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A New Tool for Holdout Bondholders: The Trust Indenture Act

Restructuring decision broadly interpreting bondholder protections under the Trust Indenture Act may significantly impact out-of-court restructurings.

On December 30, 2014, the US District Court for the Southern District of New York issued an opinion in *Marblegate Asset Management v. Education Management Corp.* interpreting broadly the protections granted to bondholders under the Trust Indenture Act of 1939 (the Act).[1] Although ultimately denying the injunction sought by the plaintiff bondholders on other grounds, a substantial portion of the 47-page opinion analyzes Section 316(b) of the Act, taking the position that the Act was intended to prohibit companies from restructuring debt out-of-court as a means to eliminate certain material rights of non-consenting bondholders. Though set forth in dicta, this ruling has potentially significant implications for distressed companies and their creditors, particularly when chapter 11 is not an option.[2] This *Client Alert* provides a brief discussion of the *EDMC* opinion and the potential impact on restructurings.

Background

Education Management Corporation (EDMC), along with its subsidiaries Education Management LLC (EDM LLC) and Education Management Finance Corporation (together with EDM LLC, the Operating Subsidiaries, and collectively with EDMC and EDM LLC, the Company), is one of the country's largest for-profit providers of college and graduate education. The Company has outstanding debt of US$1.522 billion, consisting of US$1.305 billion in secured term and revolving credit facilities (the Secured Debt, and the lenders issuing such Secured Debt, the Secured Lenders) and US$217 million in unsecured notes (the Notes, and the holders of such Notes, the Noteholders). The Secured Debt and the Notes were each guaranteed by EDMC, the parent of EDM LLC (the Parent Guarantee). The Notes are governed by an indenture (the Indenture) and are qualified under the Act. Section 6.07 of the Indenture expressly incorporates the protections provided for in Section 316(b)[3] of the Act,[4] 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*" (emphasis added).

In May 2014, EDMC informed its creditors that it was experiencing significant financial distress and determined that a comprehensive and long-term restructuring of its balance sheet was essential. Because EDMC derives the majority of its net revenue from federal student aid programs available under Title IV of the Higher Education Act of 1965 (Title IV),[5] EDMC was keenly focused on effectuating that restructuring without availing itself of the protections afforded by filing for chapter 11.[6] Thus, EDMC commenced negotiations with its creditors, including its Secured Lenders and Noteholders. The negotiations resulted in a restructuring support agreement (RSA) memorializing a proposed out-of-court restructuring (the Proposed Restructuring), whereby a portion of the Company's debt would be converted into equity.

The RSA provided that, if the Company could not obtain unanimous creditor consent to the Proposed Restructuring, the parties thereto would be obligated to effectuate the restructuring through an intercompany sale transaction (the Intercompany Sale). Prior to the restructuring, EDMC and the Operating Subsidies held substantially all of the Company's assets. The Secured Debt and the Notes were each guaranteed by a Parent Guarantee, and the Secured Debt was further secured by a pledge of substantially all of the assets of EDMC and the Operating Subsidiaries. The Intercompany Sale was structured as follows: (i) the Parent Guarantee pledged to the Secured Lenders would be released, thereby triggering the simultaneous and automatic release of the Parent Guarantee provided to the Noteholders pursuant to the terms of the Indenture,[7] (ii) the Secured Lenders would exercise their rights under the term loan to foreclose on substantially all of the assets of EDMC and the Operating Subsidiaries and (iii) the Secured Lenders would then immediately sell those assets back to a new subsidiary of EDMC (Newco), which would distribute equity in Newco only to consenting creditors. Non-consenting Noteholders, on the other hand, would no longer have the benefit of the Parent Guarantee and would be left only with claims against the Operating Subsidiaries — neither of which would have any material assets or sources of recovery for its creditors due to the Intercompany Sale.

On October 1, 2014, 90 percent (approximately US$196.6 million) of the Noteholders and 99 percent (approximately US$1.292 billion) of the Secured Lenders consented to the RSA. Marblegate Asset Management, LLC, Marblegate Special Opportunities Master Fund, L.P. (together, Marblegate), Magnolia Road Capital LP, and Magnolia Road Global Credit Master Fund L.P. (together, Magnolia and, together with Marblegate, the Plaintiffs), the holders of approximately nine percent (approximately US$20.3 million) of the Notes, did not consent to the Proposed Restructuring. Moreover, the Plaintiffs filed a motion for a temporary restraining order and a preliminary injunction to block the Proposed Restructuring. The motion argued that the Company violated its duties under the Act and the Indenture by actively supporting the Intercompany Sale, which would leave the Plaintiffs with outstanding principal and interest payments on their Notes but no practical recourse for payment. The Plaintiffs asserted that the Company's agreement to support the Secured Lenders in exercising their rights to foreclose against the Company and release the Parent Guarantee "impaired or affected" their rights to receive payment or bring suit for the enforcement of such payment in violation of Section 316(b) of the Act. The Company argued, among other things, that the Indenture was not violated because the Noteholders retained the procedural right to sue, though the Company did expressly acknowledge that because the Operating Subsidiaries no longer had any assets, the Noteholders were unlikely to receive any recovery on account of the Notes. Moreover, the Company asserted that the explicit terms of the Indenture did not prohibit the proposed transactions.

