Lend at your own risk: Lessons from the 2nd Circuit's *Marblegate* decision

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In January 2017 the 2nd U.S. Circuit Court of Appeals issued an opinion in *Marblegate Asset Management LLC v. Education Management Finance Corp.*,[1] finding that Section 316(b) of the Trust Indenture Act of 1939, which prohibits a borrower from "impairing" or "affecting" the rights of a nonconsenting holder of an indenture security, did not prohibit Education Management Corp. from restructuring outside of bankruptcy and without the consent of a group of its unsecured noteholders.

In so ruling, the 2nd Circuit vacated the decision of the U.S. District Court for the Southern District of New York and remanded the case for further proceedings consistent with its opinion. The decision has important implications for the rights of issuers, bondholders and indenture trustees who seek to restructure their debts outside of the bankruptcy court.

BACKGROUND

Education Management Corp., or EDMC, is a for-profit higher education company that relies heavily on federal funding through the Higher Education Act of 1965. Were EDMC to file for bankruptcy, it would forfeit its eligibility for federal funding.

Accordingly, in the face of deteriorating finances, EDMC's subsidiaries Education Management LLC and Education Management Finance Corp. sought to restructure their debt outside of bankruptcy.

At the time, the entities had $1.3 billion in secured debt and $217 million in unsecured notes issued by EDM and governed by a TIA qualified indenture. The notes were guaranteed by EDMC, but the guarantee on the notes could be released without the noteholders' consent if EDMC's secured creditors released any later-issued EDMC guarantee.

> The 2nd Circuit's ruling in *Marblegate* has the potential to affect the rights and strategies of issuers, bondholders and indenture trustees who seek to restructure their obligations.

The noteholders received full disclosure of the fact that the guarantee was effectively worthless prior to purchasing the notes.

In light of the fact that it was effectively unable to file for bankruptcy, EDMC negotiated a restructuring transaction, referred to as the intercompany sale, with the majority of its secured lenders and noteholders.

The sale required EDMC's secured lenders and noteholders to decide between two potential treatments. The second option forms the basis of this lawsuit.

As explained by the 2nd Circuit:

> The second option would arise only if one or more creditors refused to consent [to the first restructuring option]. Under that circumstance, a number of events would occur that together constituted the "intercompany sale." Secured creditors consenting to the intercompany sale would first exercise their pre-existing rights under the 2014 credit agreement and Article 9 of the Uniform Commercial Code to foreclose on EDMC's assets. In addition, the secured creditors would release EDMC from [a guarantee granted after the noteholders' guarantee]. That release in turn would effect a release of the [noteholders' guarantee] under the indenture. With the consent of the secured creditors (but without needing the consent of the unsecured creditors), the collateral agent would then sell the foreclosed assets to a subsidiary of EDMC newly constituted for purposes of the intercompany sale. Finally, the new EDMC subsidiary would distribute debt and equity only to consenting creditors and continue the business.

The intercompany sale was "structured to incentivize creditors to consent," since nonconsenting secured creditors would receive junior interests in the new subsidiary while nonconsenting unsecured creditors would be entirely out of the money.[2] Specifically:

> While nonconsenting secured creditors would still receive debt in the new EDMC subsidiary, that debt would be junior to the debt of consenting secured creditors. Nonconsenting noteholders would not receive anything from the new company: Though not a single term of the indenture was altered and noteholders therefore retained a contractual right to collect payments due under the notes, the foreclosure would transform [EDM and EDM

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> Finance] into an empty shell. In offering to exchange the notes for equity in the new EDMC subsidiary, therefore, EDMC … explicitly warned noteholders that they would not receive payment if they did not consent to the intercompany sale.[3]

Although the intercompany sale did not formally amend the terms of the unsecured notes, in effect it precluded nonconsenting unsecured creditors from receiving payments thereunder.

