Reinstatement of Debt: Having Your Cake and Eating It Too

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The authors review recent decisions that provide important lessons for lenders and reinstatement plan proponents.

A substantial amount of debt was raised over the last several years at near historically low interest rates and in many cases with minimal financial and other restrictive covenants. As a result, a potential restructuring strategy for many companies that continue to be overleveraged involves the use of the bankruptcy process to restructure a company's "bad" debt (i.e., debt with above-market terms) or debt with maturities in the near term, while simultaneously using the Bankruptcy Code's reinstatement provisions to retain valuable credit with below-market terms. Such a strategy may be particularly appealing when the pricing of credit risk increases substantially, as it did following the financial crisis in late 2008.

Reinstatement requires that pre-bankruptcy defaults (other than defaults based solely on the bankruptcy filing or the debtor's financial condition pre-bankruptcy) be cured and that the debtor thereafter comply with all requirements and covenants under the applicable loan documents. Not surprisingly, the battleground over reinstatement plans is typically the issue of whether non-monetary defaults can be cured or whether covenants will be breached following, or as a result of, consummation of the restructuring plan.

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Cases involving reinstatement disputes following the 2008 financial crisis have demonstrated, however, that courts may be willing to construe covenants narrowly to permit a debtor to reinstate debt to achieve a restructuring. In addition, these cases suggest that a technical covenant default may be insufficient to defeat reinstatement absent the lender providing a cogent explanation for why the lender is not receiving the benefit of its original bargain.

THE REQUIREMENTS FOR REINSTATEMENT

When an event of default occurs, a lender typically has the right to accelerate the loan and exercise remedies to collect on the total amount of its outstanding debt. By reinstating debt as part of the bankruptcy process, debtors obtain a unique opportunity to de-accelerate the prepetition loan and continue with the original terms and maturities, all without obtaining the lender's consent.[1] To succeed in reinstating the original terms, however, the debtor must cure prepetition defaults and not otherwise alter the legal, equitable or contractual rights of the lender.

Specifically, to reinstate a prepetition obligation under a plan of reorganization, a debtor must:

1. cure any prepetition defaults (other than *ipso facto* defaults or defaults that relate to the financial condition of the debtor prior to or during the bankruptcy case);
2. compensate the lender for any damages incurred as a result of reasonable reliance on the acceleration of the obligation;
3. compensate the lender for any actual pecuniary loss arising from the failure to perform a non-monetary obligation; and
4. ensure that the plan does not "otherwise alter the legal, equitable or contractual rights" of the lender.[2]

Notwithstanding that the plan alters the lender's rights by preventing the lender from enforcing a contractual right of acceleration, if the reinstatement requirements are satisfied, the lender's claim will be deemed unimpaired and the lender will be deemed to have accepted the plan.[3]

Reinstatement thus requires that the reorganized entity comply with all financial covenants following consummation of the plan. Such covenants may include requirements to maintain certain financial ratios or a certain level of earnings (typically a certain level of earnings before interest, taxes, depreciation and amortization, or "EBITDA"). In addition, consummation of the plan itself cannot result in a breach of covenants under the loan documents. Potentially problematic covenants may include restrictions on a change in control or restrictions on divestitures without consent and application of proceeds to pay down the debt. As a result, reinstatement may not be a viable strategy in situations requiring a significant operational restructuring (as opposed to a financial restructuring solely to deleverage the balance sheet). For example, if lines of business will be sold or shut down, there may be an inability to meet financial covenants based upon the premise of a much larger operation, and sale proceeds may not be available as a source of capital. The feasibility of a reinstatement plan may also be an issue, particularly if the debtor's projections show there is little cushion in its ability to meet financial covenants in the future or there is a question about the ability of the debtor to pay or refinance the reinstated debt at maturity.

