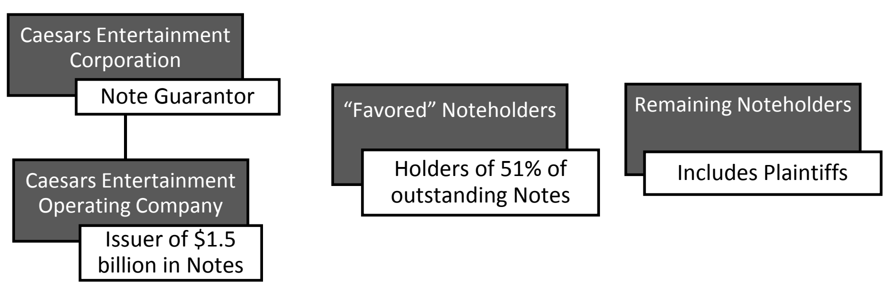
86. *Id.* at 595.
87. *Id.* at 596.
88. *Id.* at 598–603.
89. Complaint for Declaratory and Injunctive Relief, *supra* note 77, ¶¶ 25–27.
90. *Id.* ¶ 27.
91. *Marblegate*, 75 F. Supp. 3d at 600.
92. *Id.* at 600–02.
93. *Id.* at 600–01.
94. *Id.* at 601.
95. *Id.*
96. *Id.*
97. *Id.*

In sum, the structure of the exchange offer pressured the plaintiffs, and every noteholder, to accept; if they did not, that would ensure that they would be left with an essentially worthless claim against EDMC's old subsidiaries. The parent guarantee would be gone and almost all the subsidiaries' assets would be disposed of. Facing this choice, the plaintiffs filed suit, alleging that the proposed restructuring violated their right to principle and interest under § 316(b) of the TIA.[98]

B. *MeehanCombs*

In *MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entertainment Corp.*, the federal district court examined the proposed out-of-court debt restructuring of $1.5 billion in notes issued by Caesars Entertainment Operating Company, Inc., a subsidiary of Caesars Entertainment Corporation.[99] Similar to the plaintiffs in *Marblegate*, MeehanCombs Global Credit Opportunities Master Fund, LP invested in the subsidiary's distressed debt, in part, because its corporate parent was a guarantor for the notes.[100]

Figure 6



Like in *Marblegate*, Caesars Entertainment Corporation and its subsidiary (together, Caesars) sought to remove those guarantees during an out-of-court restructuring.[101] But rather than making an exchange offer conditioned on exit consents, Caesars offered to make side payments. That is, it offered to repurchase notes at a substantial premium from a select group, the so-

98. Complaint for Declaratory and Injunctive Relief, *supra* note 77, ¶ 2.

99. Complaint for Declaratory Relief and Damages ¶¶ 22–23, MeehanCombs Glob. Credit Opportunities Funds, LP v. Caesars Entm't Corp., 80 F. Supp. 3d 507 (S.D.N.Y. 2015) (No. 14-CV-7091).

100. *Id.* ¶ 31.

101. *MeehanCombs*, 80 F. Supp. 3d at 509.

called favored noteholders.[102] Specifically, Caesars approached investors holding 51% of Caesars outstanding notes and offered to pay "par plus accrued interest and transactional fees and costs"—a one hundred percent premium over the then current market price.[103] In return, Caesars required that they promise to consent to the removal of the corporate guarantee on the notes, to support any future restructuring, and to allow the covenants regarding the disposition of assets to be amended.[104] In this case, amendments to the indenture could be made so long as a majority of noteholders consented, so Caesars' proposal complied with the agreement.[105] Practically speaking, the effect of Caesars' offer to the favored noteholders is indistinguishable from that of Education Management: the indenture governing a subsidiary's issuance of notes was stripped of its protective covenants, leaving minority noteholders with an empty right against a corporate shell.[106] Yet potentially more troubling, the noteholders here did not even have the option to consent to a restructuring.[107] They were simply cut out of the deal.

