Simpson Thacher

# Memorandum

## Second Circuit Reverses SDNY Decision in *Marblegate*, Holding that Section 316(b) of the Trust Indenture Act Prohibits Only Non-Consensual Amendments to an Indenture's Core Payment Terms

January 18, 2017

### Introduction

On January 17, 2017, the Second Circuit Court of Appeals (the "**Court**") held that Section 316(b) of the Trust Indenture Act of 1939, as amended ("**TIA**"), prohibits only non-consensual amendments to an indenture's core payment terms (the amount of principal and interest owed and the date of maturity)[1]. This holding reversed the decision of the District Court for the Southern District of New York (the "**SDNY**")[2], which had held that an out-of-court restructuring that involved the elimination of a parent guarantee and a significant asset transfer was impermissible under Section 316(b) of the TIA because such actions impaired the nonconsenting noteholders' right to receive payment.[3]

### Background

Education Management LLC ("**EM**") had $1.553 billion of debt outstanding, consisting of $1.305 billion in secured debt under a credit agreement and $217 million of unsecured notes (the "**Notes**"). The Notes were guaranteed by Education Management Corp. ("**EDMC**"), the parent of EM (the "**EDMC Parent Guarantee**"). The indenture for the Notes provided that the EDMC Parent Guarantee could be released if a majority of the noteholders consented or if the secured lenders released EDMC's guarantee of the secured credit agreement, which guarantee was provided during the course of restructuring negotiations some

[1] *Marblegate Asset Management, et al.* v. *Education Management Corp., et al.*, Docket No. 15-2124-cv(L), 15-2141-cv (CON) (2d Cir. Jan. 17, 2017). Circuit Judges Cabranes and Lohier joined in the majority opinion. Circuit Judge Straub issued a dissenting opinion in the case.

[2] *Marblegate Asset Management, et al.* v. *Education Management Corp., et al.*, 111 F.Supp.3d 542 (S.D.N.Y. June 23, 2015) ("**Marblegate II**").

[3] A copy of our memorandum discussing the SDNY decision in Marblegate II can be accessed by clicking here.

months after the Notes had been issued.

EDMC recognized that it was over-levered and needed to restructure its balance sheet but it believed that it could not effectuate a restructuring through a bankruptcy process because doing so would have rendered it ineligible to receive federal funding through Title IV of the Higher Education Act of 1965, which accounted for nearly 80% of its revenue. Instead, EDMC negotiated with its creditors and entered into a Restructuring Support Agreement, which provided two alternatives, one of which required unanimous creditor support and was designed to result in the Notes being exchanged for an amount of EDMC's common stock that EDMC estimated would represent roughly a 67% reduction in value for noteholders. The other option was a three-step transaction adverse to non-consenting creditors whereby: (a) the secured lenders would release their recently issued guarantee of the secured credit agreement, thereby triggering the release of the EDMC Parent Guarantee of the Notes; (b) the secured lenders would foreclose on substantially all of the assets of EDMC and its subsidiaries; and (c) the secured lenders would immediately convey the foreclosed-upon assets back to a new subsidiary of EDMC, which would distribute new debt and equity to the consenting creditors. Under the terms of the alternative three-step transaction, non-consenting noteholders would not receive a distribution and would instead retain their Notes without modification, leaving them with claims against the original issuer, which would have no assets by virtue of the foreclosure and asset transfer, and with no claim against EDMC by virtue of the release of the EDMC Parent Guarantee. Ultimately, all of EDMC's creditors, except for Marblegate Asset Management, LLC and Marblegate Special Opportunity Master Fund, L.P. (collectively, "**Marblegate**"), consented to the three-step transaction.