All of EDMC's creditors, save noteholders Marblegate Asset Management LLC and Marblegate Special Opportunity Master Fund LP, consented to the intercompany sale.

PROCEDURAL HISTORY AND ARGUMENTS

Prior to the consummation of the intercompany sale, Marblegate filed an action in the Southern District of New York seeking declaratory, monetary and injunctive relief. Marblegate's request for a preliminary injunction was denied, and the intercompany sale was largely consummated, although EDMC refrained from releasing the noteholders' guarantee in spite of the fact that the secured lenders had released their later-issued guarantee.[4]

In its complaint, Marblegate alleged the intercompany sale violated Section 316 of the TIA, which prohibits a borrower from impairing a noteholder's right to payment, because, in effect, it prevented the Marblegate entities from collecting on their notes.

Section 316(b) provides, in relevant 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."

In response to Marblegate's claims, EDMC argued that the intercompany sale did not violate Section 316 because it did not formally alter the payment terms of the indenture that governed the notes.

Although the District Court found that Section 316 of the TIA was "ambiguous," it adopted a broad reading of Section 316(b) of the TIA in order to protect the rights of nonconsenting unsecured noteholders.

It stated that "the purpose of the [TIA], as expressed consistently throughout the legislative history, was to prevent precisely the nonconsensual majoritarian debt restructuring that occurred here, even if the act's authors did not anticipate precisely the mechanisms through which such a restructuring might occur."[5]

Accordingly, it found that the intercompany sale violated Section 316 of the TIA and directed EDMC to continue to guarantee Marblegate's notes and pay them in full, with interest.

THE 2ND CIRCUIT'S HOLDING

In a 2-1 decision, the 2nd Circuit agreed with the District Court that Section 316 of the TIA was ambiguous; however, it found that "the relevant portions of the TIA's legislative history exclusively addressed *formal* amendments and indenture provisions like collective-action and no-action clauses."[6]

It stated that Section 316 prohibits a lender from nonconsensually amending an indenture's core payment terms but found that because the intercompany sale did not change the core terms of the bonds, it did not violate the TIA, despite the fact that it allowed EDMC to consummate a transaction that effectively eliminated Marblegate's right to payment.

It held that "absent changes to the [notes'] core payment terms … Marblegate cannot invoke Section 316(b) to retain an 'absolute and unconditional' right to payment of its notes."

The court did not opine as to when a formal modification would "impair" or "affect" the rights of a nonconsenting bondholder.

The court noted that Marblegate remained free to exercise its state and federal law remedies to enforce its right to payment of principal and interest pursuant to the original notes.

On March 21 the 2nd Circuit denied Marblegate's request for en banc reconsideration of its decision.

THE RAMIFICATIONS OF *MARBLEGATE*

Marblegate's significance will be limited due to the fact that, unlike EDMC, most borrowers with an unsustainable debt burden have the option to file for bankruptcy.

Moreover, the 2nd Circuit did not elaborate as to when a formal change to an indenture's terms would "impair" or "affect" the rights of a nonconsenting bondholder.

Nevertheless, the 2nd Circuit's ruling has the potential to affect the rights and strategies of issuers, bondholders and indenture trustees who seek to restructure their obligations.

Although bankruptcy remains a viable option for most debtors and affords an array of protections, including the ability to seek court approval of settlement agreements, bankruptcy comes with an array of statutory shackles, not to mention costs, that consensual transactions avoid.

The *Marblegate* decision protects the ability of borrowers to elect to restructure out of court without the fear that their transactions will be unwound by the courts.

Furthermore, for entities seeking to restructure out of court, *Marblegate* limits the ability of minority holdouts to extract additional concessions in exchange for their consent and thereby limits harm to both borrowers and consenting parties.

By the same token, *Marblegate* reduces the risk that lenders will be reluctant to negotiate with struggling borrowers out of fear that a nonconsenting party will swoop in at the last moment and be rewarded with more favorable terms.

