Ingredients for a Successful Cram Up Reorganization

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Due to the unavailability of replacement or exit financing, companies seeking to reorganize often must restructure their existing secured debt, frequently over the objection of a lender who prefers either an asset sale, which would generate sufficient proceeds to satisfy its debt (but which may not result in a significant recovery for junior creditors), or a renegotiation of terms to reflect changed circumstances. Accordingly, "cram up" reorganization plans, where a secured debt is restructured without the lenders' consent by repaying the debt in full over time, are becoming more common.

In general, there are two cram up methodologies. One technique, reinstatement, involves the curing of defaults, de-accelerating any debt that is due as a result of default, and thereby continuing the terms and maturity of the pre-bankruptcy financing. This approach makes sense in an economic environment where interest rates have risen significantly (which many economists predict will occur in 2010 and 2011) or where debtors enjoy a favorable covenant package and have sufficient time before maturity. A reinstatement can position the debtor for a post-reorganization refinancing when circumstances may be more advantageous.

Alternatively, in situations where maturity is an issue, the indebtedness can be crammed up by either providing the secured creditor with deferred cash payments with a value equal to the debt (assuming the collateral securing the claims provides full coverage) or providing the secured creditor with the "indubitable equivalent" of its secured claim. In determining the present value of deferred cash payments, courts will apply a current market rate of interest.

When interest rates are falling, utilization of deferred payments to cram up may be attractive, as it will allow a borrower to compel its lenders to involuntarily refinance using interest rates that may be lower than an existing facility.

Two recent cases decided by the Bankruptcy Court for the Southern District of New York, *In re Charter Communications Inc.* and *In re DBSD North America Inc.*, confirmed cram up reorganization plans creatively using each of these methods, illustrating the flexibility that Chapter 11 provides financially distressed businesses.

'Cram Up' Through Reinstatement

Prior to the current credit crunch, the senior financing environment was extraordinarily borrower-friendly. Interest rates were at historically low levels and covenants were relaxed. In fact, many transactions were considered "covenant lite" due to the lack of restrictions (affirmative and negative covenants) imposed on the borrower. Given the amount of available liquidity, borrowers also were able to incur several tranches of secured and unsecured debt propelling leverage ratios to unprecedented levels.

In today's economic climate, many of these highly leveraged capital structures are no longer sustainable. However, many companies would still benefit from the favorable terms of the senior tranches of debt, while restructuring or converting all or a portion of the lower tranches to equity. This type of restructuring result is expressly provided for in §1124(2) of the Bankruptcy Code, which allows for confirmation of a plan that reinstates defaulted debt.[1]

Under this reorganization technique, an acceleration of debt due to a default can be reversed by a plan of reorganization that:

(i) provides for the cure of any default (other than a default caused by a bankruptcy filing or relative to financial condition or insolvency, a so called ipso facto default, which is not required to be cured);

(ii) reinstates the maturity of the debt as such maturity existed prior to the default;

(iii) compensates the lender for any damages incurred by it as a result of any reasonable reliance on a contractual provision;

(iv) compensates the lender for any actual pecuniary loss arising from a non-monetary default; and

(v) otherwise does not alter the legal, equitable or contractual rights of the creditor.

In order for a reinstatement cram up plan to be confirmed, there cannot be any non-curable defaults unrelated to the borrower's financial conditions, such as a change of control, so the precise terms of covenants must be scrutinized. These requirements result in disputes as to whether certain defaults are, in fact, capable of being cured.

The bankruptcy court for the Southern District recently rejected arguments that certain defaults were non-curable and confirmed a reinstatement cram up plan of unprecedented scope in *In re Charter Communications*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009),[2] over the determined opposition of secured lenders. In that case, the senior lenders were owed a staggering $11.8 billion at interest rates that were significantly lower than today's market rates. Confirmation of the plan resulted in $500 million in annual interest expense savings for Charter compared to replacement financing that may have been offered under current market pricing.

