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COMMENTARY

Marblegate: Second Circuit Reverses Broad Interpretation of Trust Indenture Act in Out-of-Court Restructurings

In its highly anticipated *Marblegate Asset Management LLC v. Education Management Corp.* decision,[1] the U.S. Court of Appeals for the Second Circuit ruled on January 17, 2017, that an out-of-court debt restructuring that impaired the practical ability of noteholders to be repaid did not violate Section 316(b) of the Trust Indenture Act of 1939 ("TIA"), since it did not amend an indenture's core payment terms. The Second Circuit reversed a 2014 district court ruling, which had concluded that Section 316(b) provides "broad protection against nonconsensual debt restructuring" and restricts such restructuring transactions if they adversely impact a noteholder's practical ability to be repaid.

The TIA was enacted to provide protections to holders of debt securities whose indentures are qualified under the statute. 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 ….

Section 316(b) protects minority bondholders by prohibiting a majority from agreeing to modify the bondholder's right to receive payment without the consent of each minority bondholder.

In 2014, Section 316(b) came under judicial scrutiny when Education Management Corp. ("EDMC") restructured approximately $1.3 billion in secured debt and $217 million in unsecured notes, which were issued by EDMC's subsidiaries, by means of an out-of-court exchange offer. Under the restructuring, secured creditors of EDMC's subsidiaries foreclosed on their collateral and transferred those assets to a newly formed subsidiary of EDMC. In addition, the secured creditors released the guaranty of their debt by EDMC, which caused a release of EDMC's guaranty of the unsecured notes pursuant to the terms of the indenture. Although the transaction did not amend the notes' payment terms (or the indenture at all), dissenting noteholders were left with nothing but claims against the EDMC subsidiaries, which at that point had no assets.

Two noteholders (collectively "Marblegate") sued to enjoin the exchange offer, alleging that it violated Section 316(b) by effectively depriving them of the practical ability to collect on the notes, the so-called

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broad interpretation of Section 316(b). Relying on a 1999 decision, the district court ruled in Marblegate's favor.[2]

In *Marblegate*, a divided Second Circuit reversed, concluding that Section 316(b) of the TIA "prohibits only nonconsensual amendments to an indenture's core payment terms." Adopting this narrow reading of Section 316(b), the majority wrote that "[a]bsent changes to the Indenture's core payment terms … Marblegate cannot invoke Section 316(b) to retain an 'absolute and unconditional' right to payment of its notes." In reaching this conclusion, the court found that the statutory language was ambiguous. Thus, the court relied upon the legislative history of the TIA, as well as its expressed concern about the "workability" of Marblegate's interpretation, which, according to the Second Circuit, "turns on the subjective intent of the issuer or majority bondholders, not the transactional techniques used." Because the Marblegate transaction neither amended any of the terms of the indenture nor prevented any dissenting bondholder from exercising its legal right to sue to collect on its bonds, the majority concluded that the exchange offer did not violate Section 316(b).

In jurisdictions that are bound by, or adopt, the Second Circuit's decision, the effect will be to narrow substantially the grounds for attacking out-of-court restructurings based on Section 316(b). Companies seeking to effectuate an out-of-court restructuring involving an exchange offer or consent solicitation of outstanding bonds, and that does not amend the indenture to impair core payment terms, are likely to take comfort in this decision. Conversely, nonconsenting bondholders will likely be more hesitant to challenge such a transaction under Section 316(b).

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Endnotes

1 *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Fin. Corp.*, 2017 BL 12251 (2d Cir. Jan. 17, 2017).

2 *See Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 75 F. Supp. 3d 592 (S.D.N.Y. 2014); *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 111 F. Supp. 3d 542 (S.D.N.Y. 2015) (relying, in part, on *Federated Strategic Income Fund v. Mechala Group Jamaica Ltd.*, 1999 BL 8776 (S.D.N.Y. Nov. 1, 1999)).

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