CLEARY GOTTLIEB

ALERT MEMORANDUM

June 30, 2015 clearygottlieb.com

S.D.N.Y. DISTRICT COURT HOLDS TRUST INDENTURE ACT LIMITS ABILITY OF ISSUER TO RESTRUCTURE BONDS OF DISSENTING BONDHOLDERS OUTSIDE OF BANKRUPTCY

On June 23, 2015, Judge Katherine Polk Failla of the U.S. District Court for the Southern District of New York (the "Court") held that a debt restructuring outside of bankruptcy that deprives dissenting bondholders of assets against which to recover violates Section 316(b) of the Trust Indenture Act of 1939 (the "Trust Indenture Act" or, the "Act"), 15 U.S.C. § 77ppp(b), even if the restructuring does not modify any indenture term explicitly governing the right to receive interest or principal on a certain date. Marblegate Asset Mgmt. v. Educ. Mgmt. Corp., No. 14 Civ. 8584(KPF), 2015 WL 3867643 (S.D.N.Y. June 23, 2015) ("Marblegate II").

The Marblegate II opinion (the "Opinion") follows an earlier December ruling by Judge Failla denying dissenting bondholders Marblegate Asset Management, LLC's and Marblegate Special Opportunities Master Fund, L.P.'s (together, "Marblegate")[1] request for a preliminary injunction against the consummation of Education Management Corporation's ("EDMC") proposed restructuring. Although the Court denied injunctive relief at that time, it 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., __ F. Supp. 3d __, No. 14 Civ. 8584(KPF), 2014 WL 7399041 (S.D.N.Y. Dec. 30, 2014) ("Marblegate I"). Marblegate II furthers the trend in the courts of the Southern District of New York towards a broad interpretation of bond protections provided by the Trust Indenture Act. This broad interpretation has potentially far-reaching consequences for out-of-court restructurings for bondholders and issuers alike – particularly issuers like EDMC, for which chapter 11 is not a viable option.

Background

EDMC is one of the country's largest for-profit providers of college and graduate education, with an enrollment of 118,090 students and 20,500 employees. In early 2014, due to a number of external factors affecting its business, EDMC determined that it was at risk of violating covenants under its approximately $1.3 billion secured credit facility (the "Secured Debt") and that a comprehensive restructuring of its balance sheet was required. The Secured Debt was secured by virtually all the assets of EDMC and its subsidiaries and was guaranteed by EDMC. EDMC also had approximately $217

[1] Marblegate was initially joined by Magnolia Road Capital L.P. and Magnolia Global Credit Master Fund L.P., which funds subsequently settled their claims with EDMC.

million of outstanding unsecured bond debt (the "Bonds") that had been issued by a subsidiary under a 2013 indenture (the "Indenture") which was qualified under the Trust Indenture Act. The Bonds were also guaranteed by EDMC (the "Parent Guarantee"); however, the Indenture provided that the Parent Guarantee could be waived by a majority of bondholders and that it would be automatically released upon the lenders' release of EDMC's guarantee of the Secured Debt.

EDMC relies heavily on federal student aid programs under Title IV of the Higher Education Act of 1965, receiving almost 80% of its 2014 revenues from Title IV funds. 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. 20 U.S.C. § 1002(a)(4)(A). Thus, EDMC was forced to pursue an out-of-court restructuring with its creditors, or risk losing access to its largest revenue stream.

In May 2014, EDMC negotiated a restructuring agreement with an ad hoc committee representing creditors holding 80.6% of the Secured Debt and 80.7% of the Bonds (the "Proposed Restructuring"). Under the terms of the Proposed Restructuring, lenders would voluntarily exchange their Secured Debt for new debt and equity in EDMC amounting to a 55% recovery, while bondholders would exchange their Bonds for EDMC equity amounting to a 33% recovery.

The Proposed Restructuring contemplated 100% voluntary participation and contained a punitive mechanism that would come into effect if any creditors did not consent: first, the participating secured lenders would release EDMC's guarantee of the Secured Debt, thereby triggering the release of the Parent Guarantee of the Bonds; second, the lenders would foreclose on their collateral; third, the lenders would immediately sell the collateral back to a new subsidiary of EDMC (the "New Subsidiary"). New Subsidiary would then distribute debt and equity to creditors that had voted in favor of the Proposed Restructuring. As EDMC warned in its exchange offer circular, the result of this process would be that "substantially all of our assets will have been transferred to [the New Subsidiary] and will not be available to satisfy the claims of [non-participating bondholders]. As a result, we anticipate that such [bondholders] will not receive payment on account of their [Bonds]."

