Reinstatement Revisited: Charter’s Lessons for Secured Lenders

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Secured lenders’ right to recover the value of their collateral usually allows them to exert powerful leverage over a debtor in plan negotiations. The Bankruptcy Code, however, does provide a debtor with two important options to confirm a chapter 11 plan over their objection: “cramdown” of a dissenting class under §1129(b)(1) and “reinstatement” of secured debt on prepetition terms under §1124. Although the scope of the cramdown option is well established, reinstatement of prepetition loans has traditionally been an untested remedy for debtors, as there is lacking any formal case law.1

1 A chapter 11 plan may “cram down” on a dissenting class of secured creditors, provided it provides fair and equitable treatment to the class and does not discriminate unfairly. See 11 U.S.C. §1129(b)(2)(A). Secured creditors generally must be provided one of the following three options for the plan to be fair and equitable: (1) retention of lien and receipt of payments equal to the value of the creditor’s interest in property of the estate; (2) lien on the proceeds from the sale of the collateral and receipt of payment equal to the value of such proceeds; or (3) realization by the holders of secured claims of the indubitable equivalent of their claims. See 11 U.S.C. §1129(b)(2)(A).

2 To reinstate a prepetition loan agreement, a plan must de-accelerate any acceleration of such debt, reinstate the original maturity of the debt and provide for the cure of certain defaults that have occurred. See 11 U.S.C. §1124(A).

3 See, e.g., In re Arnold, 806 F.2d 937 (9th Cir. 1986) (holding that prepetition loans that paid secured creditor only present value of collateral, $280,000, where its total debt was $320,000; Miller v. 7-11 New Orleans Ltd. Partnership, 10 F.3d 1099 (5th Cir. 1993) (holding that plan properly permits credit bid of full claim, not just allowed secured portion); In re Morning Bros., 755 F.2d 1336, 1339 (8th Cir. 1985) (holding that “indubitable equivalent” is not threshold requirement but merely one of three methods to cramdown).

4 See “Reinstatement Emerges as Leading Issue in Bankruptcy Litigation: Q&A with Robert Grien and Maureen Chakraborty of Analysis Group,” Business Wire, July 20, 2009, 12:30:00 (noting that reinstatement “has not, historically, been battled in bankruptcy court, and there is no formal case law on the topic”).

5 See, e.g., In re Spectrum Jungle Labs Corp., No. 09-50435 (Bankr. W.D. Tex., pet., filed March 31, 2009) (involving plan to reinstate senior secured debt, but reinstatement issue was not decided by court because case settled); In re Energy Partners Ltd., No. 09-32967 (Bankr. S.D.N.Y., pet. filed May 1, 2009) (same); In re Charter Communications, Inc., No. 09-11435 (Bankr. S.D.N.Y., pet. filed March 27, 2009) (discussed herein).

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8 Although loan reinstatement gives prepetition lenders “the full benefit of [their] original bargain,” lenders generally object to reinstatement because it deprives them of the opportunity to exit the deal or to renegotiate it at current market rates reflecting the debtor’s changed financial condition. Thus, the absence of formal case law on reinstatement has caused heated inter-creditor disputes and litigation over the chapter 11 process itself. A recent decision in In re Charter Communications, Inc. however, affirms the ability of debtors to confirm a plan that reinstates prepetition loans. It remains to be seen whether Charter will become a template for reinstatement by other debtors, but Charter does illustrate that loan agreements must be drafted with specificity and a careful eye toward prospective defaults, or lenders may be forced to reinstate a prepetition debt at unfavorable market rates.

Background to Charter’s Filing

On March 27, 2009, Charter Communications Inc. along with certain affiliates (collectively, Charter) filed for
chapter 11 protection in one of “perhaps the largest and most complex prearranged bankruptcies ever attempted.”

Though operationally sound, Charter was heavily leveraged with almost $22 billion in debt and needed to restructure immediately to avoid a potentially catastrophic “free-fall” bankruptcy.

Charter’s proposed restructuring plan sought to trim the company’s debt by having certain bondholders engage in a debt-for-equity exchange. Significantly, the plan also sought to reinstate $11.8 billion in senior debt at interest rates far below those currently available on the credit market. Charter argued that reorganization would be impossible without reinstating its existing loan because its annual interest costs in obtaining a similar facility would increase by over $500 million, if indeed the facility could be replaced on any terms at all.

The most controversial component of the proposed plan was its settlement with Charter’s controlling shareholder, Paul Allen. Crucially, the plan divested Allen of all ownership of Charter stock, but provided that Allen would retain 35 percent voting control of Charter to avoid triggering an event of default under Charter’s loan agreement. In exchange for his postpetition services yielding interest savings and preserving tax attributes worth billions, Allen received compensation totaling approximately $375 million.

