Second Circuit Overturns Marblegate, Holding That Section 316(b) of the Trust Indenture Act Protects Noteholders' Rights Only With Respect to Core Payment Terms

On January 17, 2017, the United States Court of Appeals for the Second Circuit ruled, in a 2-1 decision, in favor of the for-profit education company Education Management Corp. and its affiliated entities ("EMC"), holding that EMC's out-of-court restructuring—which severely limited a holdout creditor from receiving any repayment—did not alter any of the governing indenture's core payment terms and, thus, did not violate Section 316(b) of the Trust Indenture Act ("Section 316(b)").[1] The Second Circuit's decision reversed a 2015 decision of the Southern District of New York, which held that Section 316(b) was applicable to involuntary debt restructurings that impair a nonconsenting creditor's ability to receive repayment even without formally changing any core indenture payment terms.[2] While potentially subject to further review, this decision marks a return to the traditional interpretation of Section 316(b) as a shield only against collusive changes to core indenture terms that affect the noteholders' legal—not substantive—right to receive payment when due.

I. Background

Facing approximately $1.5 billion in debt and unwilling to file for bankruptcy,[3] in 2014 EMC negotiated with the secured lenders under its credit agreement a proposal to exchange for equity its secured debt and $217 million of unsecured notes issued by its subsidiary, Education Management LLC and guaranteed by its parent company. Under the agreement, if any noteholder rejected the exchange offer, EMC would proceed with an intercompany sale where the secured lenders would (1) release the parent guarantee of its loans, causing an automatic release of the parent guarantee of the unsecured notes and (2) foreclose on substantially all of EMC's assets, which would then be sold to a new EMC subsidiary that would distribute the debt and equity only to the consenting creditors. Although the note indenture explicitly recognized the secured lenders' right to foreclose on substantially all of the issuer's assets and the secured creditors' right to release the parent guarantee, these transactions would leave any nonconsenting creditor with only a claim on a shell company.

Marblegate Asset Management, L.C.C. and Marblegate Special Opportunities Master Fund, L.P. ("Marblegate") objected to the restructuring and sued for repayment as the lone nonconsenting creditor. After proceeding with the intercompany sale,[4] EMC counterclaimed seeking declaratory relief to allow the release of the parent guarantee on the unsecured notes. The District Court rejected this request, holding that EMC's restructuring interfered with the nonconsenting noteholder's ability to receive payment in violation of Section 316(b). On appeal, the Second Circuit, focusing on the legislative history of Section 316(b), rejected the District Court's interpretation, finding that while EMC's out-of-court restructuring may have practically removed Marblegate's ability to be repaid, it did not amend or change the indenture or prevent any noteholder from initiating suit to collect payments on the notes, and thus did not violate Section 316(b).

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[1] *Marblegate Asset Management, et. al*. v. *Education Management Corp.*, et al. Docket No. 15-2124-cv (L), 15-2141-cv (CON) (2d Cir. Jan 17, 2017).

[2] *Marblegate Asset Management, et. al*. v. *Education Management Corp., et al.*, 111 F. Supp. 3d 542 (S.D.N.Y. June 23, 2015).

[3] EMC could not file for bankruptcy without forfeiting its funding under Title IV of the Higher Education Act of 1965, which accounted for 80% of its revenue.

[4] EMC amended the indenture governing the notes to clarify that the new subsidiary would guarantee Marblegate's notes until such time as the parent guarantee was released.

II. Second Circuit's Reasoning

When faced with interpreting the plain text of Section 316(b),[5] both the District Court and the Second Circuit agreed that the provision was ambiguous.[6] Looking to the text of Section 316(b), the Second Circuit acknowledged that although the provision's protection of a noteholder's "right … to receive payment" could apply to the noteholder's legal or substantive right, the legislative history indicated that Congress did not intend for the provision to prohibit well-known forms of reorganization that might hinder a noteholder's practical ability to receive payment. In fact, the drafters had a much narrower goal: to stop collusive modifications to the core payment terms of indentures. Testimony from officials of the Securities and Exchange Commission ("SEC") when the Trust Indenture Act was enacted emphasized that Section 316(b) was drafted to preserve the right to bring an action at law when the majority changes certain core terms dealing with the right to payment and right to sue.

The Second Circuit also rejected the District Court's reasoning that the drafters did not anticipate how other kinds of debt restructurings could be as damaging to noteholders' rights as formal indenture amendments. The Second Circuit found that the drafters were aware of a range of reorganization terms, such as collective-action and no-action provisions, that could interfere with the practical ability of a noteholder to receive payment. Indeed, in its opinion the Second Circuit discussed how reports issued by the SEC during the adoption of Section 316(b) illustrate that the drafters were aware of all kinds of corporate reorganizations beyond formal contract amendments, like foreclosures, that could impair noteholders' ability to actually receive payments. Thus, the Second Circuit rejected the District Court's broad reading of the provision as intended to protect noteholders against other kinds of actions that result in noteholders receiving less than promised in the indenture.

After interpreting the legislative intent underlying Section 316(b), the Court turned to the facts of the case. Here, the governing indenture explicitly permitted secured lenders to foreclose on the issuer's assets and provided for a release of the parent guarantee automatically if the secured creditors released their guarantee. Because the substantive right to receive payment is defined by the indenture itself, the Court agreed with EMC's argument that as a sophisticated investor Marblegate assumed the risks contained in the indenture, including foreclosure. The Second Circuit concluded that Section 316(b) cannot protect noteholders from all infringements against the right to repayment and is applicable only in circumstances where there is a collusive modification of a core indenture payment term that affects a legal right.[7] The Court also explained that noteholders like Marblegate still would have the right to pursue other remedies, such as claims based on successor liability or fraudulent conveyance.

[5] The text of the section reads "Notwithstanding any other provision of the indenture to be qualified, 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 [.]" 15 U.S.C. §77ppp(b).

[6] The dissent argued that the plain text of Section was clear and that if Congress intended for the provision to solely protect actual modifications of indenture terms, it would have so stated.

[7] Justice Straub disagreed with the majority on this point, stating that EMC's out of court restructuring was much more than an impairment—it was a collusively engineered to remove any right to repayment.

III. Potential Implications

While Marblegate may seek an *en banc* rehearing from the Second Circuit or seek review in the Supreme Court, and other circuits may interpret Section 316(b) differently, at present the law in the Second Circuit is that Section 316(b) protects only against changes to core indenture payment terms that affect the noteholders' legal right to receive payment when due or to initiate suit to collect such payment.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Kimberly Petillo-Décossard at 212.701.3265 or kpetillo-decossard@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.