LATHAM&WATKINS

Client Alert Commentary

Latham & Watkins Restructuring, Insolvency & Workouts Practice January 23, 2017 | Number 2067

Out-of-Court Restructuring Transactions: What's Old Is New Again after Marblegate

Second Circuit's reversal of controversial restructuring decision may boost confidence among distressed bond issuers.

The recent decision of the United States Court of Appeals for the Second Circuit in Marblegate[1] has provided some relief from the significant uncertainties created by recent decisions of the United States District Court for the Southern District of New York with regard to the scope of the Trust Indenture Act of 1939 (the Act).[2] The District Court's decisions in the Marblegate[3] and Caesars Entertainment[4] restructurings had hamstrung out-of-court restructuring transactions and certain other transactions that involved distressed and potentially insolvent companies. The language and rationales of the District Court in these cases represented a significant departure from the previously understood meaning of Section 316(b) of the Act. The Second Circuit's opinion restores the commonly held understanding that "Section 316(b) prohibits *only* non-consensual amendments to an indenture's core payment terms." (emphasis added). We expect that the Second Circuit's opinion will provide comfort to practitioners and market participants looking to resume out-of-court restructurings and other transactions that may have stalled in the aftermath of the District Court's decisions.

Background

Education Management Corporation (EDMC), along with its subsidiaries[5] (the Operating Subsidiaries and collectively with EDMC, the Company), is one of the country's largest for-profit providers of college and graduate education. After experiencing significant financial distress, the Company sought to restructure US$1.522 billion of secured loans (the Secured Debt, and the lenders issuing such Secured Debt, the Secured Lenders) and unsecured notes (the Notes, and the holders of such Notes, the Noteholders). The Secured Debt and the Notes were each guaranteed by EDMC (the Parent Guarantee). Because EDMC derives the majority of its net revenue from federal student aid programs available under Title IV of the Higher Education Act of 1965 (Title IV), [6] EDMC was keenly focused on effectuating that restructuring without availing itself of the protections afforded by filing for chapter 11.[7] The Company and some of its creditors sought an out-of-court restructuring (the Proposed Restructuring) whereby a portion of the Company's debt would be converted into equity.

If the Company could not obtain unanimous creditor consent to the Proposed Restructuring, the parties thereto would conduct an intercompany sale transaction (the Intercompany Sale). The Intercompany Sale was structured as follows: (i) the Parent Guarantee pledged to the Secured Lenders would be released, thereby triggering the automatic release of the Parent Guarantee provided to the Noteholders pursuant to the terms of the Indenture,[8] (ii) the Secured Lenders would foreclose on substantially all of the assets of EDMC and the Operating Subsidiaries and (iii) the Secured Lenders would then immediately sell those assets back to a new subsidiary of EDMC (Newco), which would distribute equity in Newco only to

consenting creditors. Non-consenting Noteholders, on the other hand, would no longer have the benefit of the Parent Guarantee and would be left only with claims against the Operating Subsidiaries — neither of which would have any material assets or sources of recovery for its creditors due to the Intercompany Sale.

While 90% of the Noteholders and 99% of the Secured Lenders consented to the RSA, Marblegate Asset Management, LLC, Marblegate Special Opportunities Master Fund, L.P., Magnolia Road Capital LP, and Magnolia Road Global Credit Master Fund L.P. (collectively, the Plaintiffs) did not consent to the Proposed Restructuring. Moreover, the Plaintiffs filed a motion for a temporary restraining order and a preliminary injunction to block the Proposed Restructuring, arguing that, even though there was no formal amendment to the terms of the Indenture, the Proposed Restructuring violated the Act by impairing or affecting their rights to receive payment or bring suit for the enforcement of such payment.

In Marblegate I and Marblegate II,[9] the District Court agreed with the Plaintiffs and held that the Proposed Restructuring violated Section 316(b) of the Act because it deprived the non-consenting Noteholders of their practical ability to receive payment on the Notes, even though their procedural right to commence an action for nonpayment was left unaffected. The District Court concluded that the Act "simply does not allow the company to precipitate a debt reorganization outside the bankruptcy process to effectively eliminate the rights of non-consenting bondholders." In so finding, the District Court created significant uncertainties about the ability of Companies to pursue out-of-court restructuring transactions and other transactions involving potentially insolvent companies.

