SECTION 1145 of the Bankruptcy Code provides a limited exemption from the registration requirements of the Securities Act of 1933 for the issuance of securities pursuant to a plan of reorganization under chapter 11 of the Bankruptcy Code. This exemption was adopted by Congress as part of its decision to move away from the predecessor Chapter X, which permitted the Securities and Exchange Commission (SEC) to play a dominant role in reorganizations, and towards a process that put reorganizations in the hands of those having a financial stake in the result. Consistent with this objective, Section 1145 relieves reorganizing debtors and the recipients of their reorganized equity of the burdens of compliance with the securities laws, thereby facilitating reorganizations instead of liquidations and avoiding the waste that often resulted from Chapter X cases.

The increasing investor interest in securities issued under a Chapter 11 plan suggests that the objectives of Section 1145 are being met. Creditors are accepting reorganization plans (and the creditors or other sponsors of their reorganization) and the recipients of their reorganized equity, in exchange for a claim against the debtor. Hence, a theoretical problem exists that in practice is resolved by the diligence of sophisticated purchasers and conscientious bankruptcy professionals.

Overview of Section 1145

Section 1145 provides that the registration requirements of Section 5 of the Securities Act do not apply to the offer or sale under a plan of reorganization of securities of a debtor, an affiliate of the debtor or a successor to the debtor principally in exchange for a claim against the debtor to anyone other than an “underwriter,” as defined in Section 1145. A security that is sold in a transaction that meets the requirements of Section 1145 is deemed to have been issued in a public offering.

There are two principal benefits of Section 1145. First, the issuer avoids the expensive and time-consuming process of filing a registration statement with the SEC, a process that may take six months or more and typically will cost several millions of dollars to complete. Avoiding registration also means avoiding, for issuers who will have less than 500 record holders of any of their securities and are not already registered under the Securities Exchange Act of 1934), the obligation to file periodic reports under, and otherwise comply with, the Exchange Act, including the complicated and expensive provisions of the Sarbanes-Oxley Act.

The second benefit is that securities issued to parties other than “underwriters” in a Section 1145-exempt issuance are deemed to have been issued in a public offering and are therefore not “restricted securities,” as defined in Rule 144 under the Securities Act. As discussed below, this aspect of the Section 1145 exemption is its most striking and perhaps most problematic because it means that these securities can be sold to anyone, without restriction, regardless of whether the purchaser has or can obtain any information about the issuer or the security.

Section 1145 is a critical component of the reorganization scheme adopted by Congress in 1978. This new scheme was a reaction to the perceived defects in the predecessor Chapter X, which was widely viewed as dominated by the SEC, resulting in few reorganizations, unnecessarily time-consuming, expensive, litigious, rigid and ultimately ineffective in assisting the very creditors and investors it sought to protect. In contrast, the Bankruptcy Code was designed to create a reorganization process, not a liquidation process, directed at preserving “going concern” value, serving the interests of those having a financial stake in the situation and liberated from the overriding and often destructive concern for “investor protection” that characterized Chapter X.

Specific Concerns

In particular, Section 1145 is intended to respond to two specific concerns. First, it recognizes the fact that debtors cannot afford the expense and delay associated with registration. In a situation where the primary objective is to conserve cash and reorganize as quickly as possible, the registration process would be counter-productive. Similarly, securing exemptions from registration would not be practical, and might in some circumstances be impossible, given the diverse and shifting nature of a debtors’ creditor pool. Second, and perhaps more important, Section 1145 is intended to enable debtors and their creditors to realize value and obtain liquidity through the capital markets rather than forcing debtors to liquidate to provide cash to creditors and thereby sacrifice “going concern” value.

Section 1145 addresses the first of these
concerns by providing an exemption from registration that is specifically tailored to the bankruptcy scenario and reflects Congress's judgment that certain aspects of the bankruptcy process, such as the disclosure statement and confirmation requirements, will serve the objectives of the Securities Act or make its protections less necessary. Such an exemption is logical, given the limited resources and realities of a bankruptcy. The creditors who will receive the reorganized equity are often pre-petition lenders or vendors to the debtor and, as such, are very familiar with the debtor and its business. These creditors would certainly prefer that assets remain available to pay administrative expenses and provide post-effective working capital than be spent on consummating what could amount to an initial public offering. In addition, a bankruptcy is not comparable to the typical, non-distressed investment decision. In a bankruptcy, a solution must be found, and in many cases the equity of the reorganized entity is the most valuable asset available; requiring compliance with the registration requirements would be to pretend that creditors have alternatives other than investing or forcing a liquidation. As Congress recognized, the bankruptcy process requires a flexibility that the securities laws do not provide.1