Charter had a complex legal and debt structure. Simplifying things, there was an operating company (Borrower) that was the principal obligor under the credit agreement with the senior lenders and various holding companies (Holding Companies) that had separate indebtedness under various issuances of bonds.

Under Charter's reorganization plan, approximately $8 billion of junior debt owed by the Holding Companies was consensually removed from the balance sheet and the company was recapitalized with $1.6 billion of new investment. Given the huge amount of debt that would have below market interest rates locked in, the senior secured creditors mounted a vigorous attack on Charter's reinstatement strategy.

The senior lenders objected to confirmation stating that they were excluded from the prepetition negotiations and the junior creditors were utilizing the reorganization case to receive enhanced returns, while locking the senior lenders into below market interest rates. The senior lenders characterized the proposed reorganization as forcing the lenders to finance a leveraged buyout of Charter. The bankruptcy court characterized the case as among the most contentious prearranged bankruptcies in history.

The senior lenders' principal argument was that reinstatement under §1124(2) was not available to Charter because certain defaults were not capable of being cured under §1124(2). Under Charter's credit agreement, each time it borrowed funds, it was a default if any Holding Company was unable to pay its debts as they became due. The lenders claimed that when $250 million was drawn under the facility in November 2008, significant interest payments were due from the Holding Companies in the coming months and there was no available source of cash to make those payments. When the draw was made, a dividend was authorized by the Borrower's board of directors to enable certain of the Holding Companies to pay interest on their debt.

First, the lenders argued that the provision had to be read prospectively and projections showed that the Holding Companies would be unable to satisfy their debts as they became due. Second, the lenders argued that because the Borrower lacked sufficient surplus to make dividends, the Holding Companies could not receive an upstream distribution that was their only source of funds to pay debts on a current basis. The lenders argued that these defaults were fundamental to the lender-borrower relationship and were incapable of being cured, thereby precluding reinstatement.

The senior lenders also relied on a default provision that was triggered if certain Holding Companies failed to make payment on any indebtedness, provided that such failure resulted in the acceleration of the indebtedness. Upon the bankruptcy filing, certain Holding Company debt was accelerated pursuant to various instruments governing such debt. The lenders argued that this default was not an invalid ipso facto clause because it applied to a solvent entity in the Charter family, the Borrower, and because the Borrower was solvent, all of their rights against it should be enforced.

Additionally, the lenders claimed that consummation of the plan of reorganization would result in a change of control that would violate a covenant in the credit agreement that required that Paul Allen retain a specified level of voting control of the Borrower. Thus, the plan did not leave its legal and equitable rights unaltered and would trigger an enforceable default.

Under the plan the voting control was maintained through a settlement agreement with Mr. Allen whereby his $8 billion investment and any meaningful economic interest in Charter would be eliminated, but voting control was continued. Pursuant to this settlement, Mr. Allen was to receive approximately $375 million of consideration and Charter would receive benefits in excess of $3.5 billion through preservation of tax benefits and interest savings made possible by the reorganization plan, among other things.

The Court Did Not Agree

In a lengthy decision, the court rejected all the lenders' arguments and approved the cram up. In so doing, the court expressly recognized that the secured lenders openly acknowledged that their goal in objecting was to obtain an increased interest rate reflective of current higher market rates. The court also noted that the senior lenders had been paid everything owed under the loan facility and even received default interest during the pendency of the bankruptcy cases.

In turning to the specific legal and factual disputes, the court stated that Charter had the burden of establishing the confirmation requirements were met, and the secured lenders had the burden to establish that defaults existed, each by the preponderance of the evidence.

The court examined the alleged violation of the provision that required that the Holding Companies have the ability to pay their debts as they became due. The court heard expert testimony as to the enterprise value of Charter to help determine whether the Borrower had sufficient surplus that would enable it to make the dividends at issue. Faced with greatly conflicting valuations by various experts, the court was not convinced that the authorization of the dividends was improper and declined to second guess the Board's judgment in authorizing dividends.