Decision

The Second Circuit disagreed with the District Court's interpretation of the Act and held that Section 316(b) prohibits only non-consensual amendments to an indenture's core payment terms. The Second Circuit thus vacated the District Court's judgment,[10] resolving the ambiguities created by the District Court decisions and similar District Court decisions after Marblegate I and Marbelgate II.[11]

Finding the plain language of the Act ambiguous, the Second Circuit, like the District Court, turned to the legislative history of Section 316(b). While the District Court had questioned whether Congress had contemplated the use of foreclosures as a method of reorganization when drafting the Act, the Second Circuit found that Congress was indeed aware of the various forms of reorganization available to issuers and the ways they may affect a bondholder's ability to receive full payment. Pointing to reports by the Securities and Exchange Commission as well as testimony before Congress,[12] the Second Circuit concluded that Congress did not intend to prohibit all non-consensual out-of-court debt restructurings, but instead drafted the Act exclusively to address formal amendments to indentures and provisions such as collective-action clauses (which authorize a majority of bondholders to act on behalf of all noteholders) and no-action clauses (which preclude individual bondholders from suing the issuer for breaches of the indenture). The Second Circuit also dismissed the Plaintiffs' assertion that textual changes to Section 316(b) prior to its enactment in 1939 demonstrate a broadening of the Act's protections of a minority bondholder's rights from a "mere right to sue into a more substantive right" to actually "receive payment of the principal and interest."

The Second Circuit ultimately held that "absent changes to the indenture's core payment terms, Marblegate cannot invoke Section 316(b) to retain an absolute and unconditional right to payment of its notes." However, the court noted that minority bondholders are not left without any recourse. The Plaintiffs can, as the Second Circuit stated, potentially bring suit against the Operating Subsidiaries and pursue available State and federal law remedies against Newco under theories of successor liability or fraudulent conveyance.

Implications

We expect that the Second Circuit's decision will clear away many of the uncertainties involved in out-of-court restructurings in the wake of the District Court's Marblegate opinions. The District Court's interpretation of Section 316(b) of the Act created significant uncertainties that had impacted the out-of-court restructuring strategies of issuers, trustees, and their advisers. The Southern District of New York followed suit in Caesars, [13] adopting the District Court's broad interpretation of the Act and causing further concern in the industry.[14] Distressed bond issuers responded with increased bankruptcy filings as well as refinancings and exchanges specifically structured to avoid amendments to indentures that would require opinions from law firms that the amendments complied with the conditions set forth in the Indenture (including the Act). We expect that the Second Circuit's opinion, which returns to the long-held understanding of Section 316(b) of the Act, will clear away many of the uncertainties caused by these cases and allow distressed bond issuers to consider transactions that were uncertain before the Second Circuit's opinion.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Senet S. Bischoff
senet.bishoff@lw.com
+1.212.906.1834
New York

Casey T. Fleck
casey.fleck@lw.com
+1.213.891.8589
Los Angeles

David A. Hammerman
david.hammerman@lw.com
+1.212.906.1398
New York

Mitchell A. Seider
mitchell.seider@lw.com
+1.212.906.1637
New York

Keith A. Simon
keith.simon@lw.com
+1.212.906.1372
New York

Annemarie V. Reilly
annemarie.reilly@lw.com
+1.212.906.1849
New York

You Might Also Be Interested In

Rejecting Trademark Licenses in Bankruptcy: *In re Tempnology*

Public Policy Limitations of Chapter 15 of the Bankruptcy Code

Ever-Expanding Safe Harbor Leaves Creditors' Claims Stranded at Sea

Recent Developments in US Law Affecting Pension and OPEB Claims in Restructurings

Endnotes

[1] *Marblegate Asset Mgmt., LLC, Marblegate Special Opportunities Master Fund, L.P. v. Educ. Mgmt. Finance Corp., Educ. Mgmt., LLC* (2nd Cir. Decided: January 17, 2017).

[2] 15 U.S.C. §§ 77aaa-77bbbb.

[3] *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 2014 WL 7399041, 75 F.Supp. 3d 592 (S.D.N.Y. 2014) (Marblegate I); *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 2015 WL 3867643, 111 F.Supp. 3d 542 (S.D.N.Y. 2015) (Marblegate II).