From a lender's perspective, reinstatement may undermine an expectation that a default will provide an opportunity to renegotiate to prevailing market terms. In fact, because of the inability to renegotiate to current market rates, lenders may view reinstatement of their debt as the functional equivalent of a coerced loan. Notwithstanding what may have been the lender's expectations in the event of a default and perhaps a substantial delay in payment, the policy underlying reinstatement is that the lender in essence receives the full benefit of its original bargain.

Indeed, while disputes over reinstatement plans often involve issues about technical compliance with covenants, outcomes will likely depend upon whether the court is convinced the lender is in essence receiving the benefit of its original bargain. Two recent decisions involving reinstatement, *Charter Communications*[4] and *Young Broadcasting,*[5] demonstrate the critical role played by the assessment of whether the lender is in essence receiving the benefit of its bargain. The contrasting outcomes in these two cases, which involved very similar issues, likewise provide valuable lessons on issues associated with reinstatement.

CHARTER COMMUNICATIONS

At the time of its bankruptcy filing, Charter Communications ("Charter") was the country's fourth largest cable television company. Prior to bankruptcy, Charter devised a restructuring strategy premised on reinstating its senior debt to take advantage of a favorable interest rate and negotiated a deal with its junior bondholders to convert their debt to equity.[6] Ultimately, the bondholders agreed to convert their bonds into equity, while backstopping a rights offering to raise additional capital. A key component of the transaction included the reinstatement of the senior debt to take advantage of favorable credit terms.[7]

A central issue in *Charter* was the interpretation of a change in control provision in the credit agreement that required Paul Allen ("Allen"), the controlling shareholder of Charter, to retain at least 35 percent voting power over Charter's board of directors.[8] The change in control provision also required that no person or group could have more than 35 percent of the voting power unless Allen had a greater percentage of voting power. To avoid triggering a default under the change of control provision and to preserve valuable net operating losses, Charter's prepackaged Chapter 11 plan proposed a settlement with Allen, pursuant to which he would retain 35 percent of the voting power over Charter's board and receive approximately $375 million in cash and other consideration, but would retain no meaningful ongoing economic interest in the reorganized Charter. Allen's willingness to participate in the settlement was critical to the debtors' plan because it preserved the terms of the senior debt — estimated to save hundreds of millions of dollars — as well as $2.85 billion in net operating losses.[9]

In an attempt to prevent the deal, JPMorgan Chase Bank, as agent for the senior lenders, objected to the debtors' plan on the basis that, among other things, the plan would violate the credit agreement's change of control provisions.[10] With regard to those provisions, the lenders advanced two specific arguments. First, they asserted that the credit agreement required Allen to retain an ongoing economic interest, in addition to the retention of a 35 percent voting interest. Second, the lenders argued that four of the bondholders, which the lenders dubbed the "Takeover Group," constituted a "group" under the Securities and Exchange Act[11] with more than 35 percent of the voting rights — in violation of the change of control provision.[12]

The court acknowledged that "no one seriously disputes that Mr. Allen is walking away from his investment in Charter and is agreeing to maintain his voting power as a structuring device that benefits Charter and its stakeholders."[13] To determine whether the credit agreement required Allen to retain an economic interest in the reorganized company, the court analyzed the precise language of the underlying agreements. The court found that the requirement that Allen have not less than 35 percent of the ordinary voting power did not require that he likewise have a commensurate ongoing economic interest. This conclusion was bolstered by the fact that the credit agreement had previously contained an economic interest requirement that had been eliminated when the agreement was amended to reduce the voting requirement from 51 percent to 35 percent.[14]

The more difficult question for the court was whether the bondholders, who would hold over 38 percent of the stock of reorganized Charter, constituted a "group." The court pointed out that no one had "offered a cogent explanation as to the practical importance of the covenant that went beyond its mere existence and mandated technical requirements" and that "it is difficult to discern how a slight variation in the percentages, one way or the other, could have any impact on the credit risk of the borrower."[15] The court concluded that the covenant should be construed narrowly so as to enable the debtor to engage in a permissible corporate restructuring.[16] In line with this narrow interpretation, the court found that the Takeover Group would not constitute a "group" for purposes of the credit agreement because there was no proof that any formal agreement had been reached by the bondholders.[17]

