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Second Circuit Overturns Expansive Interpretation of Trust Indenture Act, Facilitating Out-of-Court Restructurings

By David C. Lopez, Sean O'Neal, David E. Webb, Humayun Khalid, and Marc B. Rotter*

The U.S. Court of Appeals for the Second Circuit has clarified that Section 316(b) of the Trust Indenture Act of 1939 does not inhibit the ability of issuers and bondholders to engage in out-of-court restructuring transactions or to make modifications to Trust Indenture Act qualified indentures that are binding on dissenting bondholders so long as the "core payment terms" are not expressly amended and the right of bondholders to bring suit for breach of the core payment terms is not restricted. The authors of this article explain the decision and its significance.

The U.S. Court of Appeals for the Second Circuit has overturned the decision of the U.S. District Court for the Southern District of New York in *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*,[1] ("*Marblegate II*").

Marblegate II raised significant questions regarding the ability of issuers and bondholders to effect certain out-of-court restructurings without unanimous consent of bondholders. The Second Circuit has now clarified that Section 316(b) of the Trust Indenture Act of 1939 (the "Trust Indenture Act" or "TIA")[2] does not inhibit the ability of issuers and bondholders to engage in out-of-court restructuring transactions or to make modifications to Trust Indenture Act qualified indentures that are binding on dissenting bondholders so long as the "core payment terms"—the dates on which interest and principal payments are due and the amounts thereof—are not expressly amended and the right of bondholders to bring suit for breach of the core payment terms is not restricted.

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[1] 111 F. Supp. 3d 542 (S.D.N.Y 2015).

[2] 15 U.S.C. § 77ppp(b).

By analogy, the same conclusion would hold true for non-TIA qualified indentures that mimic the relevant TIA text.

BACKGROUND

Marblegate II addressed the out-of-court debt restructuring of Education Management Corporation ("EDMC").[3] Prior to its restructuring, EDMC had guaranteed a secured credit facility of one of its subsidiaries (the "Secured Credit Facility") that was secured by substantially all of the assets of EDMC and its subsidiaries. EDMC had also guaranteed unsecured bonds issued by a subsidiary under a TIA-qualified indenture.

EDMC determined that it was at risk of violating covenants in its Secured Credit Facility and needed to pursue a comprehensive restructuring of its balance sheet. Because EDMC, a for-profit provider of college and graduate education, relies on federal student aid programs under Title IV of the Higher Education Act of 1965 for much of its revenue, filing for bankruptcy was not a desirable approach. Under Title IV, an institution loses its eligibility to receive funding if it, or a controlling affiliate, files for bankruptcy or has an order for relief in bankruptcy filed against it.[4]

EDMC negotiated a restructuring agreement (the "Proposed Restructuring") with an ad hoc group of creditors holding more than 80 percent of the debt under the Secured Credit Facility and more than 80 percent of the bonds issued under the relevant indenture.

The Proposed Restructuring was designed to force bondholders to consent to the restructuring or lose any practical hope of receiving repayment of their bonds. The Proposed Restructuring provided that if less than all of the bondholders consented thereto, the Proposed Restructuring would not proceed and instead the following series of transactions would occur: first, all of the assets of the issuer would be transferred to a new subsidiary of EDMC against which the bondholders had no claim; second, the secured creditors would release EDMC's guarantee of the Secured Credit Agreement, resulting in EDMC's guarantee of the bonds being released; and, third, the new subsidiary

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[3] *Marblegate I* was an earlier ruling by Judge Failla denying dissenting bondholders request for a preliminary injunction against the consummation of EDMC's proposed restructuring. Although Judge Failla denied injunctive relief at that time, she found that Marblegate was likely to succeed on the merits of its claim, and required EDMC to leave mechanisms in place to allow Marblegate to recover on its claims to the extent legally warranted. *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.,* 75 F. Supp. 3d 592 (S.D.N.Y. 2014) ("*Marblegate I*").

[4] 20 U.S.C. § 1002(a)(4)(A).

would issue equity to any bondholders that consented to the restructuring, but not to dissenting bondholders who would be left with only a claim against a corporation with no assets or operations.

Marblegate Asset Management, LLC, and Marblegate Special Opportunities Master Fund, L.P. (together, "Marblegate"), which together held less than 10 percent of the unsecured bonds, and other dissenting bondholders filed a motion seeking to enjoin the Proposed Restructuring.[5] Marblegate argued, among other things, that the Proposed Restructuring violated its rights under Section 316(b) of the Trust Indenture Act.[6]

On June 23, 2015, Judge Failla of the Southern District of New York held that the Proposed Restructuring violated Section 316(b) of the Trust Indenture Act, interpreting that provision to reach transactions that have the practical effect of impairing the bondholders' ability to receive payment if their legal right to receive payment pursuant to the terms of the indenture and to sue for the same is not formally modified. The Southern District of New York held that "the purpose of the [TIA], as expressed consistently throughout the legislative history, was to prevent precisely the nonconsensual majoritarian debt restructuring that occurred here."[7]

EDMC appealed the Southern District of New York decision to the Second Circuit.