[4] *Meehancombs Global Credit Opportunity Funds, LP v. Caesars Entertainment Corp.*, 2015 WL 221055, 80 F.Supp. 3d 507 (S.D.N.Y. 2015); *BOKF, N.A. v. Caesars Entertainment Corp.*, 2015 WL 5076785 (S.D.N.Y. 2015) (Caesars).

[5] Education Management LLC and Education Management Finance Corporation.

[6] 20 U.S.C. §§ 1070-1099.

[7] Under Title IV, EDMC would lose its eligibility to receive Title IV funds if it, or any controlling affiliate, filed for bankruptcy. *See* 20 U.S.C. § 1002(a)(4)(A); Conditions of Institutional Eligibility, 34 C.F.R. § 600.7(a)(2). Section 362(b)(16) of the Bankruptcy Code expressly provides that the automatic stay does not apply to actions affecting the eligibility of the debtor to participate in programs authorized by Title IV. 11 U.S.C. § 362(b)(16). As a general matter, for-profit education businesses cannot operate without access to Title IV funds.

[8] Section 10.06(a)(ii) of the Indenture provided that the Parent Guarantee of the Notes would be automatically released upon the release of the corresponding Parent Guarantee of the Secured Debt.

[9] As an initial matter, the District Court declined to grant a preliminary injunction but stated that Marblegate was likely to succeed on the merits of its TIA claim. *See Marblegate I*. The Intercompany Sale occurred in January 2015. The foreclosure sale then took place, the Secured Lenders released the Parent Guarantee with respect to the Secured Debt, Newco was capitalized, and the consenting bondholders participated in the debt-for-equity exchange. In light of the District Court's opinion in Marblegate I, EDMC filed a counterclaim against Marblegate seeking a declaration that the Parent Guarantee could be released with respect to the Notes without violating the TIA. However, the District Court again sided with Marblegate by holding that the release of the Parent Guarantee with respect to the Notes would violate Section 316(b) of the Act and enjoined the release of the Parent Guarantee. *See Marblegate II*.

[10] The Second Circuit remanded the matter to the District Court for further proceedings.

[11] Judge Straub dissented, stating that the plain language of Section 316(b) of the Act is clear and unambiguous and should be read to prohibit any action that impairs or affects the right to receive payment, either through formal amendment of a bond's payment terms or by any other means.

[12] *See* 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); Trust Indentures, Hearings Before a Subcomm. Of the H. Comm. On Interstate and Foreign Commerce, House of Representatives on H.R. 10292, 75th Cong. 35 (1938) (statement of William O. Douglas, Commissioner, SEC); Trust Indentures, Hearings Before a Subcomm. Of the H. Comm. On Interstate and Foreign Commerce, House of Representatives on H.R. 10292, 75th Cong. 35 (1939) (statement of Edmund Burke, Jr., Assistant Director, Reorganization Division, SEC); H.R. Rep. 76-1016 (1939); S. Rep. No. 76-248, at 26 (1939).

[13] In Caesars, the Southern District of New York relied on the District Court's reasoning in Marblegate I and held that a non-consensual release of a guarantee effectuated through an actual amendment of the indenture violated Section 316(b) of the Act. Latham & Watkins represents certain parties involved in the Caesar's restructuring and, therefore, this ruling is not addressed in detail in this article.

[14] In Cliffs Natural Resources (Cliffs), the Southern District of New York clarified that the holdings in Marblegate II and Caesars are limited to restructurings that amount to "de facto" bankruptcies where there is either an asset transfer or the removal or modification of intercompany guarantees or security interests that leave the noteholders with no practical ability to receive payment. *Waxman v. Cliffs Natural Resources Inc.*, Case No. 16-cv-1899 (S.D.N.Y. 2016). Cliffs is distinguishable from Marblegate II for a number of reasons. First, the exchange offer at issue was open only to qualified institutional buyers and to holders who were not "U.S. persons." Second, the exchange offer did not dispose of any assets, remove any guarantee, or amend any terms of the indentures. Finally, there was no vote or majority action taken and, as such, the court was less concerned about the abuse of minority bondholders that the Act was intended to prevent.