

# turnarounds & workouts

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## DEBT REINSTATEMENT

### IMPORTANT LESSONS FOR PLAN PROPONENTS AND LENDERS

by Julie Schaeffer

The November issue of Turnarounds & Workouts, discussed debt reinstatement – which involves the use of the bankruptcy process to restructure a company’s bad debt while simultaneously using reinstatement provisions to retain valuable credit with below-market terms – in the context of two bankruptcy-court decisions: Charter Communications and Young Broadcasting.

“Both looked at the issues of reinstatement of prepetition debt as part of a Chapter 11 process,” says Christopher Mirick, a partner at Pillsbury Winthrop Shaw Pittman, LLP. “In Charter Communications, the court allowed reinstatement, finding that the change of control provisions in the debt were not triggered by the plan. In contrast, Young Broadcasting denied reinstatement, for three reasons. The change of control provision in the debt documents would be triggered by the plan (despite the creative allocation of voting rights); the plan was not demonstrated to be feasible; and the distribution of reorganized equity interests to the prepetition holders violated the absolute priority rule.”

“The contrasting outcomes in these two cases, which involved very similar issues, likewise provide valuable lessons on issues associated with reinstatement,” says Daniel P. Winikka, a partner at Simon, Ray & Winikka LLP.

According to Winikka, both cases offer

an important lesson: that a lender should provide a good explanation for why a proposed debt 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,” he says. “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.” Financing a reorganized company by reinstating debt continues to be discussed as part of the process of developing Chapter 11 plans, says Mirick, but the factors that undermined that effort in Young Broadcasting continue to pose problems for other companies – “particularly incurable defaults, and the issue of how do you not have a change of control if creditors aren’t being paid in full – in other words, leaving old equity ‘in control’ seems likely to violate the absolute priority rule.”

Additionally, in the current economic climate, Mirick says the feasibility of the reorganization can be a significant hurdle as well. “In order to succeed as a reorganized company, the debtor may need to shed divisions or sell assets. Those sort of changes may themselves

may be a default under the prepetition debt and prevent reinstatement – but without these changes to the corporate structure and operations, the debtor may be unable to persuade the court that its reorganization is feasible.”

When the Young Broadcasting ruling came out in 2010, Nicole B. Herther-Spiro of Dechert thought it was ultimately not the legal arguments for reinstatement that fell short, but the inability to make the business case for the reinstatement. “Young Broadcasting highlights the limits of reinstatement as an exit financing strategy,” says Mirick. “The treatment of the debt under the plan needs to comply with the loan documents, and incurable defaults (at least incurable material defaults) are a problem. And, the plan needs to otherwise meet confirmation requirements – including demonstrating that the reorganization is feasible and that the absolute priority rule is met.”

Following Herther-Spiro’s line of thinking, restructuring professionals wishing to formulate a restructuring transaction around a reinstatement plan may want to remember that a compelling legal argument is insufficient and advance a compelling business argument as well. In addition, says Winikka, lenders should be careful to avoid creating discoverable communications that suggest their true goal is to create a covenant violation to prevent reinstatement and renegotiate debt at market terms. Meanwhile, plan

proponents should be careful to preclude any argument that the lenders are failing to receive the benefit of the bargain.

Even then, it might not work. According to David Neier, a partner at Winston & Strawn, Young Broadcasting doesn't say as much about debt reinstatement as most people think it does. "People think of Young Broadcasting as a debt reinstatement case because there are so few cases about debt reinstatement. It's actually a valuation case and a cram-up case (because the debtors were trying to cram up the lenders and put them in a different interest rate)."

According to Neier, it's "unbelievably difficult" to reinstate bank debt. "The debt reinstatement provision – 1124 – really only works with bonds. With bonds

it's a lot easier, because there aren't the covenants you have in bank deals that are impossible to cure."

People often threaten debt reinstatement, Neier says, but don't go forward with it and get a judge's decision. "Debtors threaten lenders in the hopes of wrangling out a better deal, but then they understand the hurdles they face in going forward, so they rarely go to decision."

According to Mirick, a broader issue is whether the concept of an incurable default should continue to be part of the reinstatement landscape. "In the 2005 Amendments, Congress essentially removed the incurable default from the commercial landlord's toolkit, amending section 365 to provide that a default that arises from performance or a lack

of performance and cannot be cured by performance at the effective date, can be cured by the debtor or assignee agreeing to perform thereafter."

Mirick also points out the incurable default has been curtailed in commercial leases, as illustrated by going-dark provisions, whereby a business that fails to operate a location for a certain number of days defaults under the lease, and there is no way to "cure" that after the fact. Why not curtail it elsewhere?

"Having curtailed the incurable default in commercial leases, perhaps Congress could do the same in connection with reinstatement of debt, which would provide reorganizing debtors with another, more viable, option for funding their reorganizations," Mirick says.

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