Expert Views

A Possible Resurgence of Reinstatement Cases Means Debtors and Creditors Should Heed Lessons From Charter Communications and Young Broadcasting

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Editor's Note: Below is the latest in Reorg's Expert Views series: an article written byStephen Selbst, Steven Smith and Rodger Quigley of Herrick, Feinstein LLP. Stephen Selbst is co-chair of Herrick's restructuring and finance litigation department in New York. Steven Smith is a partner in the department, and Rodger Quigley is an associate in the department.

With interest rates on the rise for the first time in years, and the availability of inexpensive credit diminishing, reinstatement under Bankruptcy Code § 1124(2) - one of the two methods in the Bankruptcy Code to accomplish a "cram-up" chapter 11 plan of reorganization - will once again become an attractive strategy. To structure a reinstatement cram-up plan that will survive challenges, debtors and their advisors should heed the lessons from two high-profile reinstatement cases from the Southern District of New York that were decided just months apart: Charter Communications and Young Broadcasting. This article provides an overview of reinstatement and explores the specific facts that led one bankruptcy judge to allow reinstatement in Charter Communications and another to reject it in Young Broadcasting.

Cram-Down vs. Cram-Up and an Overview of Reinstatement

"Cram-down" occurs when a bankruptcy court confirms a chapter 11 plan over the objection of a class of creditors. Bankruptcy Code § 1129(b) governs cram-down plans and provides that for a plan to be confirmed, it must (1) be accepted by at least one impaired class, (2) not unfairly discriminate against each impaired, nonaccepting class of claims or interest, and (3) be fair and equitable. It is common for a senior secured class of creditors to seek to cram down a plan without the consent of junior creditor classes. In contrast, a "cram-up" occurs when a bankruptcy court confirms a chapter 11 plan over the objection of a class of senior secured claims, and is far less common. A cram-up can be accomplished in two ways: (1) reinstatement under Bankruptcy Code § 1124, the subject of this article, or (2) confirmation under Bankruptcy Code § 1129(b).

In a reinstatement plan, the debtor proposes to continue to utilize its prepetition debt financing with its senior class, meaning that it accepts that debt's maturity, interest rate and other covenants and conditions. To reinstate a prepetition debt pursuant to Bankruptcy Code § 1124(2), a plan of reorganization must: (1) leave unaltered the lender's legal, equitable and contractual rights, (2) cure any prepetition defaults (other than *ipso facto* defaults), (3) reinstate maturity and terms of the original obligation and (4) compensate the lender for (a) any damages incurred as a result of reasonable reliance on the acceleration of the obligation and (b) any actual pecuniary loss arising from the failure to perform a nonmonetary obligation.

Because a loan that is reinstated is not treated as impaired under the Bankruptcy Code, the holders of claims in that class are deemed to have accepted the plan and cannot vote to reject the plan. As one court described it, reinstatement can "roll back the clock to the time before the default existed." The policy underlying reinstatement is that where a debtor can cure past defaults and perform under the original terms, the lender receives the benefit of its bargain. Reinstatement may be an attractive strategy when a debtor's secured debt carries an interest rate lower than the prevailing market rate.

The Likely Resurgence of Reinstatement Cases

Reinstatement cases became popular after the Great Recession, when credit dried up and new financing to replace the cheap loans readily available before the recession became scarce. Until very recently, interest rates had been at historically low levels since the 2009 financial crisis. During that

time, reinstatement cases were less useful and accordingly less prevalent. But global inflation is causing significant increases in interest rates, which will make refinancing more difficult for troubled borrowers. And that rise in interest rates will likely lead to a resurgence of reinstatement cases. As Congress noted when it enacted reinstatement, "The holder of a claim or interest who under the plan is restored to his original position, when others receive less or nothing at all, is fortunate indeed and has no cause to complain." But lenders often do complain and did so in *Charter Communications* and *Young Broadcasting.*

Charter Communications

Following the Lehman Brothers' chapter 11 filing in 2008, commercial lending came to a virtual halt. Against that backdrop, Charter Communications, a cable television broadcaster highly leveraged with approximately $22 billion of debt, worked with its lenders on a pre-negotiated restructuring to avoid a freefall bankruptcy. Charter proposed to reinstate its senior secured debt because of its favorable pricing, and to negotiate with its bondholders, whose claims were junior to the senior debt. Because of its large senior debt obligation, Charter was unsure whether a senior facility could be assembled on any terms.

