Client Update
Second Circuit Court of Appeals Lifts Cloud of Uncertainty over Bond Restructurings

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Yesterday, the Second Circuit reversed the controversial *Marblegate* decisions.[1] The lower court had cast doubt on a broad range of out-of-court restructurings when it endorsed a novel and broad interpretation of Section 316(b) of the Trust Indenture Act (the "TIA").[2] By rejecting that unconventional reading, the Second Circuit decision restores certainty to the restructuring world. The decision cautions, however, that restructurings remain subject to other creditor claims—and in foreclosing broad Section 316(b) claims, *Marblegate* leaves the path clear for creditors to pursue alternate theories of liability. Therefore, the decision is a useful reminder that distressed companies (and their boards and equity sponsors) should continue to follow best practices—exploring alternative transactions, evaluating all options with fiduciary duties in mind, negotiating the terms of the chosen transaction at arms' length, and fully documenting the directors' and officers' decision-making process—in order to best protect against future litigation.

BACKGROUND

In 2014, Education Management Corporation ("EDMC"), a for-profit education provider, was faced with deteriorating finances and sought to restructure approximately $1.5 billion in secured loans and unsecured notes, both issued by Education Management LLC ("EM") and guaranteed by EDMC. Because EDMC

[1] *Marblegate Asset Mgmt., LLC. v. Educ. Mgmt. Fin. Corp.*, No. 15-2124-cv(L), 15-2141-cv(CON) (2d Cir. Jan. 17, 2017); *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 111 F. Supp.3d 542 (S.D.N.Y. 2015) ("Marblegate II"); *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 75 F. Supp.3d 592, 611-15 (S.D.N.Y. 2014) ("Marblegate I").

[2] Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb. We discussed the lower court's decisions in previous Client Updates on January 25, 2015 and April 25, 2016: http://www.debevoise.com/insights/publications/2015/01/expansive-trust-indenture, http://www.debevoise.com/insights/publications/2016/04/28-law-firms-publish-white-paper.

would lose its entitlement to funds under federal student aid programs if it filed for bankruptcy, the restructuring had to be accomplished out of court.

To this end, EDMC negotiated a restructuring support agreement ("RSA") with its creditors that contemplated two possible transactions, neither of which required a bankruptcy filing. If 100% of EDMC's creditors consented, holders of secured debt would receive a combination of cash, new debt and preferred stock convertible into approximately 77% of EDMC's common stock, and noteholders would receive preferred stock convertible into at least 19% of EDMC's common stock. If 100% consent was not obtained: (i) the secured lenders would consensually release EDMC's guarantee of their loans, which under the unsecured notes indenture would automatically release EDMC's guarantee of the notes; (ii) the secured lenders would exercise their right under the credit facilities to foreclose on substantially all of EDMC's assets; and (iii) the secured lenders would in turn sell the assets back to a new subsidiary of EDMC in exchange for new debt and equity to be distributed only to consenting creditors. Under the second option, nonconsenting noteholders would lose the benefit of the EDMC guarantee and would be left with claims against an entity that no longer held any assets.

While 99% of the secured lenders and over 90% of the unsecured noteholders consented to the first option, EDMC was forced to pursue the second, nonconsensual alternative. The holdout noteholders then sought a preliminary injunction to enjoin the restructuring, alleging that it violated the TIA and the terms of the TIA-qualified indenture governing the unsecured notes.

SECTION 316(B) OF THE TRUST INDENTURE ACT

In December 2014, the U.S. District Court for the Southern District of New York initially declined to grant equitable relief to the plaintiffs, but explored in dicta the merits of their case and concluded that the plaintiffs had demonstrated a likelihood of success on their claim that the proposed restructuring violated Section 316(b) of the TIA.

