January 18, 2017

Second Circuit Holds that Trust Indenture Act 316(b) Prohibits Only Non-Consensual Amendments to Core Payment Terms of Bond Indentures

On January 17, 2017, the Court of Appeals for the Second Circuit issued its long-anticipated opinion in *Marblegate Asset Management, LLC* v. *Education Management Finance Corp*.,[1] ruling that Section 316(b) of the Trust Indenture Act of 1939, 15 U.S.C. § 77ppp(b) (the "Act"), prohibits only non-consensual amendments to core payment terms of bond indentures. The 2–1 ruling vacated and remanded the decision of the district court determining that the defendants (two affiliated note issuers and their corporate parent) violated Section 316(b) by engaging in a series of transactions that, while they did not amend the governing indentures, were designed to restructure the defendants' debt in a manner that deprived non-consenting noteholders, including the plaintiffs, of their practical ability to collect payment on the notes. The Second Circuit opinion clarifies an issue that had caused substantial doubt and debate in the debt markets and provides debt issuers with broader ability under the Act to restructure debt outside of bankruptcy court.

Section 316(b) of the Act provides in relevant part 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 . . . shall not be impaired or affected without the consent of such holder . . . ." Prior to the district court ruling in *Marblegate*, most courts had construed Section 316(b) narrowly, holding that it protects non-consenting bondholders only from changes to core payment terms that affect their legal rights to principal and interest or their standing to sue for collection, and not to transactions that might reduce only their practical ability to obtain repayment.

In *Marblegate*, however, the district court interpreted Section 316(b) more broadly, holding that in some circumstances it protects the "ability" of Noteholders to receive payment, and that, even where a transaction does not modify the payment terms of an indenture, the Act is violated whenever a transaction "effect[s] an involuntary restructuring." The plaintiffs in *Marblegate* challenged a planned restructuring of debt of EDMC, a for-profit higher education company, and two of its subsidiaries. The plaintiffs held notes issued by the subsidiaries and guaranteed by the parent. Pursuant to the restructuring, (i) substantially all assets of the subsidiary issuers would be transferred to a new EDMC subsidiary

[1] *Marblegate Asset Management, LLC* v. *Education Management Finance Corp*., Docket No. 15-2124-cv(L), 15-2141-cv (CON) (*Marblegate*), decided January 17, 2017. Paul, Weiss, Rifkind, Wharton & Garrison LLP submitted an amicus brief in *Marblegate* on behalf of a client.

following a consensual foreclosure on the assets by their secured creditors; (ii) EDMC's guarantee of the notes previously issued by the two subsidiaries would be released; and (iii) the new subsidiary would issue debt and equity to consenting creditors and continue the business. Thus, although the indentures governing the existing notes were not amended, the result of the transaction was to transform the issuers into "empty shell[s]" and deprive non-consenting noteholders of EDMC's parent guarantee.

Plaintiffs, the only holdout creditors, sued to enjoin the transaction on the ground that it violated Section 316(b) of the Act. The district court declined to grant a preliminary injunction, but concluded that the plaintiffs were likely to succeed on the merits of their TIA claim, reasoning that the Act prohibits any non-consensual debt restructuring effected outside of bankruptcy court. Following a bench trial, the district court enjoined EDMC from releasing the parent guarantee on the notes held by plaintiff. Acknowledging the "potentially troubling" implications of its holding in "rewarding holdouts" and the Act's "arguable obsolescence given the expense and complexity of modern bankruptcy," the district court nevertheless concluded that its holding was compelled by the language, structure, and legislative history of the Act.

The Second Circuit vacated and remanded, agreeing with EDMC's argument that, because the transaction did not formally amend the payment terms of the indenture governing the notes, it did not violate the Act. The Court concluded that the statutory language was ambiguous and failed to resolve the issue before it, but that the Act's legislative history "convinces us . . . 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." The Court further reasoned that the district court's ruling undermined the interest in uniform interpretation of indentures because it made the subjective intent of the issuer relevant to the statutory analysis. The Court concluded that, because the transactions did not amend the "core payment terms" of the governing indentures, the plaintiff could not invoke Section 316(b) to retain an "'absolute and unconditional' right to payment of its notes." Judge Straub, dissenting, argued that the plain language of the Act prohibited defendants "from engaging in an out-of-court restructuring that is collusively engineered to ensure that certain minority bondholders receive no payment on their notes, despite the fact that the terms of the indenture governing those notes remain unchanged."

The Second Circuit's ruling resolves uncertainty in the bond market engendered by the district court opinion and other cases following it, and enhances the ability of bond issuers to restructure debt outside of bankruptcy court without unanimous bondholder consent. Commentators have criticized the district court rulings on the grounds that they departed from practitioners' understanding of the Act, gave holdout noteholders leverage to block out-of-court restructurings, and made it more likely that issuers would file for bankruptcy protection. The Second Circuit's ruling establishes a clear rule that provides issuers with additional options to restructure debt through negotiations with creditors without resorting to the bankruptcy courts.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Susanna M. Buergel 212-373-3553 sbuergel@paulweiss.com	Lewis R. Clayton 212-373-3215 lclayton@paulweiss.com	Andrew J. Ehrlich 212-373-3166 aehrlich@paulweiss.com
Gregory A. Ezring 212-373-3458 gezring@paulweiss.com	Brian S. Hermann 212-373-3545 bhermann@paulweiss.com	Brad S. Karp 212-373-3316 bkarp@paulweiss.com
Daniel J. Kramer 212-373-3020 dkramer@paulweiss.com	Alan W. Kornberg 212-373-3209 akornberg@paulweiss.com	Richard A. Rosen 212-373-3305 rrosen@paulweiss.com
Audra J. Soloway 212-373-3289 asoloway@paulweiss.com	Lawrence G. Wee 212-373-3052 lwee@paulweiss.com	Jonathan Hurwitz 212-373-3254 jhurwitz@paulweiss.com