In 2009, Charter filed a prepackaged chapter 11 plan that proposed to accomplish three objectives. First, it reinstated $11.4 billion in senior secured debt to preserve the favorable pricing. Second, it stripped more than $8 billion in debt held by its then-leader Paul Allen and stripped him of any meaningful ongoing economic interest in the company's equity, but allowed Allen to retain his 35% voting interest in order to maintain the company's NOL tax attributes. Third, it would raise $1.6 billion in new equity capital through a rights offering.

The Charter plan was negotiated for months with Charter's lenders. But after the original deal was reached, much of the bank and bond debt traded to distressed buyers, who objected to the plan because they wanted a higher interest rate on their new debt. The case was assigned to Bankruptcy Judge James Peck, who found that prepetition negotiations were pursued at arm's length and in good faith, resulting in a prepetition agreement among Charter, Paul Allen and creditors that became the foundation of Charter's plan. Judge Peck was openly critical of postpetition efforts by distressed investors to retrade, noting that parties who were not at the table during the prepetition plan negotiations became the main objectors to confirmation.

The bankruptcy court considered two primary issues during the 19-day confirmation hearing: (1) whether defaults existed that precluded reinstatement of the senior secured debt and (2) whether the Charter/Paul Allen settlement should be approved. Charter argued that reinstatement would leave the senior lenders unimpaired. JPMorgan, as senior agent, objected, relying on three non-monetary defaults that it argued precluded reinstatement: (1) certain holding companies were unable to pay their debts as they became due at the time when funds were borrowed under the senior lenders' credit agreement (an event of default, if true), (2) an acceleration of the debt of holding companies due to the bankruptcy filing caused a cross-acceleration default, and (3) the consummation of the plan would cause a change of control to occur. Notably, JPMorgan admitted its goal was to obtain an increased interest rate and acknowledged that the senior secured lenders were being paid everything they were owed under the facility, including postpetition default interest.

The alleged change-of-control default was the most challenging for Charter. Under the senior credit agreement, the Paul Allen group was required to retain the power to vote at least 35% of the ordinary voting power for Charter's management. The senior lenders argued that reinstatement violated the "change in control" provision because: (1) the credit agreement required Paul Allen to retain an ongoing economic interest in addition to the 35% voting interest, and (2) four of Charter's junior bondholders would hold more than 35% of the voting power, which they contended was a "group" under the federal securities laws.

The Paul Allen/Charter settlement was the cornerstone of the plan and the means by which Charter avoided a change of control. Judge Peck determined that the settlement should be approved because (1) it established the grounds for reinstatement of $11.4 billion of debt at favorable interest rates, saving Charter hundreds of millions in interest expense, (2) Allen waived certain prepetition exchange rights, and his continuing 35% voting interest (stripped of economic rights) in Charter

resulted in Charter preserving $2.85 billion of net operating losses, and (3) it provided for a $1.6 billion rights offering and the purchase of Allen's preferred units.

Judge Peck overruled the senior lenders' objections and confirmed the cram-up plan. He found that the senior lenders were being paid in full, together with default-rate interest. The court analyzed the credit agreement and concluded that the change-of-control covenant did not require that Allen also have an ongoing economic interest. The court also found that a prohibition in the credit agreement on the acquisition of a voting interest exceeding Paul Allen's by any "group" did not apply to the bondholders because there was no proof they constituted a "group" under the federal securities laws. The court concluded that the term "group" had a different meaning under federal securities laws than under the credit agreement. *Charter Communications* was, at the time, one of the largest and most complex prearranged bankruptcies ever attempted, and it remains a playbook for how to achieve reinstatement.

Young Broadcasting

Just five months after the *Charter* decision, Young Broadcasting Inc., or YBI, the owner of 10 television stations, filed for chapter 11, and the case was assigned to Bankruptcy Judge Arthur Gonzalez. Like Charter, YBI was burdened with excessive debt: $338 million in secured debt and $484 million in senior subordinated notes. YBI pursued a dual-track process: (1) a sale of its business and (2) a consensual standalone plan. While the case was pending, YBI's business substantially improved its cash flow. The bankruptcy court permitted consideration of two competing plans of reorganization: the YBI plan and the committee plan.