C. Reaffirming the Legislative Intent of § 316(b)

In both cases, the defendant corporations contended that § 316(b) of the TIA only protected the "formal" right to principle and interest and should not apply to majority votes that do not explicitly alter those rights to payment.[108] However, after reviewing the facts the court in *Marblegate Asset Management*, which was quoted in *MeehanCombs*, declared that it would be "unsatisfying . . . [to hold] that Section 316(b) protects only against formal, explicit modification of the legal right to receive payment, and allows a sufficiently clever issuer to *gut* the Act's protections through a transaction such as the one at issue here."[109] Both courts held that such a formal reading of § 316(b) would have been at odds with Congress's intent to prevent the "[e]vasion of judicial scrutiny of the fairness of debt-readjustment plans."[110]

102. *Id.* at 511.

103. *Id.*

104. *Id.*

105. Complaint for Declaratory Relief and Damages, *supra* note 99, ¶ 33.

106. *MeehanCombs*, 80 F. Supp. 3d at 516.

107. *See* Complaint for Declaratory Relief and Damages, *supra* note 99, ¶ 4 (explaining that the transaction was negotiated and executed in secret).

108. *MeehanCombs*, 80 F. Supp. 3d at 515; Marblegate Asset Mgmt. v. Educ. Mgmt. Corp., 75 F. Supp. 3d 592, 612 (S.D.N.Y. 2014).

109. *MeehanCombs*, 80 F. Supp. 3d at 515; M*arblegate*, 75 F. Supp. 3d at 613 (emphasis added).

110. *Marblegate*, 75 F. Supp. 3d at 614 (quoting H.R. REP. 76-1016, at 56 (1939) and S. REP. NO. 76-248, at 26–27 (1939)); *accord MeehanCombs*, 80 F. Supp. 3d at 513 (citing S. REP. NO. 76-248, at 26 (1939)).

Although the outcomes in *Marblegate Asset Management* and *MeehanCombs* were not surprising given the legislative history of the TIA,[111] the two opinions did upset current industry custom, and it is not clear how the out-of-court restructuring market will respond.[112] Previously, out-of-court restructurings existed alongside the TIA, despite its underlying principles. Now, it is questionable whether there is room for workouts within the current statutory framework. After *Marblegate* and *MeehanCombs*, issuers will be limited in the types of exit consents that they can include in their exchange offers; anything that could be construed as substantially impairing a bondholder's right to principle and interest could expose the issuer to litigation and jeopardize the restructuring.[113] This could be especially troublesome because these exit consents have been the primary means of disciplining holdouts.[114] Issuers rely on being able to apply a certain amount of pressure (or coercion) in these renegotiations—otherwise, the problem of holdouts may be intractable. But after these decisions, issuers may not have the negotiating leverage to strike a deal with their bondholders.[115]

The inability of issuers to renegotiate outside of bankruptcy would be much more than a shift back to earlier restructuring practices. It would be a deadweight loss to society. Limiting the ability of issuers to renegotiate with their bondholders only increases the risk of default, and this in turn drives up the cost of capital.[116]

To be sure, the rulings in *Marblegate* and *MeehanCombs* probably will not spell the end of workouts and force all firms seeking to restructure into bankruptcy. There are almost certainly teams of lawyers and bankers working on other ways to facilitate these renegotiations. However, it is impossible to predict how the restructuring market will react and whether this solution to the problem of holdouts will be better than the last. Given this uncertainty and the frustrating difficulty of improving upon satisfactory but ultimately second-best options, the climate is ripe for amending the TIA and allowing for collective action.

---

111. H.R. REP. 76-1016, at 56; S. REP. NO. 76-248, at 26–27.

112. *See* Gretchen Morgenson, *Obscure Law Is Getting Its Sexy On*, N.Y. TIMES (Jan. 24, 2015) http://www.nytimes.com/2015/01/25/business/25gret.html?_r=0 [https://perma.cc/MRA6-F6E6] (explaining that the invocation of the trust indenture law may change the way debt restructurings are handled).

113. *MeehanCombs*, 80 F. Supp. 3d at 512–13; *Marblegate*, 75 F. Supp. 3d at 614–15.