On October 28, 2014, Marblegate, which held $14m of Bonds, and other dissenting bondholders filed a motion seeking to enjoin the Proposed Restructuring. Marblegate argued, among other things, that the Proposed Restructuring violated its rights under Section 316(b) of the Trust Indenture Act, which 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[.]*

15 U.S.C. § 77ppp(b). Judge Failla declined to enjoin the Proposed Restructuring because Marblegate failed to establish that the harm it would suffer was "irreparable," but found that the Proposed Restructuring was "precisely the type of debt reorganization that the Trust Indenture Act is designed to preclude" and that "Plaintiffs have a likelihood of succeeding on an eventual claim for payment against EDMC and its subsidiaries." Marblegate I. at **19-20.

On January 5, 2015, EDMC and participating creditors consummated the Proposed Restructuring. However, EDMC refrained from removing the Parent Guarantee from Marblegate's Bonds and amended the Indenture to provide that New Subsidiary would continue to guarantee those Bonds until the release of the Parent Guarantee. EDMC then interposed a counterclaim seeking a declaration that it could release the Parent Guarantee. On February 4, 2015, Marblegate and EDMC entered into a stipulation retroactively consolidating the preliminary injunction hearing and record into a trial on the merits and extending the period to supplement the record and the briefing. Briefing was completed on March 11, 2015.

The Opinion

The Court viewed the question posed to it as straightforward: "does a debt restructuring violate Section 316(b) of the Trust Indenture Act when it does not modify any indenture term explicitly governing the right to receive interest or principal on a certain date, yet leaves bondholders no choice but to accept a modification of the terms of their bonds?" Marblegate II at *3. After conducting an extensive review of the legislative history of Section 316(b), the Court concluded that the answer to this question was "yes."

The Court rejected EDMC's arguments that Section 316(b) was intended to protect only the legal right to demand payment, rather than any substantive right to receive it. The Court noted that, although the 1937 and 1938 versions of the Trust Indenture Act and the initial draft of the 1939 Act "each spoke to 'bringing action to collect the principal of and interest upon…'" an indenture security, the final 1939 Act added an "entirely separate right" – namely, "the right of any holder…to receive payment of the principal of and interest on such indenture security." Id. at *11.

In reaching its conclusion, the Court emphasized it was not relying solely on textual interpretation but also on statutory history and intent, which it found supported a broader reading of Section 316(b). As the Court observed "the purpose of the Act, as expressed consistently throughout the legislative history, was to prevent precisely the nonconsensual majoritarian debt restructuring that occurred here, even if the Act's authors did not anticipate precisely the mechanisms through which such a restructuring might occur." Id. The Proposed Restructuring did not amend any term explicitly governing any right to payment, however, it forced Marblegate to make "a Hobson's choice: take the common stock, or take nothing." Id. at *13. Although Judge Failla recognized the potential "troubling implications" of the Trust Indenture Act in rewarding holdout bondholders and the unforeseen interplay between Title IV's funding requirements and Section 316(b), the court concluded that it was "beyond peradventure" that the Proposed Restructuring violated the protections of Section 316(b). Id.

Significance of the Opinion

Building upon her decision in Marblegate I, Judge Failla's Opinion in Marblegate II supports a broad interpretation of the protections afforded to minority bondholders under the Trust Indenture Act. The analysis of the Court in the Marblegate opinions also aligns with a recent decision by Judge Scheindlin in Meehancombs Global Credit Opportunities Master Fund, LP v. Caesars Entm't Corp., No. 14-Civ.-7091 (SAS), 2015 WL 221055 (S.D.N.Y. Jan. 15, 2015) that denied Caesars Entertainment Corp.'s motion to dismiss a Trust Indenture Act claim brought in connection with a similar out-of-court restructuring. While it remains to be seen whether Marblegate II will be appealed, this interpretation of the protections of 316(b) of the Trust Indenture Act could embolden holdout bondholders to force – or threaten to force – companies that might otherwise pursue out-of-court restructurings into expensive chapter 11 proceedings. For companies like EDMC, for which chapter 11 is not a viable option, out of court restructurings may become more contentious, expensive and difficult to negotiate to a final global resolution.

* * *

Please feel free to contact Lisa Schweitzer (lschweitzer@cgsh.com), Luke Barefoot (lbarefoot@cgsh.com), or any of your regular contacts at the firm if you have any questions.

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road, Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Cleary Gottlieb Steen & Hamilton LLP
45th Floor, Fortune Financial Center
5 Dong San Huan Zhong Lu
Chaoyang District
Beijing 100020, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Abu Dhabi Global Market Square
Al Maryah Island, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T:+82 2 6353 8000
F:+82 2 6353 8099