# Alert

## The Marblegate Oral Argument in the Second Circuit Court of Appeals

*By Miranda Schiller and Agustina Berro*

The Second Circuit Court of Appeals heard oral arguments in *Marblegate Asset Management LLC v. Education Management Corp.* on May 12, 2016. One might have thought from the courtroom's overflow crowd that it was the opening argument in a mob trial, but this is a case about a bond indenture. At issue is whether an out-of-court debt restructuring that did not amend the indenture's principal and interest terms, but that effectively precluded the noteholders' ability to be repaid, violated § 316(b) of the Trust Indenture Act (TIA). After concluding that it did, the district court enjoined Education Management Corp. from, among other things, stripping a guarantee which was the principal source of repayment for the notes. Following this decision, a number of similar actions have been filed by holdout noteholders, most notably *MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entm't Corp.,* in which another district judge applied *Marblegate* to hold that § 316(b) bars impairment of the right to payment, as well as the right to bring suit but only with respect to nonconsensual (i) amendments to core terms of a debt instrument or (ii) out of court debt reorganizations.

At the heart of the debate is whether § 316(b) operates to protect noteholders of an insolvent or nearly insolvent company where majority action is taken that does not violate any covenant of the indenture but has the practical effect of making repayment to the non-consenting holders impossible. Education Management Corporation, a for-profit education company, and its affiliated entities (EDMC) sought to restructure approximately $1.5 billion of debt, comprised of secured debt and unsecured notes. The unsecured notes were qualified under the TIA. EDMC was precluded from filing for bankruptcy because doing so would have rendered EDMC ineligible for federal funding under Title IV of the Higher Education Act of 1965, depriving it of 80% of its revenue.

Accordingly, EDMC pursued an out-of-court restructuring under which the noteholders' treatment varied dramatically, depending on whether they accepted the company's exchange offer. If 100% of the noteholders accepted the company's offer, then the notes would be converted into equity of the issuer's parent-guarantor. If 100% of the creditors did not consent to the proposed restructuring, however, the company would implement an alternative transaction under which the secured lenders would foreclose on substantially all of the assets of EDMC and release the EDMC parent guarantee of their loans. Under the terms of the parent guarantee for the unsecured notes, the guarantee could be released either by majority vote of the unsecured noteholders or by the secured lenders. For this reason, the offering circular for the notes warned investors not to assign any value to the parent guarantee. While the transaction did not amend the actual terms of the unsecured notes, it was designed to ensure that any noteholder who dissented from the out-of-court restructuring would receive no payment on its notes and would be left with only claims against a worthless subsidiary.

Based on questions that were asked of all three counsel who presented argument, the court appears interested in whether there is a way to limit the *Marblegate* holding. The answer from the appellants was an unequivocal no; Marblegate, on the other hand, said the case was a "Black Swan," unlikely to reoccur.[1] But as the appellants pointed out, more noteholder actions have been filed for alleged § 316(b) violations in the wake of *Marblegate* than in the preceding 70 years since the passage of the TIA in 1939.[2] Another question that all counsel were asked was the meaning of the word "impairment" in § 316(b), which provides that "the right of any holder… to receive payment of the principal [] and interest…shall not be impaired or affected without the consent of such holders…." Appellants argued that these words have a settled meaning based on decades of practice and the TIA's legislative history. Marblegate argued in favor of a literal, plain English meaning, as one member of the panel suggested it should have.

## Appellant – Education Management's Argument

Education Management opened by arguing that § 316(b) serves an important but limited function: it prohibits majority bondholders from collusively modifying an indenture's payment terms. That is, the statute only protects the right to receive payment. The right to receive payment is necessarily defined by the indenture itself. Nothing in the TIA prevents parties from placing conditions on the right to payment. In this case, there were two critical conditions: one, the indenture explicitly recognized that secured lenders could foreclose on the issuer's assets. Two, the indenture explicitly recognized that guarantees could be released by secured creditors.

Judge Lohier asked whether the company contended that Marblegate was not injured. The gist of counsel's response is that the noteholders bargained for what they got: there were conditions to the right to payment.

Judge Straub asked how noteholders' rights were not impaired within the meaning of § 316(b): in "laymen's terms, impaired means diminished" and § 316(b) says nothing about the terms of the indenture having to be rewritten or formally amended. Counsel explained that the "right" stems, and is limited, by the language of the indenture and cited legislative history noting that the purpose of § 316(b) is to "prohibit provisions authorizing a majority to force a non-consenting security holder to accept a reduction of his claim."

Judge Cabranes questioned that answer and read from § 316(b)'s legislative history, that it is "designed to place a check or control over the majority forcing on the minority a debt readjustment plan" and asked, "isn't that exactly what took place here?" Counsel responded that it wasn't for two reasons: (1) there was no majority action and (2) there was no debt readjustment because debt readjustment only refers to sections of the contract that deal with principal and interest.

