Second Circuit Confirms That Bond Issuers Can Restructure Out-of-Court Via Consent Solicitations

Skadden

01/26/17

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Gregory A. Fernicola
New York
212.735.2918
gregory.fernicola@skadden.com

Jay M. Goffman
New York
212.735.2120
jay.goffman@skadden.com

Mark A. McDermott
New York
212.735.2290
mark.mcdermott@skadden.com

Sarah E. Pierce
Wilmington
302.651.3127
sarah.pierce@skadden.com

Liz Downing
Boston
617.573.4879
elizabeth.downing@skadden.com

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

On January 17, 2017, the U.S. Court of Appeals for the Second Circuit issued an opinion in *Marblegate Asset Management v. Education Management Corp.,* 15-2124-cv(L), 15-2141-cv(CON) (2nd Cir. Jan. 17, 2017), overturning a broad interpretation of the Trust Indenture Act (TIA) by the U.S. District Court for the Southern District of New York.[1] The Second Circuit held that § 316(b) of the TIA prohibits only nonconsensual amendments to an indenture's core payment terms, such as the amount of principal, interest and term, and does not guarantee a holder that noncore payment terms, such as covenants and guarantees, cannot be modified or removed. In so holding, the Second Circuit disagreed with the district court's finding that the TIA protects noteholders' "practical ability" to be repaid.[2] The Second Circuit's ruling restores some level of comfort for practitioners and the business community, by finding that troubled issuers offering to properly exchange outstanding debt securities for new securities can incentivize holders to accept the exchange by removing noncore terms, such as protective covenants and guarantees, from the indenture of the holders who reject the exchange.

* * *

Section 316(b) of the TIA provides that "the right of any holder of an 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." Prior to the district court's decision in *Marblegate* and a similar ruling by the court in the *Caesars* restructuring,[3] issuers, bondholders and practitioners had largely understood § 316(b) to protect only a holder's *legal* rights to payment under the indenture, not the holder's *practical* ability to recover such payment. However, in the *Marblegate* and *Caesars* cases, the district court disagreed with this position, instead finding that the TIA is meant to protect noteholders from out-of-court restructurings that are designed to impair their practical ability to recover the principal and interest on their notes. The Second Circuit's decision, along with a recent decision of the Southern District of New York in the *Cliffs Natural Resources* case,[4] have reinforced the status quo that was in place prior to the district court decisions in *Marblegate* and *Caesars* — namely that § 316(b) of the TIA protects the legal right, not the practical right, to payment under an indenture.

The Second Circuit's ruling is good news for issuers and bondholders who support an issuer's out-of-court restructuring efforts. Because the TIA prohibits nonconsensual changes to core payment terms, troubled issuers often incentivize holders to accept new notes in an exchange offer by penalizing holdouts through amendments to their indentures to remove protective covenants and guarantees. Long-standing practice was for indentures to allow such changes upon a vote of a majority of the holders. This threat minimized holdouts, which in turn assisted issuers in avoiding bankruptcy. Bankruptcy can be used to eliminate holdouts and dissenters via a statutory provision that binds *all* holders if the proposed treatment is accepted by a majority of holders who hold at least two-thirds of the dollar amount of the indebtedness, counting for such purposes only those holders who actually vote. But bankruptcy has risks and costs that issuers historically have tried to avoid through coercive exchange offers designed to minimize holdouts.

[1] *Marblegate Asset Mgmt. v. Education Mgmt. Corp.*, 75 F. Supp. 3d 592 (S.D.N.Y. 2014); 111 F. Supp. 3d 542 (S.D.N.Y. 2015).

[2] Marblegate has sought, and EDMC has consented to, an extension of time to file its petition for a rehearing and a rehearing *en banc* through February 7, 2017, indicating that Marblegate intends to seek further relief at the Second Circuit.

[3] *Meehan Global Credit Opportunities Funds, LP v. Caesars Entertainment Corp.*, 80 F. Supp.3d 507 (S.D.N.Y. 2015); BOKF, N.A. v. Caesars Entertainment Corp., 144 F. Supp. 3d 459 (S.D.N.Y. 2015). The *Casesars* matters ultimately settled without further appeal to the Second Circuit.

[4] *Wasman v. Cliffs Natural Resources Inc.*, 16-cv-01899 (S.D.N.Y. Dec. 6, 2016).

Second Circuit Confirms That Bond Issuers Can Restructure Out-of-Court Via Consent Solicitations

The district court decisions in *Marblegate* and *Caesars* hampered the ability of issuers to undertake such actions by majority consent expressly permitted under an indenture. Indeed, issuers feared increased bondholder challenges to exchange offers and related consent solicitations that contemplated elimination of covenants and guarantees, thereby enhancing the odds of troubled issuers having to forego these tools altogether in favor of more risky and costly bankruptcy cases. In light of the Second Circuit's decision, troubled issuers can continue, as they have for decades, to explore out-of-court restructuring options that do not alter core payment terms of the underlying indenture.

