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The Gate Swings Shut: Second Circuit Ruling Narrows Restructuring Limitations

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January 27, 2017 - After a 2014 decision in the Southern District of New York holding that section 316(b) of the Trust Indenture Act ("TIA") barred any non-consensual restructuring that impaired a creditor's actual ability to receive payment, issuers, creditors and the financial markets more generally have been uncertain as to the contours of permissible out-of-court restructurings.[1] The recent decision by the Second Circuit Court of Appeals in *Marblegate Asset Management, LLC v. Education Management Finance Corp.*, 2017 WL 164318 (2d. Cir 2017) reversed the 2014 ruling and held that section 316(b) only bars restructurings that that impact a creditor's core payment right, which is different from the practical ability to demand payment. The Second Circuit's *Marblegate* ruling will help resolve the disquiet among practitioners and issuers and restore expectations as to the ability of companies to conduct out-of-court restructurings without being hamstrung by non-consenting creditors.

Background of the *Marblegate* Rulings:

The Second Circuit's decision arose from the restructuring of the debt of Education Management Corporation ("EDMC"). EDMC is a for-profit higher education company that had: (i) $1.3 billion in secured obligations that were collateralized by virtually all of EDMC's assets, and (ii) $217 million of unsecured notes (the "Notes") that were issued by a subsidiary of EDMC and governed by an indenture qualified under the TIA (the "Indenture"). The Notes were guaranteed by EDMC, but the guarantee was basically worthless as it had been issued solely to satisfy EDMC's reporting obligations and would be automatically released if any secured creditor provided a release of any separate guarantee of EDMC (a fact that was clearly disclosed to potential Noteholders in the offering circular for the Notes).

Cash-strapped EDMC entered into negotiations with its secured creditors that resulted in a restructuring proposal.[2] Under the proposed restructuring, the secured lenders would exercise their rights under their credit agreement and Article 9 of the Uniform Commercial Code to foreclose on all of EDMC's assets and release EDMC from their guarantee (thereby automatically releasing EDMC from the Note guarantee). The secured lenders' collateral agent would then transfer all of the foreclosed assets to a newly created subsidiary of EDMC that would then issue new secured debt and stock to the secured lenders and any unsecured lenders that consented to the restructuring. Importantly, the restructuring did not change the actual payment terms of the Indenture or limit the Noteholders' ability to sue the EDMC subsidiaries that issued the Notes to collect the payment due on the Notes (albeit a futile exercise, because the EMDC subsidiaries would have no assets after the restructuring).

All of EMDC's creditors, representing 98 percent of the company's debt, consented to the proposed restructuring. The sole holdout creditor was Marblegate Special Opportunity Master Fund ("Marblegate"), which sued to enjoin the restructuring on the grounds that it violated the TIA.

The District Court Decision

Noting that the TIA itself was ambiguous, the District Court agreed with Marblegate and held that the proposed restructuring violated Section 316(b) of the TIA,[3] which prohibits any restructuring that "impair[s] or affect[s]" the "right" of any security holder to receive payment due under a note.[4] After reviewing the text and legislative history of Section 316(b), the District Court concluded that the TIA "protects the *ability*" of the Note holders "to receive payment in some circumstances."[5] Even though the Indenture payment terms remained the same, the District Court held, Section 316(b) is violated whenever a transaction "effect[s] an involuntary debt restructuring."

EDMC appealed and argued that the prohibition contained in section 316(b) of the TIA applies only to non-consensual amendments to an Indenture's core payment terms (here the ability of Marblegate to commence suit to demand payment from the EDMC issuers).

The Second Circuit's Ruling

The issue before the Second Circuit therefore was whether section 316(b)'s prohibition on any restructuring that "impair[s]" or "affect[s]" a "right . . . to receive payment" contained in Section 316(b) of the TIA should be read narrowly to bar only non-consensual amendments to an indenture's core payment terms, or whether it should be read broadly to prohibit any restructuring that affects the ability of a noteholder to receive payment. After a review of the parties' competing readings of the statute, the Second Circuit agreed that the text of Section 316(b) was ambiguous on this issue.[6] The court noted that the use of "'right' to describe what it sought to protect from non-consensual amendment suggests a concern with the legally enforceable obligation to pay that is contained in the Indenture, not with a creditor's practical ability to collect on payments."[7] However, the Court also noted that the section of 316(b) stated that such a right "cannot be 'impaired or affected,'" and Congress' inclusion of these terms implied that a creditor's payment right could not validly be reduced or "otherwise affect[ed] in an injurious manner."[8]