114. *See* Coffee & Klein, *supra* note 36, at 1233 (stating that "eliminating all elements of coercion [including exit consents] from the recapitalization context would also disarm the ability of the majority of the bondholders to discipline holdouts").

115. *Id.*

116. *See id.* at 1211 ("In the view of the professionals in this field, the cost and delay of bankruptcy . . . make avoiding bankruptcy (except on a "prepackaged" basis) the common goal of all creditors.").

IV. Amending the Trust Indenture Act: Mandatory Collective Action

The TIA should be amended: specifically, § 316(b) should be repealed, and in its place a new SEC rule should be implemented that makes uncoerced majority voting the sole mechanism for negotiating out-of-court restructurings. The following provisions, which were initially proposed by Professor Mark Roe, could serve as a model:

> (1) Two-thirds of all the holders (less any holders that are excluded insiders under subparagraph (2)) of any indenture security may by affirmative vote, without side payments and without exit consents, bind all holders of such indenture security to a renegotiation of the terms of the indenture, including a uniformly applicable change in maturity date, principal amount, interest rate or exchange of the indenture security for capital stock of the issuer. No bond shall be issued under an indenture providing for such a vote unless the indenture prohibits the trustee from lending to the issuer.
>
> (2) The vote under subparagraph (1) shall be without regard to the vote of the issuing corporation and of any insider, as defined under Section 101(30) of the Bankruptcy Code, as amended. Prior to the vote, the indenture trustee shall inform the holders of the content of Section 101(30) and provide appropriate interpretive commentary. All holders shall be required to inform the indenture trustee whether they are insiders.[117]

Although my recommendation draws heavily from Professor Roe's work, it differs in one important respect: the mandate of majority voting. Professor Roe proposed simply repealing § 316(b) of the TIA.[118] Under that approach, bondholders and issuers would be expected to contract for collective action clauses on their own. Assuming there is a well-functioning market for efficient contract terms, repealing § 316(b) may be the simplest, or least cumbersome, means of allowing for recapitalizations by bondholder vote.

However, the out-of-court restructuring market has changed since Professor Roe first proposed repealing the prohibition on collective action, notably with the growing prevalence of exit consents and side payments.[119]

---

117. Roe, *supra* note 8, at 270–71.

118. *Id.* at 270.

119. *See, e.g.*, MeehanCombs Glob. Credit Opportunities Funds, LP v. Caesars Entm't Corp., 80 F. Supp. 3d 507, 511 (S.D.N.Y. 2015) (using side payments to induce bondholders to participate in the out-of-court restructuring); Marblegate Asset Mgmt. v. Educ. Mgmt. Corp., 75 F. Supp. 3d 592, 600–01 (S.D.N.Y. 2014) (making an exchange offer conditioned on exit consents).

A. The Benefits of Mandatory Majority Voting

1. Safeguarding Against Coercive Exchange Offers.—While repealing § 316(b) would remove an outdated legal barrier to workouts and allow parties to contract for efficient majority voting provisions—ones that would prohibit exit consents and side payments—such a proposal could also open the door to even more coercive tactics on the part of issuers. The recent rulings in *Marblegate* and *MeehanCombs* reestablished § 316(b)'s protections for bondholders, but if the prohibition were simply repealed now, that judicial supervision would be lost. Safeguarding those protections would be left to the private parties that negotiate indentures. While it may not be unreasonable to expect parties to negotiate for efficient contracts that include collective action clauses, there is no guarantee that they will do so. Even though indentures are typically negotiated among sophisticated parties, such as large publicly traded companies and investment banks who can be expected to bargain for efficient contract terms, they may not, in fact, be concerned about the coercive use of exit consents or side payments.

