# SDNY Issues Novel Opinion Holding that Out-of-Court Restructurings May Violate Noteholder Rights Under the Trust Indenture Act

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In ***Marblegate Asset Management v. Education Management Corp.* (S.D.N.Y. 2014)**, the Southern District of New York found that a proposed out-of-court debt restructuring to the detriment of non-consenting creditors likely violated provisions of the Trust Indenture Act of 1939 (TIA), a Depression-era federal statute intended to protect rights to payment under a TIA-qualified indenture, which is a feature of any U.S. public offering of debt securities. Unlike earlier TIA cases, a critical element of the proposed restructuring here was explicitly permitted by the governing indenture, and no consent was required under the indenture. Nonetheless, the Court read the TIA to give creditors a substantive right to protection against out-of-court restructurings they did not consent to on an individual basis. This far-reaching conclusion, if followed by other courts, is likely to have important implications for restructurings. Companies have long relied upon out-of-court restructurings to keep them afloat during financial difficulties. The potential for a minority creditor to call into question this ability, especially in light of provisions it knowingly agreed to at the time the debt securities were purchased, could have serious consequences.

## Background

Education Management's[1] debt consisted of (i) $1.3 billion in secured debt consisting of a revolving credit facility and term loans and (ii) $217 million in unsecured notes. The secured debt was secured by collateral consisting of substantially all of the assets of Education Management's parent company and its subsidiaries. The unsecured notes, partially held by the plaintiffs, were guaranteed by the parent company, although at the time of issuance of the unsecured notes the secured debt was not guaranteed by the parent company. As the offering memorandum for the unsecured notes stated, the parent guarantee was not meant to provide any value to creditors, and was in place solely to satisfy reporting requirements by furnishing financial information of the parent company (which was a public company) rather than the issuer, Education Management. The TIA-qualified indenture governing the unsecured notes provided two methods to terminate the parent guarantee: (i) by the consent of a majority of noteholders or (ii) automatically, upon release of the parent guarantee of the secured debt by the lenders thereunder. Since the secured debt was not guaranteed by the parent at the time the unsecured notes were issued, the second prong of the release mechanism was, at first, only a theoretical possibility.

In May 2014, the company disclosed that it was facing financial difficulties and would soon be in non-compliance with certain financial covenants in its secured debt facility. Rather than file for bankruptcy — a course of action that would have been fatal for the company as it would render it ineligible for federal student loan funding — the company struck an agreement to amend the secured debt facility. As part of the amended facility, the parent company became a guarantor of the secured debt and as a result, the secured debtors now had the ability to extinguish the parent guarantee of the unsecured notes, through extinguishing the parent guarantee of the secured debt. Soon thereafter, the parent company negotiated

[1] References to Education Management throughout refer to Education Management LLC. References to the parent guarantor refer to Education Management Corp.

a longer-term restructuring plan aimed at salvaging its balance sheet. The plan offered two paths to the proposed restructuring. The first path, which would have required each creditor's consent and ultimately was unworkable as 100% consent was not obtained, would have resulted in a recovery of approximately 55% for the secured creditors and approximately 33% for the unsecured creditors. Under the second path, the proposed restructuring would be effected through an intercompany sale in which the secured creditors would (i) release the parent company guarantee of their loans and thereby extinguish the same on the unsecured notes, (ii) foreclose on substantially all of the debtors' assets and (iii) immediately sell those assets to a new subsidiary of the parent company, which would then distribute debt and equity to the consenting creditors. This second path was permitted under the plain language of the notes indenture and did not require noteholder consent thereunder (although consent was obtained out of caution). Objecting unsecured creditors would have received nothing under the second path, although the Court found that in a bankruptcy, unsecured creditors were likely to receive very little more than nothing. Plaintiffs, holding less than 10% of the unsecured notes did not consent to the restructuring plan (virtually all other holders consented) and therefore the parent company moved to implement the second path towards a restructuring. Plaintiffs filed for a preliminary injunction to bar the company from taking the second path.

## The Trust Indenture Act and Noteholder Rights

Under Section 316(b) of the TIA, "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, . . . shall not be impaired or affected without the consent of such holder[.]" Courts have interpreted this provision to require the unanimous consent of noteholders in order to effect any change to the payment terms of the indenture. However, in extreme situations, courts have recognized that amendments to certain other terms of the indenture can have the effect of taking away a holder's *ability* to receive principal, and have ruled that such amendments require unanimous consent as well. For example, in ***Federated Strategic Income Fund v. Mechala Group Jamaica Ltd.*** **(S.D.N.Y. 1999)**, the debtor company was seeking majority consent to eliminate restrictive covenants to permit it to transfer all of its assets to another entity, effectively leaving an empty shell behind. The Court held that, as a result, the effect of the amendments was to deprive holders of the right to receive payments, and required unanimous consent, notwithstanding the fact that the legal right to payment from the now empty shell issuer was still available. Earlier this month, the Court, relying in part on the *Education Management* decision, issued a similar decision, ***Meehancombs Global Credit Opportunities Funds, LP v. Caesars Entertainment Corp.*** **(S.D.N.Y. 2015)**, holding that a majority amendment to strip parent guarantees similarly deprived noteholders of their practical ability to recover payment, and thus required unanimity to avoid a violation of the TIA.

