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Keeping *Marblegate* in Perspective: Implications for Debt Restructurings, Indenture Amendments and New Bond Issues

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Involuntary debt restructurings that have the effect of impairing a bondholder's right to receive payment may violate the Trust Indenture Act. This was recently held in *the Marblegate/Education Management Corp*. bondholder litigation. A first read of the case suggests potentially problematic implications. A deeper analysis shows a less troubling decision. The case is also relevant for the 144A for life market that is technically not subject to the statute.

- Involuntary debt restructurings may violate the Trust Indenture Act if they have the *effect* of impairing a bondholder's right to receive payment, even though they leave that right *formally* intact. That was recently held by the court in the ***Marblegate/Education Management Corp***. bondholder litigation. The SDNY's recent opinion on the merits (*Marblegate II*)[1] confirmed its earlier holding on a request for a preliminary injunction to block the restructuring (*Marblegate I*)[2].
- A first read of the *Marblegate* decisions (and another recent SDNY decision involving Caesars Entertainment Corp.)[3] may suggest broad-reaching and potentially problematic implications for debt restructurings and indenture amendments. A deeper analysis shows a less troubling case.
- While the case is unlikely to drive issuers from the SEC-registered market, it may be a factor in the decision of whether to access the 144A for life market. Many US 144A for life indentures contain a provision that tracks the statutory provision at issue in *Marblegate*, so issuers may consider removing this provision in new bonds.
- This may spark a discussion about modifying the amendment provisions in US 144A for life bond indentures to allow for greater flexibility than would be permitted by the Trust Indenture Act.

Introduction

In *Marblegate*, the defendant (EDMC) was a for-profit operator of colleges and professional schools. A bankruptcy filing was neither a viable alternative nor a credible threat for EDMC because upon a filing it would have lost access to the federal student aid programs on which it depended for the vast majority of its net revenues. To avoid that result, while still achieving a significant debt restructuring, the subsidiary of EDMC that issued the bonds launched an exchange offer and consent solicitation, pursuant to which bondholders would receive different treatment depending on the acceptance rate of the exchange/consent. If there were 100% participation by bondholders, the bonds would be exchanged into equity that then would be convertible into common stock of the parent guarantor of the bond issuer. If that level of participation could not be achieved, the company would implement an alternative restructuring in which all of its assets would be transferred to another subsidiary of the parent guarantor via a foreclosure sale by the company's secured lenders, the parent guarantee would be released, and non-consenting bondholders would be left only with recourse against a bond issuer that would have become an empty shell. Consenting bondholders would receive equity in a distribution from the other subsidiary.

Marblegate was a holder of unsecured bonds that challenged this restructuring on the basis that it violated Section 316(b) of the Trust Indenture Act, which provides in pertinent part that the right of any bondholder "to receive payment of the principal of and interest on such indenture security, on or after the respective due dates" or "to institute suit for the enforcement of any such payment" shall not be "impaired or affected" without the consent of that holder.

The issuer argued that the provision was not implicated because Marblegate's legal right to receive payment would not be affected, even though the restructuring would render that right effectively worthless. Marblegate asserted that the statute would be violated, even if as a matter of form its payment right was not affected, because as a matter of substance, the restructuring resulted in the elimination of its ability to receive payment. After concluding in *Marblegate I* that the likelihood of success on the merits weighed in favor of Marblegate (though the court denied the request for injunctive relief on other grounds), in *Marblegate II*, after a detailed analysis of the legislative history of Section 316(b), the court found in favor of Marblegate.

Keeping *Marblegate* in Perspective and Limiting It to Its Facts

In reaching its opinion in *Marblegate I*, the court indicated that:

> Practical and formal modifications of indentures that do not explicitly alter a core term "impair [] or affect []" a bondholder's right to receive payment in violation of the Trust Indenture Act only when such modifications effect an involuntary debt restructuring.

Involuntary debt restructurings. In further defining the scope of an involuntary debt restructuring, the court in *Marblegate I* distinguished indenture amendments that eliminated important protective covenants from a reorganization "that seeks to involuntarily disinherit the dissenting minority," finding only the latter to violate the "fundamental purpose of the Trust Indenture Act." It also characterized the reorganization as effecting "a complete impairment of dissenters' right to receive payment" and a "wholesale abandonment" of that right. The opinion concluded that Section 316(b) did not allow companies "to effectively eliminate the rights of non-consenting bondholders."

The court expanded on this line of reasoning in *Marblegate II*. Citing from the offering circular for the exchange offer, the court noted that the company itself had described the restructuring as one in which non-consenting holders would "not receive payment on account of their Notes." The court highlighted that although the reorganization "would not formally alter the dissenting Noteholders' right to payment [. . .] it was unequivocally designed to ensure that they would receive *no*

payment if they dissented from the debt restructuring." (emphasis added) As the opinion put it in a different place, the restructuring gave dissenting holders only the choice to take the stock offered in the exchange "or take nothing." The court found that the complaining bondholder had "bought a $14 million bond that the majority now attempts to turn into $5 million of stock, with consent procured only by threat of total deprivation."

