CLIENT MEMORANDUM

Second Circuit Overturns S.D.N.Y. Decision in *Marblegate*, Finding that the Trust Indenture Act Does Not Prohibit Coercive Restructurings

January 19, 2017

In a significant reversal of recent S.D.N.Y. decisions that complicated out-of-court restructurings for issuers of corporate bonds, the U.S. Court of Appeals for the Second Circuit held earlier this week that the Trust Indenture Act of 1939 (the "TIA") does not prevent amendments to indentures or out-of-court restructurings that have the effect of limiting the practical ability of nonconsenting bondholders to receive payment on their bonds, so long as the legal right to receive payment when and in the amount due is not affected.

Prior to the Second Circuit's highly anticipated decision in *Marblegate Asset Management, LLC v. Education Management Finance Corp* [1] (the "Decision"), the S.D.N.Y. held in a recent series of cases [2] that TIA Section 316(b)[3] prevents issuers of TIA-qualified notes (which include publicly traded, and many private-for-life, corporate bonds) and their creditors from entering into "restructuring" transactions that limited the "practical ability" of nonconsenting holders to receive payment on their notes. That is, even if the core payment terms of the relevant indenture remained unchanged, if the terms of the restructuring had the effect of impairing the issuer's ability to make payment when due on the nonconsenting holders' notes, under these S.D.N.Y. cases, Section 316(b) would be implicated and might prohibit the transaction.

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1 Case No. 15-2124-cv(L) (2d Cir. Jan. 17, 2017). Clients should note that until April, the Decision may be appealed to the Supreme Court.

2 *See Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 111 F. Supp. 3d 542 (S.D.N.Y. 2015)*; Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 75 F. Supp. 3d 592 (S.D.N.Y. 2014); *BOKF, N.A. v. Caesars Entm't Corp.*, 144 F. Supp. 3d 459 (S.D.N.Y. 2015); *Meehancombs Global Credit Opportunities Funds, LP v. Caesars Entm't Corp.*, 80 F. Supp. 3d 507 (S.D.N.Y. 2015); *Federated Strategic Income Fund v. Mechala Grp*., 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999).

3 15 U.S.C. § 77ppp(b).

The Second Circuit's Decision restores the view commonly held by issuers and practitioners (as well as by decisions in other courts[4]) before the recent S.D.N.Y. cases that Section 316(b) "prohibits only non-consensual amendments to an indenture's core payment terms" – namely, the amount of principal and interest owed, and the date of maturity. As a result, the Decision can be expected to facilitate the ability of issuers to work with the majority of their creditors to effect a consensual out-of-court restructuring.

A further description of the Decision is included below. Please do not hesitate to reach out to any of the individuals listed at the end of this Client Alert or the Willkie attorney with whom you regularly work should you wish to discuss the effects of this Decision on your institution.

Background

Under the challenged transactions, Education Management Corporation ("EDMC"), a for-profit education company, sought to restructure roughly $1.5 billion in debt, including approximately $1.3 billion in secured debt and $217 million in unsecured notes (the "Notes"), both of which were incurred by a subsidiary and guaranteed by EDMC. EDMC's only option was to restructure out-of-court because bankruptcy would render it ineligible for certain federal educational funding that was critical to its business.

The transaction was structured to occur in one of two ways. If all of EDMC's creditors consented, bondholders would receive a portion of the equity in EDMC, resulting in a recovery of approximately 33%. Alternatively, if one or more creditors refused to participate, the transaction would be effected through a series of transactions referred to as the "Intercompany Sale."[5] The Intercompany Sale was structured to "incentivize creditors to consent": while any bondholder who did not consent would keep its Notes without amendment to their terms, its contractual remedies would be limited to recovering against the issuer-subsidiary, which would be transformed as a result of the Intercompany Sale to an "empty shell."

All of EDMC's creditors (representing 98% of its debt) consented to the Intercompany Sale except the plaintiffs-appellees ("Marblegate"). Marblegate sued EDMC to enjoin the Intercompany Sale and EDMC counterclaimed seeking declaratory judgment.

