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Second Circuit Reverses District Court in *Marblegate*, Making It Easier to Restructure Bonds Outside of a Chapter 11 Case

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On Jan. 17, 2017, in a closely watched dispute surrounding Section 316(b) of the Trust Indenture Act of 1939, the U.S. Court of Appeals for the Second Circuit issued its long-anticipated decision in *Marblegate Asset Management, LLC v. Education Management Finance Corp*. (the "Decision").[1] In a 2-1 ruling reversing the District Court,[2] the Court of Appeals construed Section 316(b) narrowly, holding that it only prohibits "non-consensual amendments to an indenture's core payment terms" and does not protect noteholders' practical ability to receive payment.[3]

In the ruling, the Second Circuit considered the issue arising in the recent Southern District of New York District Court decisions in *Marblegate* and two cases relating to Caesars Entertainment ("*BOKF/MeenhanCombs*")[4] as to when an out-of-court debt restructuring may violate Section 316(b) of the TIA. Some, but not all, of the cases before and after them that have dealt with the issue have treated Section 316(b) as providing a narrow and specific protection for noteholders: requiring noteholder unanimity to alter the legal right to repayment under the terms of an indenture and the right to sue to enforce that right, but not protecting the practical right to receive payment.

The *Marblegate* and *BOKF/MeenhanCombs* District Court decisions, however, construed Section 316(b) as a broad protection of noteholders' practical ability to receive payment. The potential implications of those decisions were not insignificant — under those holdings, any out-of-court restructuring that deprived dissenting noteholders of assets against which to recover could violate Section 316(b), even absent any formal amendments to the indenture's payment terms. According to counsel for EDMC and its secured creditors, more noteholder actions for Section 316(b) violations were filed in the wake of the District Court decision in *Marblegate* than in the preceding 70 years since the enactment of the TIA, despite a significant decrease in the number of out-of-court restructurings.

The Second Circuit in *Marblegate* rejected the District Court's broad reading of Section 316(b), construing it as prohibiting only the actual amendment of an indenture's payment terms or right to sue for payment.

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[1] No. 15-2124-CV(L), 2017 WL 164318 (2d Cir. Jan. 17, 2017).

[2] *Marblegate Asset Management v. Education Management Corp.*, 75 F.Supp.3d 592 (S.D.N.Y. 2014) ("*Marblegate I*"); *Marblegate Asset Management, LLC v. Education Management Corp.*, 111 F.Supp.3d 542 (S.D.N.Y. 2015) ("*Marblegate II*").

[3] Decision at *1.

[4] *BOKF, N.A. v. Caesars Entertainment Corp.*, 144 F.Supp.3d 459 (S.D.N.Y. 2015); *MeehanCombs Glob. Credit Opportunities Funds, LP v. Caesars Entm't Corp.*, 80 F.Supp.3d 507 (S.D.N.Y. 2015).

What Happened in *Marblegate*

Marblegate involved a dispute between Education Management Corp., a for-profit education company, and its affiliates ("EDMC"), and one of its noteholders, Marblegate Asset Management LLC ("Marblegate"), regarding an out-of-court restructuring designed to incentivize all of EDMC's creditors to accept an exchange offer by the company.

The transaction contemplated two scenarios: (i) if all noteholders consented to the proposed restructuring, then the notes would be converted into equity of the issuer's parent guarantor; however, (ii) if there were any dissenting noteholders, then there would be an alternative transaction under which the secured lenders would foreclose on substantially all of EDMC's assets and release the EDMC parent guarantee of the notes. Although the transaction did not formally amend the actual terms of the unsecured notes, it was structured to ensure that dissenting noteholders would be left only with claims against a subsidiary with no assets.[5] Marblegate, the sole dissenting noteholder, sued to enjoin the restructuring transaction on the ground that it violated TIA Section 316(b).

The District Court Proceedings: *Marblegate I* and *II*

The core issue in *Marblegate* was whether the "right ... to receive payment" is to be read narrowly, as a legal entitlement to demand payment, or broadly, as a substantive right to actually obtain such payment.

EDMC argued the former — that Section 316(b) only prohibits nonconsensual amendments to an indenture's core payment terms, and that the transaction was outside the purview of Section 316(b) because it did not amend any terms of the indentures. Marblegate, on the other hand, argued the latter — that Section 316(b) should be broadly construed as a protection against any impairment to a noteholder's practical ability to receive payment, even absent any formal amendments to the indenture's payment terms. According to Marblegate, the transaction violated Section 316(b), since it stripped the issuers of their assets and removed the parent guarantee, effectively preventing payments to the dissenting noteholders.

