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Marblegate Ruling is Reversed on Appeal: Second Circuit Adopts Narrow Interpretation of TIA Section 316(b)

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The Second Circuit issued its much anticipated decision in *Marblegate Asset Management LLC v. Education Management Corp.*, holding that "Section 316(b) prohibits only non-consensual amendments to an indenture's core payment terms." At issue is whether the phrase "right . . . to receive payment" forecloses "more than formal amendments to payment terms that eliminate the right to sue for payment." The Second Circuit held that it does not.

Since the inception of the TIA in 1939, most practitioners and courts have interpreted §316(b) as providing only limited protection to noteholders by prohibiting formal modifications of the payment terms or the right to sue. The traditional view, which remained largely unchanged for more than seven decades, is that §316(b) protects only a noteholder's legal right to receive payment when due rather than any practical ability to receive it. By contrast, the *Marblegate* District Court decisions interpreted §316(b) as prohibiting amendments that impair noteholders' practical ability to receive payment.[1]

Among the immediate effects of the District Court's decisions was to call into question the validity of transactions (and the scope of legal opinions that can be delivered in connection with those transactions) that may impact a distressed issuer's practical ability to repay its bonds, such as debt exchange offers and consent solicitations. The District Court decisions also led to a decline in the number of out-of-court restructurings of insolvent issuers as well as a wave of lawsuits by noteholders asserting §316(b) claims.[2] Many issuers of new notes chose not to register their debt with the U.S. Securities and Exchange Commission so that they did not have to qualify their indentures under the TIA or incorporate §316(b) into their indentures.

The Second Circuit's reversal provides much needed clarity to issuers evaluating and practitioners counseling clients in situations where a restructuring transaction may impact a distressed issuer's practical ability to repay its bonds.

Summary of the Second Circuit's Decision

The Second Circuit agreed with the District Court that §316(b) is ambiguous. On the one hand, Congress's use of the term "right" suggests a "concern with the legally enforceable obligation to pay that is contained in the Indenture,

not with a creditor's practical ability to collect on payments." On the other hand, Marblegate's broad reading of the term "right" as including the practical ability to collect payment leads to both "improbable results and interpretive problems."

Because the plain text of §316(b) is ambiguous and the TIA's structure does not remove this ambiguity, the Court turned to §316(b)'s legislative history. Over half of the majority's 42-page decision (Judge Straub dissented in a separate opinion) is devoted to the TIA's legislative history. The Court noted that the TIA's legislative history exclusively addressed *formal* amendments and indenture provisions like collective-action and no-action clauses, and emphasized that the right to foreclosure is not prohibited by the TIA, "even when [it] affect[s] a bondholder's ability to receive full payment."

The Court rejected Marblegate's interpretation of §316(b) as unworkable because it would require that courts determine in each case whether a challenged transaction constitutes an "out-of-court debt restructuring . . . designed to eliminate a non-consenting holder's ability to receive payment." The Court reiterated its "distaste for interpreting boilerplate indenture provisions" based on the "relationship of particular borrowers and lenders" or the "particularized intentions of the parties to an indenture," both of which undermine "uniformity in interpretation."

The Court also rejected Marblegate's argument that the right to receive payment is impaired "when the source of assets for that payment is deliberately placed beyond the reach of non-consenting noteholders." This description could apply to every foreclosure in which the value of the collateral is insufficient to pay creditors in full. Marblegate argued that §316(b) permits "genuinely adversarial" foreclosures but prohibits the type of consensual foreclosure that occurred here – where 98% of the noteholders consented to the restructuring. The Second Circuit rejected this view, finding that "neither the text nor the legislative history of §316(b) supports a distinction between adversarial and 'friendly' foreclosures."

Finally, the Court noted that its ruling would not leave noteholders like Marblegate without recourse: "[b]y preserving the legal right to receive payment, [the court] permits creditors to pursue available State and federal law remedies."

Precedential Effect

This case is likely to be persuasive authority outside of the Second Circuit because it is well-reasoned. While the indenture is governed by New York law, the decision rests on the construction of a federal statute. The Second Circuit has issued more decisions on indenture construction than any other circuit; while these are still few in number, they have been widely cited by state and federal courts around the country for decades. It is unlikely that the Second Circuit will grant a rehearing en banc (between 2011 and July 2016, the Court granted rehearing in only two appeals).[3] And the absence of a circuit court split makes it very unlikely that the U.S. Supreme Court would grant a cert petition.

Take Away

The Second Circuit decision restores the status quo and reinstates the traditional view that §316(b) provides only limited protection to noteholders by prohibiting formal modifications of the payment terms or the right to sue. While the decision does not mention *Federated Strategic Income Fund v. Mechala Grp. Jamaica Ltd.,* 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999) – the only *pre-Marblegate* case to hold that §316(b) protects the practical ability to be repaid – it effectively overrules this long-criticized decision.

Noteholders like Marblegate are not without recourse: they will continue to have whatever contractual protections exist in their indentures as well as

protections under fraudulent conveyance, foreclosure and other state laws protecting creditors and, in the case of insolvent issuers, potential claims against officers and directors for breach of fiduciary duty. Noteholders can also seek to protect against the type of out-of-court restructuring that occurred in *Marblegate* by requiring the inclusion of specific protective convents in the indenture.

1. *See Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 75 F. Supp. 3d 592, 610 (S.D.N.Y. 2014); *Marblegate Asset Management LLC v. Education Management Corp.*, 111 F. Supp. 3d 542, 546 (S.D.N.Y. 2015).
2. *See* Miranda S. Schiller & Agustina G. Berro, *Restoring Some Certainty Post-Marblegate*, Law360 (Dec. 12, 2016), available at https://www.law360.com/articles/871601/restoring-some-certainty-post-marblegate
3. Martin Flumenbaum & Brad S. Karp, *The Rarity of En Banc Review in the Second Circuit*, 256 N.Y.L.J. 38 (Aug. 24, 2016), available at https://www.paulweiss.com/media/3679578/24august2016flumenbaumkarp.pdf

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