Second Circuit Vacates *Marblegate* and Removes Uncertainty Surrounding Out-of-Court Restructurings

The Second Circuit's decision brought case law back in line with historic market practice, relieving recent uncertainty in the corporate debt market.

The U.S. Court of Appeals for the Second Circuit vacated and remanded a controversial district court decision that had held that the Trust Indenture Act (TIA) prohibits amendments to an indenture if the practical impact would be to eliminate a bondholder's right to receive payment. For decades, practitioners had read the TIA provision at issue to prohibit only non-consensual amendments to an indenture's core payment terms. The lower court's decision, as well as the district court's decision in *BOKF, N.A. v. Caesars*, had created uncertainty as to whether an issuer could legally engage in a consensual out-of-court restructuring with creditors that could have a negative impact on recoveries of non-consenting creditors.

The Second Circuit held that the restructuring plan did not violate Section 316(b) of the TIA because the restructuring did not impair the minority bondholder's *legal* right to payment on the notes, even if it eliminated the minority bondholder's practical ability to collect. The court further held that absent changes to an indenture's core payment terms, Marblegate could not invoke Section 316(b) to retain an absolute and unconditional right to repayment on its notes. The Second Circuit's decision brought case law back in line with historic market practice, relieving recent uncertainty in the corporate debt market. In light of the Second Circuit's ruling, companies should feel greater comfort in exploring and negotiating out-of-court amendments of their bond indentures with requisite majority bondholder consent.

Background

In 2014, Education Management Corporation ("EDMC") fell into severe financial distress, but could not file for bankruptcy because it would lose federal funding, which was the basis for its business model, so EDMC entered into negotiations with its creditors to restructure its debt.

EDMC's outstanding debt consisted of:

- $1.3 billion of loans under a credit agreement co-borrowed by two of EDMC's subsidiaries (together, the "Issuer"), secured by substantially all of EDMC's assets, and later guaranteed by EDMC as part of the restructuring negotiations; and
- $217 million of unsecured notes co-issued by the Issuer and guaranteed by EDMC.

EDMC and a committee of secured creditors developed a proposed restructuring plan that would only require the consent of the secured creditors (the "Intercompany Sale"), which included:

- the secured creditors foreclosing on EDMC's assets (so the indenture would not need to be amended and the bondholders would retain the contractual right to payment on the notes, but not the practical ability to collect because the Issuer would become an empty shell);
- the secured creditors releasing EDMC's guarantee of loans (which would automatically release EDMC's guarantee of the notes);
- the collateral agent selling the foreclosed assets to a new subsidiary of EDMC; and
- the new EDMC subsidiary distributing debt and equity to the consenting creditors (the non-consenting secured creditors would receive junior debt and the non-consenting bondholders would get nothing).

All of EDMC's creditors consented to the Intercompany Sale, except Marblegate Asset Management, LLC and Marblegate Special Opportunity Master Fund, L.P. (together, "Marblegate"). Marblegate held $14 million of the unsecured notes, or approximately 2% of the outstanding debt.

In light of the Second Circuit's ruling, companies should feel greater comfort in exploring and negotiating out-of-court amendments of their bond indentures with requisite majority bondholder consent.

Marblegate I

Marblegate sued for a preliminary injunction to block the Intercompany Sale as a violation of Section 316(b) (right to payment) of the TIA because Marblegate's practical ability to collect payment on the notes would be eliminated by the Intercompany Sale after the Issuer was stripped of assets.

EDMC argued that it would not need to amend the indenture to effect the Intercompany Sale and Marblegate's legal right to payment under the TIA would not be violated.

The district court did not grant the injunction, but signaled that Marblegate would be likely to prevail on the merits of a TIA claim.

Marblegate II

EDMC effected the Intercompany Sale in January 2015, except that EDMC did not release its guarantee of the notes in light of the district court's indication that Marblegate would likely prevail on the merits of the TIA claim. EDMC sued Marblegate for a declaratory judgment that it could release its guarantee of the notes.

The district court decided on the merits that the Intercompany Sale violated Section 316(b) of the TIA because it had eliminated Marblegate's practical ability to collect payment, and so did not allow EDMC to release its guarantee of the notes.

EDMC appealed the district court's ruling to the Second Circuit.

Second Circuit

On January 17, 2017, the Second Circuit held that the Intercompany Sale did not violate Section 316(b) of the TIA because it did not amend any payment terms of the indenture and Marblegate still had the legal right to sue for payment. The Second Circuit reasoned that neither the plain text nor the legislative history of Section 316(b) of the TIA protect a practical right to payment beyond a legal right. The Second Circuit determined that Section 316(b) of the TIA only prohibits non-consensual amendments to an indenture's core payment terms (generally considered to be the amount and timing of principal and interest owed and the date of maturity).

Dissenting bondholders are not necessarily at the mercy of bondholder majorities. Sophisticated creditors can always negotiate for more covenants prohibiting the type of conduct at issue in Marblegate and may have avenues of recovery under other causes of action such as theories of successor liability or fraudulent conveyance.

The Second Circuit indicated that it was not sympathetic to a minority bondholder seeking payment of 100 cents on the dollar on notes in a restructuring when the only reason the Issuer would be able to pay the notes in full is because it was able to continue its operations after all other creditors consented to a value haircut in a restructuring plan.

Nonetheless, the Second Circuit indicated that minority bondholders are not left without recourse. The court explained that bondholders can negotiate protections into debt agreements, or can bring state law successor liability or fraudulent conveyance claims where assets are transferred to a new entity. Outside of bankruptcy, minority bondholders can also challenge foreclosure under state law.

The Second Circuit's decision eased uncertainty in the corporate debt market by re-aligning case law with historic market practice, and allowing companies to feel greater comfort in exploring and negotiating out-of-court amendments of their bond indentures with requisite majority bondholder consent.

It is possible Marblegate may seek a rehearing *en banc* before the full Second Circuit panel (Marblegate has requested an extension on the deadline to file for a rehearing) or appeal to the U.S. Supreme Court.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland author or your regular Kirkland contact.

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