Charter's success in reinstating its senior debt was due in part to Charter's careful prepetition planning, in which Charter avoided any obvious monetary defaults (bolstering the impression that the lenders had no real complaint) and the bondholders avoided entering into any formal prepetition agreements.[18] The debtors were also successful in framing a narrative for the court—namely, that the lenders' objections were largely based on the fact that the lenders were excluded from the prepetition discussions.[19] Finally, the lenders did not present convincing evidence that they would not receive the benefit of their original bargain with Charter.[20]

YOUNG BROADCASTING

Subsequent to *Charter*, another Chapter 11 debtor, Young Broadcasting Inc. ("Young Broadcasting"), followed a similar blueprint in an attempt to reinstate its senior debt. Young Broadcasting's bankruptcy case began as an asset sale under Section 363(b) of the Bankruptcy Code, with a senior lender stalking horse bid ($220 million) substantially below the amount of the secured debt ($338 million). Before the sale was consummated, however, the debtors' businesses and cash flows began to improve. As a result, the court found that there were no longer exigent circumstances necessitating a sale outside of a plan process and required the sale to be handled as part of a Chapter 11 plan.[21]

Both the debtors and the official committee of unsecured creditors eventually proposed plans. The debtors' plan provided for: (i) an exchange of all the senior secured debt for equity; (ii) $1 million to be distributed to the general unsecured creditors; and (iii) equity warrants to noteholders accepting the plan.[22] In contrast, the committee's plan proposed: (i) reinstatement of the senior secured debt; (ii) $1 million to general unsecured creditors; and (iii) the noteholders would receive 10 percent of the common stock in the reorganized company and an opportunity to participate in a $45.6 million rights offering under which the noteholders could purchase a pro rata share of preferred stock and 80 percent of the common stock in the reorganized company.[23]

The debtors agreed to seek confirmation of the committee's plan in the first instance, and that they would pursue confirmation of their own plan only if the court denied confirmation of the committee's plan.[24] The lenders raised three primary challenges to confirmation of the committee's plan: (i) reinstatement was not permitted because the plan violated the credit agreement's change of control provision;[25] (ii) the plan was not feasible because the debtors could not demonstrate they could repay the reinstated debt upon maturity;[26] and (iii) the plan violated the absolute priority rule because Vincent Young ("Young"), one of the debtors' founders, was receiving new equity on account of his existing ownership.[27]

Change of Control

As in *Charter*, a critical issue in the case was whether the committee's plan provisions violated the credit agreement's change of control provisions.[28] Specifically, the credit agreement required Young to retain control over at least 40 percent of the voting stock. To avoid triggering a default, the plan proposed to grant Young all of the Class B stock in the reorganized company, which shares would be entitled to cast over 40 percent of the total number of votes for the directors, but only permitted Young to elect one of the seven directors.[29]

Both the committee and the lenders cited the *Charter* opinion for support of their position. The committee argued that *Charter* stood for the proposition that so long as a plan allows for a "formalistic retention of control," there will be no default under change of control provisions, notwithstanding the shift in economic ownership. The lenders countered that the structure in *Charter* actually complied with the credit agreement, as Allen retained the ability to control 35 percent of the board, whereas in the current case, Young may have 40 percent of the total number of votes, but could only control the ability to elect one of the seven directors.[30] The lenders further argued that they had bargained for the assurance that Young would exert control over the board of directors.