The District Court adopted Marblegate's broader reading and construed Section 316(b) as a broad protection of noteholders' practical ability to receive payment.[6] In the District Court's view, Section 316(b) may be violated whenever a transaction "effect[s] an involuntary debt restructuring" — even where the payment terms of an indenture are not explicitly amended by the transaction.[7] Because the transaction at issue, while not directly amending the indenture's payment terms, impaired dissenting noteholders' ability to be repaid, the District Court held that it violated Section 316(b). Although it so held, the District Court denied the preliminary injunction sought by Marblegate because it concluded there was no irreparable harm.

Thereafter, EDMC proceeded with the restructuring, but refrained from releasing the parent guarantees of Marblegate's notes, in light of the *Marblegate I* decision. Instead, EDMC filed a counterclaim, seeking a declaration that the parent guarantees of Marblegate's notes could be released without violating Section 316(b). The District Court rejected EDMC's claims and, abiding by its earlier decision in

[5] Despite that, because EDMC was able to reduce its debt burden through the very transaction to which Marblegate objected, EDMC apparently now actually has the assets to pay on Marblegate's notes. Decision at *4. However, that did not play any role in the Court's decision.

[6] *See Marblegate I*, 75 F.Supp.3d at 614.

[7] *Id.*

Marblegate I, permanently enjoined EDMC from releasing the parent guarantees.[8] EDMC appealed the judgment.

The Second Circuit Decision

In a decision written by Judge Raymond Lohier Jr., in which Judge José Cabranes joined, the Second Circuit vacated and remanded the District Court's judgment, rejecting the District Court's broad reading of Section 316(b). The Court adopted a narrow reading of Section 316(b), holding that Section 316(b) only prohibits "non-consensual amendments to an indenture's core payment terms" and not the practical ability to receive payment.[9] As such, the Court concluded that the transaction at issue, which "did not amend any terms of the Indenture" or "prevent any dissenting bondholders from initiating suit to collect payments due on the dates specified by the Indenture," did not violate Section 316(b).[10]

The Court began by reviewing the language of Section 316(b), which is entitled "Prohibition of impairment of holder's right to payment" and provides as follows:

> 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, except as to a postponement of an interest payment consented to as provided in paragraph (2) of subsection (a) of this section, and except that such indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien.

15 U.S.C. § 77ppp(b) (emphasis added). Focusing on the terms "right," "impaired" and "affected," the Court — like the District Court — concluded they were ambiguous, and did not resolve the question of whether they prohibited only the amendment of an indenture's terms or a more broadly proscribed interference with an issuer's ability to pay.[11] The Court also concluded that the structure of the TIA did not provide the answer either.[12]

Despite finding Section 316(b) ambiguous, the Court noted what it believed were the "improbable results and interpretive problems" that would result from a broad interpretation of the relevant terms."[13] "Among other things," the Court observed, "interpreting 'impaired or affected' [in Section 316(b)] to mean any *possible* effect would transform a single provision of the TIA into a broad prohibition on any conduct that could influence the value of a note or a bondholder's practical ability to collect payment."[14] The Court also said that if the "right … to receive payment" meant "a bondholder's

[8] *See Marblegate II*, 111 F.Supp.3d at 556-57.

[9] Decision at *1.

[10] *Id.* at *12.

[11] *Id.* at *4-5.

[12] *Id.* at *5.

[13] *Id.*

[14] *Id.* (emphasis in original).

practical ability to collect payment," it would embrace — and therefore render superfluous — the "right … to institute suit for the enforcement of any such payment," which Section 316(b) also expressly protects.[15]

The Court then turned to the legislative history of Section 316(b).[16] Reviewing the testimony and reports leading up to and immediately following the enactment of the TIA, the Court determined that "Congress sought to prohibit formal modifications to indentures without the consent of all bondholders, but did not intend to go further by banning other well-known forms of reorganization like foreclosures."[17] Specifically, the Court noted that, contrary to the District Court's contention that Congress did not contemplate the use of foreclosures as a method of reorganization at the time that Section 316(b) was drafted, "[t]he authors of the 1936 SEC Report (and by inference the drafters of the TIA) were clearly aware that corporate reorganizations could be achieved through foreclosure."[18] Notwithstanding such awareness, however, the reports leading up to and immediately following the enactment of Section 316(b) "exclusively addressed *formal* amendments and indenture provisions like collective-action and no-action clauses," but did not prohibit foreclosure-based reorganizations, even if they may affect a bondholder's ability to receive full payment.[19] As such, the Court concluded that it was Congress' intent that Section 316(b) would only be directed at "reorganization by contract" and would only prohibit amendments to core payment terms.[20] The Court also relied on previous testimony of the drafters of Section 316(b), the House and Senate Reports on the final version of the TIA, a subsequent report by the SEC, and certain textual changes to Section 316(b) through its enactment in 1939 — all of which the Court found to support a narrow construction of the provision.[21]

