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Debt Reinstatement

Important Lessons for Plan Proponents and Lenders

by Julie Schaeffer

In the past few years, businesses have raised a significant amount of debt at historically low interest rates, and, in many cases, with few restrictive covenants – making debt reinstatement a potentially good restructuring strategy for overleveraged companies, says, Daniel P. Winikka, a partner at Jones Day.

"Debt reinstatement involves the use of the bankruptcy process to restructure a company's bad debt while simultaneously using the Bankruptcy Code's reinstatement provisions to retain valuable credit with below-market terms," says Winikka.

"Reinstatement can be attractive to a reorganizing company if the loans are at a favorable interest rate (i.e., below the rates that would be available to the company as part of its exit from Chapter 11) and have some period left before maturity," says Christopher Mirick, a partner at Pillsbury Winthrop Shaw Pittman, LLP.

"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," adds Winikka.

When a company defaults on its debt, the lender typically has the right to accelerate the loan and collect any outstanding debt. Debtors can reinstate debt as part of the bankruptcy process, however – and in doing so, continue with the original terms and maturities without obtaining the lender's consent.

To succeed, however, the debtor must meet three criteria. First, it must cure any prepetition defaults. Second, it must ensure that the plan does not "otherwise alter the legal, equitable, or contractual rights" of the lender. Third, it must compensate the lender for any damages incurred as a result of reasonable reliance on the acceleration of the obligation, and for any actual loss arising from the failure to perform a non-monetary obligation. In other words, reinstatement requires a reorganized company to comply with all existing financial covenants, such as maintaining a certain level of earnings before interest, taxes, depreciation, and amortization (EBITDA) following consummation of its reorganization plan. "Potentially problematic covenants may include restrictions on a change in control," says Winikka.

That said, Winikka continues, "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."

As a result of these requirements, Winikka notes that reinstatement may not be a viable strategy for all companies. Certainly, it can work with a financial restructuring designed solely to deleverage a company's balance sheet. In situations requiring a significant operational restructuring, however, debt reinstatement may be less likely to succeed. "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," says Winikka.

The viability of a reinstatement plan may also be an issue if the debtor's financial situation is precarious – specifically, if the debtor projects little cushion in its ability to meet future financial covenants or if it's possible that the debtor may not be able to pay or refinance the reinstated debt at maturity.

Lenders may also be wary of reinstatement, says Winikka. Although the lender receives the full benefit of its original bargain, it may be hoping that a default will provide an opportunity to renegotiate to prevailing market terms. "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." Indeed, according to Winikka, outcomes of debt reinstatement typically depend upon whether the court is convinced the lender is essentially receiving the benefit of its original bargain.

Winikka points to two recent decisions by the Bankruptcy Court for the Southern District of New York decisions – in *Charter Communications* and *Young Broadcasting* – to illustrate how courts perceive whether a lender is 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," says Winikka.

In the first case, *Charter Communications* prior to bankruptcy developed a restructuring strategy premised on reinstating its senior debt to take advantage of a favorable interest rate. However, a change-in-control provision in the credit agreement required Charter's controlling shareholder, Paul Allen, to retain at least 35 percent voting power over Charter's board of directors, and to retain more voting power than any other person or group.

Thus, Charter's prepackaged Chapter 11 plan proposed a settlement with Allen wherein he would retain 35 percent of the voting power and receive approximately $375 million, but retain no meaningful ongoing economic interest in the reorganized company.

JPMorgan Chase Bank, agent for the senior lenders, attempted to prevent the deal by arguing that the plan would violate the credit agreement's change of control provisions. Specifically, JPMorgan Chase Bank argued that the credit agreement required Allen to retain an ongoing economic interest as well as 35 percent voting interest, and that four bondholders constituted a "group" that together had 38 percent voting rights, more than Allen.

The court found that the requirement that Allen have 35 percent of the voting power did not require that he have a commensurate ongoing economic interest. As to JPMorgan Chase Bank's second argument, the court ruled that the four bondholders did not constitute a "group" for purposes of the credit agreement because there was no proof that they had reached any formal agreement, or that any such agreement would matter. Charter was thus successful in reinstating its debt.

After *Charter Communications*, another Chapter 11 debtor, Young Broadcasting, attempted to reinstate its senior debt in a similar manner.

In *Young Broadcasting*, the official committee of unsecured creditors proposed a plan of reorganization that provided for, among other things, reinstatement of the senior secured debt.

The credit agreement required Young to retain control of at least 40 percent of voting stock. In the event of a triggering default, the plan granted Young all 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.

The lenders, in turn, argued primarily that reinstatement was not permitted because the plan violated the credit agreement's change-of control provision.

This time the court sided with the lenders on the grounds 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.

The next issue of *Turnarounds & Workouts* will offer advice for restructuring professionals wishing to formulate a restructuring transaction around a reinstatement plan.

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