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4 *Brady v. UBS Fin. Servs., Inc.*, 538 F.3d 1319, 1326 n. 9 (10th Cir. 2008); *YRC Worldwide Inc. v. Deutsche Bank Tr. Co. Am.*, 2010 WL 2680336, at *7 (D. Kan. July 1, 2010); *UPIC & Co. v. Kinder-Care Learning Ctrs., Inc.*, 793 F. Supp. 448, 456 (S.D.N.Y. 1992); *Magten Asset Mgmt. Corp. v. Nw. Corp. (In re Nw. Corp.)*, 313 B.R. 595, 600 (Bankr. D. Del. 2004).

5 The Intercompany Sale was structured as a series of steps. First, the secured lenders foreclosed on the issuer's assets and released EDMC's parent guarantee of the secured loans. Under the Note indenture, such release also effected a release of the Note's parent guarantee. Next, the collateral agent immediately sold the assets to a newly formed subsidiary of EDMC. The new subsidiary then distributed debt and equity to those creditors who consented to the Intercompany Sale. Notably, the Intercompany Sale did not involve the amendment of the Notes or indenture.

<u>The "Narrow" vs. "Broad" Interpretation of Section 316(b)</u>

The dispute at issue in the litigation focused on the scope of Section 316(b)'s protections – specifically, what a "right … to receive payment" consists of and when it is "impaired or affected without the consent" of bondholders.[6] EDMC advanced a narrow reading, arguing that Section 316(b)'s "legal right" to receive payment only prohibits a modification to an indenture's core payment terms without a bondholder's consent. Marblegate, on the other hand, advanced a broad reading, arguing that, unless bondholders consent or the restructuring occurs in bankruptcy, bondholders were protected from transactions that may leave their legal rights intact but eliminate their "practical ability" to collect.

In two separate opinions, the District Court generally agreed with Marblegate's interpretation, and EDMC subsequently appealed.

<u>The Decision</u>

In vacating the lower court's decision, the Second Circuit determined that the relevant text of Section 316(b) and structure of the TIA were ambiguous.[7] Based on a lengthy analysis of the legislative history,[8] the panel concluded that Section

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6 Section 316(b) of the TIA provides:

"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." (emphasis added)

7 Nevertheless, the Second Circuit noted that Marblegate's "broad reading of the word 'right' as including the practical ability to collect payment leads to improbable results and interpretative problems." For example, it transformed Section 316(b) into "a broad prohibition on any conduct that could influence the value of a note or a bondholder's practical ability to collect payment," and rendered superfluous other language in Section 316(b) that protects the "right … to institute suit for the enforcement of any such payment."

Judge Straub filed a written dissent, which expressed the view that the Intercompany Sale violated the plain text of Section 316(b). Applying a plain meaning approach, Judge Straub concluded that Section 316(b)'s focus on whether the bondholders' payment rights are "impaired" or "affected" requires a broader reading than one limited to amendments to a bondholder's legal entitlements. Because "[t]his scheme did not simply 'impair' or 'affect' Marblegate's right to receive payment – it annihilated it," Judge Straub concluded that Section 316(b) is violated when an out-of-court debt restructuring 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."

316(b) sought to prohibit formal amendments to the core payment terms of an indenture through "collective action" clauses without the consent of all bondholders. The panel rejected the District Court's view that Section 316(b) went further by also prohibiting other transactions, such as foreclosures.

The Second Circuit also highlighted issues with the practical application of Marblegate's interpretation, which would require courts (and practitioners) to determine on a case-by-case basis whether a challenged transaction constitutes "an out of court debt restructuring … designed to eliminate a non-consenting holder's [practical] ability to receive payment." This approach – which would turn on the subjective intent of the issuer and majority bondholders, rather than the transactional techniques that were employed – runs afoul of the general principle that boilerplate indenture provisions should be interpreted in a way that promotes "uniformity in interpretation," instead of being based on "the relationship of particular borrowers and lenders" or the "particularized intentions of the parties to an indenture."[9]

In limiting Section 316(b)'s applicability, the panel was careful to note that its Decision nonetheless leaves dissenting creditors with recourse to pursue available state and federal law claims, such as challenges to a foreclosure under the U.C.C., or successor liability and fraudulent conveyance claims.

