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Feature

By Jason W. Harbour and Shannon E. Daily

Marblegate: Second Circuit Limits TIA Prohibition to Altering Legal Right to Payment

Jason W. Harbour
Hunton & Williams LLP
Richmond, Va.

Shannon E. Daily
Hunton & Williams LLP
Richmond, Va.

Jason Harbour is a partner and Shannon Daily is an associate in the Bankruptcy, Restructuring and Creditors' Rights Practice at Hunton & Williams LLP in Richmond, Va.

In a 2-1 decision, the U.S. Court of Appeals for the Second Circuit held that § 316(b) of the Trust Indenture Act (TIA) prohibits only amendments to the legal right to payment without the consent of bondholders, but does not prohibit changes that would limit the practical ability to receive payments.[1] The Second Circuit's holding reverses the U.S. District Court for the Southern District of New York, which held that § 316(b) protected nonconsenting bondholders from an out-of-court restructuring that would deprive them of the practical ability to collect future payments.[2]

The Second Circuit's *Marblegate* decision applies a narrow interpretation to § 316(b) that would allow financially distressed companies to pursue out-of-court restructurings that impair its bondholders' practical ability to receive future payments as long as the legal right to receive payment remains unaltered. *Marblegate* is consistent with decisions from other jurisdictions that previously have held that § 316(b) only prohibits amendments to an indenture's core payment terms absent bondholder consent.[3]

Background

Education Management Corp. (EDMC) is a for-profit higher-education company that provides college and graduate education through campus and online instruction.[4] To support its programs, EDMC depends on federal funding under title IV of the Higher Education Act of 1965.[5] By 2014, EDMC had developed an unsustainable debt burden of approximately $1.5 billion, consisting of $1.3 billion in secured loans and $217 million in unsecured notes (the "notes") issued by EDMC's subsidiaries and fellow appellants, Education Management Finance Corp. and Education Management LLC (together, the "EDM issuer"; and collectively with EDMC, the "appellants").[6]

A credit agreement between the EDM issuer and secured creditors (the "2010 credit agreement") governed the secured debt and gave EDMC's secured creditors the right to deal with the collateral, substantially all of EDMC's assets, as the "absolute owner" upon a default.[7] The notes were governed by an indenture that is covered by the TIA. EDMC guaranteed the notes as the parent company of the EDM issuer (the "notes guarantee").[8]

Due to the fact that EDMC depended on title IV funding, it could not file for bankruptcy, as it would have stripped EDMC of its eligibility to receive federal student-aid funds. In August 2014, EDMC reached an agreement with the majority of its creditors.[9] In the short term, holders of the majority of EDMC's secured and unsecured debt agreed to accept the payment of interest-in-kind through fiscal year 2015.[10] EDMC's secured

1 *Marblegate Asset Mgmt. LLC v. Educ. Mgmt. Fin. Corp.*, Nos. 15-2124, 15-2141, 2017 U.S. App. LEXIS 782, *1 (2d Cir. 2017) ("*Marblegate*").
2 *See Marblegate Asset Mgmt. LLC. v. Educ. Mgmt. Corp.*, 111 F. Supp. 3d 542 (S.D.N.Y. 2015) ("*Marblegate II*").
3 *See, e.g., YRC Worldwide Inc. v. Deutsche Bank Trust Co. Am.*, No. 10-civ-2106, 2010 U.S. Dist. LEXIS 65878, at *7 (D. Kan. 2010) ("TIA § 316(b) does not provide a guarantee against the issuing company's default or its ability to meet its obligations. Accordingly, the fact that the deletion of section 5.01 might make it more difficult for holders to receive payment directly from plaintiff does not mean that the deletion without unanimous consent violates TIA § 316(b)."); *Magten Asset Mgmt. Corp. v. Northwestern Corp. (In re Northwestern Corp.)*, 313 B.R. 595, 600 (Bankr. D. Del. 2004) (holding that § 316(b) only applies to bondholder's legal rights, not practical ability to receive principal and interest).
4 *Marblegate*, 2017 U.S. App. LEXIS 782, at *3.
5 *See* 20 U.S.C. §§ 1070-1099; *see also* Brief for Education Management Appellants at 7 [Doc. No. 64], *Marblegate Asset Mgmt. LLC v. Educ. Mgmt. Fin. Corp.*, No. 15-2124 (2d Cir. Sept. 9, 2015) ("Appellants' Brief").
6 *Marblegate*, 2017 U.S. App. LEXIS 782, at *3-4.
7 *Id.* at *4.
8 *Id.* at *4-5.
9 Appellants' Brief at 7.
10 *Id.* at 7-8.

