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Client Alert

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Get Ready for Out of Court Bond Restructurings: *Cliffs* and the Reversal of *Marblegate*

In its long-awaited January 17 decision, [1] the United States Court of Appeals for the Second Circuit provided greater certainty to debt holders and companies navigating restructuring of debt outside of bankruptcy court by overturning the district court's decision in *Marblegate Asset Mgmt., LLC* v. *Educ. Mgmt. Corp.*[2] Together with the December 16 decision of the United States District Court for the Southern District of New York in *Waxman* v. *Cliffs Natural Resources Inc.*,[3] the Second Circuit decision could now set the stage for more aggressive out of court debt restructuring efforts by distressed borrowers. Against the backdrop of recent cases on which we commented recently that limited the techniques available to borrowers, these more recent decisions appear to limit the reach of Section 316(b) of the Trust Indenture Act (the "TIA") to invalidate restructuring efforts.

In an opinion that narrowed the scope of the District Court's interpretation of Section 316(b) of the Trust Indenture Act (the "TIA"), the Second Circuit in *Marblegate* agreed with the defendants and held that Section 316(b) of the TIA only prohibits "non-consensual amendments to an indenture's core payment terms" rather than the practical ability to collect payment.[4] The lower court's judgment in *Marblegate* was vacated and the case was remanded to the District Court.

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[1] Slip op., no. 15-2124 (2d Cir. Jan. 17, 2017).
[2] *Marblegate Asset Mgmt., LLC* v. *Educ. Mgmt. Corp.*, 75 F. Supp. 3d 592 (S.D.N.Y. 2014).
[3] *Waxman* v. *Cliffs Natural Resources Inc.*, No. 16 CIV 1899 (S.D.N.Y. filed Dec. 6, 2016).
[4] Slip op. at 4.

Background

Recent decisions from the United States District Court for the Southern District of New York, including the 2015 *Marblegate* decision, had complicated the traditional debt restructuring landscape by concluding that certain exchange offers may be precluded by the TIA, an act intended to safeguard the rights of bondholders. Section 316(b) of the TIA provides in part that "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." That right to receive payment had been broadly interpreted in such cases to mean a "practical right," a reading of the TIA that could force companies in financial distress to file for bankruptcy in lieu of completing an out-of-court restructuring. By looking to "practical" impacts, these decisions initially appeared to open the doors to challenges to a variety of regularly used approaches, including a panoply of coercive exchanges, to restructure bond debt outside of bankruptcy.

In *Marblegate*, the district court applied this expansive reading of Section 316(b), concluding that bondholders should be protected even when a restructuring transaction does not modify the "core terms" of an indenture, such as the payment terms, but still leaves the bondholder with no choice but to participate in the transaction. In the case, Education Management Corporation ("EDMC") and its subsidiaries (collectively, "EDM"), a for-profit education company with $217 million in unsecured notes and $1.3 billion in outstanding secured debt on its balance sheet, entered into a series of transactions to restructure its debt burden and avoid bankruptcy. The unsecured notes were guaranteed by EDMC as the parent company. EDM presented its bondholders with two alternatives: an exchange offer requiring the unanimous consent of all bondholders, resulting in an exchange of most of the secured debt for new secured loans and equity and an exchange of the unsecured notes for equity, or an "Intercompany Sale" triggered in the event one or more bondholders refused to participate in the exchange offer, whereby assets would be transferred to a newly created subsidiary and the parental guarantee on the unsecured notes would be released, resulting in only a shell entity for non-participating bondholders to recover against. The plaintiff in *Marblegate* was the sole dissenting bondholder and argued that

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although the indenture terms remained intact, its ability to receive payment was practically eliminated without its consent, rendering Section 316(b) meaningless if EDM and the secured creditors could effect a restructuring with the intent of impairing its rights.

