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U.S. Court of Appeals Issues Important Decision for Bond Market

In a well-reasoned decision, the Second Circuit yesterday resolved an issue that has caused significant uncertainty for out-of-court debt restructurings and, as a result, for the corporate debt market as a whole. Under the Trust Indenture Act (TIA), bond indentures include a provision stating that the “right . . . to receive payment” cannot be “impaired” without a bondholder’s consent. For decades, issuers and bondholders have assumed that this provision permits corporate actions that do not alter any contract rights, even if they have the “practical” effect of limiting bondholder recoveries. But in a series of district court decisions beginning in late 2014, that basic premise was called into question.

Yesterday’s decision in Marblegate Asset Management, LLC v. Education Management Corp., reinstates the traditional understanding of the TIA. It holds that the TIA only prohibits non-consensual amendments to an indenture’s “core payment terms.”

Marblegate involved transactions undertaken by Education Management, an education company that faced significant financial difficulties, but could not file for bankruptcy without losing key funding sources. Secured lenders agreed to exchange much of their debt for equity. Unsecured noteholders were offered two options: they too could exchange their debt for equity, or they could retain their notes. If any noteholders chose the latter option, however, secured lenders would exercise their contractual rights to foreclose upon the issuers’ assets and release a guarantee of the notes by the issuers’ parent company.

Marblegate argued, and the district court agreed, that the transactions, by virtue of their practical effect, would violate the TIA’s provision relating to a noteholder’s right to receive payment. Based on a thorough analysis of the statute’s history and purpose, the Second Circuit rejected this position, holding instead that the TIA only prohibits transactions that “formally amend” the indenture’s “core payment terms” (such as the amount owed and maturity dates).

The Marblegate decision restores much-needed certainty to issuers and creditors in developing out-of-court solutions to distressed situations. As a result, it is a welcome development for the corporate debt market.

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