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Potential Continuing Impact of the *Marblegate* Saga

By Eric Sibbitt and Paul Porter*

The authors of this article discuss a decision by the U.S. Court of Appeals for the Second Circuit, vacating prior rulings in the Marblegate *dispute, which has restored a degree of certainty around the effectiveness of out-of-court restructuring negotiations.*

The decision by the U.S. Court of Appeals for the Second Circuit, in a 2-1 ruling,[1] to vacate the rulings by the District Court of the Southern District of New York in the *Marblegate* dispute reopens the traditional flexibility that companies have had for consent solicitations as part of liability management transactions, although some uncertainty may continue to persist.

BACKGROUND

Prior to the district court's decisions, practitioners had generally assumed that an involuntary debt restructuring that *substantively* deprived bondholders of payments while not *legally* depriving them of payments would not violate the Trust Indenture Act of 1939 ("TIA"). This could happen, for example, if, in connection with an out-of-court restructuring, a majority of bondholders voted under the indenture to release a parent guarantee, leaving no source of funds for further bond payments on the remaining bonds. The district court's holdings, however, could be interpreted to mean that such an amendment would be prohibited under Section 316(b) of the TIA, as the district court held that substantively depriving bondholders of payments violates Section 316(b). Section 316(b) provides 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

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[1] *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, No. 15-2124, Doc. 195 (2d Cir. Jan. 17, 2017), *vacating* 75 F. Supp. 3d 592 (S.D.N.Y. 2014), and 111 F. Supp. 3d 542 (S.D.N.Y. 2015).

> 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*. . . .[2]

The effect of these decisions was to limit the scope of restructuring options issuers could legally take under the TIA, thereby handing additional leverage to holdouts in an out-of-court debt restructuring.

REVERSAL OF THE DISTRICT COURT DECISIONS

The 2-1 ruling by the Second Circuit held that Section 316(b) of the TIA prohibits non-consensual amendments only to core payment terms (i.e., amount of principal and interest owed, and the maturity date), based primarily on a review of legislative history (interpreting that history differently than the district court). The Second Circuit also reasoned that, even under its interpretation of the TIA, non-consenting bondholders were still afforded remedies to preserve their legal right to receive payment because they could still sue for payments as they come due under state and federal law. The Second Circuit also articulated that the district court's broad reading of Section 316(b) to include the protection of the practical ability to collect payment would cause interpretive problems that turned on the subjective intent of the issuer and/or the majority bondholders.

IMPLICATIONS FOR RESTRUCTURING OPTIONS

The reversal suggests that companies may pursue traditional restructuring options that adversely affect holdouts in consensual restructurings, such as exchange offers, but continued caution may be advisable.

Although the Second Circuit denied Marblegate—the plaintiff bondholder under the original case—an *en banc* review, Marblegate could potentially seek to have the decision ultimately reviewed by the U.S. Supreme Court. The legal landscape, therefore, may continue to change.

A reversal in whole or in part by the Supreme Court may make it very difficult for advisors to provide the necessary legal certainty in connection with out-of-court debt restructurings. This would be a significant issue because in recent years there has been a trend toward out-of-court restructurings as parties seek to avoid the expense of a Chapter 11 case. Generally, a bond trustee will not take any action under an indenture unless the trustee receives an opinion of counsel that the action is permitted under the four corners of the indenture;

[2] Emphasis added.

and when an indenture is qualified under the TIA, such an opinion impliedly states that the action is permitted under the TIA as well. In some cases, trustees have demanded that these opinions explicitly state compliance with the TIA. As a result, lawyers would hesitate to give this opinion in out-of-court restructurings where the right of bondholders to receive payment was substantively impaired. In addition, as reflected in the Second Circuit's opinion, the district court's broad reading of Section 316(b) would create interpretive problems for advisors. The inability to be able to provide the required opinions to trustees in out-of-court restructurings could lead to an increase in Chapter 11 restructurings.[3]

Another potential implication if the district court decisions were reinstated would be that exchange offers under Section 3(a)(9) of the Securities Act involving the issuance of new debt securities in exchange for existing securities could become less attractive. In circumstances where the conditions of Section 3(a)(9) are met (including the absence of payment of an advisor for solicitation), 3(a)(9) can be attractive because existing bondholders can receive unrestricted securities and all bondholders (including non-accredited investors) can freely participate in the exchange. However, the requirement that the indenture in a 3(a)(9) exchange be qualified under the TIA could be problematic for the same reasons described above. As a result, more issuers may be forced to conduct exchange offers as private placements limited to accredited investors or to resort to Chapter 11.

CONCLUSION

Although the Second Circuit's decision has restored a degree of certainty around the effectiveness of out-of-court restructuring negotiations, the potential for review by the Supreme Court warrants caution for the reasons described above.

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[3] In the *Marblegate* case, the issuer of the bonds was a for-profit educational provider that depended on federal student aid programs for its business, making a bankruptcy filing impossible because it would cut off its access to those programs.