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The US Trust Indenture Act, Out of Court Restructurings and the Marblegate Decision

Given the substantial amount of capital invested in Canadian businesses by American investors a considerable number of trust indenture documents are governed by US law and are "qualified" under the *Trust Indenture Act* of 1939 (the "**TIA**"). Accordingly, in many cases restructuring professionals of a Canadian debtor company with publicly held debt must understand the implications of the TIA, in particular, section 316(b) of the TIA, which provides that the right of a bond holder under an indenture to receive payment of principal or interest shall not be impaired without the consent of such holder. This provision of the TIA, if strictly applied, could materially restrict an issuer's ability to restructure its public debt outside of a formal court supervised insolvency proceeding. The back and forth judicial interpretation of section 316(b) of the TIA by the US courts has evoked uncertainty regarding the application of section 316(b), with the latest state of the law resting in the Second Circuit Court's decision in *Marblegate v. Education Management*.[1]

Background of *Marblegate*

In *Marblegate*, Education Management Corp. ("**EDMC**") sought to restructure over $1.5 billion of its debt in an out of court restructuring.[2] As a for-profit education company, EDMC wanted to

[1] *Marblegate Asset Management v Education Management Finance Corp.*, No 15-2124 (2d Cir 2017) [*Appeal Marblegate*].

[2] *Marblegate Asset Management v Education Management Finance Corp.*, No 14 Civ 8584 (Dist. Court, SD New York) at pg 544-545 [*District Marblegate*].

avoid filing for bankruptcy as a filing would preclude it from receiving future federal funding. As a result, EDMC wished to negotiate an agreement with a group of its largest creditors to carry out the restructuring.

The outstanding debt consisted of $1.305 billion in secured debt and $217 million in unsecured notes. This case focused on the $217 million in unsecured notes that were issued by a subsidiary of EDMC, Education Management LLC. and guaranteed by EDMC. The terms of EDMC's guarantee for the unsecured notes allowed the guarantee to be released by: (1) a majority vote of the unsecured note holders; or (2) a corresponding release of the separate parent guarantee that was granted in favor of the secured lenders.[3]

In connection with the proposed out of court restructuring, a restructuring agreement with EDMC contemplated that the secured notes would recover roughly 55% and the unsecured notes would recover roughly 33% through a combination of debt and new equity.

The proposed agreement anticipated 100 percent participation by the creditors.[4] However, the restructuring agreement contained a provision that if 100 percent of the creditors did not consent to the restructuring then an "alternative transaction" intercompany sale would be implemented providing for: (i) a foreclosure of the assets by the secured lenders thereby triggering the release of the guarantee in favour of the noteholders; (ii) a sale by the secured lenders of the assets to a new subsidiary of EDMC; and (iii) debt and equity of this new subsidiary would be distributed to the creditors who had consented to the restructuring agreement. This alternative transaction, while not formally altering a creditor's rights under the TIA, was designed to ensure that there would be no payment to unsecured bondholders who did not vote in favour of the restructuring agreement.[5]

[3] *District Marblegate* at pg 545

[4] *District Marblegate* at pg 545

[5] *District Marblegate* at pg 545

Marblegate, which held roughly $14 million of unsecured debt, declined to participate in the proposed agreement and attempted to halt the intercompany sale via a court ordered injunction.[6] The Court denied the motion, but found that Marblegate would likely succeed on the merits of its claim. Subsequently, the parties moved forward with the intercompany sale with a few adjustments designed to protect Marblegate's rights in the event the court issued a final ruling in its favor.

The District Court Decision

In the decision by the District Court, the Court framed the legal questions with respect to the proposed restructuring as follows:

> Does a debt restructuring violate Section 316(b) of the Trust Indenture Act when it does not modify any indenture term explicitly governing the right to receive interest or principal on a certain date, yet leaves bondholders no choice but to accept a modification of the terms of their bonds?[7]

The Court answered this question in the affirmative. In coming to this decision, the Court held that the purpose of Section 316(b) of the TIA was to protect non-consenting minority bondholders from being forced to accept a reduced claim, which was happening to the bondholders in *Marblegate*. The Court highlighted that "there is little question that the Intercompany Sale or foreclosure is precisely the type of debt reorganization that the Trust Indenture Act is designed to preclude."[8]

To the District Court, Section 316(b) of the TIA protected the substantive right of a bondholder to recover payment, particularly in the context of out of an court debt restructuring rather than protecting solely against technical amendments to the indenture altering payment terms. Accordingly, the effect of the District Court's decision in *Marblegate* was that debt restructurings which did not

[6] *District Marblegate* at pg 546

[7] *District Marblegate* at pg 547

[8] *District Marblegate* at pg 557

have unanimous consent may violate the TIA if they have the effect of impairing a bondholder's right to receive payment, even though they leave that right formally intact in the indenture.

The Appeal Decision

On appeal, the Second Circuit Court of Appeals reversed the controversial District Court decision in *Marblegate*.[9] The Second Circuit disagreed with the District Court's interpretation of the TIA and held that Section 316(b) prohibits only technical non-consensual amendments to the payment terms of an indenture rather than a prohibition of non-consensual out of court restructurings. In coming to its decision, the Court noted that the use of foreclosures and other out of court restructurings were widely used at the time the TIA was drafted and that the history of the TIA, and of Section 316(b) in particular, shows that the TIA does not prohibit foreclosures or out of court restructurings even when they affect a bondholder's ability to receive full payment. The Second Circuit Court ultimately held that "absent 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."[10] Minority bondholders who are dissatisfied however are not without recourse and can bring lawsuits against the operating companies or against newco under fraudulent conveyance or successor liability.

Implications

In Canada, debtor companies often look to restructure their debt under the arrangement proceedings of the Canadian Business Corporations Act ("**CBCA**"). For Canadian companies whose bond indentures are governed by the TIA, the *Marblegate* Second Circuit decision may bring greater flexibility to a company conducting non-consensual out of court restructurings notwithstanding the fact that such restructurings may have the effect of negatively impacting payment terms of principal and interest.

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[9] *Appeal Marblegate, supra* note 1.

[10] *Appeal Marblegate* at pg 17.

However, it should be noted that that other US circuits may not adopt the same interpretation of the TIA as the Second District. Additionally, the Marblegate decision is based on a unique set of facts where the reorganization contemplated a foreclosure of the assets by the secured creditor. On alternative facts where there is no foreclosure and the bondholders are taking a reduction of principal and interest, the resulting decision could very well be different. If this were to occur, there may be a risk for Canadian debtors subject to the TIA, that an arrangement under the CBCA which has the effect of reducing a bond holder's claim would require unanimous consent of the bond holders notwithstanding that there is no specific voting approval threshold in the CBCA to approve such arrangements. A common trend of Canadian professionals to deal with this risk is for a debtor company to file for chapter 15 recognition of the CBCA proceedings as a means to protect the US trustee and to establish an exception to the requirements of the TIA to have unanimous consent. Accordingly, we may continue to see Canadian debtors in a CBCA proceeding filing for recognition proceedings under Chapter 15 in order to reduce the risk of being subject to the parameters of the TIA. The trajectory of the *Marblegate* case reminds us all that US judicial interpretation of the TIA and of indentures governed by United States law can have significant consequences for Canadian debtors who are subject to the TIA and wish to restructure.

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