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Losing Your Marbles: A Sensible Interpretation of Section 316 of the Trust Indenture Act

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The U.S. Court of Appeals for the Second Circuit issued its ruling in *Marblegate Asset Management, LLC v. Education Management Corp.* that provided much needed clarity to creditors and issuers involved in out-of-court restructurings affecting noteholders. The issue for the court was whether Education Management Corp. ("EDMC") violated the Trust Indenture Act (the "*TIA*") when it implemented a restructuring that impaired the rights of one of its unsecured noteholders, Marblegate Asset Management, LLC (the "*Noteholder*"). The issue in front of the court was whether Section 316(b) of the TIA prohibits either (i) any action that could affect a noteholder's practical ability to recover payment or (ii) just actual amendments to the payment terms of an indenture. The majority Appeals Court opinion overturned the District Court's decision, which was that the foreclosure and restructuring by EDMC violated Section 316(b) of the TIA, and held that the TIA "prohibits only non-consensual amendments to an indenture's core payment terms." The dissenting opinion supported the District Court's interpretation that Section 316(b) should protect noteholders from "collusively engineered" restructurings.

The Facts

EDMC was in severe financial distress but could not avail itself of a bankruptcy filing because such a filing would have caused EDMC to lose eligibility for certain federal funding it received as a for-profit higher education company. EDMC's subsidiaries had approximately $1.3 billion of secured debt under a credit agreement and approximately $217 million of unsecured debt in the form of notes. At the time of the proposed restructuring EDMC was a guarantor of all of the debt. The terms of the notes, agreed upon by the noteholders at the time the notes were issued, provided that the parent guarantee would be automatically released without any consent from noteholders upon the release of any parent guarantee provided in the future to the holders of secured debt.

The restructuring consisted of a number of steps. First, the secured creditors would foreclose on EDMC's assets and release EDMC from its guarantee of the secured debt (which would result in a concurrent release of EDMC's guarantee of the notes). Second, the foreclosed assets would be sold to a newly-formed subsidiary of EDMC to which the existing creditors had no recourse. The new subsidiary would issue debt and equity only to consenting creditors. Non-consenting secured creditors would receive junior debt in the new subsidiary and non-consenting noteholders would receive nothing, although they would retain their claim against the original bond issuer, which had been transformed into "an empty shell" without any assets and most likely eliminating recourse by non-consenting noteholders on the unsecured bonds.

Section 316(b)

Section 316(b) of the TIA is entitled "Prohibition of impairment of holder's right to payment" and the relevant part requires the consent of any affected noteholder to take action that would impair or affect such noteholder's "right … to receive payment". In the Appeals Court decision, EDMC prevailed in its argument that this consent requirement should apply only to changes of "core payment terms". The Noteholder, on the other hand, argued that Section 316(b) "would be rendered meaningless if issuers and secured creditors could collaborate to restructure debt without formally amending any payment terms", an argument which had prevailed in the District Court.

All parties agreed that the actual language of Section 316(b) is ambiguous and could lead to multiple interpretations. Nonetheless, the Appeals Court decision noted that, if the intent of the legislation had been to protect the practical ability to receive payment, then the second half of Section 316(b), which prohibits the impairment of the right to sue for payment, would be entirely superfluous because limiting the right to sue for payment is "the most obvious impairment of the creditor's practical ability to collect". Moreover, the court noted that "no other provision in the TIA purports to regulate an issuer's business transactions, which would be a likely result of the Noteholder's broad reading".

The Second Circuit's Analysis

The court spent considerable time reviewing the legislative history to determine their view of the intention behind the relevant TIA provision. The court came to the conclusion that the intent of the provision was only to "restrict the power of the majority to change…particular phases of the contract" (*Douglas Testimony*) and not to govern out-of-court restructurings. This view was based on (i) a 1936 SEC Report focused on protective organizations in restructurings (and a specific part of that report focused on "Trustees Under Indentures"), (ii) 1938 testimony to Congress of then-SEC Chairman William O. Douglas and (iii) a subsequent 1940 SEC Report.

In addition, and most important for issuers and creditors in the post-*Marblegate* environment, the Second Circuit recognized that to adopt the broader reading of the provision would require the courts to make a determination in every case as to whether a restructuring constitutes an out-of-court restructuring designed to eliminate non-consenting holders' ability to receive payment. Since the District Court's original ruling, issuers and creditors have struggled with their ability to enter into modifications and restructurings for fear of non-consenting noteholders arguing that any such amendment, waiver or modification might affect the noteholders' ability to receive payment. In its broadest interpretation, it could have been argued that transactions such as permitting an asset sale could have been viewed, depending on the facts and circumstances, as prohibited by Section 316(b).

In its effort to interpret Section 316(b) in a way that provides greater clarity to issuers and creditors as to what is permitted and what is prohibited, the court reiterated its dissatisfaction for interpreting boilerplate indenture provisions based on "the relationship of particular borrowers and lenders" or the "particularized intentions of the parties to an indenture" (the Appeals Court quoting from *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*). As many courts have noted in prior decisions "uniformity in interpretation" of contracts is essential.

Finally, the court pointed out that if the Noteholder's interpretation were followed, Section 316(b) could be read to prohibit all out-of-court restructurings in which the assets are not sufficient to satisfy 100% of the outstanding debt. In such scenarios, any non-consenting holder would have its practical right to receive payment impaired by the agreed restructuring.

Post-Marblegate

The Appeals Court's *Marblegate* decision provides more clarity to issuers, creditors and market participants by limiting the remit of Section 316(b) to formal amendments of an Indenture's "core payment terms". The leverage of non-consenting noteholders has been significantly reduced, as they will have to rely much more heavily on other federal and state remedies, as the Appeals Court noted in its decision. That said, out-of-court restructurings are still not entirely free from risk. Absent the protection of a formal bankruptcy filing, third party creditors and non-consenting noteholders could still disrupt out-of-court restructuring processes by seeking payment of principal, interest or other damages.

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If you have any questions, please contact any of the following attorneys or your Cadwalader contact:

William P. Mills	+1 212.504.6436	william.mills@cwt.com
Adam D. Summers	+1 212.504.5760	adam.summers@cwt.com