Judge Lohier then discussed what he viewed as the unworkability of the District Court's broad interpretation of Section 316(b). According to the Court, the broad interpretation would "require[ ] that courts determine in each case whether a challenged transaction constitutes an 'out-of-court debt restructuring … designed to eliminate a non-consenting holder's ability to receive payment'," and thus, under that interpretation, liability under Section 316(b) would "turn[ ] on the subjective intent of the issuer or majority bondholders, not the transactional techniques used."[22] That, the Court believed, would "undermine uniformity in interpretation" by requiring courts to "interpret[ ] boilerplate indenture provisions based on the relationship of particular borrowers and lenders or the particularized intentions of the parties to an indenture" — an approach that the Second Circuit has "expressed a particular distaste for."[23]

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[15] *Id.*

[16] Among other things, the Court reviewed an eight-part report published by the SEC, entitled "Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective Reorganization Committees," which examined the role of protective committees in reorganizations ("SEC Report"). *See id.* at *6 n.5 (citing Securities and Exchange Comm'n, Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, Pts. 1, 6, 8 (1936-1940)).

[17] Decision at *10.

[18] *Id.* at *8.

[19] *Id.* at *7 (emphasis in original).

[20] *Id.* at *8.

[21] *See id.* at *8-11.

[22] *Id.* at *11 (citation omitted).

[23] *Id.* (quoting *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982)) (internal quotation marks omitted). As an example of a case where the court applied this "particular[ly] distaste[ful]" mode of interpretation, the Court cited *BOKF*, where the district

Finally, the Court said that its narrow interpretation of Section 316(b) "will not leave dissenting bondholders at the mercy of bondholder majorities" because such holders still could "pursue available State and federal law remedies" and/or "insist on credit agreements that forbid transactions" like the one at issue.[24]

The Dissenting Opinion

Judge Chester Straub, in a dissenting opinion, focused on the text of Section 316(b).[25] Contrary to the majority panel and the District Court, however, he did not find the provision to be ambiguous. Relying on the "plain text of the statute," he concluded that "an out-of-court debt restructuring 'impairs' or 'affects' a non-consenting noteholder's 'right to receive payment' 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." [26]

Judge Straub was "cognizant of the parade of horrors that Appellants predict will result from interpreting the TIA" as he did.[27] However, he concluded that "threatening dire commercial consequences" did not provide a sufficient basis to "override the correct interpretation of the law" by reading the statute in a manner inconsistent with its plain meaning, inasmuch as "making law is the job of the legislature and not of the courts."[28] Therefore, he concluded that even though "[c]ertain undesirable consequences might well arise from the fact that Section 316(b) prohibits actions such as those taken by EDMC in this case," the resolution of such consequences is for Congress and not the courts.[29]

Further Proceedings

It appears that the appellees next intend to seek *en banc* review of the Second Circuit panel's decision by the entire Court — inasmuch as they submitted an unopposed motion to extend their time to do so until Feb. 7, 2017, and their motion has recently been granted by the Court.[30] Such review is generally granted only in particularly significant cases, which *Marblegate* is, but even in such instances it is the exception rather than the rule.

Conclusion

The Second Circuit's ruling is of significant import, as it provides guidance — at least in the Second Circuit — on the scope of Section 316(b), holding that out-of-court debt restructurings, even if they may impair noteholders' practical ability to receive payment, do not fall within the purview of Section 316(b).

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court, while adopting Marblegate's interpretation of Section 316(b), "sen[t] to the factfinder the question of whether the 'overall *effect*' of the transactions at issue was a 'debt restructuring or a series of routine corporate transactions'." *See* Decision at *11 n.17 (quoting *BOKF*, 144 F.Supp.3d at 474-75 & n.86).

[24] Decision at *12.

[25] *See id.* at *12-16.

[26] *Id.* at *15.

[27] *Id.* at *16.

[28] *Id.*

[29] *Id.*

[30] Order, *Marblegate*, No. 15-2124 (2d Cir. Jan. 23, 2017).

Assuming the Second Circuit's decision stands and is either affirmed by the Supreme Court or is otherwise followed in other circuits, the decision will make it far easier for companies with TIA registered bonds (or "private for life" bonds that include a clause comparable to Section 316(b)) to implement an out-of-court restructuring with the support of a majority of the bondholders, such as debt exchanges with coercive features, like releasing guarantees and stripping covenants, designed to induce minority hold-outs to participate. So long as the restructuring does not violate the express terms of the applicable indenture or result in nonconsensual modifications to the indenture's "core payment terms," minority hold-outs would lose their leverage under the TIA to block the restructuring with the threat of litigation.

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