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In light of *Marblegate*, practitioners are advised to take care in drafting trust indentures and to specifically delineate what rights are available to borrowers and lenders. In particular, parties should articulate what rights exist with respect to formal modifications to the terms of the indentures and what rights exist with respect to payment.

In sum, *Marblegate* protects an alternative avenue through which parties may restructure their obligations. We expect to see its effects resound throughout the 2nd Circuit as practitioners articulate new indenture terms to comply with (and, inevitably, attempt to extend) *Marblegate*'s holding. WJ

NOTES

1 846 F.3d 1 (2d Cir. 2017).

2 *Id.*

3 *Id.*

4 *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 75 F. Supp. 3d 592 (S.D.N.Y. 2014).

5 *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 111 F. Supp. 3d 542, 554 (S.D.N.Y. 2015).

6 *Marblegate,* 846 F.3d at 9 (emphasis in original).

NOTICE

High court lets stand decision that allowed ignition switch plaintiffs to sue 'new GM'

By Donna Higgins

The U.S. Supreme Court will not review a federal appeals court ruling that said certain owners of General Motors vehicles with defective ignition switches can sue the "new GM" that emerged from the automaker's Chapter 11 bankruptcy.

General Motors et al. v. Elliott et al., No. 16-764, cert. denied (U.S. Apr. 24, 2017).

In its petition for review, new GM argued that the 2nd U.S. Circuit Court of Appeals impermissibly required it to provide the ignition switch plaintiffs with more notice than is required under Section 363 of the Bankruptcy Code, 11 U.S.C.A. § 363, the provision that governed the sale of the old GM's assets to create the new GM.

Elliott v. Gen. Motors LLC (In re Motors Liquidation Co.), 829 F.3d 135 (2d Cir. 2016).

The appeals court allowed plaintiffs who had claims on or before July 10, 2009, to sue the new GM that emerged from the Chapter 11 process. The sale that created new GM took effect on that date.

As a matter of due process, these plaintiffs were entitled to direct notice of the sale, which allowed the new GM to buy old GM "free and clear" of successor liability for claims arising from old GM's actions, the appeals court said. Instead, the plaintiffs received only notice by publication, so they did not have the opportunity to object to the sale, according to the opinion.

> "Petitioner's plea that it thinks its case is really important echoes the hyperventilating claims of innumerable denied petitions that involve the routine application of settled law to large dollar amounts," a group of plaintiffs seeking to sue "new GM" says.

"Requiring a debtor, amidst the urgency of an emergency asset sale, to issue notices that identify every potential claim that might someday be brought against it would cause untold delay and defeat Section 363's core objective of facilitating expeditious sales at prices that will provide the greatest benefit to creditors," the company said.

In a ruling last summer, the 2nd Circuit said GM knew or should have known about defective ignition switches in its vehicles before the company filed for bankruptcy.

The appeals panel said the ignition switch claimants should be allowed to sue new GM because they were prejudiced by the lack of direct notice.

The decision reversed a ruling by the U.S. Bankruptcy Court for the Southern District of New York. *In re Motors Liquidation Corp.*, 529 B.R. 510 (Bankr. S.D.N.Y. Apr. 15, 2015).

REUTERS/John Gress

New GM argued the 2nd Circuit impermissibly required it to provide the plaintiffs claiming their ignition switches were defective with more notice than is required under the Bankruptcy Code. One of the recalled switches is shown here.

In its certiorari petition, new GM argued that the 2nd Circuit's decision wrongly penalized the new GM for any alleged notice deficiencies by the old GM.

"Even if the 2nd Circuit were correct that Old GM failed to comply with its due process obligations, nothing in bankruptcy law, the Constitution, or common sense supports the court's decision to remedy the seller's mistake by punishing the good-faith purchaser," GM says. "In fact, Section 363(m) expressly prohibits that result."

GM argued that the 2nd Circuit's decision "will vitiate the very provisions that make Section 363 sales viable."