The court interpreted the "unable to pay debts as they become due" provision as addressing a present ability to pay debts, not a forward looking covenant addressing a future occurrence. The court noted that a prospective reading was not appropriate, as a covenant tied to future events that might or might not come to pass lacks specificity, and it was not practical to permit a lender to enforce a default based on presumptions that could be wrong. Moreover, the evidence was inconclusive as to any prospective inability, even accepting the lenders' interpretation, given that Charter had multiple strategies for moving cash within the corporate family by intercompany transfer.

The court also rejected the lenders' argument that the acceleration of the Holding Companies debt created an incurable default. The court noted that cross defaults must be carefully scrutinized to prevent the enforcement of a provision that would override federal bankruptcy policy and improperly hamper a debtor's reorganization. Given that the secured lenders made loans to an integrated network of legal entities, and the defaults were all integrated legally and factually, the court held that such cross default was an unenforceable ipso facto clause.

The court also rejected the argument that the restructuring of Charter would result in a change of control. The court noted that the lenders had failed to proffer a convincing explanation as to the business importance of the covenant or how it affected Charter's credit profile, and declined to deny reinstatement based on a "corporate land mine."

Thus, the court held that reinstatement was appropriate and confirmed Charter's reorganization plan.

Indubitable Equivalent Cram Up

Historically, the most common cram up of secured debt utilized §1129(b)(2)(A)(i) of the Bankruptcy Code, which permits confirmation of a plan over the objection of a class of secured claims if the creditors

(i) retain their liens and

(ii) receive deferred cash payments with a present value equal to the amount due, or equal to the value of the collateral, whichever is less.

While this provision can be useful, secured creditors must maintain their liens, which can preclude use of the reorganized debtor's assets for a working capital facility or other purposes. This can hamper a reorganized debtor's ability to operate post-confirmation and imposes a practical limitation on the effectiveness of this strategy.

However, an example of a cram up strategy that allowed junior debt to be restructured while making a portion of senior lenders' collateral available for working capital is *In re DBSD North America Inc.*, 419 B.R. 179 (Bankr.

S.D.N.Y. 2009). In that case, the debtor confirmed a plan over the secured creditor's objection using §1129(b)(2)(A)(iii) of the Code by providing the secured creditor with the "indubitable equivalent" of its claims.

Under the plan, the first lien debt was restructured under an amended facility with a four year term and PIK (payment in kind) interest at 12.5 percent, such that there would be no cash payments until maturity. In considering whether the plan should be confirmed, the court analyzed whether the creditor was provided the indubitable equivalent of its claim.

The court examined whether the secured creditors' claim was protected to the same extent it was pre-confirmation, i.e., whether the claim was sufficiently over collateralized. The court answered this question affirmatively as the assets securing the debt had an enterprise value six times the obligations due at maturity. (The court compared this to a case where the margin was only 10 percent and confirmation was denied).

The court held that an interest rate of 12.5 percent, which was payable in kind at the debtor's option, was an appropriate interest rate for the four year amended facility given the current low interest rates on treasury securities.

The *Charter* and *DBSD* cases demonstrate the Bankruptcy Code's utility in restructuring secured debt if the right factual predicates are present.

If a company has a favorable loan facility that has below market interest rates or a favorable covenant package, a reinstatement cram up can be of great value. The *Charter* case illustrates that loans made with a relaxed covenant package may not present incurable defaults and can be prime candidates for a reinstatement cram up.

Alternatively, the *DBSD* case illustrates that if there is sufficient collateral coverage, an indubitable equivalent cram up may be workable, although the *DBSD* case presented a somewhat unusual set of facts in the magnitude of the assets securing the debt. Under such a reorganization, the maturity of the secured debt can be extended with interest that accrues, thereby conserving cash flow for use in the business, and assets can be removed from the collateral package to provide working capital or support for another financing facility.

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Endnotes:

1. Reinstated debt that satisfies §1124(2) will be rendered "unimpaired" and accordingly the holder will be unable to vote on the plan and may not be able to argue that the plan is not "fair and equitable."

2. This decision is currently on appeal. However, as the plan of reorganization has been consummated, the appellants may have to overcome a motion to dismiss on the grounds of equitable mootness.