lenders agreed to amend the credit agreement to extend the maturity and eliminate certain covenants.[11] In return, EDMC guaranteed the secured loans (the "loan guarantee").[12] In addition, EDMC and the majority of its creditors entered into a restructuring support agreement (RSA), which contemplated two options.[13]

If creditors unanimously consented, (1) the approximately $1.5 billion of secured debt would be exchanged for $400 million of new secured term loans plus preferred stock convertible into approximately 77 percent of EDMC's common stock, and (2) unsecured noteholders could exchange the notes for preferred stock convertible into approximately 19 percent of EDMC's common stock plus warrants.[14] If one or more creditors refused to consent, an event of default would occur, and the collateral agent for the secured lenders would exercise its rights to foreclose on the EDM issuer's assets and sell those assets to a new EDMC subsidiary (the "intercompany sale").[15] In addition, the secured lenders would release EDMC from the loan guarantee, which (under the terms of the indenture) would have the effect of releasing EDMC from the notes guarantee.[16] The new EDMC subsidiary would then distribute debt and equity only to secured creditors and consenting unsecured creditors.

Under the first option, secured creditors would receive a 45 percent reduction in their claims and unsecured creditors would receive a 67 percent reduction in their claims.[17] Under the second option, unsecured creditors that failed to consent to the intercompany sale would receive nothing.[18]

Appellees Marblegate Asset Management LLC and Marblegate Special Opportunities Master Fund LP (together, "Marblegate") held $14 million in notes and were the only creditors that did not consent to the intercompany sale. Marblegate filed a complaint for declaratory and injunctive relief and motion for preliminary injunction and temporary restraining order in district court, seeking to halt the intercompany sale.

Marblegate I and *Marblegate II*

Marblegate argued that the intercompany sale and the removal of the notes guarantee would violate § 316(b) of the TIA because the transactions would impair its practical ability to receive payments of principal and interest on the notes without its consent by transferring all of the assets of EDMC and the EDM issuer and releasing EDMC from the notes guarantee.[19] Section 316(b) provides, in pertinent part, that "[n]otwithstanding 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 ... shall not be impaired or affected without the consent of such holder."[20]

The district court initially refused to grant Marblegate a preliminary injunction on the basis that Marblegate failed to demonstrate actual, imminent or irreparable harm, lack of an adequate legal remedy, a balance of equities in its favor, or that public interest favored an injunction.[21] However, in its opinion, the district court concluded that Marblegate likely would succeed on a claim under the TIA because § 316(b) "is violated whenever a transaction 'effect[s] an involuntary debt restructuring.'"[22] In addition, the district court noted that there is "little question that the Intercompany Sale is precisely the type of debt reorganization that the [TIA] is designed to preclude."[23]

Following the district court's initial decision, EDMC moved forward with the intercompany sale. In connection with the sale, the secured creditors released the loan guarantee, the new EDMC subsidiary received the EDM issuer's old assets, and consenting noteholders participated in the debt-for-equity exchange.[24] Marblegate nevertheless continued to refuse to consent to the debt restructuring. EDMC, along with the steering committee for the ad hoc committee of term loan lenders of Education Management, filed a counterclaim against Marblegate seeking a declaration that EDMC could release the notes guarantee without violating the TIA.[25]

After considering the counterclaim, the district court ultimately held that the release of the notes guarantee would violate Marblegate's rights under § 316(b) of the TIA because it would impair or affect Marblegate's practical ability to receive payments despite the fact that the release was permitted under the terms of the indenture and did not formally amend the indenture's payment terms.[26] The appellants subsequently appealed.

Caesars I and *Caesars II*

Shortly after *Marblegate II*, the district court rendered a similar holding in *Meehancombs Global Credit Opportunities Funds LP v. Caesars Entertainment Corp.*, concluding that § 316(b) of the TIA should be interpreted broadly to protect both the legal right and the practical ability of a bondholder to receive payments under an indenture.[27] As a result, the district court held that the removal of guarantees through the issuance of supplemental indentures was "an impermissible out-of-court debt restructuring achieved through collective action," which "is exactly what TIA section 316(b) is designed to prevent."[28]

