# New York Court of Appeals Ruling Could Shift Negotiating Leverage to Holdout Noteholders in Out-of-Court Restructurings

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The New York Court of Appeals' recent 4-3 opinion in *CNH Diversified Opportunities Master Account, L.P. v. Cleveland Unlimited, Inc.*, 2020 WL 6163305 (NY Oct. 22, 2020), could provide minority noteholders with additional negotiating leverage in the context of attempted out-of-court restructurings. However, the scope of this decision's impact, and whether it conflicts with the U.S. Court of Appeals for the Second Circuit's prior holding in *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Fin. Corp*., 846 F.3d 1 (2d Cir. 2017), is poised to be clarified in future litigation concerning out-of-court restructurings by issuers with indentures governed by New York law.

## Background

*Cleveland Unlimited* centers on certain senior secured notes (the Notes) issued by Cleveland Unlimited, Inc. While the indenture for the Notes (the Indenture) was not qualified under the Trust Indenture Act of 1939 (TIA), it incorporated by reference "[a]ny provision of the TIA which is required to be in a qualified indenture" and also contained language that directly tracked Section 316(b) of the TIA. Such language provided that, "[n]otwithstanding any other provision of [the] Indenture," the rights of each noteholder to receive payment of principal and interest on the Notes when due, or to bring suit for the enforcement of any such payment, could not be "impaired or affected" absent the consent of such noteholder. Regarding the exercise of remedies in the event of a default, in addition to the provisions tracking the TIA, the Indenture also provided that a majority of the noteholders could "direct the time, method, and place of conducting any proceeding for exercising any remedy" available to the Indenture trustee (the Trustee).

As the maturity of the Notes approached and Cleveland Unlimited recognized that it would not be able to make the required principal and interest payments, the company commenced negotiations with a group of noteholders holding 96.3% of the principal amount of the Notes (the Majority Noteholders). In connection with these negotiations, after Cleveland Unlimited defaulted on the Notes, the company entered into a forbearance agreement with the other guarantors of the Notes, the Trustee and CUI Holdings, LLC, the 100% equity owner of Cleveland Unlimited. Pursuant to the forbearance agreement, CUI Holdings became a guarantor of the Notes and pledged all of the stock of Cleveland Unlimited as collateral. Simultaneously, CUI Holdings entered into an asset purchase agreement to sell the stock of Cleveland Unlimited to a new entity formed by the Majority Noteholders. A group of minority noteholders holding only 3.33% of the principal amount of the Notes (the Minority Noteholders) refused to participate in the transaction, asserting that the Indenture provided them with the legal right to seek full payment of the Notes. As such, the sale transaction did not close within the period prescribed by the forbearance agreement.

Subsequently, and as an alternative to the proposed sale transaction that was designed to achieve similar results, the Majority Noteholders directed the Trustee to strictly foreclose on the equity of Cleveland Unlimited pursuant to Sections 9-620 and 9-622 of the model Uniform Commercial Code. These provisions permit a secured party to retain some or all of the collateral at issue in full satisfaction of the remaining debt, thereby extinguishing any deficiency claim. Importantly, Cleveland Unlimited's assets were not transferred or foreclosed upon — the strict foreclosure only involved the equity interests in Cleveland Unlimited. Despite the Minority Noteholders' continued unwillingness to participate in any form of debt-for-equity exchange, the strict foreclosure process proceeded, and all noteholders were informed that their Notes would be deemed paid and canceled in exchange for their receipt of the Cleveland Unlimited stock.

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The Minority Noteholders sued Cleveland Unlimited and the other guarantors on the Notes (including CUI Holdings) for breaches of contract and guaranty, arguing that, because they had not consented to the debt-for-equity exchange, their right to payment of principal and interest on the Notes, and their legal right to seek enforcement of such payments, had been improperly eliminated in violation of the protections provided to them under the Indenture. Cleveland Unlimited argued that the rights of the Minority Noteholders were properly extinguished in accordance with the strict foreclosure, which was a remedy expressly authorized by the Indenture.

After both parties moved for summary judgement, the New York Supreme Court ruled in favor of Cleveland Unlimited and dismissed the Minority Noteholders' complaint, finding that the Majority Noteholders properly directed the Trustee to exercise a valid remedy. In accordance with the Second Circuit's opinion in *Marblegate* (discussed in more detail below), the lower court also held that the strict foreclosure did not violate Section 316(b) of the TIA or the equivalent language of the Indenture because the core payment terms of the Indenture had not been amended through the strict foreclosure process. Further, the court held that, despite the dismissal of the Minority Noteholders' complaint, such holders apparently still had the legal right to sue the issuer in order to seek payment on the Notes. The Appellate Division of the Supreme Court affirmed the dismissal, holding that the TIA "prohibits only non-consensual amendments to an indenture's core payment terms" and that the strict foreclosure at issue did not constitute such an amendment, "even if it had a similar effect." The Minority Noteholders appealed again to the highest New York state court.

