SULLIVAN & CROMWELL LLP

January 19, 2017

Second Circuit Overturns *Marblegate*, Rejecting Expansive Interpretation of Section 316(b) of the Trust Indenture Act

In Split Decision, Appeals Court Rules That Section 316(b) of the Trust Indenture Act of 1939 Prohibits Only Formal Non-Consensual Amendments to a Qualified Indenture's Core Payment Terms

SUMMARY

On January 17, 2017, a split panel of the U.S. Court of Appeals for the Second Circuit held that the series of transactions to restructure the debt of Education Management Corporation ("EDMC") did not violate Section 316(b) of the Trust Indenture Act of 1939 (the "TIA"). The Court concluded that Section 316(b) prohibits "only non-consensual amendments to an indenture's core payment terms", overturning a widely publicized and controversial decision from the district court for the Southern District of New York that expansively interpreted Section 316(b) to protect bondholders' "practical ability" to receive payments.

While the Court's much-anticipated ruling is potentially subject to further appeal, it likely ends the uncertainty created by several lower court decisions in 2014 and 2015. The Second Circuit's narrow interpretation of Section 316(b) will give participants in "out-of-court" financial restructurings and distressed liability management exercises involving U.S. bonds greater flexibility to structure and execute those transactions.

BACKGROUND

In 2014, EDMC, a for-profit higher education company, faced significant financial difficulties, with rapidly declining EBITDA and the likelihood of significant negative cash flow. EDMC's financial problems were intertwined with its capital structure, which at that time consisted of approximately $1.3 billion in secured loans governed by a credit agreement and secured by essentially all of EDMC's assets and $217 million

in unsecured bonds governed by an indenture qualified under the TIA. All of the debt was borrowed and/or issued by two subsidiaries of EDMC (the "EDMC Borrowers"). Absent relief from its creditors, EDMC faced the possibility of covenant breaches and the inability to pay amounts coming due under its credit agreement.

Unable to seek a debt restructuring in bankruptcy—a path foreclosed by EDMC's heavy reliance on federally funded student aid programs—EDMC sought to undertake a financial restructuring out-of-court and embarked on negotiations with its creditors.[1] Following negotiations with an ad hoc committee consisting of holders of EDMC's secured loans and unsecured bonds, EDMC and the ad hoc committee agreed upon two alternative structures for implementing its financial restructuring:

- ***Unanimous consent structure*** – If unanimous consent could be obtained from the holders of EDMC's secured loans and its unsecured bondholders, lenders would receive a combination of new secured loans and equity and bondholders would receive equity.
- ***Majority consent structure*** – If unanimous consent could not be obtained, the financial restructuring would be implemented through a series of interim steps that involved, among other things, EDMC causing the EDMC Borrowers to transfer substantially all of their assets to a newly formed EDMC subsidiary (a sister company to the EDMC Borrowers ("Newco"), and obtaining a release of EDMC's guarantee of the secured loans and unsecured bonds. A "consenting creditor" would be entitled to receive a mix of Newco debt and equity. A "nonconsenting creditor" would be treated differently, depending on the type of debt instrument it held: a nonconsenting lender would be entitled to receive Newco junior debt, while a nonconsenting bondholder would continue to hold its bonds. The result for a nonconsenting bondholder, however, was particularly harsh because all of its borrowers' assets would be gone and the guarantor's guarantee released, leaving the bondholder with only "empty shell" obligors and a potential fraudulent transfer claim.

In the end, EDMC did not obtain unanimous consent. Approximately 98% of EDMC's loan and bond creditors consented to the financial restructuring, with only Marblegate Asset Management, LLC and Marblegate Special Opportunity Master Fund, L.P. (together, "Marblegate") failing to do so. Marblegate filed suit in federal court in the Southern District of New York seeking to enjoin the financial restructuring on the basis that it violated Section 316(b) of the TIA, which provides that:

> Notwithstanding any other provision of the indenture . . . 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 . . . .[2]

Although the district court denied the injunction because of Marblegate's failure to show a likelihood of irreparable harm, the court, in a widely publicized opinion, subsequently ruled in June 2015 that EDMC could not release its guarantee of the EDMC Borrowers' obligations as doing so would violate Section 316(b). After examining the text and legislative history of Section 316(b), the district court concluded that Section 316(b) broadly protected a bondholder's right to "receive" principal and interest and that protection applied whether the legal right to receive payment was infringed (e.g., by an amendment to the

core terms in the underlying indenture) or the right was impaired as a practical matter (e.g., by an out-of-court restructuring). The court thus concluded that, even though the EDMC financial restructuring did not directly amend any core payment term of the indenture governing the unsecured notes, it violated Section 316(b) because its practical effect was to leave non-consenting noteholders with essentially worthless claims.