THE OPINION

The Second Circuit ruled in a 2-1 decision to overturn the Southern District of New York's decision, holding that EDMC's stripping of assets and guarantees did not constitute a violation of Section 316(b) of the TIA.[8]

Judge Lohier, writing for the Second Circuit in an opinion joined by Judge Cabranes, found that Section 316(b) of the Trust Indenture Act contained two independent prohibitions.

The first, the "right . . . to receive payment," prevents dissenting bondhold-

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[5] The other holdout creditors eventually consented, leaving Marblegate as the sole objector.

[6] Section 316(b) of the Trust Indenture Act provides, in relevant part:

> 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[.]

[7] *Marblegate II* at 554.

[8] *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 846 F.3d 1 (2d Cir. 2017) ("*Marblegate III*").

ers from being bound by amendments to core payment terms in a Trust Indenture Act qualified indenture, prohibiting the application of collective action clauses and similar provisions to core payment terms. Critically, the Second Circuit held that this "right . . . to receive payment" only protects bondholders against formal amendments to the core payment terms, not other actions that affect the credit quality of outstanding bonds.

The second prohibition, the "right to sue," prohibits no-action clauses that prevent individual bondholders from bringing suit for breach of the core payment terms.

The Second Circuit's holding was based largely on a detailed review of the legislative history of the Trust Indenture Act. It also highlighted the difficulty inherent in applying the approach proposed by Marblegate.

The majority opinion states that Marblegate's interpretation of Section 316(b) of the Trust Indenture Act would require courts to evaluate the subjective intent of the parties which would "undermine uniformity in interpretation" of boilerplate indenture provisions. The majority noted that bondholders retained the right to pursue other state law remedies, including under successor liability or fraudulent conveyance theories.

Judge Straub dissented based on his reading of the plain text of the statute, particularly the breadth of the words forbidding bondholders' rights from being "impaired" or "affected." The dissent seems particularly troubled by the deliberately coercive nature of the transaction, arguing that an out-of-court restructuring violates Section 316(b) of the Trust Indenture Act "when it is designed to eliminate a non-consenting noteholder's ability to receive payment, and when it leaves bondholders no choice but to accept a modification of the terms of their bonds."[9]

Judge Straub distinguished between ordinary course business transactions that impair the credit of the issuer, which he found permissible based on the "implied consent" of the bondholder and "a deliberate act to render [bondholders'] right to receive payment worthless," which he found would be impermissible absent the explicit consent of each noteholder.[10]

SIGNIFICANCE

The Southern District of New York's decision in *Marblegate II* and a decision by Judge Scheindlin of the Southern District of New York in *Meehancombs*

[9] *Marblegate III.*

[10] *Id.*

Global CreditOpportunities Master Fund, LP v. Caesars Entm't Corp.,[11] ("*Caesars*"), resulted in significant concern regarding the ability of issuers to conduct out of court restructurings that are binding on dissenting bondholders. The two Southern District of New York decisions have encouraged holdout bondholders to file or threaten challenges in other distressed situations and have made it more difficult to implement out-of-court restructurings because of the difficulty of obtaining the requisite legal opinions.[12]

Two proposals were quickly brought before Congress to amend the Trust Indenture Act to effectively overrule those cases, though both faced opposition from some bondholders and neither was adopted. Additionally, 28 major law firms (including ours) published a white paper providing guidance with respect to an opinion giver's ability to provide legal opinions in connection with out-of-court restructurings, which opinions are typically required by indentures and trustees prior to effecting those transactions.

While the caselaw in this area continues to evolve, the Second Circuit's decision provides greater certainty about the ability of companies to implement out-of-court restructurings that do not formally amend the core payment terms of their debt when that debt is either governed by a TIA qualified indenture or, as is typically the case with debt issued in the Rule 144A market, contains substantially similar requirements.

At the same time, potential purchasers and existing holders of debt containing TIA mandated or similar language should not view the Second Circuit's decision as leaving them unprotected.

As the Second Circuit noted, sophisticated creditors can negotiate for appropriate protective covenants and, in cases including movements of assets

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[11] 80 F. Supp. 3d 507 (S.D.N.Y 2015).

[12] *Marblegate II* and *Caesars* both dealt with the removal of a parent guarantee and transfer of assets to affiliates of the issuer that did not guarantee the notes. However, those cases created concern regarding the enforceability of amendments to the terms of indentures that affected the credit quality of outstanding bonds and if other transactions entered into as part of an out-of-court debt restructuring, including those that disadvantage non-participating holders through structural subordination, would be respected.

In another recent case in the Southern District of New York, Judge Sweet declined to extend the holdings of *Marblegate II* and *Caesars* to an exchange offer in which secured debt was offered in exchange for unsecured debt issued under a Trust Indenture Act qualified indenture that was only open to "qualified institutional buyers," as defined in Rule 144A of the Securities Act of 1933 (the "Securities Act") and non-"U.S. persons," as defined in Regulation S under the Securities Act. *Waxman v. Cliffs Natural Resources, Inc.*, 16 Civ. 1899 (S.D.N.Y. 2016).

that potentially render an issuer insolvent, creditors may have recourse to extensive creditor-protection laws available under state law.