Counsel was asked to explain the company's position that the district court's decision lacks "a limiting principle." He replied that the attempt to limit the holding to restructurings is not workable: "since the decision was issued, there have been a slew of lawsuits challenging all sorts of restructuring transactions under § 316(b)."

Judge Cabranes inquired whether a holding that § 316(b) forbids only transactions that amount to a "comprehensive restructuring of all of the issuer's debt" would be an appropriate way to limit the holding of *Marblegate*. Counsel replied that this limiting principle is untethered from the statute and has no statutory basis.

Judge Cabranes asked how Marblegate's reading of the statute would have a chilling effect on the bond market. Counsel pointed out that the decision has already caused a lot of uncertainty and cited a recent article which reported that "out-of-court restructurings have ground to a halt" because "law firms are too afraid to issue opinions." The court requested a copy of the article.[3]

Judge Straub asked whether, under the company's interpretation of the TIA, "anything goes" in an out-of-court restructuring as long the majority bondholders don't change the interest and principal payment terms. Counsel explained that investors assume whatever risks are contained in the indenture. Judge Lohier noted that, while the right may come to nothing, the right itself to pursue a claim was not extinguished here.

## The Secured Creditors

Counsel for the secured creditors explained the impact of the *Marblegate* decision on her clients, effectively depriving them of their ability to foreclose on the collateral securing their loan. In this unusual case, foreclosure would have triggered a change of control under their credit agreement, resulting in a termination of the company's federal funding, which is the source of nearly 80% of its revenue. Marblegate, on the other hand, which may be on the cusp of recouping its entire investment following the next interest payment, stood to profit from its investment. Counsel pointed out that the decision had significantly reduced out-of-court restructurings by giving holdouts an effective remedy of a 100% recovery.

## Marblegate

Counsel for Marblegate argued that the transaction entailed a comprehensive reordering of the company's capital structure that was designed to coerce all holders to exchange their notes for equity or risk being left with a worthless note. He argued that there is an easy fix for companies seeking to issue debt: they can simply opt out of qualifying their indentures under the TIA and sell only to sophisticated investors. However, if a company reaps the benefits of qualifying its notes, it should not complain that it needs to honor the TIA's qualifications.

While many companies have chosen not to qualify their bond debt after *Marblegate* and expressly exclude § 316(b) from their indentures, this does not address the billions of dollars of bond debt that *is* qualified under the TIA and does not come due for years in the future.

Judge Lohier questioned whether the rights of the holdouts were actually violated, since their indenture included a provision allowing for the guarantee to be released under certain circumstances. "Weren't these steps contemplated in the indenture?" he asked.

Judge Lohier also asked whether there was a way to limit the district court's decision. Counsel for *Marblegate* said that the court should follow the same limiting principle in *Mechala*, that is, if the transaction was directly intended to impair the notes, then it violates the statute. In this case, the offering memorandum for the exchange offer warned that non-consenting noteholders would be left with worthless notes if they did not consent to the exchange.

Over the last few decades, the Second Circuit has issued only a handful of decisions concerning restructurings that were challenged by noteholders: mostly notably, *Sharon Steel and First Millennium*.[4] Because the vast majority of bond indentures are governed by New York law, but disputes between issuers and their noteholders are regularly litigated in courts around the country, the Second Circuit's decisions in this area continue to be widely cited by other courts. The *Marblegate* decision is expected to provide a useful guidepost for counseling clients who wish to engage in consensual out-of-court restructurings of their bond debt. The decision will likely be of interest to the class action plaintiffs' securities bar which, following *Marblegate*, has begun to bring class actions on behalf of noteholders under § 316(b).[5]

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1. The Black Swan reference is to the unique facts of *Marblegate, i.e.* that EDMC is effectively ineligible for Chapter 11 because 80% of its revenue is derived from Title IV federal funds and a bankruptcy would terminate further funding.
2. The only other case with a similar holding, *Federated Strategic Income Fund v. Mechala Grp. Jamaica Ltd.,* 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999), was described by the appellant as an unpublished outlier which has been criticized and not followed.
3. Ben H. Logan, *The Trust Indenture Act, Debt Restructuring and Reorganization Tourism (Part I),* 36 No. 3 Bankruptcy Law Letter 1 (March 2016).
4. *See Bank of New York v. First Millennium, Inc.,* 607 F.3d 905 (2d Cir. 2010); *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.,* 691 F.2d 1039 (2d Cir. 1982)
5. *See e.g. Barkau v. California Resources Corp.,* No. 16-cv-02971 (S.D.N.Y. 2016); *Cummings v. Chesapeake Energy Corp.,* No. 16-cv-02338 (S.D.N.Y. 2016).

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