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Marblegate II and the "Tyranny of the Minority" – Another Weapon is Added to Bondholders' Arsenal to Disrupt Exchange Offers and Restructurings

A recent decision in the Southern District of New York interpreting the Trust Indenture Act (the "TIA")[1] will likely provide bondholders additional leverage in out-of-court restructurings, and may result in future restructurings and exchange offerings occurring through a bankruptcy process rather than a structured out-of-court settlement process.

The case, *Marblegate Asset Management v. Education Management Corp*. ("*Marblegate II*"),[2] centers on the interpretation of § 316(b) of the TIA,[3] which provides that an issuer may not impair the rights of holders of registered notes to receive payment of principal, premium and interest without the consent of the holders. In reaching its decision, the District Court read the TIA broadly, holding that not only did specific amendments curtailing payment violate the TIA, but that the TIA was also violated by actions that may have a substantive effect on an issuer's ability to pay as well.[4]

In this instance, the issuer sought to eliminate a parent guarantee and approve certain actions that would have had the effect of eliminating the amount of assets available from which to pay noteholders in the future. A small group of noteholders objected. Even though such changes were expressly permitted under the governing indenture, and the vast majority of bondholders consented to such changes, the Court held that such actions constituted an impairment of the non-consenting noteholders' rights to receive payments of principal and interest, and were impermissible under the TIA.

This decision represents an expansion of TIA jurisprudence that will likely provide minority bondholders and noteholders new avenues to block out-of-court restructurings, limiting issuer's ability to effectuate non-consensual out-of-court restructurings, thereby making future exchange offers much more difficult, and forcing bond restructurings that might otherwise occur out-of-court to be effectuated through a bankruptcy filing. As a result, *Marblegate II* is an opinion that all issuers and holders of debt should understand.

Background

Education Management Corporation ("*EDMC*") is one of the country's largest for-profit providers of college and graduate education. Like many for-profit educational institutions, EDMC derives the vast majority of its revenue from federal student aid programs.[5] Prior to its restructuring, EDMC had outstanding debt of approximately $1.522 billion, consisting of $1.305 billion in secured term and revolving credit facilities (the "*Secured Debt*") and $217 million in unsecured notes (the "*Notes*").[6] The Secured Debt was secured by a pledge of substantially all of the assets of EDMC and its operating subsidiaries. The Notes were issued by a subsidiary, Education Management LLC, but were guaranteed by EDMC, and governed by an indenture (the "*Indenture*"), qualified under the TIA.[7] Importantly, the Indenture contained a covenant that specified if the secured lenders were to release a guarantor of the Secured Debt from its guarantee, then such guarantor's guarantee of the Notes would also be automatically released.[8] While no guarantee of the Secured Debt existed when the Notes were issued, a guarantee by EDMC was later added to the Secured Debt.

In May 2014, EDMC announced that due to significant financial distress, it planned to restructure its balance sheet, and subsequently commenced negotiations with the various secured lenders and noteholders. Because a bankruptcy filling would render EDMC ineligible to receive payment from the federal student loan program, which would force it to close its operations, bankruptcy was not a viable option, leading EDMC to attempt an out-of-court restructuring.

The various negotiations resulted in a Restructuring Support Agreement ("*RSA*"), signed by all of the secured lenders and holders of a majority in principal amount of the Notes. The RSA contemplated two possible transactions, neither of which required a bankruptcy proceeding. As the first option, if the company obtained the consent of all creditors to the terms of the restructuring, holders of Secured Debt would receive a combination of cash, new debt and preferred stock, and the noteholders would receive a distribution of preferred stock. As a second option, if the company failed to obtain 100% consent of the creditors, however, the signatories to the RSA would effectuate the restructuring through a multiple step process. First, the secured lenders would release EDMC of its guarantee of the Secured Debt, thereby triggering an automatic release of EDMC's guarantee of the Notes under the Indenture. Second, the secured lenders would exercise their right to foreclose on substantially all of the assets of the obligor and other parties pursuant to their rights under the Credit Agreement and Article 9 of the Uniform Commercial Code. Third, there would be an "Intercompany Sale," whereby the secured lenders would immediately sell the assets back to a new subsidiary of EDMC. Lastly, the new subsidiary would distribute debt and equity to creditors who had consented to the restructuring.[9] EDMC warned noteholders that should they withhold consent, those parties would no longer have the benefit of the parent guarantee and would be left only with claims against certain operating subsidiaries, which, following the Intercompany Sales, would have no material assets or sources of recovery, essentially ensuring that they received no payment.

While 99% of the secured lenders and over 90% of the noteholders consented to the exchange, because EDMC did not receive unanimous consent, it was forced to pursue the second non-consensual alternative.

Following the non-consenting holder's failed bid for a preliminary injunction,[10] EDMC proceeded with the restructuring, including the Intercompany Sale, the secured lenders foreclosed on the assets and EDMC's debts were reduced from $1.5 billion to $400 million.

The District Court's Decision on the Merits

In the District Court's decision, the Court began by acknowledging that other courts have narrowly interpreted TIA § 316(b) to prohibit only formal modifications of the right to payment. In both *YRC Worldwide Inc. v. Deutsche Bank Trust Co. Am.*[11] and *In re NW Corp.*,[12] courts previously held that actions taken without full consent of noteholders that were permitted by the terms of an indenture and which made it more difficult or unlikely that holders would receive payment did not violate the TIA. Both of these courts held the TIA did not by itself guarantee against a payment default.