Background

Education Management Corp. (EDMC) is a for-profit education provider that in 2014 derived revenue primarily from federal student aid programs under Title IV of the Higher Education Act of 1965. EDMC owed in excess of $1.3 billion, consisting primarily of nearly $1.1 billion in secured term loans and $217 million in unsecured notes. The unsecured notes were issued by a subsidiary of EDMC under an indenture qualified under the TIA. The indenture included a provision restating § 316(b) of the TIA, specifically providing that, notwithstanding any other provision of the indenture, "the right of any Holder of a Note to receive payment ... shall not be impaired or affected without the consent of such Holder." The notes were guaranteed by EDMC (as parent of the issuer). However, the indenture provided that this parent guarantee could be removed (1) by consent of a majority of the holders of the notes and/or (2) automatically, if the company's secured creditors released EDMC's guarantee of their secured debt (which, at time of issuance of the notes, was not subject to such a parent guarantee). These provisions were highlighted in the offering circular for the notes, which likewise provided that no value should be assigned to the parent guarantee of the notes given the possibility of it being released.

In spring 2014, EDMC informed investors and creditors that it was in significant financial distress and that, by the end of June 2014, it would not be in compliance with its secured facility's financial covenants. EDMC's secured creditors ultimately waived those financial covenants until September 2014, to allow for the development of a comprehensive restructuring plan. EDMC obtained an amendment of its secured credit facility to eliminate, alter or delay many payment obligations, and in exchange EDMC guaranteed the secured debt. EDMC likewise began restructuring negotiations with an ad hoc committee of term lenders.

EDMC's restructuring options were complicated and limited: EDMC could not restructure under the bankruptcy code without losing eligibility for Title IV funds under the Higher Education Act — the company's primary source of revenue. Accordingly, EDMC had to restructure out of court. The company and the ad hoc committee therefore entered into a restructuring support agreement that provided a two-path restructuring: first, if 100 percent creditor consent was received, EDMC's secured and unsecured debt would be converted into a smaller amount of debt and equity (with ratios varying based on type of debt), and second, if less than 100 percent creditor consent was received, the exchange would not occur and instead an "intercompany sale" would be undertaken, as described further below.

EDMC launched an exchange offer for the unsecured notes on October 1, 2014, in accordance with the restructuring support agreement, pursuant to which holders of more than 90 percent of the notes, but less than 100 percent, agreed to exchange their notes. EDMC therefore sought to consummate the intercompany sale, pursuant to which: (1) the secured lenders would release the EDMC parent guarantee, thereby causing an automatic release of the parent guarantee of the notes under the terms of the notes indenture, (2) the secured lenders would foreclose on their collateral — substantially all of the assets of the company, and (3) the secured lenders would immediately sell those assets to a newly created subsidiary of EDMC, which would distribute new debt and equity to the signatories of the restructuring support agreement. The impact of the intercompany sale on the holders of notes was explicit in the exchange offer documents: While the holders would maintain their claims against certain of EDMC's issuer and guarantee subsidiaries, those entities would have no assets from which to satisfy the noteholders' claims. EDMC's guarantee of the notes would be released.

District Court Decision

Two investment funds holding collectively $20.3 million of the unsecured notes commenced a preliminary injunction action in the Southern District of New York to block EDMC's proposed restructuring, arguing that the intercompany sale would violate the TIA. While recognizing that two aspects of the intercompany sale — the asset foreclosure and release of parent guarantee — had a contractual basis in the notes indenture, the district court evaluated whether such aspects of the intercompany sale, and the release of the parent guarantee in particular, would impermissibly impair or affect the right to receive payment on the notes. The district court framed the issue as a dispute over the scope of the TIA and whether it is "a broad protection against nonconsensual debt restructurings, or a narrow protection against majority amendment of certain 'core terms,'" ultimately finding the former interpretation "more persuasive."

In reaching this conclusion, the district court considered the legislative history surrounding the TIA, which, in the district court's view, confirmed a broad reading of the Act's provisions regarding right to payment. The court also considered other rulings that the TIA protects only legal rights (*i.e.*, right to sue) and not the practical

Second Circuit Confirms That Bond Issuers Can Restructure Out-of-Court Via Consent Solicitations

ability to be repaid.[5] Initially, the district court found that if the TIA protected only the rights set forth in a notes indenture (as may be limited in that indenture), preemptive limitations on the ability to receive payments set forth in an indenture — including by majority vote — would be permissible. Such a result, in the district court's view, would render the TIA meaningless. To support its reading of § 316(b) of the TIA, the district court looked to the legislative history's statement of purpose: to prevent "evasion of judicial scrutiny of the fairness of debt-readjustment plans." From this, the district court reasoned that "Section 316(b) [of the TIA] was intended to force bond restructurings into bankruptcy where unanimous consent could not be obtained." Applying this reasoning to the proposed restructuring, the court indicated that the intercompany sale was "precisely" the type of restructuring that the TIA precludes.