However, *Caesars I* left several questions unanswered, including what a plaintiff must "prove to demonstrate an impairment that violates section 316(b)."[29] The district court answered this question in *BOKF NA v. Caesars Entertainment Corp.*, concluding that "plaintiffs must prove either an amendment to a core term of the debt instrument, or an out-of-court debt reorganization."[30] Subsequently, Caesars Entertainment Corp. moved for leave to appeal *Caesars II*

11 *Id.* at 8.
12 *Id.*; *see also Marblegate*, 2017 U.S. App. LEXIS 782, at *5-6.
13 Appellants' Brief at 8.
14 *Id.* at 8-9.
15 *Id.* at 9.
16 *Id.* at 10.
17 *Marblegate*, 2017 U.S. App. LEXIS 782, at *7.
18 *Id.*
19 Complaint for Declaratory and Injunctive Relief at ¶ 45 [Doc. No. 1], No. 14-cv-08584, *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.* (S.D.N.Y. Oct. 28, 2014).
20 15 U.S.C. § 77ppp(b).
21 *See Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 75 F. Supp. 3d 592, 605-10 (S.D.N.Y. 2014) ("*Marblegate I*").
22 *Marblegate*, 2017 U.S. App. LEXIS 782, at *10 (quoting *Marblegate I*, 75 F. Supp. 3d at 614).
23 *Marblegate I*, 75 F. Supp. 3d at 615.
24 *Marblegate*, 2017 U.S. App. LEXIS 782, at *10.
25 *Id.*
26 *See Marblegate II*, 111 F. Supp. 3d at 557.
27 *See* 80 F. Supp. 3d 507 (S.D.N.Y. 2015) ("*Caesars I*"); *see also BOKF NA v. Caesars Entm't Corp.*, 144 F. Supp. 3d 459 (S.D.N.Y. 2015) ("*Caesars II*").
28 *Caesars I*, 80 F. Supp. 3d at 516.
29 *Caesars II*, 144 F. Supp. 3d at 468.
30 *Id.*

and consolidate the appeal with *Marblegate*. The Second Circuit denied the motion for leave to appeal, but Caesars still participated in *Marblegate* by filing an *amicus curiae* brief in support of the appellants.[31]

The Second Circuit's Decision

On appeal, EDMC asserted that the district court erred in holding that § 316(b) of the TIA protects a noteholder's practical ability to receive a payment.[32] EDMC argued that § 316(b) should be construed narrowly to only protect a creditor's right or entitlement to receive payment at maturity and the right or entitlement to sue if payment is not made — not a creditor's practical ability to collect on payments.[33] On the other hand, Marblegate argued that § 316(b) should be construed broadly to protect the practical ability to receive payment even if a formal amendment does not explicitly modify the legal right to payment.[34]

The Majority Opinion

The Second Circuit panel's two-judge majority reversed the district court's decision in *Marblegate II* and held that the TIA prohibits only formal amendments to the "core" payment terms of an indenture security without the consent of the bondholders. The majority agreed with the district court's conclusion that the text of § 316(b) is ambiguous and acknowledged that it could be interpreted to favor either side.[35] The majority concluded that the district court's "broad reading of the term 'right' as including the practical ability to collect payment leads to both improbable results and interpretive problems."[36]

After concluding that § 316(b) is ambiguous, the majority conducted an analysis of the legislative history of § 316(b), testimony regarding the section, and Securities and Exchange Commission reports regarding the original intent of the section. The majority disagreed with the district court's conclusion that the legislative history compels a broad reading of § 316(b) because the TIA's drafters did not understand the precise methods through which a restructuring might occur.[37] Instead, the majority noted that the drafters appeared to have recognized the range of possible forms of reorganization, including foreclosures, and concluded that the drafters did not intend for § 316(b) to be read broadly to include the practical ability to collect a payment.[38]

The majority also stated that if "right to receive payment" meant the practical ability to collect payment, then § 316(b)'s express protection of the right to sue to enforce payment would be unnecessary "because limiting the right to file a lawsuit for payment constitutes one of the most obvious impairments of the creditor's practical ability to collect payment."[39] Thus, the majority determined that the "'right ... to receive payment' is not ... so broad as to encompass the 'right ... to institute suit.'"[40] Instead, the majority concluded that the right to receive payment "prohibits nonconsensual amendments of core payment terms (that is, the amount of principal and interest owed, and the date of maturity)," whereas the right to sue for payment "ensures that individual bondholders can freely sue to collect payments owed under the indenture."[41]

