CROSS BORDER-PROCEEDINGS

S.D.N.Y. Court Watch: Out-Of-Court Deals Post-Marblegate & Caesars

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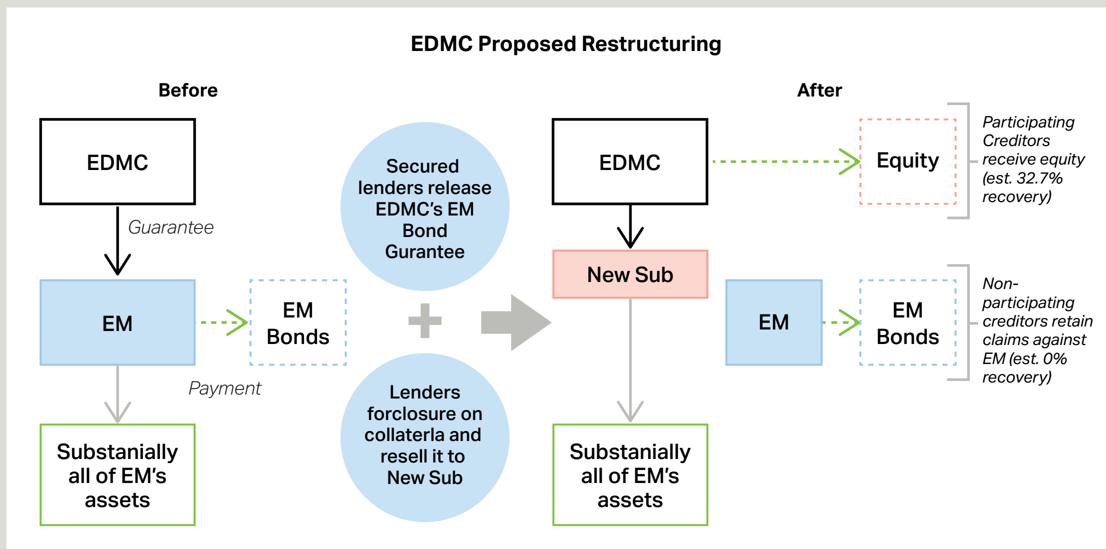
A popular and potent tool to execute out-of-court restructurings—the "exit consent"—has been mired in considerable uncertainty following recent SDNY decisions in *Marblegate Asset Mgmt. v. Education Mgmt. Corp.* ("*Marblegate*") and *Meehan Global Credit Opportunities Funds, LP v. Caesars Entertainment Corp.* ("*Caesars*"). Both cases interpret §316(b) of the Trust Indenture Act of 1939 ("TIA"), a Depression-era law intended to prevent insider transactions that "demolish retail bondholders." The TIA generally applies to debt securities sold through SEC-registered transactions—irrespective of the issuer's domicile.

Under §316(b), a bond's so-called "core terms"—the right to payment of principal and interest—cannot be "impaired or affected" without consent of the bondholder (thus, requiring 100% consent for an out-of-court restructuring). However, indentures typically include auxiliary, "non-core," provisions nevertheless essential to a bondholder's ability to receive payments—for instance, parent company guarantees and restrictions on asset sales or transfers.

In highly simplified terms, exit consents facilitate out-of-court deals by allowing participating bondholders to modify "non-core" terms prior to exchanging their bonds through the transaction. This incentivizes participation, since non-consenting bondholders will be left without the protections of the modified "non-core" terms (albeit while maintaining un-modified claims to principal and interest). While not *per se* invalidating this structure, *Marblegate* and *Caesars* suggested that the TIA's prohibition on "impairing" core terms also extends to modifications of non-core terms that have the practical effect of impairing the bondholder's core right to payment.

Marblegate stemmed from the 2014 restructuring of Education Management Corporation ("EDMC"), a for-profit education provider which could not file for Chapter 11 without losing access to federal education funding. The capital structure was relatively straight forward—$1.3 billion in secured debt and $217 million of unsecured bonds, issued by Education Management LLC ("EM") and guaranteed by EDMC (the "EM Bonds").



The proposed restructuring provided holders of EM Bonds with an estimated 32.7% recovery in post-reorganization equity and sought to ensure 100% voluntary participation through, as the Court put it, "a stick that would come into effect if any creditors did not consent." As illustrated below, the "stick" worked as follows: first, participating secured creditors would consent to releasing EDMC's guarantee of the EM bonds; then, the secured creditors would foreclose on EM's collateral and transfer it to a new subsidiary that would issue equity to participating creditors. Putting all this together, EM would be left effectively asset-less. Correspondingly, as noted in the offering circular, EDMC "anticipate[d]" that, as a result of the transaction, non-participating bondholders would not receive payment (and would not have recourse against any entity with assets).

A distressed debt-focused hedge fund, Marblegate, held out, refusing to exchange its $14 million of EM Bonds in what it argued to be a coercive transaction. The Court broadly agreed, finding EDMC's proposed restructuring to violate §316(b) by forcing Marblegate to make "a Hobson's choice: take the common stock, or take nothing."

Shortly after *Marblegate*, the SDNY Court reprised its broad reading of the TIA through two opinions in the hotly-contested *Caesars* bankruptcy. In short, the transaction at issue involved stripping a parent company's guarantees of a subsidiary's bonds. Consenting holders of the subsidiary's bonds would receive a par claim against a creditworthy entity (valued significantly above the bonds' trading prices) in exchange for participating in the transaction and promising to support Caesar's restructuring; in contrast, non-consenting creditors would retain claims against a subsidiary with substantially reduced assets. Broadly tracking the reasoning in *Marblegate*, the Court also adopted an expansive interpretation of §316(b)'s protections for minority bondholders.

Prior to *Marblegate* and *Caesars*, it was largely accepted that §316(b) protected a bondholder's legal rights to payment, but not the practical ability to recover. This key distinction allowed modification of non-core terms without 100% consent, facilitating integrative transactions.

Although these decisions remain under appeal—and may potentially be the target of legislative action to reverse their holdings—as they currently stand, *Marblegate* and *Caesars* raise questions about whether exit consents can continue to be part of the toolkit to successfully effectuate out-of-court restructurings.