Decision

The court framed the issue as "essentially boiling down to a dispute over the scope of the protections afforded by the Trust Indenture Act: is it a broad protection against nonconsensual debt restructurings, or a narrow protection against majority amendment of certain 'core terms'?" In addressing this question, the court acknowledged prior court decisions holding that Section 316(b) guarantees a noteholder's *procedural* right to commence an action for nonpayment, but not its *practical* rights to the principal and interest itself. However, the court ultimately made the opposite conclusion — that the Act "protects the *ability*, and not merely the formal right, to receive payment in some circumstances."

The court pointed to the legislative history of Section 316(b), which provides that "evasion of judicial scrutiny of the fairness of debt-readjustment plans is prevented by this prohibition...this prohibition does not prevent the majority from binding dissenters by other changes in the indenture or by a waiver of other defaults."[8] Relying on the legislative history, as well as the opinions of other courts and commentators, the court ultimately concluded that "Section 316(b) was intended to force bond restructurings into bankruptcy where unanimous consent could not be obtained." However, the court was careful to address the inevitable concern that this interpretation of the Act would lead to unnecessary judicial intrusion into business decisions, stating that "practical and formal modifications of indentures that do not explicitly alter a core term will only 'impair or affect' a bondholder's right to receive payment in violation of the Trust Indenture Act when such modifications effect an involuntary debt restructuring."

Based on the foregoing, the court found that the Intercompany Sale is exactly the type of debt reorganization that the Act prohibits because the sale left the non-consenting Noteholders without a source of recovery or prospect of recovery. Although acknowledging that the findings regarding Plaintiffs' right to full payment may cause disruptions to the Proposed Restructuring, the court found that "the Trust Indenture Act simply does not allow the company to precipitate a debt reorganization outside the bankruptcy process to effectively eliminate the rights of non-consenting bondholders."[9]

Notwithstanding the above, the court denied the Plaintiffs' motion for a preliminary injunction on the grounds that the Plaintiffs failed to demonstrate a likelihood of irreparable harm because the Plaintiffs could potentially recover monetary damages under various legal principles. Given the Plaintiffs' right to recover monetary damages against the Notes' issuer and its affiliates, as well as the relatively small size of the Plaintiffs' claims compared to the size of the overall debt, the court also found that the balance of the equities and the public interest weighed against granting the motion.

Implications

Although the court's interpretation of the Act is mostly dicta,[10] the potential implications are significant. By finding that Section 316(b) protects a bondholder's ability to sue in the practical sense, and not just the procedural right to sue, the court may have given minority bondholders significant leverage in future negotiations with companies and secured lenders. Many may argue that any material modification of their rights violates the Act because the modification impairs or affects their ultimate right to payment. Ultimately, the decision may result in more distressed issuers resorting to chapter 11 to effectuate their restructurings and could significantly increase costs as litigation becomes more prevalent. Moreover, those issuers who are effectively prohibited from filing for relief under chapter 11 — by virtue of their reliance on federal funding or otherwise — may be precluded from altering the repayment terms of their bond debt altogether. At a minimum, issuers have yet another reason to avoid issuing notes in registered securities offerings (or granting registration rights) that would cause their notes to be subject to the Act.

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Endnotes

1 15 U.S.C. §§ 77aaa-77bbbb.

2 As discussed more fully in the client alert, various companies are either not permitted, or are practically prohibited, from filing for chapter 11, including Native American tribes and regulated education providers (due to their reliance on federal funding). In addition, chapter 11 may not be a practical option for other companies for various business reasons.

3 Section 316(b) of the Act provides in relevant part:

Notwithstanding any other provision of the indenture to be qualified, 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[.] 15 U.S.C. § 77ppp(b).

4 15 U.S.C. § 77ppp(b).

5 20 U.S.C. §§ 1070-1099.

6 Under Title IV, EDMC would lose its eligibility to receive Title IV funds if it, or any controlling affiliate, filed for bankruptcy. *See* 20 U.S.C. § 1002(a)(4)(A); Conditions of Institutional Eligibility, 34 C.F.R. § 600.7(a)(2). Section 362(b)(16) of the Bankruptcy Code expressly provides that the automatic stay does not apply to actions affecting the eligibility of the debtor to participate in programs authorized by Title IV. 11 U.S.C. § 362(b)(16). As a general matter, for-profit education businesses cannot operate without access to Title IV funds.

7 Section 10.06(a)(ii) of the Indenture provided that the Parent Guarantee of the Notes would be automatically released upon the release of the corresponding Parent Guarantee of the Secured Debt.

8 H.R. Rep. 76-1016, at 56 (1939); S. Rep. No. 76-248, at 26-27 (1939).

9 Whether the court's broad interpretation of Section 316(b) will affect a more typical out-of-court transaction, such as an issuer's incurrence of additional debt that moves the bondholders down the chain of priority, remains to be seen.

10 Although set forth in dicta, the court specifically states that its analysis of the Act was made "in the hopes of providing clarity for subsequent litigation in this and other cases." Indeed, in a recent decision out of the Southern District of New York, the court relied upon Judge Katherine Polk Failla's reasoning when holding that the non-consensual release of a guarantee violated Section 316(b) of the Act. *Meehancombs Global Credit Opportunities Funds, LP, Relative Value-Long-Short Debt v. Caesars Entertainment Corp.*, Case No. 14-cv-7091 (S.D.N.Y. Jan. 15, 2015). Latham & Watkins represents certain parties involved in the Caesar's restructuring and, therefore, this ruling is not addressed in detail in this article.