The court sided with the lenders, holding that the benefit of the bargain and the plain meaning of the credit agreement required Young to have the power to influence 40 percent of the composition of the board — not simply the power to cast 40 percent of the total votes for directors.[31]

Feasibility

In addition to the issues associated with the change of control provisions, the lenders also argued that the committee's plan, which left the reorganized entity with over $300 million in secured debt, was not feasible because it was unlikely that the debtors would be able to pay or refinance their senior debt at maturity in three years.[32] The court agreed. In concluding that the committee plan was not feasible, the court found the valuation of the committee's expert based on a "novel" discounted cash flow analysis inadmissible and thus excluded the expert's opinion that the debt could be satisfied at maturity through a sale.[33] The court also found that the debtors' projections the expert relied upon, which projected EBITDA to double in the following year, were "aggressive and unrealistic."[34]

Absolute Priority Rule

Finally, the lenders also succeeded in demonstrating that the plan violated the absolute priority rule[35] because Young received new equity on account of his existing equity. While the lenders as a senior, unimpaired class had no standing to press this issue and none of the unsecured creditors objected on this basis, the court found that it had an independent duty to analyze the issue.[36] The committee, relying in part on the decision in *Charter*, argued that Young (like Allen) received new equity on account of his cooperation in the reorganization, and not on account of his existing equity.[37] The court disagreed, noting that in *Charter*, the court found that the new value provided to Allen was found to be substantially outweighed by the benefits and savings to the debtor. In *Young Broadcasting*, however, the court found that the committee failed to quantify the value of the reinstated credit agreement compared to the 10 percent economic interest to be distributed to Young.[38]

CONCLUSION

Both *Charter Communications* and *Young Broadcasting* provide important lessons for lenders and reinstatement plan proponents. As demonstrated in both cases, if possible, a lender should provide a cogent explanation for why the proposed reinstatement fails to provide the benefit of the original bargain. The lenders in *Charter Communications* did not do so, perhaps leaving the court with an incentive to construe narrowly what was necessary to constitute a "group" in violation of the change in control covenant. In contrast, the committee in *Young Broadcasting* took an overly technical approach to the voting control covenant, which permitted the lenders to argue, and the court to conclude, that the lenders were not getting the benefit of their bargain.[39] In fact, the committee had a less aggressive alternative to avoid violating the provision, but the court did not permit resolicitation of votes on the Chapter 11 plan with that alternative because of the plan's other failures.[40]

Lenders should be careful to avoid creating discoverable communications that might suggest their true goal is to drum up a covenant violation to prevent reinstatement and renegotiate the debt to prevailing market terms. In situations where non-monetary covenant breach contentions are highly technical and there is not a good business rationale for the covenant or convincing explanation for why the lender is not receiving the benefit of its bargain, lenders may want to consider possible compromises. Debtors and creditors may be willing to offer improved economics in exchange for covenant modifications.

Plan proponents should be careful when structuring ways to avoid non-monetary defaults to preclude any argument that the lenders are failing to receive the benefit of the bargain. Debtors in particular should consider reinstatement as a component of a restructuring strategy before filing for bankruptcy — and should attempt to avoid all monetary defaults to bolster the case that the lenders are receiving everything they bargained for. If existing equity holders will be equity holders of the reorganized entity to comply with change in control restrictions, proponents should also work to secure support from other creditor classes to avoid giving lenders any cramdown arguments.

Because of the need to continue to comply with covenants in the loan documents, the circumstances in which reinstatement is a viable strategy, and the flexibility in structuring a reinstatement plan where it is a viable strategy, can be limited. Nonetheless, reinstatement is an important restructuring tool that can provide debtors and junior creditors with a valuable source of capital, especially in an environment where the pricing of credit risk increases substantially.