Stripping covenants from indentures. Typical covenant strips or other indenture amendments, through exit consents or otherwise, that occur in the absence of a broader restructuring that removes significant assets from the recourse of bondholders, should not be affected by the *Marblegate* decisions. In *Marblegate I*, the standard it adopted did not prevent "majority amendments of a significant range of indenture terms, including many that can be used to pressure bondholders into accepting exchange offers." The court also approvingly quoted from a law review article stating that, although the Trust Indenture Act prohibited alterations of "core" provisions, "bondholders can agree to eliminate other important protective covenants – for example, covenants prohibiting the firm from paying dividends, covenants requiring the firm to maintain a specified net worth, or covenants prohibiting the firm from incurring debt senior in any respect in right of payment to the debt for which the exchange offer is made."

A case of substance over form. Overall, *Marblegate* perhaps is best viewed as a case in which the court privileged substance over form. In the eyes of the court, as a substantive matter, dissenting bondholders were being deprived of the entirety of their recovery even if their legal rights remained intact. The court specifically highlighted that the company had apparently assured its regulators that the structure of the transaction was "purely a formality." The court also sided with the plaintiffs in their contention that the right protected by the statute was "substantive" rather than "formalist," and the opinions contain several other examples of this "form over substance" rhetoric. Finally, the court was not persuaded by the company's argument that the asset strip was immune from attack because it was accomplished through foreclosure by the secured lenders, rather than through a direct action by the company.

Earlier cases. In *Marblegate*, the defendant unsuccessfully relied on two earlier decisions by courts in other judicial districts that, on different facts that did not involve a present intention of asset transfers, had held that Section 316(b) protected only a holder's legal right to receive payment, but not its ability to ultimately recover on its claim.[4] The court relied instead on *Federated Strategic Income Fund v. Mechala Group Jamaica Ltd.*, a 1999 SDNY case that had found that a restructuring plan under which the company would have transferred all of its assets to another entity, leaving bondholders with an empty shell, violated the Trust Indenture Act.

Implications for the US 144A for Life Market?

US 144A for life indentures typically contain Section 316(b)-style provisions. *Marblegate* has implications not just for SEC-registered bonds that are subject to the Trust Indenture Act, but potentially also for bonds that are issued only to qualified institutional buyers under Rule 144A without registration rights in so-called "144A for life" transactions. That is because, although not legally required, even in 144A for life issues the indenture typically contains a provision similar to the one mandated by Section 316(b). Courts are likely to interpret those indenture provisions in a similar way, even if the corresponding statutory provision on which those indenture provisions were modeled does not apply.

How to make 144A for life indentures "Marblegate-proof." Issuers seeking to avoid *Marblegate*-style bondholder actions in a future restructuring would therefore have to remove those Section 316(b)-style provisions from their 144A indentures when issuing new bonds, or at least modify them so that they only protect a bondholder's right *to sue* for payment, but not its right *to receive* payment. (This distinction played a role in the analysis in *Marblegate*.) However, given the prevalence of these provisions in US bond indentures, it is possible that attempts to issue new bonds without them may meet with resistance from investors. Of course, even under indentures that do not contain Section

316(b)-style provisions, depending on the facts, bondholders may be able to advance other legal theories to attack a restructuring.

Lowering consent thresholds for change of payment terms from 100% to 90%? The next step would be to not only remove the Section 316(b)-style language from 144A for life indentures, but to also change the amendment provision in those indentures so that it permits direct amendments to payment terms, without a need to resort to asset-stripping. Having said this, the bond market may not be comfortable with moving from a rule of 100% to a rule of 51% for such changes to "money terms." In a restructuring, not all bondholders may have the same incentives, and the market may well take the view that a greater percentage of principal amount that needs to consent to a restructuring will make it more likely that that a deal is genuinely fair to all holders. While there is no magic number in this regard, 90% is a percentage that we have seen in a recent US high yield transaction by a financial sponsor. In the European high yield market, where local laws have traditionally not been as flexible as the US Bankruptcy Code in permitting a change of payment terms through a cramdown, 90% has long been common. (In *Marblegate*, more than 90% of the principal had agreed to the exchange.)

Would large long-term bondholders welcome a change? Minimizing the opportunity for free riders and holdouts could be in the interest of large long-term bondholders. Those holders may have spent considerable time and resources working with the company to come up with a plan for a restructuring that reduces debt to a sustainable level and avoids a value-destroying bankruptcy. In addition, large holders often do not have the luxury of sitting on the sidelines because the restructuring will not be feasible unless they participate. Large bondholders that have agreed to see their claims reduced will generally not look favorably on investors that have purchased a relatively small amount of bonds at a steep discount and now seek to extract value by holding up the consummation of the restructuring. It is also possible, however, that the bond market will be wary, at least for now, of giving US issuers too much flexibility in that regard.

[1] Marblegate Asset Management v. Education Management Corp. (SDNY 2015).

[2] Marblegate Asset Management v. Education Management Corp. (SDNY 2014).

[3] Meehancombs Global Credit Opportunities Funds, LP v. Caesars Entertainment Corp. (SDNY 2015).

[4] In re Northwestern Corp., 313 B.R. 595 and YRC Worldwide Inc. v. Deutsche Bank Trust Co. Americas (D. Kan. 2010).

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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