Section 1145 also addresses the second objective, providing a route to liquidity for creditors who receive reorganization securities. Unlike other exemptions from registration, Section 1145 provides that securities issued to non-underwriters in compliance with Section 1145 are freely tradable, unrestricted securities. Citing its determination that many creditors in a bankruptcy will desire to quickly resell the reorganized equity they receive in exchange for their claims, Congress believed that permitting these securities to be characterized as restricted would act as "a retarding force on the flexibility of the reorganization process." Congress concluded that the same safeguards that justified the initial exemption from registration - principally the disclosure statement and confirmation procedures under the Bankruptcy Code — would operate to protect subsequent purchasers of reorganization securities.2

Section 1145 in Practice

Section 1145 is intended to strike a balance between the need to create a bankruptcy scheme that encourages reorganizations while still respecting the importance of disclosure in connection with the offer and sale of securities. Central to the logic behind Section 1145, therefore, is Congress's determination that the dissemination of a disclosure statement and the confirmation process in general will provide an appropriate amount of disclosure. But Section 1145 relies on more than these statutory requirements to function properly. For example, while it is true that a disclosure statement should provide adequate information and thereby serve to protect creditors, the scope of this protection is dependent upon conscientious, diligent debtors and active, engaged creditors, rather than regulatory oversight and rule-making. Fundamentally, the statutory scheme that includes Section 1145 assumes that creditors are "involuntary" investors whose greatest concerns are maximizing recovery and understanding alternatives (including comparisons of reorganization recoveries to liquidation recoveries), that creditors are adequately incentivized to protect their own interests.

To appreciate this point, consider the differences between the required contents of a prospectus and a disclosure statement. A prospectus is prepared based on hundreds of specific rules and many years of practitioners' and underwriters' experience preparing disclosure documents intended for the specific purpose of providing potential investors with the information (and cautions) they need to make educated investment decisions. In contrast, the contents of a disclosure statement are prescribed relatively economically by Section 1125 of the Bankruptcy Code, which says, in essence, that a disclosure statement should provide the information that a reasonable, typical investor will need to make an informed decision about whether to vote for or against the plan of reorganization. Although lawyers are commonly guided by the securities laws when preparing a disclosure statement, this approach is not required, and adequate disclosure may ultimately depend on whether the presiding Bankruptcy Court (often only in response to an objection) decides the disclosure is inadequate and must be supplemented.

Conscientious debtors and their counsel recognize that a disclosure statement should not be considered an automatic proxy for a prospectus. For example, in a situation in which the reorganization securities will be issued by an entity (a "successor" to the debtor) that will own less than all of the debtor's assets, a debtor should consider including specific information regarding the discrete portion of the business that the reorganized entity will own. Otherwise, the disclosure statement will only reflect the business of the debtor as a whole, which might be misleading or inadequate. In addition, a disclosure statement should include post-reorganization financial projections with respect to the issuer of the securities and set forth accounting adjustments required by generally accepted accounting principles that may make material differences in the issuer's reported financial condition. This augmented disclosure will be supplemented by the plan and confirmation requirements, especially as they relate to identifying management, its plans and the prospects for the reorganized business. Again, the effectiveness of these requirements rests with the debtor and its creditors.

One might argue that this reliance on the efforts of debtors and creditors is a flaw in Section 1145, but it is quite likely that most bankruptcy practitioners and creditors would report that the Section 1145 approach is a generally successful one, especially when compared to the counter-productive nature of Chapter X. Significantly, however, the protections that justify the exempt issuance of reorganization securities to creditors pursuant to a plan of reorganization do not as obviously reach beyond the consummation of that plan and the initial issuance of those securities. In theory at least, Section 1145 permits reorganization securities to be resold with no prospectus delivery requirement, no requirement that there be publicly available information, and no requirement that the seller determine that the buyer has the experience and resources to make an informed decision. Does this possibility suggest that reform is necessary?3

"Viewed in the abstract, permitting such unrestricted selling of securities is surely contrary to the public policy concerns of the securities laws. But today's experience confirms that, to the extent there is any trading in these securities between the time they are issued and the time they are listed on an exchange, it is done by sophisticated investors that are well equipped to make investment decisions (and risk losing their investments) in transactions that would likely qualify as private placements. In other words, widows and orphans do not buy these securities, and we believe it would be rash to reinstitute elements of a discredited bankruptcy regime to protect investors who do not need protection. Instead, we should view the growth in the secondary market for reorganization securities as vindication of the judgment of Congress and the success that Chapter 11 has achieved in facilitating the reorganization of businesses."

2. Section 12(g)(1)(B) of the Securities Exchange Act of 1934 requires issuers with an equity security held by 500 or more record holders to register that security with the Securities and Exchange Commission and commence filing periodic reports thereunder.
3. Section 1145 does not absolve "insiders," "affiliates" or others with material non-public information of their responsibilities or potential liability under Rule 10b-5 under the Exchange Act.
5. Id.
6. Id.
7. Id.

This article is reprinted with permission from the December 30, 2004 edition of the NEW YORK LAW JOURNAL © 2004 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact American Lawyer Media, Reprint Department at 800-888-8300 x6111. #070-02-05-0019