For instance, the underwriter—the party who typically negotiates the terms of an indenture—might reasonably conclude that bargaining for a prohibition against the use of exit consents or side payments is not worth it. Many of the buyers who will participate in a bond offering are likely to be large institutional investors,[120] and they might reasonably anticipate selling their holdings long before an issuer ever sought to restructure its obligations. Hence, the protections afforded by § 316(b) might only be valued by the subsequent owners of the bonds—not those who participated in the offering. Under this set of circumstances, there is less of an incentive for the underwriter to insist on the inclusion of protective majority voting provisions because there would be insufficient demand. The underwriter's efforts would be devoted to negotiating terms that are valued by the initial buyers. In fact, this concern echoes one of the issues raised by Congress during the hearings on the TIA. There, Congress was concerned that "bondholders [had] not taken steps to protect themselves by insisting upon the inclusion of adequate protective provisions in indentures."[121] Although Congress did not explicitly address the problem of bargaining for contractual protections that might only be valued by subsequent buyers, it recognized that the underwriters who represent bondholders may fail to adequately protect their interests without regulation.[122]

120. *See* Roe, *supra* note 8, at 259 (noting that "[*n*]*inety percent* of the bond market . . . [was] institutional" in 1987).

121. S. REP. NO. 76-248, at 12 (1939).

122. *Id.*

To be fair, the first generation of bondholders, such as the large institutional investors, would probably still derive some benefit from these protections. After all, when this first generation of holders seeks to sell their bonds, the bonds with greater contractual protections should be more valuable. But it is unclear that this marginal benefit would be sufficient to ensure that these protections are included in the first place. Hence, lifting the prohibition on collective action would not necessarily prevent issuers from making coercive exchange offers like those addressed in *Marblegate* and *MeehanCombs.*

Granted, Professor Roe suggested in his initial article that there would be instances where the SEC should require that recapitalizations occur by a majority vote.[123] But, at the time, this was thought of as an exception to the general rule.[124] Now, I propose that uncoerced majority voting should be the required mechanism for negotiating out-of-court restructurings in all cases.

2. Upholding the Purpose of the Trust Indenture Act.—Mandating the use of majority voting in bond workouts would admittedly be a drastic departure from the rights-based approach of the TIA.[125] Currently, a bondholder's right to principal and interest cannot be altered without his consent, whereas with my proposal those "rights" could change if a sufficient majority of other bondholders approved an amendment. And yet, collective action may better protect the interests of retail investors. Initially, Congress and the SEC believed that a rights-based approach was necessary to safeguard retail investors from backroom deals.[126] In particular, the commissioner of the SEC at the time, William O. Douglas, believed that judicial supervision of workouts was needed to ensure corporate insiders did not take advantage of bondholders.[127] This regulatory focus was rightfully directed at bondholder protection, but to meet that goal today the law should be updated to protect investors from the most pressing threat, namely coercive exchange offers. Despite the concerns about corporate insiders abusing majority voting, there

---

123. Roe, *supra* note 8, at 272.

124. *Id.* at 260 & n.92.

125. *See* Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp(b) (2012) ("[T]he right . . . to receive payment of the principal of and interest . . . shall not be impaired or affected without the consent of [the] holder . . . .").

126. H.R. REP. NO. 76-1016, at 56 (1939); S. REP. NO. 76-248, at 26–27.

127. Roe, *supra* note 8, at 251–53.

has only been one such attempt ever documented, and it failed.[128] Moreover, my proposal still accounts for such risks while also working to prevent the coercive exchange offers.

To be sure, abandoning a rights-based approach to bond workouts could lead to a loss of confidence among retail investors. After the rulings in *Marblegate* and *MeehanCombs*, a bondholder can feel relatively assured that their core contractual rights under the indenture will be honored, irrespective of the side deals that other creditors reach with an issuer. The value of that confidence cannot be dismissed. With the aggressive tactics of distressed debtor investors and private equity firms, such as those discussed in *Marblegate* and *MeehanCombs*,[129] average investors may hesitate to subject their right to payment of principal and interest to a majority vote. Similar to the original concern about corporate insiders co-opting an out-of-court restructuring, bondholders might rationally fear that so-called vulture investors could abuse the voting process and profit at their expense.

But ultimately, these concerns are outweighed by the costs of continuing to adhere to the rights-based approach of the TIA, especially after *Marblegate* and *MeehanCombs*. Most notably, such an approach would further embolden holdouts. So much so that an even greater number of troubled corporate issuers would be forced to declare Chapter 11 bankruptcy. This would only cause the borrowing costs of corporate borrowers to rise further.

