

# Client Alert

Financial Restructuring Practice Group

January 23, 2017

## Second Circuit Reverses District Court's *Marblegate* Decision; Narrows Protections Provided to Bondholders Under Section 316(b) of Trust Indenture Act

The Trust Indenture Act of 1939 (the "TIA")<sup>1</sup> codifies a select set of requirements and prohibitions intended to protect perceived "sacred rights" of holders of public bond instruments. When the U.S. District Court for the Southern District of New York issued a ruling greatly expanding the traditional perceived scope of one of the TIA's sacred protections, the financial industry took serious note.

More specifically, in *Marblegate Asset Management v. Education Management Corporation*,<sup>2</sup> the District Court held that Section 316(b) of the TIA, which prohibits any amendment to note payment terms (e.g., maturity, payment of principal or interest) absent an affected bondholder's consent, also prohibits any other modifications that would have the *practical effect* of hindering a bondholder's ability to receive payment. Consternation rippled throughout Wall Street and beyond as bond issuers, bondholders, and professionals in the leveraged finance and restructuring communities sought to understand the implications of the District Court's broad interpretation.

Education Management Corporation ("EDMC") appealed the District Court's decision, and, on January 17, 2017, a divided panel of the U.S. Court of Appeals for the Second Circuit reversed the District Court's decision and held that Section 316(b) of the TIA "prohibits only non-consensual amendments to an indenture's core payment terms[,] and nothing more."<sup>3</sup> The Second Circuit's ruling reinstates section 316(b)'s traditional scope and, for the time being, provides parties the certainty to which they traditionally were accustomed pre-*Marblegate*.

### Background and District Court Decision

In 2014, EDMC, a for-profit education company, and its subsidiaries, sought to restructure over \$1.5 billion of indebtedness, comprised of \$1.305 billion in secured debt (the "Secured Debt") governed by a credit agreement and \$217 million of unsecured notes (the "Notes") governed by an indenture qualified under the TIA. Education Management, LLC and Education Management Finance Corporation (together, the "EDM Issuer"), each a subsidiary of EDMC, were borrowers and issuers under the Secured Debt

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facility and Notes, respectively, and EDMC guaranteed the obligations under each debt instrument.

In 2014, EDMC found itself in severe financial distress. EDMC, however, could not look to chapter 11 to reorganize due to limitations under Title IV of the Higher Education Act of 1965. More specifically, federal funding under Title IV is not available to an otherwise eligible recipient in chapter 11. Accordingly, EDMC looked to a creative out-of-court restructuring strategy whereby, if a sufficient number of creditors (but not all) consented to the proposed restructuring, secured creditors would release EDMC's guarantee of the Secured Debt (which, under the terms of the Notes, would cause EDMC to simultaneously release its guarantee of the Notes), EDMC would sell its assets to a new affiliated subsidiary, and the new subsidiary would then distribute debt and equity only to consenting creditors and continue the business (the "Intercompany Sale"). Non-consenting holders of Notes would retain their Notes under the existing indenture, which Notes would be essentially valueless because EDMC Issuer would have no assets following the Intercompany Sale and the Notes would no longer benefit from an EDMC guarantee.

Only one creditor withheld its consent to the proposed out-of-court restructuring: Marblegate Asset Management ("Marblegate"), a holder of the Notes. More specifically, Marblegate commenced an action seeking to enjoin the Intercompany Sale on the grounds that it violated Section 316(b) of the TIA because the transaction had the practical effect of altering Marblegate's ability to receive payment on its Notes without Marblegate's consent. The District Court declined to enjoin the Intercompany Sale but, controversially, noted that Marblegate was likely to succeed on the merits of its TIA claim. The District Court stated in its opinion that Section 316(b) of the TIA should be read broadly to prohibit a transaction that "effect[s] an involuntary debt restructuring," even where the payment terms of an indenture are not explicitly modified.<sup>4</sup> In subsequent litigation between the parties on whether EDMC's guarantee of the Notes could be released without violating the Section 316(b) of the TIA, the District Court also ruled in favor of Marblegate and held that the release of EDMC's guarantee of the Notes would violate Section 316(b) of the TIA.

## Second Circuit Reversal

EDMC appealed the District Court's decision to the Second Circuit. The Second Circuit agreed with the District Court that the language in Section 316(b) of the TIA is ambiguous; however, the Second Circuit concluded that the District Court's interpretation was far broader than Congress intended. Rejecting the District Court's ruling, the Second Circuit, in a split 2-1 decision, instead held that Congress, in its adoption of Section 316(b), sought only to prohibit formal modifications to indentures without the consent of bondholders, but did not intend to go further by banning other well-known forms of reorganization that may be accomplished by majority action, such as foreclosures.

The Second Circuit noted that Marblegate's proposed interpretation of Section 316(b) was unworkable because it would require courts to determine, on a case-by-case basis, whether a challenged transaction had been "designed to eliminate a non-consenting holder's ability to receive payment."<sup>5</sup> The Second Circuit further observed that the District Court's interpretation of Section 316(b) would "undermine 'uniformity in interpretation'" by requiring any analysis to turn primarily on the subjective intent of the issuer and/or majority bondholders, not the transactional techniques in fact used.<sup>6</sup> The Second Circuit made clear that its decision does nothing to foreclose a bondholder's use of other avenues to challenge transactions like the Intercompany Sale, such as state or federal law claims under theories of successor liability or fraudulent conveyance (although the Second Circuit declined to opine on the merits of any such claims).

Judge Straub, in a vigorous dissent, disagreed with the majority's reasoning, arguing instead that the plain meaning of Section 316(b) prohibited EDMC 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."<sup>7</sup> Judge Straub noted that if Congress intended to merely protect against modification of an indenture's payment terms, it could have so stated, and that "[n]othing in the language of

Section 316(b), however, cabins the protections on impairing or affecting ‘right . . . to receive payment’ to mere *amendment* of the indenture.” (emphasis supplied).<sup>8</sup>

## Conclusions and Lessons Learned

The Second Circuit’s decision in *Marblegate* restores, in many respects, the prevailing view of the protections offered by Section 316(b) of the TIA to holdout bondholders in a nonconsensual out-of-court restructuring. *Marblegate* retains the right to request an *en banc* rehearing at the Second Circuit and, thereafter, could seek to have its case heard at the U.S. Supreme Court. On January 19, 2017, two days after the Second Circuit’s decision was published, *Marblegate* filed a motion with the Second Circuit seeking to extend the deadline to file a petition for panel rehearing and rehearing *en banc*, and EDMC consented to the requested extension. Accordingly, the debate concerning Section 316(b) of the TIA may not be over just yet.

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<sup>1</sup> Trust Indenture Act of 1939, § 316(b), 15 U.S.C.A. § 77ppp(b).

<sup>2</sup> See *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 75 F. Supp.3d 592 (S.D.N.Y. 2014) (“*Marblegate I*”) and *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 111 F. Supp. 3d 542 (S.D.N.Y. 2015) (“*Marblegate II*”).

<sup>3</sup> Slip op. at 2, no. 15-2124 (2d Cir. Jan. 17, 2017).

<sup>4</sup> *Marblegate I*, 75 F.Supp.3d at 614.

<sup>5</sup> Slip op. at 37-38.

<sup>6</sup> *Id.* at 38 (quoting *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982)).

<sup>7</sup> Straub Dissent, at 1.

<sup>8</sup> *Id.* at 7.