The district court recognized the company's and lenders' arguments that an acceptance of the plaintiffs' position would permit a holdout noteholder to block a transaction based on a "standardless 'ability to receive payment test,'" and likewise indicated that it did not wish to evaluate each new "widget factory" investment to determine whether such investment would negatively impact a bondholder's ultimate ability to receive payment. However, notwithstanding these concerns, the district court found "unsatisfying" the argument that the TIA prohibits only formal and explicit alteration of the right to receive payment, which in the court's view would allow "clever" transactions, such as the intercompany sale, to avoid the protections of the Act.

Following the preliminary injunction decision, EDMC proceeded with the intercompany sale, but with a few adjustments designed to protect Marblegate's rights, in case the court issued a final ruling in the investment firm's favor. The changes included an amendment to the indenture that provided the firm with a guarantee by the newly formed Education Management entity until the parent guarantee was released and a delay of the release of the parent guarantee for Marblegate's notes. EDMC then filed an answer and counterclaim for declaratory relief that would enable it to release the parent guarantee on the notes, effectively teeing up the question on the TIA for a final determination by the court. The court's decision was unsurprising, in light of the preliminary injunction decision. The court, relying again on the legislative history and purpose of the Trust Indenture Act, as well as two Southern District of New York decisions in Caesars that came down in the interim period, firmly adopted the broad reading of § 316(b).[6]

Second Circuit's Decision

EDMC appealed on the grounds that the district court misinterpreted and misapplied § 316(b), and that its intercompany «friendly foreclosure» sale and concomitant release of the parent guarantee complied with § 316(b), as it did not "formally amend" the indenture's express payment terms. The Second Circuit agreed with EDMC. While the Second Circuit agreed with the district court that the text of § 316(b) is ambiguous, the Second Circuit concluded, based on the statute's legislative history, that Congress did not intend the broad reading of § 316(b) that the district court adopted. The court concluded that § 316(b) of the TIA's protection of the "right to payment" could not be so broadly read as to include the practical ability to collect on such payment. Rather, the Second Circuit found that Congress "sought to prohibit formal modifications to indentures without the consent of all bondholders, but did not intend to go further in banning other well-known forms of reorganization like foreclosures." The Second Circuit added that its holding leaves frustrated noteholders with some recourse — namely, pursuing state and federal law remedies, including fraudulent transfer actions. In addition, the Second Circuit noted that sophisticated creditors can insist on provisions in debt instruments that prohibit transactions like the intercompany sale.

Looking Forward

Had the Second Circuit upheld the district court's decision, it would have reduced the feasibility of out-of-court restructurings of public bonds. In particular, it would have increased the likelihood that holdout noteholders could challenge out-of-court restructuring of publicly held bonds in an effort to gain leverage in negotiations. Such challenges can derail proposed restructurings due to litigation delay and provide further leverage to holdouts to negotiate different terms. While prepackaged bankruptcy plans may "solve" this dilemma, other than where Chapter 11 is unavailable to the issuer (such as educational institutions, like EDMC and securities and commodities brokers), the price for this solution is the potential risk and expense of a bankruptcy proceeding. Such risk and expense largely are minimized with prepackaged bankruptcies, but they are eliminated altogether if the restructuring can be done out of court. Indeed, if the district court decision had stood, there was concern that there would be an increase in bondholder lawsuits challenging corporate actions that were not explicitly prohibited by the governing indenture or were permissible by majority consent under the indenture on the theory that such actions could potentially affect a noteholder's right to payment.

* * *

The Second Circuit's decision provides much-needed guidance regarding the narrow scope of § 316(b)'s protection of a holder's right to payment without that holder's consent, and provides comfort to practitioners and the business community that out-of-court restructurings that do not formally alter the indenture's express payment terms can be accomplished, as they have been for decades, without violating the TIA.

[5] *In re Nw. Corp*, 313 B.R. 595, 600 (Bankr. D. Del. 2004); *YRC Worldwide Inc. v. Deutsche Bank Trust Co. Am.*, Case No. Civ. 2106 (JWL), 2010 WL 2680336, at *7 (D. Kan. July 1, 2010).

[6] 111 F. Supp. 3d 542 (S.D.N.Y. 2015).