NOTES

[1] In addition to de-accelerating the debt, reinstatement effectively allows a debtor to "roll back the clock to the time before the default existed." *MW Post Portfolio Fund Ltd. v. Norwest Bank Minn., N.A. (In re Onco Inv. Co.)*, 316 B.R. 163, 167 (Bankr. D. Del. 2004). In *Onco*, for instance, the ability to roll back the clock permitted the debtor to de-accelerate the debt both for itself and its non-debtor affiliates. *Id.*

[2] 11 U.S.C. § 1124(2).
[3] 11 U.S.C. § 1126(f).
[4] *In re Charter Commc'ns*, 419 B.R. 221, 231-32 (Bankr. S.D.N.Y. 2009)
[5] *In re Young Broad. Inc.*, 430 B.R. 99, 108 (Bankr. S.D.N.Y. 2010).
[6] *Charter*, 419 B.R.at 231-32 ("This complex enterprise is endeavoring with singular creativity and determination to reduce its heavy debt load and recapitalize itself during perhaps the most challenging period in the modern era or global corporate finance.").
[7] *See id.* at 232–33 ("[Charter's restructuring advisor] was behind the decision to engage in a high velocity negotiation with the bondholders while leaving the senior debt in place to take full advantage of favorable pricing applicable to the existing senior indebtedness.").
[8] *Id.* at 240.
[9] *Id.* at 253-54. As part of the settlement, Allen agreed to forbear from exercising his prepetition exchange rights. This forbearance resulted in Charter's preservation of the NOLs. *Id.*
[10] *Id.* at 248.
[11] The Securities and Exchange Act's ("SEA") definition of "group" was relevant because the underlying credit agreement imported the SEA's definition for purposes of determining whether any group exercised more than the requisite level of control. *Id.* at 237.
[12] *Id.* at 248-49. The lenders were in essence contending that, in violation of the intent of the credit agreement, major bondholders would effectively be controlling the reorganized Charter rather than Allen. As the court described it, the "nominal retention of voting power has been attacked as a gimmick fashioned by corporate lawyers to obscure a takeover of the company by bondholders." *Id.* at 230.
[13] *Id.* at 231.
[14] *Id.*, 419 B.R. at 237-39.
[15] *Id.* at 239.
[16] *Id.*
[17] *Id.* at 240, 249.
[18] *See id.* at 231-33 (describing the process by which the plan was negotiated and drafted prior to bankruptcy).
[19] *See id.* at 233 ("Parties who were not at the table during this process have become the main objectors to confirmation…. [T]hey openly admit that their goal here is to obtain an increased interest rate that reflects what would be

charged for a new loan in the current market….”).

[20] *See id.* at 234 (“The senior lenders have been paid everything that they are owed under the existing facility and have even received default interest during the bankruptcy cases.”).

[21] *In re Young Broad. Inc.,* 430 B.R. 99, 108 (Bankr. S.D.N.Y. 2010).

[22] *Id.* at 109.

[23] *Id.* at 109–10.

[24] *Id.* at 106. The debtors agreed to seek confirmation of the committee's plan in the first instance because it significantly improved recoveries to noteholders.

[25] *Id.* at 112.

[26] *Id.* at 128.

[27] *Id.*, at 141.

[28] *Id.* at 112.

[29] *Id.* at 113.

[30] *Id.* at 114.

[31] *Id.* at 117.

[32] *Id.* at 139.

[33] *Id.* at 127–28.

[34] *Id.* at 132.

[35] The absolute priority rule requires that creditors be paid in full before equity holders receive any distributions. *See* 11 U.S.C. § 1129(b)(2).

[36] *Id.* at 139.

[37] *Id.* at 141.

[38] *Id.*

[39] *See, e.g.*, *id.* at 113 (“The lenders contend that the Committee's manipulation of the votes allocated to the Voting Stock is an effort to circumvent the protections negotiated by the Lenders.”).

[40] *See id.*, 430 B.R. at 121 (“Under other circumstances, the Court might have allowed the Committee to re-solicit and more fully describe the suggested alternative proposed board structure…. In the context of these cases, however, and for the reasons that will be discussed in this Opinion, the Court does not reach the issue of whether the Committee should be afforded an opportunity to re-solicit its plan.”). The court was not required to reach the issue of resolicitation due to the fact that the court was able to confirm an alternative plan (the debtor's plan), which had been proposed in the event that the court did not confirm the committee's plan. *Id.* at 106.