Section 316(b) of the TIA provides that "the right of any holder of any indenture security to receive payment of the principal of an interest on such indenture security ... shall not be impaired or affected without the consent of such holder...."[3] Relying upon an unpublished district court decision and the TIA's legislative history, the District Court reasoned that the TIA should be read as "a broad protection against non-consensual debt restructurings" protecting each

[3] 15 U.S.C. § 77ppp(b).

noteholder's "substantive right to actually obtain" payment, and not merely the "legal entitlement to demand payment."[4] Applying this expansive interpretation of the TIA, the District Court found that the nonconsensual restructuring contemplated by the RSA would "effect a complete impairment of dissenters' right to receive payment" and therefore was illegal under the TIA.[5] The District Court also stated that Section 316(b) is violated by "practical and formal modifications of indentures that do not explicitly alter a core term" whenever a transaction "effect[s] an involuntary debt restructuring."[6]

In light of the District Court's decision, EM consummated the restructuring under the RSA without releasing EDMC's guarantee of the unsecured notes. Thereafter, EDMC filed a counterclaim against the plaintiffs seeking a declaration that the EDMC guarantee could be released without violating the TIA. In June 2015, the District Court concluded that the release of the EDMC guarantee would violate Section 316(b) of the TIA,[7] and EDMC appealed that decision.

THE SECOND CIRCUIT'S DECISION

The Second Circuit, in a 2-1 decision, found that Section 316(b) is ambiguous as to whether it prohibits more than just formal amendments to bond payment terms that eliminate the right to sue for payment. As a result, the Second Circuit extensively analyzed the relevant legislative history and ultimately concluded that "Congress did not intend the broad reading that … the District Court embraced." In its analysis, the Second Circuit noted that the legislative history of Section 316(b) of the TIA "exclusively addressed formal amendments and indenture provisions like collective-action and non-action clauses," and that nothing in the legislative history indicated that the TIA was enacted to prohibit "well-known forms of reorganization like foreclosures."

In further support of its ruling, the Second Circuit observed that the plaintiffs' interpretation of Section 316(b) was unworkable and threatened the uniform interpretation of boilerplate indenture provisions by requiring courts to determine the subjective intent of an issuer or a majority of bondholders in evaluating whether a challenged transaction was a permissible "out-of-court debt restructuring." Finally, the Second Circuit also noted that, even if a transaction is not prohibited under the TIA, minority bondholders retained their remedies

[4] Marblegate I at 611–15.
[5] *Id.* at 615.
[6] *Id.*
[7] Marblegate II at 556–57.

under other state and federal laws, citing to theories of successor liability and fraudulent transfers as examples.

IMPLICATIONS

The Second Circuit's decision lifts the cloud of uncertainty that has hung over out-of-court bond restructurings since late 2014. The decision reverses the District Court's expansive interpretation of Section 316(b) of the TIA. Although the Second Circuit's analysis of the legislative history gives much weight to the fact that the challenged transaction involved a foreclosure, the Second Circuit's narrow reading of Section 316(b) is not limited by that fact. As a result, the traditional interpretation of Section 316(b)—only prohibiting nonconsensual amendments to an indenture's core payment terms—has now been restored in the Second Circuit.

While this decision should facilitate out-of-court restructurings by removing uncertainty that the District Court's decisions had created, it also highlights the importance for distressed companies and equity sponsors to follow best practices when pursuing out-of-court restructurings. The Second Circuit expressly noted that, while the transaction was not prohibited by the TIA, minority bondholders could still bring potential state or federal law claims. Although the Second Circuit highlighted fraudulent transfer and successor liability remedies as examples, other potential causes of action, such as those related to fiduciary duties or tortious interference with contract, would also be preserved. Disgruntled minority bondholders or opportunistic investors have long employed the tactic of bringing litigation claims in order to seek value in a restructuring context, and the importance of these alternate theories of liability may be heightened if a plausible claim can no longer be asserted under Section 316(b). Therefore, while the path toward out-of-court bond restructurings has once again become clearer and more predictable, distressed companies, their officers and directors, and their professionals should continue to maintain best practices throughout a restructuring transaction.

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Please do not hesitate to contact us with any questions.