In addition, the majority addressed other arguments, including expressing concern that Marblegate's interpretation of § 316(b) would require the court to consider whether the subjective intent of the issuer or majority bondholders was to eliminate the nonconsenting bondholder's ability to receive payment.[42] The majority expressed reluctance to consider the intentions of the parties in interpreting indenture provisions because doing so would "undermine uniformity in interpretation."[43]

The majority also stated that Marblegate's argument is problematic because the argument that the right to receive payment is impaired "when the source of assets for the payment is deliberately placed beyond the reach of nonconsenting noteholders" could apply to any foreclosure action in which the value of the collateral is less than the creditors' claims.[44] Finally, the majority noted that its holding does not leave Marblegate without recourse because Marblegate could pursue a range of available state and federal law remedies.[45]

The Dissenting Opinion

The dissent disagreed with the majority opinion and concluded that § 316(b) of the TIA is unambiguous.[46] The dissent further concluded that the plain meaning of § 316(b) is consistent with Marblegate's and the district court's broader interpretation.[47]

The dissent noted that "[h]ad Congress intended merely to protect against modification of an indenture's payment terms, it could have so stated. Nothing in the language of Section 316(b), however, cabins the prohibition on impairing or affecting the 'right ... to receive payment' to mere *amendment* of the indenture."[48] Further, the dissent concluded that "[a]t a minimum, the language of section 316(b) covers the actions taken by EDMC and the Steering Committee here."[49] Further, "[t]his scheme did not simply 'impair' or 'affect' Marblegate's right to receive payment — it annihilated it."[50] The dissent cautioned that the fear of undesirable commercial consequences should not influence the judiciary's interpretation of the plain language of a statute.[51]

Implications of *Marblegate*

As of the writing of this article, *Marblegate* is not yet final as it remains subject to a request for rehearing and a potential appeal to the U.S. Supreme Court. Specifically, on

31 *See* Order [Doc. No. 23], *Caesars Entm't Corp. v. BOKF NA, Caesars Entm't Corp. v. UMB Bank NA*, Nos. 15-287, 15-2854 (2d Cir. Dec. 22, 2015); *see also* Brief of *Amicus Curiae* Caesars Entm't Corp. in Support of Defendants-Appellants [Doc. No. 76], *Marblegate Asset Mgmt. LLC v. Educ. Mgmt. Fin. Corp.*, Nos. 15-2124, 15-2141 (2d Cir. Sept. 16, 2015).
32 Appellants' Brief at 17.
33 *Id.* at 20-21.
34 Response Brief for Appellees at 22 [Doc. No. 97], *Marblegate Asset Mgmt. LLC v. Educ. Mgmt. Fin. Corp.*, No. 15-2124 (2d Cir. Dec. 9, 2015) ("Appellees' Brief").
35 *Marblegate*, 2017 U.S. App. LEXIS 782, at *12.
36 *Id.* at *13.
37 *Id.* at *17-18.
38 *Id.* at *33.
39 *Id.*
40 *Id.*
41 *Id.* at *13-14.
42 *Id.* at *34.
43 *Id.* (internal citations omitted).
44 *Id.* at *34-35.
45 *Id.* at *36.
46 *Id.* at *37.
47 *Id.*
48 *Id.* at *42 (emphasis in original).
49 *Id.* at *45.
50 *Id.*
51 *Id.* at *46.

Feb. 8, 2017, Marblegate filed a petition for rehearing *en banc*.[52] Nevertheless, *Marblegate* restores a level of certainty concerning the meaning of § 316(b) of the TIA to issuers and bondholders seeking to move forward with out-of-court restructurings. *Marblegate* also aligns the Second Circuit with courts in other jurisdictions that have concluded that although the TIA requires unanimous consent to amend the legal right to payment, § 316(b) does not require unanimous consent to impair the practical ability to receive payment. In addition, *Marblegate* may provide assistance to practitioners issuing opinions in connection with out-of-court restructurings concerning certain interpretative issues with respect to § 316(b).[53] abi

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52 *See* Appellee's Petition for Rehearing *En Banc* [Doc. No. 217], *Marblegate Asset Mgmt. LLC v. Educ. Mgmt. Fin. Corp.*, No. 15-2124 (2d Cir. Feb. 8, 2017).

53 On April 25, 2016, a group of law firms published an opinion white paper analyzing the implications of *Marblegate II* and *Caesars* on opinion practice and offering guidance moving forward. The opinion white paper is *available at* americanbar.org/content/dam/aba/administrative/business_law/newsletters/CL510000/full-issue-201605.authcheckdam.pdf.