In contrast, other courts have held that actions permitted or required under the terms of an indenture, even if resulting in a loss of payments, do not violate the TIA. Most notably, in 1992, in ***UPIC & Co. v. Kinder-Care Learning Centers, Inc.*** **(S.D.N.Y. 1992)**, the Court held that subordination provisions that block payments of principal and interest on certain occasions did not impair noteholders' absolute and unconditional right to payment in violation of the TIA. In addition, two other courts have held that Section 316(b) of the TIA does not provide creditors a substantive right to payment. The court in ***In re Northwestern Corp.*** **(Bankr. D. Del. 2004)** held that a transfer permitted under the indenture that allegedly left a bankrupt debtor insolvent did not violate the TIA because Section 316(b) "applies to the holder's *legal* rights and not the holder's *practical* rights to the principal and interest itself" and that "there is no guarantee against default." The court in ***YRC Worldwide Inc. v. Deutsche Bank Trust Co. Americas*** **(D. Kan. 2010)** similarly limited application of Section 316(b) to "legal rights" to payment where a majority-approved amendment to the indenture would have permitted the issuer to merge or transfer substantially all of its assets to another entity without such entity assuming the obligations under the indenture. In that decision, unlike in *Mechala*, the issuer's credit was not shown to be threatened as no merger or transfer of assets was contemplated.

Here, plaintiffs brought an action seeking a preliminary injunction to block the proposed restructuring, urging an extension of the position adopted in *Mechala* that, "elimination of the guarantors and the simultaneous disposition of all meaningful assets . . . will effectively eliminate plaintiffs' ability to recover [payment] . . ." in violation of Section 316(b) of the TIA even though, in this case, this action was permitted by the indenture and was not the subject of any amendment to the indenture. Defendants offered three arguments against this, each of which were rejected.

- First, defendants argued that courts have restricted the protections of the TIA to "core terms," or those that affect a noteholder's right to receive payment of principal or interest on each stated due date. The Court did not dispute this but indicated that the question of whether the "right" created by the TIA is "substantive rather than formalist" remains open. Furthermore, if plaintiffs were correct that the right is substantive, the Court agreed that they were correct to consider the impact on such rights in the context of the overall transaction.
- Second, defendants argued that the TIA protects only those rights provided for in the indenture, and subject to limitations contained therein; since the indenture permitted the actions here and no vote was required, the TIA was not implicated. The Court disagreed, reasoning that the TIA would be rendered superfluous if it did not protect against ex ante limitations on the right to receive payment. Therefore, the TIA "must protect *some* rights against at least *some* ex ante constraints."
- Finally, defendants suggested that if plaintiffs' position were to be accepted, then noteholders would have license under the TIA to challenge any transaction contemplated by the debtor calling into question its ability to make payment or otherwise weakening its credit, even if such transaction is permitted by the indenture. In response, the Court looked to the TIA's legislative history, which it believed showed that the TIA was intended to force bond restructurings into bankruptcy in situations where unanimous consent is absent. As a result, the Court concluded: "Practical and formal modifications of indentures that do not explicitly alter a core term [impair or affect] a [noteholder's] right to receive payment [are] in violation of the [TIA] only when such modifications effect an involuntary debt restructuring." In other words, if a company is doing an out-of-court restructuring that involves substantive harm to noteholders' *ability* to receive payment if not their legal right to payment, *all* noteholders must approve, even if no vote is required under the indenture.[2] (The Court did decline to issue an injunction as the plaintiffs could not satisfy other required elements for this extraordinary relief.)

Effectively, the Court decided that the TIA is meant to impose substantive limitations on out-of-court restructurings that harm noteholders' ability to receive payment and not just their legal right to payment, even when permitted by the indenture such that no vote is required thereunder, unless all noteholders consent.

The TIA has been in effect for more than 75 years, and we are not aware of any precedent for reading Section 316(b) of the TIA to bar issuers from implementing actions permitted by the indenture that reduce the likelihood of payment of the notes without unanimous creditor consent. While Education Management's actions were certainly aggressive, the Court's view, if adopted by other courts, could have the effect of creating an overriding ability for any noteholder to block a restructuring — even when permitted by the indenture — leading to more bankruptcies. If followed to that conclusion, the opinion would be a potentially material and unwelcome change to the legal landscape.

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[2] The Court stated that its standard neither "contravene[s] . . . decisions that have allowed preexisting subordination terms to survive a challenge under Section 316(b)" nor "prevent[s] majority amendment of a significant range of indenture terms," such as changes to covenants proscribing dividend payments or the incurrence of new, senior debt, although it is not clear how this is true.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.


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