The district court in *Marblegate* relied mainly on the legislative history of the TIA and found that the relevant textual changes to Section 316(b) pointed to the expansion of the provision from a right to sue to a broader right to receive payment and that the purpose of the provision was to "prevent precisely the nonconsensual majoritarian debt restructuring that occurred here."[5]

Second Circuit Overturns

On a 2-1 vote, the Second Circuit's majority opinion concluded that "[a]bsent changes to the Indenture's core payment terms…Marblegate cannot invoke Section 316(b) to retain an 'absolute and unconditional' right to payment of its notes" and held that the restructuring transaction did not "prevent any dissenting bondholders from initiating suit to collect payments due on the dates specified by the Indenture." EDM argued that the restructuring transactions did not violate the TIA because they did not amend the payment terms of the indenture. The Second Circuit's decision significantly narrowed the scope of the district court's Section 316(b) interpretation and held that Section 316(b) of the TIA only prohibits "non-consensual amendments to an indenture's core payment terms."

Although the Second Circuit panel agreed with the district court that the text of Section 316(b) is ambiguous and open to various interpretations, its review of the legislative history of the TIA led to the conclusion that Section 316(b) should be interpreted to preclude modifications of core indenture terms without the approval of all bondholders.

Additional Clarity from *Cliffs*

In the wake of the district court decision in *Marblegate*, minority debt holders in distressed companies seemed emboldened to challenge exchange offers, as in the case of *Waxman* v. *Cliffs Natural Resources*

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[5] *Marblegate Asset Management LLC* v. *Education Management Corp.*, 111 F. Supp. 3d 542, 554 (S.D.N.Y. 2015).

Inc.[6] However, Judge Sweet's decision in Cliffs, which he rendered a few weeks prior to the Second Circuit's ruling on *Marblegate*, departed from the district court's broad interpretation of the TIA in *Marblegate* and helped clarify to investors and companies how to restructure corporate debt outside of the bankruptcy process.

In *Cliffs*, noteholders filed a complaint in a class action suit claiming the defendant, a publicly traded company with $2.898 billion of funded debt, violated the TIA when it carried out a restructuring transaction that only allowed a select group of noteholders to exchange six of the company's seven types of unsecured notes for new "1.5 Lien" secured notes, denying certain noteholders an opportunity to participate. The only holders eligible to participate in the exchange offer were qualified institutional buyers and non-U.S. persons. The plaintiffs did not fall within these categories and were thus ineligible to participate in the exchange offer. They alleged in their complaint that by issuing the 1.5 Lien notes, which were senior to the unsecured notes they held, the company created two classes of notes with disparate rights and "impaired Class members' right to receive payment of the principal and interest under the Class Notes and the right to institute suit to compel such payment,"[7] in violation of Section 316(b) of the TIA.

The district court granted Cliffs' motion to dismiss all claims and concluded that the exchange offer did not violate Section 316(b) of the TIA. The district court apparently was not persuaded by arguments that the exchange improperly favored qualified institutional buyers and non-U.S. persons over others.

Key Takeaways

Together, the district court's decision in Cliffs and the Marblegate appellate decision provide guidance on out-of-court debt restructurings and the assurance to restructuring participants that exchange offers remain a workable option for distressed companies seeking to avoid bankruptcy.[8] While future challenges could look to expand the concept

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[6] *Waxman* v. *Cliffs Natural Resources Inc.*, No. 16 CIV 1899 (S.D.N.Y. filed Dec. 6, 2016).
[7] Complaint at 3, *Cliffs.*
[8] For the time being, the *Marblegate* appeal decision likewise appears to call into question the viability of the district court's ruling in *MehanCombs Global Credit Opportunities Funds, LP* v. *Caesars*

of "core payment terms," for now, the recent Second Circuit decision in Marblegate appears to have interpreted the TIA more narrowly than prior decisions and provides significant latitude in restructuring corporate debt burdens. In addition, Cliffs suggests that, absent indenture terms to the contrary or breaches of other covenants, exchange offers open to only certain groups of debt holders, such as qualified institutional buyers, should not amount to violations of Section 316(b).

The plaintiffs in Marblegate can still petition for a rehearing before the full Second Circuit and then attempt to appeal before the United States Supreme Court. We will be monitoring developments in these cases closely. For more information, please contact the Olshan attorney with whom you work regularly or one of the Olshan attorneys listed below.

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Entm't Corp., 80 F. Supp. 3d 507 (S.D.N.Y. 2015) that an amendment to release parental guarantees required unanimous consent since it impaired bondholders' practical ability to recover payment. The district court in *Caesars* did not explicitly address "core payment terms", the concept that is now the relevant touchstone to challenge bond restructurings pursuant to Section 316(b) of the TIA.