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Second Circuit Adopts Narrow Interpretation of Trust Indenture Act Provision Intended to Protect Bondholders

On January 17, the US Court of Appeals for the Second Circuit rendered a much anticipated decision in *Marblegate Asset Management, LLC v. Education Management Corp.*, No. 15-2124-cv(L), 15-2141-cv(CON), reversing the Southern District of New York's holding that only a non-consensual amendment to an indenture's core payment terms violates Section 316(b) of the Trust Indenture Act (TIA). The Court found that an out-of-court debt restructuring that effectively (but not directly) precluded noteholders' ability to be repaid did not violate the TIA because there was not an actual amendment to the indenture's core terms regarding principal and interest. The Second Circuit concluded, "Section 316(b) prohibits only non-consensual amendments to an indenture's core payment terms." Opinion at 4.

The Restructuring

The appeal has its roots in Education Management LLC's (EML) issuance of $1.305 billion in secured debt under a credit agreement and $217 million in unsecured notes due in 2018. Education Management Corp. (EMC), the parent of EML, guaranteed both the unsecured notes (the "EMC Guarantee") and the secured debt. The indenture governing the unsecured notes provided that the EMC Guarantee could be released by majority noteholder consent or secured creditor release of EMC's guarantee of the secured debt. When EMC could no longer support the debt, it attempted to restructure and negotiated a restructuring support agreement (RSA) with certain creditors.[1]

EMC's restructuring solution involved two options. First, if all creditors consented, secured creditors would receive new debt (approximately $400 million) and equity in EMC (approximately 77 percent). Unsecured creditors would receive only equity in EMC (approximately 19 percent). The second option addressed the possibility of holdout creditors and provided that if any creditors refused to consent, participating secured lenders would release their guarantee of the secured debt, which would have the effect of releasing the EMC Guarantee. The secured lenders also would foreclose on the assets of EMC and convey those assets to a subsidiary of EMC, which would distribute new debt and equity to the consenting creditors. Foreclosing would result in non-consenting creditors having unaltered unsecured notes that were not supported by any assets; hence, the notes

Margaret J. McQuade, an associate in the Litigation practice, contributed to this advisory.

[1] EMC could not restructure in bankruptcy because it would have become ineligible to receive federal funding under Title IV of the Higher Education Act of 1965.

For more information, please contact any of the following members of Katten's **Insolvency and Restructuring** practice.

Craig A. Barbarosh
+1.714.966.6822
craig.barbarosh@kattenlaw.com

Karen B. Dine
+1.212.940.8772
karen.dine@kattenlaw.com

Jerry L. Hall
+1.202.625.3646
jerry.hall@kattenlaw.com

John P. Sieger
+1.312.902.5294
john.sieger@kattenlaw.com

could not be paid. Non-consenting creditors would still have their claims against the original issuer, but the issuer would have virtually no assets to satisfy their claims. The non-consenting creditors would lose their claims to pursue the EMC Guarantee.

All noteholders consented to the RSA except Marblegate, which dissented and filed for a preliminary injunction. After EMC moved forward with option two—the foreclosure and guarantee release—the district court held a consolidated trial and granted Marblegate's request for an injunction.

The Meaning of Trust Indenture Act Section 316(b)

Marblegate's primary argument was that EMC's actions violated Section 316(b) of the TIA, a bondholder-protection law created after the Great Depression, 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 . . . ." (Emphasis added.)

In granting Marblegate's request for a preliminary injunction, the District Court concluded that a debt restructuring violates the TIA § 316(b)—even if it does not modify any indenture terms governing principal and interest—if it leaves bondholders no choice but to accept the restructuring. In so holding, the Court examined the legislative history and determined that the provision was intended to prevent a majority from forcing non-assenting noteholders to accept a reduction or postponement of their claims. The Court held, "whatever the ultimate cost to EDMC, its creditors, its employees, and its students, the Trust Indenture Act simply does not allow the company to precipitate a debt reorganization outside the bankruptcy process to effectively eliminate the rights of nonconsenting bondholders."

On appeal before the Second Circuit, EMC proffered a much narrower interpretation of Section 316(b), namely, that it protects noteholders against modification of an indenture's core payment terms (i.e., the amount owed and the due dates). EMC stressed that, by its terms, Section 316(b) protects only the noteholder's "right" to receive payment when due and to sue for enforcement of such payment, and that the provision makes no mention of conduct by issuers. Marblegate, in turn, argued that Congress, in choosing the words "impair" and "affect," intended for the TIA's protection to extend beyond formal amendments to the indenture's payment terms, as a holder's rights could be "impaired" or "affected" by other means.

The Second Circuit determined that the language of Section 316(b) is ambiguous. One concern the Court noted is that Marblegate's broad proposed interpretation of "impaired or affect" would lead to improbable results, transforming "a single provision of the TIA into a broad prohibition on any conduct that could influence the value of a note or a bondholder's practical ability to collect payment." *Id*. at 15. The Court undertook a lengthy examination of the TIA's legislative history, and noted that the legislature's concern had been focused on formal amendments to certain indenture provisions, such as no-action and collective action clauses. *Id*. at 21. Acknowledging the District Court's concern that "a sufficiently clever issuer [would] gut the Act's protections" by using a foreclosure action instead of amending the indenture or filing for bankruptcy, the Second Circuit concluded that the drafters of the TIA understood the range of possible reorganization available to issuers—including foreclosures like the one at issue. *Id*.

The Court pointed out that every foreclosure (particularly those involving assets with insufficient value to cover the debt) arguably impairs a holder's right to receive payment. Moreover, the Court noted that its holding does not leave non-consenting holders without recourse. Specifically, the Court observed that the foreclosure in this case may be challenged under state law using, for example, theories of successor liability or fraudulent transfer. *Id*. at 40.

In short, the Court held that the transaction did not violate the TIA because it did not amend any material terms of the indenture and it did not prevent any dissenting holders from suing to collect payment.

Practical Implications

The Second Circuit's ruling may have the effect of reversing the recent marketplace caution with respect to registered debt and out-of-court restructurings. However, significant questions regarding the protections afforded by TIA 316(b) remain to be settled. Notably, in other recent, high-profile cases surrounding this provision, parties have argued that guarantees are core terms of their indentures, and that releasing those guarantees over their objections violates of the TIA. The Second Circuit did not directly address this question. It did, however, uphold the transactions that resulted in the EMC Guarantee being released, implying that either a guarantee is not a core term, or that since the release was not specifically accomplished through an express amendment that it did not fall within the purview of 316(b).