Marblegate was the sole holdout noteholder and sought a preliminary injunction to block the proposed restructuring on the ground that it violated Section 316(b) of the TIA ("**Section 316(b)**").[4] In Marblegate I, the SDNY declined to grant a preliminary injunction but indicated that it believed that Marblegate was likely to succeed on the merits.[5] In Marblegate II, the SDNY held that even when the payment terms of an indenture are not explicitly modified by a transaction, Section 316(b) was violated whenever a transaction "effect[s] an involuntary debt restructuring." The SDNY concluded that the TIA protects the ability of noteholders to receive payment in some circumstances and held that a debt restructuring that deprives dissenting noteholders of assets against which to recover can violate the TIA. The SDNY determined that the proposed restructuring stripped Marblegate of its practical ability to collect payment on the Notes and as a result, ordered EDMC to continue to guarantee the Notes held by Marblegate. EDMC appealed the SDNY judgment on the ground that the SDNY misinterpreted Section 316(b).

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[4] *Marblegate Asset Management et al.* v. *Education Management Corp. et al.*, 75 F.Supp.3d 592 (S.D.N.Y. Dec. 30, 2014) ("**Marblegate I**").

[5] A copy of our memorandum discussing Marblegate I and another decision by the SDNY interpreting Section 316(b), *Meehancombs Global Opportunities Funds, L.P., et al.* v. *Caesars Entertainment Corp., et al.*, 80 F.Supp.3d 507 (S.D.N.Y. Jan. 15, 2015), can be accessed by clicking here.

## Analysis

The Court indicated that "the core disagreement in this case is whether the phrase 'right…. to receive payment' in Section 316(b) forecloses more than formal amendments to payment terms that eliminate the right to sue for payment." Examining the text and history of the TIA, the Court concluded that "[a]bsent changes to an indenture's core payment terms, Marblegate cannot invoke Section 316(b) to retain an 'absolute and unconditional' right to payment of its [N]otes."

The Court began its analysis by reviewing Section 316(b), which provides, in relevant part:

> the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder…

While the Court agreed with the SDNY that the text of Section 316(b) is ambiguous insofar as it lends itself to multiple interpretations, the Court nonetheless expressed concern that to adopt Marblegate's broad reading of the term "right" as including the practical ability to collect payment "leads to both improbable results and interpretative problems." The Court noted that "if the 'right . . . to receive payment' means a bondholder's practical ability to collect payment, then protecting the 'right . . . to institute suit for the enforcement of any such payment' would be superfluous . . . ." The Court further noted that no other provision in the TIA purports to regulate an issuer's business transactions, which would likely be a result of the broad reading of Section 316(b).

The Court then examined the testimony and reports leading up to and immediately following the enactment of Section 316(b). The Court found that the relevant portions of the TIA's legislative history exclusively addressed indenture provisions that would allow majorities to amend core payment terms, such as "collective-action clauses,"[6] and that would preserve an individual holder's right to sue to collect his interest and principal in accordance with the terms of his contract, such as "no-action clauses."[7] Contrary to the SDNY's conclusion that Congress did not contemplate the use of foreclosures as a method of reorganization at the time the Section 316(b) was drafted, the legislative history showed the Court that the drafters of the TIA were well aware of the range of possible forms of reorganization available to issuers, including foreclosures.

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[6] The Court described such clauses as indenture provisions that authorize a majority of bondholders to approve changes to payment terms and force those changes on all bondholders.

[7] The Court described such clauses as indenture provisions that preclude individual bondholders from suing the issuer for breaches of the indenture, leaving the indenture trustee as the sole initiator of suit.

## Conclusion

This decision alleviates in the Second Circuit the ambiguities relating to the application of Section 316(b) of the TIA introduced by Marblegate II and a similar SDNY opinion issued in *Meehancombs Global Credit Opportunities Funds, L.P. v Caesars Entertainment Corp*. Based on the opinion of the Second Circuit, which could be subject to rehearing or an appeal to the Supreme Court, a transaction would not violate Section 316(b) as long as the transaction does not amend the core payment terms of the indenture, namely the amount of principal and interest owed and the date of maturity, without the consent of each affected noteholder.

You can download a copy of the Second Circuit opinion and dissent by clicking here.

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