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Client Alert

Second Circuit Reverses *Marblegate* Decision

Trust Indenture Act Section 316(b) Limited to Actual Amendments to An Indenture's Core Terms

By Edward M. Fox

Seyfarth Synopsis: On January 17, 2017, in a 2-1 decision in *Marblegate Asset Management, LLC v. Education Management Finance Corp.*, (15-2124) (the "Decision"), the United States Court of Appeals for the Second Circuit (the "Second Circuit") held that "Section 316(b) [of the Trust Indenture Act of 1939] prohibits only non-consensual amendments to an indenture's core payment terms," Decision at 4, reversing the decision of the United States District Court for the Southern District of New York (the "District Court"), *Marblegate Asset Management, LLC v. Education Management Corp.*, 111 F. Supp.3d 542 (S.D.N.Y. 2015), which held that a series of transactions meant to restructure the debt of Education Management Corporation ("EDMC") outside of bankruptcy over the objections of certain unsecured noteholders violated Section 316(b) of the Trust Indenture Act of 1939 ("TIA"), 15 U.S. C. § 77 ppp (b).

The Facts

EDMC's subsidiaries, Education Management, LLC ("EDM") and Education Management Finance Corporation ("EDM Finance") had approximately $1.3 billion of secured debt (the "Secured Debt") governed by a 2010 credit agreement and $217 million of unsecured notes (the "Notes") issued by EDM and governed by a March 2013 TIA qualified indenture. The Notes were guaranteed (the "Note Guarantee") by EDM's parent, EDMC, but the Note Guarantee could be released upon a release by the holders of the Secured Debt (the "Secured Lender") of any later guarantee of the Secured Debt given by EDMC.

EDMC negotiated certain changes to the terms of the Secured Debt in September 2014 and, in return, EDMC agreed to guarantee repayment of the Secured Debt (the "Secured Guarantee"). EDMC and an ad hoc group of its Secured Lenders and noteholders (the "Ad Hoc Group") then negotiated a swap of (i) the Secured Debt for new secured loans and 77% of EDMC's common stock and (ii) the Notes for 19% of EDMC's common stock. If creditors refused to consent to this restructuring proposal, EDMC and the Ad Hoc Group agreed that the Secured Lenders would (i) release EDMC's Secured Guarantee, thus triggering the release of the Note Guarantee, (ii) foreclose on EDMC's assets, and (iii) sell the foreclosed assets to a newly formed subsidiary of EDMC, which would then distribute debt and equity in the new subsidiary to creditors who consented to the restructuring. Noteholders who did not consent retained their legal right under the indenture to payment of the principal and interest on their Notes, but the issuer of the Notes was left with no assets with which to repay them.

Marblegate Asset Management, LLC ("Marblegate"), a holder of the Notes which refused to consent to the restructuring sued, claiming that the restructuring violated Section 316(b) of the TIA which provides that:

> 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 . . . .

TIA Section 316(b). The District Court held that, although the language of Section 316(b) of the TIA was ambiguous, the legislative history led to the conclusion that:

> the purpose of the Act, as expressed consistently throughout the legislative history, was to prevent precisely the nonconsensual majoritarian debt restructuring that occurred here, even if the Act's authors did not anticipate precisely the mechanisms through which such a restructuring might occur.

Marblegate Asset Management, LLC v. Education Management Corp., 111 F. Supp.3d at 552.

The Court of Appeals Decision

On appeal, a divided panel of the Second Circuit reversed, holding that "Section 316(b) prohibits only non-consensual amendments to an indenture's core payment terms." Decision at 3-4. The issue on appeal was whether the phrase "'right . . . to receive payment' forecloses more than formal amendment to payment terms that eliminate the right to sue for payment." Decision at 13. Although the majority agreed with the District Court that the language of Section 316(b) of the TIA is ambiguous, it concluded that "the relevant portions of the TIA's legislative history exclusively addressed formal amendments and indenture provisions like collective action and no action clauses." Decision at 21.

The majority noted "that foreclosures were a known method of reorganization well before the enactment of the TIA in 1939," Decision at 23, and that "neither the text nor the legislative history of Section 316(b) supports a distinction between adversarial and 'friendly' foreclosures." Decision at 39. Moreover, the majority noted that the negotiations were "clearly adversarial before the parties agreed on a course to preserve the value of the assets." Decision at 40.

Finally, the majority noted that the dissenting noteholder retained its legal rights and remained able "to pursue available State and federal law remedies," Decision at 40, including "under State law theories of successor liability or fraudulent conveyance." Decision at 41.

The dissent, finding no ambiguity in the meaning of Section 316(b), stated that "[h]ad Congress intended merely to protect against modification of an indenture's payment terms, it could have so stated." Dissent at 7, and concluded that "an out-of-court debt restructuring 'impairs' or 'affects' a non-consenting noteholder's 'right to receive payment' when it is designed to eliminate a non-consenting noteholder's ability to receive payment, and when it leaves bondholders no choice but to accept a modification of the terms of their bonds." Dissent at 13.

What the *Marblegate* Decision Means

Although TIA Section 316(b) will continue to prohibit formal amendments that change the right of a noteholder to receive principal and interest as provided for in an indenture, the Second Circuit's decision may allow issuers and holders of a majority of TIA qualified securities to engage in somewhat more creative ways to restructure outside of bankruptcy notwithstanding dissenting creditors. *Marblegate* is unusual, however, because EDMC would have lost its eligibility for Title IV funds had it filed for bankruptcy, thus giving Marblegate leverage it would not otherwise have had with a more typical issuer, while also constraining it from filing an involuntary bankruptcy against EDMC. Consequently, *Marblegate* may have limited practical effect in cases where the issuer can simply negotiate a pre-packaged or pre-negotiated restructuring agreement and then file for bankruptcy, which avoids the restrictions of Section 316(b).

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