MARKET REACTION

The district court's *Marblegate* decisions generated immediate and widespread debate and affected practice in the market, as the *Marblegate* decisions (together with two other decisions in the Southern District of New York that adopted *Marblegate*'s general analysis)[3] transformed a long-standing and relatively insignificant provision of the TIA into a potentially potent tool for dissenting bondholders. Participants in out-of-court financial restructurings and distressed liability management exercises struggled with how to structure such transactions without violating Section 316(b). Bondholders relying on the district court decisions filed litigation against several issuers, claiming that corporate financing transactions had practically impaired their rights to payment under Section 316(b). Meanwhile, some bond issuers attempted to avoid the impact of *Marblegate* on subsequent corporate actions by issuing bonds under indentures that were not qualified under the TIA and did not include a contractual right to receive payment based on the Section 316(b) language.[4]

THE SECOND CIRCUIT DECISION

EDMC appealed the district court's decision to the U.S. Court of Appeals for the Second Circuit, which heard oral arguments on this case in May 2016.

On January 17, 2017, in a much-anticipated decision authored by Judge Raymond Lohier, the Court agreed with EDMC that Section 316(b) protects "only non-consensual amendments to an indenture's core payment terms" (which the Court identified as the "amount of principal and interest owed, and the date of maturity") and that accordingly the release of EDMC's guarantee did not violate such protections. In reaching this decision, the Court concluded that the plain text of Section 316(b) was ambiguous but that the legislative history and purpose of Section 316(b) demonstrated that the section was designed to address only "formal" amendments to an indenture affecting the "right . . . to receive payment" rather than provide bondholders with a broader shield against other corporate actions that might "impair a bondholder's practical ability to recover payment". The Court stressed that its decision would not leave dissenting bondholders "at the mercy of bondholder majorities", as they could still seek to avail themselves of state law remedies such as successor liability and fraudulent conveyance.

On that basis, the Court vacated the trial court's decision. Judge José Cabranes joined Judge Lohier's opinion in full. Judge Chester Straub dissented, concluding that the plain language of Section 316(b) supports *Marblegate*'s broader construction.

A. PLAIN TEXT OF SECTION 316(B)

The Court's opinion first explored whether the "plain text" of Section 316(b) is sufficiently clear as to resolve the interpretive question surrounding the "right . . . to receive payment". The majority opinion explained that the individual words used in Section 316(b) cut both ways: "right" suggests a "legally enforceable obligation", whereas the phrasing that such right cannot be "impaired or affected" could suggest that Section 316(b) is designed to protect against any relaxation or diminution of that right. The Court noted that a broad reading of those terms could lead to untenable results, such as interpreting "impaired or affected" to prohibit "any" conduct that could possibly "influence the value of a note or a bondholder's practical ability to collect payment". It also wrestled with the "general rule" that different statutory phrases should be afforded different meanings and that a broad reading of the individual words would have the "right . . . to receive payment" subsume Section 316(b)'s separately identified protection of the "right . . . to institute suit".

The Court ultimately concluded that the language of Section 316(b) is ambiguous and insufficient to resolve the question of whether the release of EDMC's guarantee in the financial restructuring would contravene the TIA.

B. LEGISLATIVE HISTORY

The majority opinion next undertook a detailed analysis of the legislative history of Section 316(b). The Court began by noting that it disagreed with the district court's conclusions that the drafters of the TIA "did not anticipate precisely the mechanisms" by which a non-consensual majoritarian restructuring might occur and that they only "understood involuntary reorganizations to operate in a rather straightforward fashion: a majority of the bondholders would simply vote to amend the payment or interest provisions of the indenture".

On the contrary, the Court concluded that the drafters of the TIA were "well aware of the range of possible forms of reorganization available to issuers" and that, despite that awareness, the TIA's "legislative history exclusively addressed formal amendments and indenture provisions like collective-action and no-action clauses". Among other pieces of legislative history, the Court considered:

- ***Contemporary SEC Reports*** – The Court examined portions of contemporary reports published by the Securities and Exchange Commission (the "SEC"), including a report published in 1936 on the role of protective committees in reorganizations, noting that its language suggested its authors (and, as the Court inferred, the drafters of the TIA) were "clearly aware" that corporate reorganizations could be achieved in ways beyond contractual amendments (such as foreclosures, which had been understood for decades as a tool to facilitate "the transfer of the company's assets to a new corporation"), and yet the report's concern "was directed at 'reorganization by contract'". Another

report from 1940 provided an overview of the "decades-long use of foreclosure proceedings to effect reorganizations", which noted, in facts reminiscent of *Marblegate*, that if junior creditors "refused participation" in a foreclosure they would be left with only those assets "as to which senior creditors could lay no prior claims", assets that were "at best nominal". The 1940 report did not suggest, in any way, that the newly enacted TIA prohibited such reorganizations.