## Distinguishing *Cleveland Unlimited* From *Marblegate*

Judge Michael J. Garcia of the Court of Appeals, writing for the majority in a divided 4-3 decision, reversed the lower courts' dismissal, finding that the strict foreclosure improperly deprived the Minority Noteholders of their legal right (as opposed to their practical ability) under the Indenture to seek full payment of principal and interest on the Notes, absent their consent to modify such right. In arriving at this decision, the court emphasized that the language in the Indenture tracking Section 316(b) of the TIA was qualified by the phrase "[n]otwithstanding any other provision of [the] Indenture." Because this language was derived from the TIA, the court looked to the TIA for guidance, noting that while the TIA does allow for a majority of noteholders to direct an indenture trustee to exercise (or refrain from exercising) certain remedies on behalf of all noteholders, certain core rights of minority holders — such as the legal right to payment and to bring suit for payment — are explicitly intended to be insulated from any collective action and may not be modified absent consent of each affected holder. As such, the court found that while the Majority Noteholders acted appropriately under the Indenture in instructing the Trustee to pursue the remedy of strict foreclosure, such remedy could not extinguish the Minority Noteholders' rights to sue for payment, as such rights were to be protected "[n]otwithstanding any other provision of [the] Indenture."

Cleveland Unlimited's arguments in favor of dismissing the Minority Noteholders' complaint centered on *Marblegate*, a 2017 Second Circuit case in which the federal court narrowly interpreted Section 316(b) of the TIA, finding that such section had not been violated even when an out-of-court restructuring transaction rendered payment practically impossible because there had been no formal amendment of the payment terms in the indenture at issue in the case. However, here the New York Court of Appeals distinguished *Cleveland Unlimited* from *Marblegate* by focusing on the legal rights of the Minority Noteholders: Because the transactions at issue in these cases were structured differently, the minority noteholders in *Marblegate* retained certain rights that were eliminated in *Cleveland Unlimited*. Specifically, in *Marblegate*, the issuer sold all of its assets to a newly formed subsidiary for subsequent distribution only to the majority noteholders. Whereas the minority holders in *Marblegate* retained the right to sue the issuer of the notes for payment (even if, due to the transfer of all of the issuer's assets, the chances that such holders would actually recover against the issuer were exceedingly remote), in *Cleveland Unlimited* the New York Court of Appeals found the legal rights of the Minority Noteholders to sue for payment had been impermissibly terminated by the strict foreclosure and the subsequent cancellation of the Notes.

In a strongly worded dissent, Judge Eugene M. Fahey argued that the strict foreclosure was authorized by the Collateral Trust Agreement, an agreement executed concurrently with the Indenture. That agreement expressly provided that the Trustee, at the direction of the majority of the noteholders, may take certain remedial actions, including strict foreclosure, in the event of a default by the issuer. To the dissent, the execution of this separate agreement, when read together with the Indenture, constituted the requisite consent of the Minority Noteholders to the exercise of remedies directed by the Majority Noteholders, even if those remedies (i) were not unanimously supported by all holders and (ii) had the effect of modifying core payment rights. The dissent also viewed the majority's decision as potentially conflicting with *Marblegate*, noting that the opinion will lead to confusion as it "needlessly disconnects the law of the two courts most relevant to the markets in which these securities are traded." Finally, the dissent argued that the majority inappropriately emphasized its analysis of the TIA in a case that should instead have been decided by looking to the full suite of agreements executed by the parties in order to determine their intent.

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## Takeaways

The broader implications of this case are murky at present. While it is clear that the *Cleveland Unlimited* decision provides minority noteholders with additional negotiating leverage in the context of nonconsensual out-of-court restructurings, the type of strict foreclosure at issue in this case is not necessarily a common method of implementing restructuring transactions. More common — especially when issuers can achieve super-majority consents north of 96%, as was the case in *Cleveland Unlimited* — is an exchange offer whereby participating noteholders receive incentives for exchanging their notes for new securities. In such cases, the outgoing noteholders typically amend the existing indentures to strip covenants, guarantees and other protective terms (other than the TIA-protected right to receive payments of principal and interest). Moreover, issuers can seek to skirt the outcome of *Cleveland Unlimited* by structuring transactions consistent with *Marblegate* — in other words, rather than leave assets at the issuer and extinguish noteholders' claims through strict foreclosure like in *Cleveland Unlimited*, parties may attempt to remove assets from the issuer while leaving noteholders' rights to receive principal and interest technically intact, though practically impossible to enforce.

However, in the event that certain issuers are unable to structure around *Cleveland Unlimited*, this decision could result in an increase in in-court restructurings and prepackaged bankruptcy cases to effectuate transactions that previously may have been more efficiently accomplished in an out-of-court setting. Finally, as noted in Judge Fahey's dissent, this decision highlights a potential divide between New York's highest court and the Second Circuit that we expect may be clarified in future litigation. While the Second Circuit's interpretation of a federal statute such as the TIA is binding, a state court is free to interpret its own laws and contracts that are governed by such laws. We will continue to watch with great interest how federal and state courts decide these issues going forward.