Charter’s senior lenders vigorously opposed the plan, arguing that the reduction of Allen’s ownership interest triggered an event of default under the loan agreement that precluded Charter’s ability to reinstate the loan and entitled the lenders to renegotiate the loan on current market terms.

The Court’s Decision

In its confirmation opinion, the court lauded Charter’s plan to reduce its debt load during “perhaps the most challenging period in the modern era of global corporate finance” as an “extraordinary achievement” pursued with “singular creativity and determination.” Contrary to the lenders’ contention, the court found that the plan’s consummation would not result in a “change of control” because Paul Allen would retain sufficient voting power.

The court noted that the amended credit agreement required Allen to maintain the minimum voting requirement of 35 percent, but specifically omitted the requirement that Allen hold any economic interests in Charter. The court explained that these amended provisions were designed to “allow for a formalistic retention of control” by Allen while allowing for equity investment by other parties “in the very manner proposed” by Charter’s plan.

In addition, the court found the settlement between Charter and Paul Allen to be fair and in the best interests of the estate. Although the court noted that Allen should naturally take actions to benefit Charter without valuable consideration, it recognized that “Mr. Allen is a businessman and that Charter is not and never was a philanthropic venture,” making compensation for his postpetition actions and forbearances appropriate.

The court also noted that although Allen’s compensation of roughly $375 million was significant in absolute dollars, it was “not excessive in comparison to what Charter is to receive.” Because Charter established that no defaults had occurred or would occur under the credit agreement upon the plan’s consummation and that the senior lenders were paid in full under the plan with interest, the court found that Charter’s plan satisfied the requirements for reinstatement under Bankruptcy Code §1124.

Lessons of Charter

During the credit boom, lenders allowed many companies to obtain credit at favorable terms, with particularly loose restrictions and covenants. As seen in Charter, however, many of these loosely written covenants and restrictions may present little obstacle to reinstatement of prepetition loans.

In rejecting the lenders’ argument that an ambiguously drafted change-of-control provision precluded reinstatement of Charter’s loan, the court emphasized that the lenders had not offered any “cogent explanation” as to the “practical importance” of a formula in the covenant or otherwise illustrated how it related to the credit risk of the borrower.

The court emphasized that the lenders’ suggested reading of the covenant lacked any business rationale and instead appeared to be a mere “corporate land mine” to be avoided if reinstatement was to be achieved.

The court also rejected the lenders’ argument that an “intentionally vague” surplus covenant in Charter’s credit agreement was in default. The bankruptcy court was displeased with the lenders’ claim of purposeful ambiguity, noting that vagueness is not a “desirable characteristic for identifying a potential default,” particularly in cases where there are billions of dollars at stake.

The court held that the lenders’ suggested reading of the covenant was so “speculative, so impractical and so potentially problematic in its application as to be unworkable and implausible.”

Thus, Charter appears to suggest that loosely drafted loan covenants will offer lenders little protection from reinstatement in future cases unless lenders are able to articulate a business purpose in support of their suggested reading beyond a technical “landmine” function. In the event that such a provision is ambiguously written, bankruptcy courts may interpret the ambiguity in favor of the nondrafting party, especially if lenders drafted such covenants with intentional ambiguity.

See also Eric Morath, “Companies Mull Loan Reinstatement in Bid to Exit Bankruptcy.” Daily Bankruptcy Review, Aug. 19, 2009 (“The possibility of breached [change-of-control] covenants opens the door for lenders to claim they are not being made whole, but that can be difficult to prove.”) and Todd Zywnicki, a bankruptcy law professor at George Mason University. "Lenders would have to show that there is some tangible harm to them," he said. "That the change in ownership somehow makes it a fundamentally different company than what they loaned to.”

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Conclusion

Traditionally, a debtor’s best negotiation tool with a secured creditor was the threat of cramdown on the secured class, so long as one impaired “noninsider” class has accepted the plan and the plan satisfies the provisions of §1129(b). If Charter is affirmed on appeal, however, debtors will have yet another bargaining tool in out-of-court workouts with the threat of “cramming-up” a plan on secured lenders through reinstatement of prepetition loans.

Given the continuing dislocation in the DIP lending market, many companies may follow Charter’s example of seeking to reorganize while holding on to attractively priced financing negotiated during the pre-2008 credit bubble. Charter’s precedent may provide debtors with a powerful defense against secured lenders seeking to force a quick liquidation of the debtor’s assets to obtain a quick recovery. On the other hand, widespread application of Charter could also raise concerns for companies emerging from bankruptcy with excessive debt, creating increased risk of repeat filings.

Though the full consequences of its precedent are difficult to predict, Charter will undoubtedly influence the pre-bankruptcy negotiating landscape between debtors and prepetition lenders for the foreseeable future, as DIP lending remains scarce.


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