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Second Circuit Rolls Back Expansive Trust Indenture Act Interpretation

In a 2-1 decision that deals a potential blow to holdout noteholders in out-of-court restructurings, the United States Court of Appeals for the Second Circuit (the *"Second Circuit"*) adopted a narrow interpretation of Section 316(b) of the Trust Indenture Act, holding that the provision prohibits only non-consensual amendments to an indenture's core payment terms, and rejecting a claim that the provision confers a substantive right to noteholders' practical ability to collect payment on their notes. Although the ruling leaves open the prospect of state law remedies for disaffected holdout noteholders, such as fraudulent conveyance and successor liability, it may embolden issuers to attempt out-of-court restructuring transactions that functionally deprive non-consenting noteholders of substantive rights while leaving core payment terms technically unchanged.

On January 17, 2017, the Second Circuit issued its ruling in *Marblegate Asset Management LLC, et al. v. Education Management Finance Corporation, et al.,* Case No. 15-2124-cv(L).[1] The appellant, Education Management Corporation and its subsidiaries (collectively, *"EDMC"*) fell into financial trouble in 2014, which prevented it from servicing its considerable debt load. EDMC is a recipient of Title IV educational funding from the U.S. government, however, and could not therefore reasonably file for bankruptcy, as a bankruptcy filing would have rendered it ineligible to receive the Title IV funds on which it relies.[2] As such, EDMC sought to avoid bankruptcy by pursuing an out-of-court restructuring with its secured and unsecured creditors.[3]

EDMC's secured debt was governed by a credit agreement under which EDMC had pledged substantially all of its assets. Marblegate Asset Management, LLC and Marblegate Special Opportunity Master Fund, L.P. (collectively, *"Marblegate"*) held a portion of EDMC's unsecured notes, which were issued under an indenture that was qualified under the Trust Indenture Act of 1939, 15 U.S.C. § 77ppp(b) (the *"TIA"*) and which were guaranteed by Education Management Corporation.

As part of the out-of-court restructuring, EDMC and a steering committee of its creditors proposed two options: one if the consent of all creditors were obtained, and one if certain creditors refused to consent.[4] If fewer than all creditors agreed, after a subsidiary of EDMC was created, certain EDMC assets foreclosed upon by the secured creditors (albeit consensually) would be transferred to the subsidiary through an intercompany sale, and then the new subsidiary would distribute certain debt and equity to creditors.[5] However, only those creditors who consented to the sale would receive distributions of the new debt.[6] The parent, Education Management Corporation, would also cease to guarantee payment on the EDMC unsecured notes held by Marblegate.[7]

Marblegate, the appellee, was the only EDMC creditor that did not eventually agree to the proposed transaction. Marblegate objected to the sale on the grounds that the transaction violated Section 316(b) of the TIA.[8]

Section 316(b) provides that "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..."[9]

Marblegate's practical ability to receive payment was essentially wiped out without its consent because of the intercompany sale and simultaneous removal of the parent guarantee.[10] The issuer of the notes became an asset-less shell corporation with no ability to make payments on the notes. While no amendments were made to the indenture, Marblegate argued that the restructuring was barred by Section 316(b) of the TIA because the transaction had the practical effect of impairing its ability to collect principal and interest without Marblegate's consent. The U.S. District Court for the Southern District of New York agreed.[11] As a result, the District Court ordered Education Management Corporation to continue to guarantee Marblegate's notes and pay them in full.[12]

EDMC appealed that ruling, claiming there was no violation. In reviewing the statute, the Second Circuit found that Section 316(b) of the TIA is ambiguous.[13] It then turned to an

examination of the legislative history.[14] The Second Circuit reviewed SEC reports, testimony presented to Congress, House and Senate reports, and amendments to the TIA, but still found no support for the District Court's expansive interpretation that the TIA protects against certain practical effects of a restructuring where the noteholders' contractual rights to full principal and interest payments remain unimpaired.[15] Rather, the Second Circuit explained that the "history of the TIA, and of Section 316(b) in particular, shows that it does not prohibit foreclosures even when they affect a bondholder's ability to receive full payment."[16] In addition to pointing out elements of those materials that supported their decision, they also explained the functional problems with Marblegate's interpretation, namely that their interpretation would inject an element of subjectivity into Section 316.[17] The interpretation encouraged by Marblegate, the Second Circuit noted, turns on the subjective intent of the issuer or majority bondholders, not the transactional techniques used.[18] The Second Circuit said that this would undermine the uniformity in interpretation, a result not encouraged by the court.[19]

However, the Second Circuit did not leave Marblegate without some recourse. The decision noted that creditors can "pursue available State and federal law remedies" or include contractual provisions in future indentures to prohibit these types of transactions by contract.[20] Although the Court did not opine on the merits of any such claims, it noted that creditors may be able to pursue theories of successor liability or fraudulent conveyance.[21]

Although the ruling represents a retreat from an expansive interpretation of Section 316(b), the debate is far from over. A vigorous dissent was also filed, which argued that the plain meaning of the section dictates that there can be no diminution in value without noteholder consent. Thus, there will likely continue to be a tension between the "Hobson's choice" complained of by Marblegate and the "tyranny of the minority" complained of by EDMC who could use Section 316(b) to extract value and block out-of-court restructurings with widespread support.

For More Information

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1 *Marblegate Asset Mgmt. LLC v. Educ. Mgmt. Fin. Corp.,* No. 15-2124-cv(L) (2d Cir. Jan. 17, 2017) [hereinafter *"Slip op."*]

2 *Id.*

3 Slip op. at 5.

4 Slip op. at 7.

5 *Id.*

6 Slip op. at 8.

7 Under the Indenture, if the senior guarantee was released, this junior guarantee would also be released.

8 Slip op. at 9.

9 15 U.S.C. § 77ppp(b).

10 Slip op. at 10.

11 *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.,* 111 F. Supp. 3d 542, 547 (S.D.N.Y. 2015).

12 *Id.* at 557.

13 Slip op. at 13.

14 Slip op. at 18.

15 Slip op. at 21-33.

16 Slip op. at 21.

17 Slip op. at 38.

18 Slip op. at 38-39.

19 Slip op. at 38.

20 Slip op. at 40.

21 Slip op. at 41.

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