Granted, unanimous consent clauses were prevalent in the past, and this did not spell the end of out-of-court restructurings. But the recent developments in the case law have tipped the scales too far in favor of bondholders. The TIA already favored Chapter 11 bankruptcy before *Marblegate* and *MeehanCombs* were decided, and now that the use of exit consents and side payments have been curtailed, the current rights-based approach, which is embodied by unanimous consent clauses, has become unworkable. In effect, these clauses have become an increasingly formidable barrier to private negotiations, which has created an inefficient bias against workouts.

Moreover, the problems with exit consents and side payments are well documented. As discussed earlier, these bargaining tactics give corporate issuers the power to make coercive exchange offers. Conversely, the concerns about abandoning a rights-based approach are often amorphous and unsubstantiated.[130] So bondholders are better served by regulation that

128. *Id.* at 252 & nn.53–54 (discussing *Hackettstown National Bank v. D. G. Yuengling Brewing Co.*, 74 F. 110, 112 (2d Cir. 1896), which held that the "sanctioning [of] a modification of the rights of the bondholders, passed by a corrupt majority for the purpose of effectuating such a collusive consent, is not within the power contemplated by the provision in the trust deed").

129. *See supra* subparts III(A)–(B).

130. Coffee & Klein, *supra* note 36, at 1233.

addresses the material problems of exit consents and side payments. To do otherwise would simply tailor the TIA to protect against an unrealized threat of corporate insiders.

And lastly, because the requirement of majority voting would be implemented as an SEC rule, the rule could be updated without an act of Congress if these potential harms arose.

3. Eliminating Adverse Signaling Effects.—Requiring majority voting for all bond workouts eliminates the problem of adverse signaling effects. Any time a firm tries to make it easier to restructure its obligations, outsiders will wonder whether this is a sign of bad things to come, and having to negotiate for a majority action clause increases this problem.[131] In recommending the repeal of § 316(b), Professor Roe noted this problem: "Prospective bondbuyers may take the majority action clause to signal managers' belief in a bleak future."[132] While it is unclear how pronounced this signaling effect may be, it is a clear benefit that a requirement of majority voting avoids the effect entirely. A mandatory rule would completely remove the signal.

B. The Drawbacks

1. Is Bankruptcy More Expensive?—The impetus for repealing § 316(b) of the TIA, and allowing for some form of majority voting—whether by mandate or otherwise—ultimately rests on an assumption that bankruptcy is relatively expensive.[133] If the costs of undergoing a prepackaged bankruptcy actually turn out to be roughly equivalent to the costs of negotiating a workout, then the rationale behind repealing § 316(b) and making new SEC rules is significantly diminished.[134] Majority voting was originally suggested as an alternative to the current law so that troubled firms could avoid the expense of bankruptcy and reach private, and less costly, agreements with their creditors.[135] And yet there is a lack of empirical evidence to support the conventional wisdom that bankruptcy is per se more expensive. The evidence is mixed, at best, with some studies finding that the costs of prepackaged bankruptcy are approximately equal to that of a workout[136] while others suggest that workouts are a much cheaper option.[137] To fully evaluate the feasibility of my proposal, more empirical research must be conducted

131. Roe, *supra* note 8, at 274.

132. *Id.*

133. *Id.* at 235–46.

134. *Id.* at 279.

135. *Id.* at 278–79.

136. Brian L. Betker, *The Administration Costs of Debt Restructurings: Some Recent Evidence*, FIN. MGMT., Winter 1997, at 56, 56–57.

137. Hotchkiss et al., *supra* note 32, at 251.

into the relative costs of different types of restructuring. If workouts were as expensive as bankruptcy, there would be little reason to act; the two federal court rulings in *Marblegate* and *MeehanCombs* recently interpreted the Trust Indenture Act as providing bondholders with robust protections, and if all parties were able to affordably rely on the courts to enforce those rights, then the current law would be sufficient.

