Simpson Thacher

Memorandum

Alert Update: SDNY Decision Holds that the Termination of Parent Guarantee Violates Section 316(b) of the Trust Indenture Act

July 7, 2015

Introduction

On June 23, 2015, the District Court (the "**Court**") for the Southern District of New York (the "**SDNY**") 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 Trust Indenture Act of 1939, as amended ("**TIA**"). The Court held that the elimination of the guarantee and asset transfer impaired the nonconsenting noteholders' right to receive payment, which was protected by the TIA. This decision, *Marblegate Asset Management et al. v. Education Management Corp. et al.*, No. 14 Civ. 8584, 2015 WL 3867643 (S.D.N.Y. June 23, 2015) ("**Marblegate II**") follows an earlier decision of the Court, *Marblegate Asset Management et al. v. Education Management Corp., et al.*, -- F. Supp. 3d --, No. 14 Civ. 8584, 2014 WL 7399041 (S.D.N.Y. Dec. 30, 2014) ("**Marblegate I**"), in which the Court denied a request for a preliminary injunction to prevent consummation of the contemplated out-of-court restructuring.[1]

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 due in 2018 (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 creditors released EMDC's guarantee of the secured

[1] A copy of our memorandum discussing *Marblegate I* and another decision by the Southern District of New York interpreting Section 316(b) of the TIA, *Meehancombs Global Opportunities Funds, L.P., et al. v. Caesars Entertainment Corp., et al.*, -- F. Supp. 3d --, No. 14 Civ. 7091 (SAS) (S.D.N.Y. Jan. 15, 2015), can be accessed by clicking here.

credit agreement, which guarantee was granted during the course of the restructuring negotiations, some months after the Notes had been issued.

In need of a balance sheet restructuring, EDMC 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. To induce creditors to support the transaction, the Restructuring Support Agreement contemplated an alternative 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 creditors would not receive a distribution and would be left with claims against the original issuer, which would have no material assets by virtue of the foreclosure and asset transfer, and no claim against EDMC by virtue of the release of the EDMC Parent Guarantee.

Holders of 90% of the Notes and 99% of the debt under the secured credit agreement consented to the proposed restructuring. Certain of the holdout holders of the Notes, however, sought a preliminary injunction to block the proposed restructuring. Although the Court denied the preliminary injunction in *Marblegate I* because the prerequisites for injunctive relief were not met, the Court stated that it was likely that the plaintiffs would prevail in their claim that the termination of the EDMC Parent Guarantee, coupled with the foreclosure and immediate transfer of the assets back to a new subsidiary of EDMC, violated the TIA.

Subsequent to *Marblegate I*, EDMC proceeded with the three-step transaction but refrained from removing the EDMC Parent Guarantee from the plaintiffs' notes pending the Court's decision on the matter.

Analysis

In *Marblegate II*, the Court framed the issue to be determined and its conclusion in the following terms:

> [D]oes a debt restructuring violate Section 316(b) of the Trust Indenture Act when it does not modify any indenture term explicitly governing the right to receive interest or principal on a certain date, yet leaves the bondholders no choice but to accept a modification of the terms of their bonds? Examining the text, history, and purpose of the Trust Indenture Act, the Court concludes that the answer is yes.

The Court began its analysis by reviewing Section 316(b) of the TIA, 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...

The Court reviewed extensively the legislative history and the statutory purpose of Section 316(b) of the TIA and concluded that the provision was intended to "prevent precisely the nonconsensual majoritarian debt restructuring that occurred here . . . ." The Court held that the TIA was not "targeted only at a particular method of restructuring—straightforward amendment—as opposed to an undesirable result: allowing 'a majority to force a non-assenting security holder to accept a reduction or postponement of his claim'." Accordingly, the Court held that minority holders should not be "forced to relinquish claims outside of the formal mechanism of debt restructuring."

The Court also noted that although two courts have found that Section 316(b) protects "only the legal right to demand payment, rather than any substantive right to receive it",[2] at least two other courts in the SDNY have interpreted the right protected in Section 316(b) to be "a broader right to receive payment, and thus held that a debt restructuring that deprives dissenting bondholders of assets against which to recover can violate the Trust Indenture Act."[3]

The Court recognized the "troubling implications of the Trust Indenture Act in rewarding holdouts [and] its arguable obsolescence given the expense and complexity of modern bankruptcy . . . ." Nonetheless, the Court required EDMC to guarantee principal and interest payments to the plaintiffs in accordance with the EDMC Parent Guarantee.

Conclusion

This decision and the other similar SDNY decisions are important in that they may limit the ability of an issuer and a majority or even a super-majority of its noteholders to effectuate a non-consensual out-of-court restructuring. The Court in *Marblegate I* acknowledged that not all revisions to the terms of an indenture would implicate Section 316(b) of the TIA,[4] but the *Marblegate II* decision and the other similar SDNY

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[2] *YRC Worldwide Inc.* v. *Deutsche Bank Trust Co. Am.*, No. 10 Civ. 2106 (JWL), 2010 WL 2680336 (D. Kan. July 1, 2010); *In re Nw. Corp.*, 313 B.R. 595 (Bankr. D. Del. 2004).

[3] *MeehanCombs Global Credit Opportunities Funds, LP* v. *Caesars Entm't Corp.*, No. 14 Civ. 7091 (SAS), 2015 WL 221055 (S.D.N.Y. Jan. 15, 2015) (citing *Marblegate I*); *Federated Strategic Income Fund* v. *Mechala Grp. Jam. Ltd.*, No. 99 Civ. 10517 (HB), 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999).

[4] For example, in *Marblegate I*, the Court stated that:

> Practical and formal modifications of indentures that do not explicitly alter a core term 'impair[] or affect[]' a bondholder's right to receive payment in violation of the Trust Indenture Act only when such modifications effect an involuntary debt

decisions leave interpretative questions as to what constitutes an impermissible involuntary debt restructuring. This decision and the similar SDNY decisions requires a careful analysis of any indenture consent solicitation to determine whether the proposed transaction may be characterized as a non-consensual restructuring, and accordingly, the amendment to the indenture required to effect such transaction may violate the TIA without the consent of each holder affected by such amendment.

You can download a copy of the *Marblegate I* opinion by clicking here and you can download a copy of the *Marblegate II* opinion by clicking here.

restructuring. Such a standard does not contravene the decisions that have allowed preexisting subordination terms to survive a challenge under Section 316(b). [cite omitted] Nor does it prevent majority amendment of a significant range of indenture terms, including many that can be used to pressure bondholders into accepting exchange offers.

For further information about this decision, please contact any member of Simpson Thacher's Liability Management or Restructuring Practices including:

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