<u>Observations</u>

Prior to the Decision, the cases adopting the "broad" interpretation of Section 316(b) unsettled many expectations among legal practitioners and market participants about the scope of the TIA's protections. Given the prominence of New York courts in interpreting the laws that govern financial market transactions, these decisions raised substantial questions and uncertainty regarding the ability of issuers to effectuate many out-of-court restructurings. Among other things, the position advanced by these cases complicated the restructuring of corporate debt by possibly limiting the ability of issuers to provide advantageous treatment to bondholders participating in a restructuring and to disadvantage the practical (but not legal rights) of hold-outs. The risk was more than theoretical: in several cases, bondholder-plaintiffs filed lawsuits challenging exchange offers based on Section 316(b).[10]

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8 The panel analyzed SEC reports, congressional testimony of two former SEC chairmen who drafted the TIA, congressional reports and the textual evolution of the statute.

9 *See Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982).

10 *See, e.g., Waxman v. Cliffs Nat. Res.*, No. 16-civ-1899 (S.D.N.Y.); *In re Vanguard Nat. Res. Bondholder Litig.*, No. 16-cv-01578-PKC (S.D.N.Y. 2016); and *Cummings v. Chesapeake Energy Corp.*, No. 16-cv-00647-HE (W.D. Okl.). On December 6, 2016, S.D.N.Y. District Judge Sweet issued an opinion in *Cliffs Natural Resources* that, among other things, considered the application of Section 316(b) to an exchange offer that was only open to certain institutional and non-U.S. holders, rendering the plaintiffs who could not participate subordinated. Without expressly adopting either the "narrow" or "broad" interpretations of Section 316(b), the court dismissed the class action plaintiffs' Section 316(b) claims because the transaction did not involve a majority's abuse of minority holders and there were was no indication it was like an "out-of-court pseudo-bankruptcy." *Cliffs Nat. Res.*, 2016 WL 7131545, at *6-7 (S.D.N.Y. Dec. 6, 2016).

The precise impact of the Decision remains to be seen, and the Decision will no doubt invite further scrutiny and analysis from practitioners and courts as to the scope of its holding and its application to other out-of-court restructurings. Nevertheless, the Second Circuit's holding that Section 316(b) prohibits only non-consensual amendments to core payment terms should quell many of the concerns that the prior S.D.N.Y. cases had raised, and provide further comfort to issuers, indenture trustees and bondholders regarding the uniform interpretation of its protections.

As a result, to the extent that issuers were previously chilled from pursuing out-of-court restructurings, one may expect to see an uptick in such attempts by issuers, possibly at the expense of chapter 11 filings. The Second Circuit's recognition that these transactions may be structured to "incentivize" bondholders to consent may encourage the use of more coercive transactions instead of the Bankruptcy Code's plan voting and cram-down provisions.

While the Decision is binding upon lower courts in the Second Circuit, it is not binding in other circuits. Other courts, however, may find its reasoning persuasive. Moreover, Marblegate retains two possible avenues for review of the decision. First, it may file a petition for en banc review of the three-judge panel's decision, which would require the appellate court to determine that the proceeding involves one or more questions of exceptional importance such that a hearing before the entire Second Circuit bench is warranted. Alternatively, Marblegate may file a petition for certiorari, requesting Supreme Court review. The absence of a circuit split and the fact that the issue has yet to percolate through a critical mass of jurisdictions will present a challenge to obtaining review under either avenue. That said, the finality of the Decision will be uncertain until Marblegate's deadline to file for certiorari expires in mid-April. Until then, a close eye should be kept on the emergence of any other opinions bearing on the interpretation of Section 316(b) and on the trajectory of any appellate petitions filed by Marblegate.

If you have any questions regarding this memorandum, please contact one of the following attorneys or the Willkie attorney with whom you regularly work.

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January 19, 2017