2. Inability to Affect Existing Indentures.—Courts are generally reluctant to disturb existing contracts, so a mandatory rule would most likely not apply to current indentures.[138] This is a serious drawback to the proposal, especially because many indentures are long-term contractual relationships, lasting ten, fifteen, or even thirty years. There would admittedly be a significant lag in its implementation, even if the mandatory rule were adopted in the near term.[139]

However, any legislative change that aims to tackle this problem will likely run up against this issue. Despite the fact that § 316(b) is a statutory prohibition, almost all indentures also contain provisions banning the use of majority voting to amend core terms.[140] Hence, this issue does not so much highlight a flaw in the proposal but instead illustrates the extent of the problem.

3. Gaming the Majority Vote.—Sufficiently clever issuers and bondholders may admittedly be able to skirt a collective action requirement for bond workouts. Even though insiders are excluded from voting, side payments are not allowed, and exit consents are banned, market participants may find other ways to circumvent the law. But the recommended rule, originally proposed by Professor Roe, accounts for this. The new regulation would be implemented through SEC rulemaking, so future amendments to the rule would not require an act of Congress.[141] Hence, the SEC should oversee the mandatory rule's application and have authority to issue rulings in order to uphold its integrity.[142]

4. Limiting Contractual Freedom.—If collective action were to become the only means of negotiating a bond workout, there would obviously be a loss of contractual freedom. Large, sophisticated institutional investors increasingly dominate bond markets, and one could contend that it would be

---

138. Roe, *supra* note 8, at 275.

139. *Id.*

140. *See id.* at 250 ("[The TIA] prohibits use of an indenture that allows modification by majority action on any core term of the bond . . . .").

141. *Id.* at 270.

142. *Id.* at 272.

a mistake to require that all workouts be resolved by majority action. Critics might legitimately argue these parties are in a much better position to judge what contract terms best serve their interests than the Legislature.

While repealing § 316(b) of the TIA would obviously preserve this flexibility, that approach creates a problem of its own. For some types of recapitalizations, such as those where the risk of bondholder coercion is especially high and the secondary debt markets are too thin, regulators will likely have to require majority voting.[143] But this leaves regulators with the difficult task of deciding which types of recapitalizations will require majority voting. Implementing a mandatory rule, on the other hand, avoids this problem altogether.

Moreover, the SEC rule requiring majority voting would not be imposing an untested approach. Bonds governed by both English and Canadian law often allow for majority voting.[144] While neither of these countries requires them, collective action clauses are commonly used, which should alleviate concerns about imposing a mandate on issuers and bondholders. Each country has regulatory and financial systems that are similar to those in the United States.[145]

5. Agency Costs.—Making workouts easier is not necessarily a good thing. The more inefficient and difficult restructurings are, the more likely it is that managers will work hard to ensure that firms stay solvent.[146] Hence, by favoring majority voting clauses, the law could increase agency costs.[147] Nevertheless, this may be tolerable because it would encourage managers to take additional risks, which all diversified shareholders should theoretically want their managers to do.

V. Conclusion

The TIA should be amended. Specifically, § 316(b) should be repealed and uncoerced majority voting should become the sole means of negotiating a workout. Although legal commentators have called for allowing majority voting in out-of-court debt restructurings since the junk bond crisis of the 1980s, the literature has not delved into how this might come about—with the exception of simply repealing § 316(b). But a mere repeal of § 316(b) may not suffice to ensure an efficient workout market; the parties may fail to contract for collective action clauses that contain adequate protections for

143. *Id.*
144. *Id.* at 277.
145. *Id.*
146. *Id.* at 274.
147. *Id.*

average retail investors. As evidenced by the growing prevalence of coercive exchange offers, it is unwise to entrust issuers and bondholders with the task of ensuring that indenture agreements contain these efficient terms.

Even assuming that § 316(b) did strike the appropriate balance between the needs of issuers and the rights of bondholders, that is no longer the case after the decisions in *Marblegate* and *MeehanCombs*. Now that exit consents and side payments are barred in certain circumstances, the TIA has become a problematic, expensive barrier to private negotiations.

In order to be faithful to the spirit of the TIA, but also update the law so that troubled firms are not needlessly pushed into bankruptcy, a mandatory majority voting rule is necessary.

—*Harold B. Groendyke*