- ***Testimony of Contemporary SEC Representatives*** – The Court considered the testimony of the chairman of the SEC when the TIA was enacted, who referred to the language that eventually became Section 316(b) as a provision that "merely restricts the power of the majority to change those particular phrases of the contract", and the testimony of the then-assistant director of the reorganization division of the SEC, who testified that "[a]ll that the section [316(b)] does is preserve the individual holder's right to bring an action at law".

Based on its reading of the legislative history, the Court concluded that Congress had not intended to create a "broad right to actual payment" with Section 316(b) and that instead Section 316(b) provides "merely a right to sue for payment under fixed indenture terms". The Court accordingly had no need to discuss the acts or circumstances that could constitute a practical impairment of those rights. The Court stressed that sophisticated creditors could insist at the outset on debt documentation that prohibited aggressive financial restructurings and that dissenting bondholders could still resort to state-law remedies such as successor liability and fraudulent conveyance.

C. DISSENT

In dissent, Judge Straub explained that, based on the "plain text" of Section 316(b), he would hold that an out-of-court financial restructuring could impair or affect a bondholder's "right to receive payment" when it was designed to "eliminate" that bondholder's ability to receive payment. As a result, Judge Straub saw no need to engage in an examination of the legislative history of Section 316(b). He concluded his dissent by acknowledging that although he is "cognizant of the parade of horrors" that EDMC alleged would result from an expansive interpretation of Section 316(b), that risk was not a "sufficient basis" to embrace the majority's reasoning and that instead any defects in the statute should be remedied by Congress.

D. POSSIBILITY OF FURTHER LITIGATION

While the initial reaction to the Second Circuit's decision has been generally positive, the uncertainty caused by the *Marblegate* decisions may not yet be at an end, as Marblegate can still petition for a rehearing *en banc* in the Second Circuit or for certiorari to the U.S. Supreme Court.

IMPLICATIONS

If the Court's decision ultimately stands, it likely marks the end of a period of uncertainty in the context of out-of-court restructurings and distressed liability management transactions that began with the district court's initial decision in *Marblegate* in 2014. By vacating the district court's decision, the Second Circuit has ensured that both issuers and holders of U.S. bonds can now act with the benefit of a clear understanding of the scope of protections afforded by Section 316(b). The decision also would seem to

require dismissal of existing litigation claims predicated on the district court's broad reading of Section 316(b). Going forward, this clarity will allow for greater confidence in structuring and implementing out-of-court financial restructurings involving U.S. bonds without the threat of Section 316(b) challenges by dissenting minority bondholders. Such confidence will be especially important in out-of-court financial restructurings involving such actions as asset and guarantor releases or covenant stripping.

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ENDNOTES

[1] The protections provided by Section 316(b) would not have been relevant to EDMC in a formal bankruptcy proceeding due to the recognized exception that bankruptcy proceedings are not within the scope of Section 316(b). *See, e.g., In re Board of Directors of Telecom Argentina, S.A.*, 528 F.3d 162, 172 (2d Cir. 2008).

[2] 15 U.S.C. § 77ppp(b).

[3] Although the Court's decision does not specifically address the Southern District of New York's decision in *Meehancombs Global Credit Opportunities Fund* v. *Caesar's Entertainment Corp.*, 14-cv-7091 (SAS) (S.D.N.Y. Jan. 15, 2015), we expect that the analysis embraced in *Caesar's* has also been effectively overruled given the similarities between the district court decisions in *Marblegate* and *Caesar's* and the breadth of the Court's decision here.

[4] Although the *Marblegate* decisions involved an indenture that was qualified under the TIA (and accordingly automatically incorporates the protections of Section 316(b)), the resulting ambiguity from the *Marblegate* decisions was far-reaching, as many U.S. law-governed indentures that are not TIA-qualified nonetheless contain contractual provisions mirroring the "right to receive payment" language of Section 316(b), and there was concern that those provisions could be interpreted under the *Marblegate* framework.

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