

January 24, 2017

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Litigation & Arbitration Group Client Alert: Milbank Prevails in Second Circuit Appeal with Significant Implications for Corporate Debt Market

The Second Circuit's decision in the *Marblegate* case restores certainty to issuers and creditors and stability to the corporate debt market.

Milbank, Tweed, Hadley & McCloy LLP has achieved a significant victory before the United States Court of Appeals for the Second Circuit in a case that has attracted widespread attention in the financial markets. The decision restores much-needed certainty regarding the permissibility of out-of-court debt restructurings, and brings stability to the corporate debt market as a whole. The case has been closely watched by investors and other market participants for over two years.

The Second Circuit's decision vacates the district court's decision in *Marblegate Asset Management, LLC v. Education Management Finance Corp.* The district court held that an out-of-court debt restructuring would, if implemented, violate the Trust Indenture Act (TIA).

At issue was a transaction undertaken by Education Management Corporation and its affiliates, with the support of an overwhelming majority of their secured and unsecured creditors, that reduced the company's debt burden by approximately \$1.1 billion. As part of the transaction, lenders that were owed approximately \$1.3 billion secured by substantially all of the assets of the company foreclosed on their collateral and planned to release a guaranty from the parent corporation. The lenders' release of the parent's guaranty would automatically trigger, under the indenture governing the company's unsecured notes, a corresponding release of the parent's guaranty of those unsecured notes. An unsecured holder challenged the company's restructuring and sought an injunction. The district court below held that release of the parent's guaranty of the notes, when coupled with the fact that all of the issuer's assets had been foreclosed on, would deprive the unsecured noteholders of their right to payment under section 316(b) of the TIA.

The district court's decision generated significant uncertainty in the world of debt restructurings and the capital markets: market participants, scholars, and prominent restructuring advisors viewed the decision as calling into question the permissibility of a wide variety of corporate transactions by bond issuers; the ability of issuers to restructure obligations outside of bankruptcy; and the ability of secured creditors to exercise their state law foreclosure rights. The decision generated considerable academic scholarship, and spawned a series of new lawsuits challenging the propriety of corporate transactions that are now pending before the district courts.

Commentators observed that the district court's decision reduced the frequency of out-of-court bond restructurings and caused borrowers increasingly to pursue private debt offerings, rather than public offerings that are subject to the TIA.

This ruling by the Second Circuit should restore confidence in an issuer's ability to reorganize outside of bankruptcy and in its secured creditors' ability to exercise remedies without violating the TIA. The decision represents a critical development in the law governing corporate debt. It holds that section 316(b) only prohibits non-consensual, formal amendments to an indenture's "core payment terms." This bright-line rule, which conforms to the traditional understanding of the statute, makes unmistakably clear that corporate transactions do not violate section 316(b) merely because of the practical effect they might have on a bondholder's ability to collect payment. The decision will affect an array of recent lawsuits commenced under the TIA, in which bondholders sought to challenge various types of corporate transactions based on allegations that the transactions made issuers less financially capable of paying their debts.

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