The YBI plan proposed to (1) deleverage YBI by canceling the senior notes and secured lenders' claims, (2) pay in full all administrative, priority and secured claims other than the secured lenders' claims, (3) create a new company in which the lenders would receive all of the equity, (4) provide general unsecured creditors with their pro rata share of $1 million, (5) provide equity warrants to noteholders if they voted to accept the plan, and (6) wipe out existing equityholders.

The committee plan proposed to (1) reinstate all $338 million of senior secured debt, (2) provide the same treatment for administrative, priority, secured and general unsecured claims and equityholders, (3) provide noteholders with their pro rata share of 10% of the common stock and the opportunity to participate in a rights offering of up to $45 million of preferred stock plus 80% of the common stock, and (4) provide an additional $45 million to (a) cover all monetary defaults under the credit agreement, (b) fund plan payments and (c) provide the reorganized debtors with sufficient working capital.

Both the committee and the lenders who opposed reinstatement relied on *Charter* as support for their positions. The committee argued that reinstatement was proper because the plan complied with the credit agreement, including the provision that no change of control occur. To avoid triggering the change of control, the credit agreement required that Young, his family members and management retain more than 40% of the voting power. The credit agreement also required that if any person or group owned more than 30% of the voting power, the Young group must own more than 30% or have the right to elect or designate a majority of the debtors' board.

The lenders made three arguments in opposition to the reinstatement plan. First, they argued that the plan did not satisfy the 40% control test. Under the plan, Young had only a nominal number of votes for the election of Class A directors; most of his votes only allowed him to vote for the one Class B director. Thus, Young could control the election of only one out of seven directors, far less than 40%. Second, the plan violated the credit agreement by ceding control of over 30% of the voting stock to a group other than the Young group (i.e., the lenders who agreed to backstop the rights offering). Third, the default was not being cured, so the loan could not be reinstated.

Like Judge Peck in *Charter*, Judge Gonzalez began by analyzing the YBI change-of-control provisions and found that the plain meaning required the Young group to retain the power to elect 40% of the board, but that Young retained the power to control less than 15% of the board. By allowing Young to control a large number of votes that had no power to influence the composition of the board, the plan would not comply with the purpose of the change-of-control covenant, which was to prevent

another group from gaining more control than the Young group. Accordingly, Judge Gonzalez denied reinstatement under the committee plan and confirmed the debtors' plan.

Reconciling Charter Communications and Young Broadcasting

In both cases, the central issue was whether the plan would result in breach of change-in-control provisions. And each debtor formulated a structure to avoid a change in control by separating voting power from economic interest in the reorganized company. Why, then, did reinstatement succeed in *Charter Communications* but fail in *Young Broadcasting*?

The keys to success in *Charter* included significant prepetition planning and the conduct of the challenger lenders, which Charter used to frame a narrative for the court to favor reinstatement. As to prepetition planning, the *Charter* plan was negotiated for months among Charter's lenders. Thus, the strategy was already structured prepetition. And Charter was careful to avoid obvious monetary defaults. In terms of the narrative framing, Charter was able to use to its advantage the fact that the challenger lenders did not deny that their goal was to obtain an increased interest rate. The challengers also manufactured defaults to get a seat at the table and could not deny they were receiving the benefit of their bargain.

There were two key reasons why the committee plan in *Young Broadcasting* failed. First, the committee plan's structure to avoid a change-of-control default required an aggressive, hyper-technical reading of provisions enabling lenders to argue they were not getting the benefit of their bargain. Second, the court noted that the committee did not present a compelling feasibility case. For example, they could have raised more capital in the rights offering, and the court noted that the cram-down requirements could have been satisfied with adequate evidence.

Conclusion

Rising interest rates and the lack of available inexpensive credit point toward the resurgence of reinstatement bankruptcy cases. Debtors and creditors may look to lock in such favorable rates in order to save the estate from significant interest expenses. But in order to pursue a successful reinstatement strategy, debtors and creditors should pay close attention to the success of the Charter reinstatement plan and the failure of the Young Broadcasting reinstatement plan. Although the holdings in those cases were fact specific, they demonstrate the benefit of careful planning and how lenders' conduct might influence the court's ultimate decision on whether to allow reinstatement.

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