Nonetheless, the *Marblegate II* Court held that the purpose and legislative history behind the TIA supported a broader reading of its terms and the TIA was designed "to prevent precisely the nonconsensual majoritarian debt restructuring that occurred here, even if the [TIA's] authors did not anticipate precisely the mechanisms through which such a restructuring might occur."[13] The Court went on to state that the TIA was designed not just to prohibit formal restrictions and/or alterations to the payments required under an indenture, but actions that would ultimately make such payment impossible, and that it did not matter whether such action was "carried out straightforwardly or circuitously."[14]

Importantly, the Court also held that it was of no moment that the proposed restructuring under the RSA "did not directly amend any term explicitly governing any individual bondholder's right to receive payment."[15] Rather, even though the removal of EDMC as a guarantor of the Notes was permitted by the Indenture, the Court stated that § 316(b) of the TIA supersedes such a provision, because the provision would prevent the non-consenting noteholders from actually receiving payment under the Notes.

Lastly, while the Court held that it "recognizes the potentially troubling implications of the [TIA] in rewarding holdouts" which may have the effect of creating a "tyranny of the minority," it held that, nonetheless, the facts of this case required the result.[16]

A notice of appeal has been filed and it remains to be seen what an appellate court will determine in this matter.

Implications of *Marblegate II* Holding

The holding in this case is significant for a number of reasons. First, it may suggest that any modifications of an indenture – such as a release of a parent guarantee or other action that may impair a dissenter's ability to obtain payment – might be prohibited under the TIA without unanimous approval of the holders. Such a reading will allow holders to argue that any material modification of their rights violates the TIA because the proposed modification possibly impairs or affects the ultimate right to payment. It remains to be seen how far that argument can be stretched to cover even relatively insignificant modifications, but importantly, the fact that the modifications may have been expressly permitted under the terms of an indenture will not be a defense.

Second, given the added complexities of executing an exchange offer or out-of-court restructuring, this decision may make Chapter 11 a relatively more attractive option for companies given that the plan process does not necessarily require unanimity. Although bankruptcy apparently was not a practical option for EDMC, that will not be the case for most companies and most industries.

Third, to avoid issues related to the TIA, companies may, where possible, begin to avoid registering their bonds with the Securities and Exchange Commission and thereby subjecting their bond indentures to the TIA.

Fourth, given the uncertainty in this area that the decision raises, issuers' counsel may be more reluctant to issue legal opinions concerning whether a proposed indenture amendment violates § 316(b) of the TIA. At the same time, indenture trustees may be more likely to require such opinions before entering into supplemental indentures.

Ultimately, the largest take-away is that minority bondholders may now have increased leverage when negotiating with issuers and other creditors, and troubled companies and their creditors will therefore likely have to reconsider what they can accomplish in an out-of-court restructuring on a non-consensual basis, without resorting to the filing of a bankruptcy petition.

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1 15 U.S.C. §§ 77aaa-77bbbb.

2 Docket No. 78, Case No. 14 Civ. 8584(KPF); 2015 WL 3867643 (S.D.N.Y. June 23, 2015) ("*Marblegate II*").

3 Specifically, § 316(b) of the TIA, provides, in relevant part:

the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder .. . .

4 This is the second time this Court has addressed this issue. The first time was in the context of a preliminary injunction proceeding. *See Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, Case No. 14 Civ. 8584 (KPF), 2014 WL 7399041 (S.D.N.Y. Dec. 30, 2014) ("*Marblegate I*"). In that instance, while the Court ultimately denied the injunction, it held, in *dicta*, that the plaintiffs likely would succeed on the merits of their claim that EDMC's actions violated the TIA. Marblegate II formally held that such action violated the TIA and that damages for such violation were available.

5 Specifically, EDMC derived almost 80% of its revenues from Title IV of the Higher Education Act of 1965, 20 U.S.C. §§ 1070-1099. *Marblegate I*, 2014 WL 7399041, at *1-2.

6 *Marblegate II* at *3.

7 Section 6.07 of the Indenture expressly incorporates the protections provided for in § 316(b)3 of the Act, stating that "the right of any Holder of a Note to receive payment of principal, premium...and interest on the Note...or to bring suit for the enforcement of any such payment...shall not be impaired or affected without the consent of such Holder."

8 Indenture, § 10.06.

9 *Marblegate II* at *4-5.

10 In *Marblegate I*, the District Court denied the non-consenting noteholders' request for a preliminary injunction, holding that they failed to establish the required elements for a preliminary injunction. Specifically, the Court found the noteholders had failed to establish irreparable harm, since if the non-consenting noteholders prevailed in their suit they would have the opportunity to collect monetary damages against EDMC or whatever subsidiary the assets were conveyed to through the Intercompany Sale. Significantly, however, the Court found, in *dicta*, that the non-consenting noteholders would likely succeed on the merits of their claims under the TIA. *Marblegate I*, 2014 WL 7399041.

11 No. 10 Civ. 2106 (JWL), 2010 WL 2680336 (D. Kan. July 1, 2010) (finding "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 § 316(b).").

12 313 B.R. 595, 600 (Bankr. D. Del. 2004) ("[S]ection 316(b) applies to the holder's legal rights and not the holders practical rights to the principal and interest itself … there is no guarantee against default.")

13 *Marblegate II* at *11; In reaching its decision, the Court cited two other decisions from the Southern District of New York which had each given the TIA a broad reading: *MeehanCombs Global Credit Opportunities Fund, LP v. Caesars Entm't Corp.*, No. 14 Civ 7091 (SAS), 2015 WL 221055, at *4-5 (S.D.N.Y. Jan. 15, 2015) (citing *Marblegate I*); *Federated Strategic Income Fund v. Mechala Grp. Jam. Ltd.*, 99 Civ. 10517 (HB), 1999 WL 993648, at *5-7 (S.D.N.Y. Nov. 2, 1999).

14 *Id.* at *12.

15 *Id.* at *13.

16 *Id.*

For More Information

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