To resolve these competing interpretations, the Second Circuit analyzed the legislative history of the TIA and ultimately concluded that Congress intended a limited application of the prohibition contained in Section 316(b).[9] Based on its review, the court determined that Congress was well aware of "possible forms of reorganization available to issuers, up to and including foreclosures like the one that occurred in this case" and noted that "foreclosure-based reorganizations were widely used at the time the TIA was drafted."[10] This fact, combined with the expert testimony submitted to Congress at the time of the TIA's drafting on the limited purposes of the TIA, demonstrated that Congress intended section 316(b) of the TIA to be applied narrowly to bar revisions to the core payment terms of an indenture but did not intend to prohibit the type of foreclosure-based restructuring employed by EDMC.

In addition, the court noted that the broad reading of section 316(b) put forth by Marblegate and endorsed by the District Court raised a number of practical problems, as it would require courts in every case to divine "whether a challenged transaction constitutes an 'out-of-court debt restructuring . . . designed to eliminate a non-consenting holder's ability to receive payment.'"[11] The practical requirement of determining the subjective intent of the parties to the restructuring, as opposed to a review of the transaction itself, ran afoul of the Second Circuit's "particular distaste for interpreting boilerplate indenture provisions based on the 'relationship of particular borrowers and lenders' or the 'particularized intentions of the parties to an indenture,' both of which undermine 'uniformity in interpretation.'"[12]

<u>Conclusion</u>

The Second Circuit's ruling provides a framework by which companies can achieve out-of-court restructurings even though they might deprive dissenting creditors of the value of their notes. The fact that core payment terms remain unchanged, though, may encourage companies to take a more aggressive stance with creditors. Nevertheless, creditors are not without remedies, as the preservation of core payment terms allows dissenting creditors to pursue judicial remedies. The ability of dissenting creditors to pursue successor liability or fraudulent conveyance claims may operate as a check against restructurings that are not conducted at arms' length or with improper intentions to deprive certain credit groups of payment.

Footnotes

[1] *See Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 75 F.Supp.3d 592, 612-615 (S.D.N.Y. 2014); *see also BOKF, N.A. v. Caesars Entm't Corp.*, 144 F. Supp. 3d 459, 466-67 (S.D.N.Y. 2015); *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 111 F. Supp.3d 542 (S.D.N.Y. 2015).

[2] EDMC was unable to commence a bankruptcy proceeding because such a filing would cause it to lose its eligibility for Tile IV funds pursuant to 20 U.S.C. § 1002(a)(4)(A).

[3] 15 U.S.C. § 77ppp(b).

[4] Section 316(b) of the TIA, entitled "Prohibition of impairment of holder's right to payment," provides:

Notwithstanding any other provision of the indenture to be qualified, 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, except as to a postponement of an interest payment consented to as provided in paragraph (2) of subsection (a) of this section, and except that such indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien.

[5] *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 75 F.Supp.3d 592, 612-615 (S.D.N.Y. 2014).

[6] Judge Straub dissented on this basis and believed that the text of the TIA was clear and unambiguous and supported the District Court's ruling. Judge Straub noted that if Congress had "intended merely to protect against modification of an indenture's payment terms, it could have so stated" and that "nothing in the text of the statute requires the narrow reading that Section 316(b) merely prohibits modification of an indenture's core payment terms (amount and due date) by noteholder majority action without consent of the individual noteholder." He

recognized the practical difficulties and uncertainty that his interpretation of the TIA would cause, but noted that such concerns were insufficient to override what he reasoned was the correct reading of the statute.

[7] *Marblegate Asset Management, LLC v. Education Management Finance Corp.*, 2017 WL 164318 at *4 (2d. Cir 2017).

[8] *Id.*

[9] Starting in 1936, the Securities and Exchange Commission (SEC) published a comprehensive eight-part report examining the role of protective committees in reorganizations.5 Part VI of that report, published in 1936 and entitled "Trustees Under Indentures" (the "1936 SEC Report"), led to enactment of the TIA. Additionally, the Court reviewed subsequent congressional reports, testimony, and other statements by SEC officials in reaching its decision.

[10] *Marblegate Asset Management, LLC v. Education Management Finance Corp.*, 2017 WL 164318 at *7 (2d. Cir 2017).

[11] *Id.* at *12.

[12] *Id.* at *12 (citing to *Sharon Steel corp. v. Chase Manhattan Bank. N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982)).

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