REINSTATEMENT OF DEBT: A BANKRUPTCY COURT'S STRICT INTERPRETATION AND APPLICATION OF CHANGE-IN-CONTROL PROVISIONS TO PROTECT SENIOR SECURED LENDERS

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In *In re Young Broadcasting, Inc., et al.*, 430 B.R. 99 (Bankr. S.D.N.Y. 2010), a bankruptcy court strictly construed the change-in-control provisions of a pre-petition credit agreement and refused to confirm an unsecured creditors' committee's plan of reorganization, which had been premised on the reinstatement of the debtors' accelerated secured debt under Section 1124(2) of the Bankruptcy Code.

"Reinstatement" refers to a chapter 11 plan proponent's ability to reinstate the pre-default terms of an accelerated debt by curing all defaults. This cure is typically accomplished by paying off all late payments and other arrearages and bringing the loan current. The bankruptcy court in *Young Broadcasting* rejected the committee's attempt to reinstate the debtors' senior secured debt because the committee's plan resulted in a default under the change-in-control provisions of the pre-petition credit agreement. In so holding, the bankruptcy court rejected the committee's arguments that certain provisions of the plan which "formalistically" complied with the change-in-control provisions were sufficient to avoid a default, finding the plan provisions to violate the plain terms and clearly expressed purpose of the change-in-control provisions.

Factual Background

Young Broadcasting, Inc. ("**YBI**") and certain affiliates (collectively, the "**Debtors**") owned and operated various television stations across the country and a national television sales representation firm. Prior to the bankruptcy filing, YBI had obtained senior secured financing of $350 million (the "**Senior Secured Debt**"). In addition, YBI had issued senior subordinated notes in the amount of $640 million.

After filing for chapter 11, competing plans of reorganization were filed in the Debtors' jointly-administered cases by the Debtors and the Official Committee of Unsecured Creditors (the "**Committee**"). Under the Debtors' proposed plan, holders of the Senior Secured Debt would receive equity in a new company formed to hold all of the common stock of the reorganized Debtors and the senior subordinated noteholders would receive equity warrants in the new company. As a result, the Debtors would be completely deleveraged.

By contrast, the Committee's proposed plan would reinstate $338 million of the Senior Secured Debt. The Committee's plan would also provide the senior subordinated noteholders with a pro rata share of 10% of the reorganized Debtors' common stock and options to purchase preferred stock and additional common stock. In connection with the proposed reinstatement, and in an attempt to remain in compliance with the change-in-control provisions of the credit agreement (described below), the Committee's plan provided that Vincent Young, one of the Debtors' founders ("**Mr. Young**"), would receive all of the Class B shares of common stock of the reorganized Debtors and certain accompanying voting rights described further below. Upon full repayment of the Senior Secured Debt in November 2012 (the original maturity date), such stock would convert to 10% of the Class A common stock.

Holders of the Senior Secured Debt objected to confirmation of the Committee's plan on the grounds that the proposed reinstatement was impermissible as it would violate certain change-in-control provisions in the credit agreement and that the plan was not feasible and violated the absolute priority rule.

Analysis

Section 1124 of the Bankruptcy Code defines when a creditor's claim is deemed "impaired", thereby entitling the creditor to vote on a plan of reorganization. A creditor whose claim is "unimpaired" is not entitled to vote. Pursuant to Section 1124(2), a plan of reorganization may render a claim unimpaired by providing for the reinstatement of the original terms of the prepetition obligation as it existed before default. This Section requires (i) that the plan provides for the cure of any payment or performance defaults (other than an *ipso facto* default), (ii) that the plan provides for compensation for any damages caused by the creditor's reasonable reliance on the right of acceleration, (iii) that the plan provides for compensation for any actual pecuniary losses incurred as a result of a failure to perform a nonmonetary obligation, (iv) that the plan provides for the affirmation of the original terms, including maturity, and (v) that the plan not otherwise alter the legal, equitable or contractual rights of the creditor. Because an obligation that is so reinstated is deemed to be unimpaired, the reinstated creditor is deemed to have accepted the plan of reorganization and will have no right to vote. In effect, by meeting the requirements set forth under Section 1124(2), the plan proponent will have the ability to reverse a lender's exercise of its contractual or legal right of acceleration and reinstate the original terms of the obligation. This can be a powerful tool for debtors and creditors when formulating plans under chapter 11 of the Bankruptcy Code. It is typically used with respect to obligations that had been accelerated pre-petition. Fully matured obligations must be paid in full in order to be reinstated.

In *Young Broadcasting*, the holders of the Senior Secured Debt argued that reinstatement was improper because the terms of the plan violated the change-in-control provisions in the credit agreement, resulting in uncured defaults. Both sides cited to *In re Charter Communications*, 419 B.R. 221 (Bankr. S.D.N.Y.

2009), where the bankruptcy court found no default under a change-in-control provision when a plan of reorganization provided the relevant principal with the necessary voting rights and voting power, but divorced those rights from the underlying economic interest in the company (i.e., the principal's voting power was out of proportion to his underlying equity interest in the reorganized debtor).

The pertinent provisions of the Senior Secured Debt holder's credit agreement provided that a change-in-control default would occur if Mr. Young, his immediate family members, certain persons controlled by Mr. Young and members of management ceased to hold over 40% of the Voting Stock (which stock granted the holder general voting power to elect the board of directors). The credit agreement also required that if any person or group were to own more than 30% of the total outstanding Voting Stock, then the Young group must own more than 30% or, alternatively, have the right or ability to elect a majority of the Debtors' board of directors.

The Committee's plan provided for two classes of directors and two classes of stock with different voting rights. There would be six Class A directors and one Class B director. The stock was likewise split between Classes A and B, with Mr. Young receiving all of the Class B shares of common stock of the reorganized Debtor. Each Class A share of common stock (5,000,000 of which were to be issued) would have 20 votes for Class A directors and 1 vote for the Class B director. Each Class B share of common stock (500,000 of which were to be issued) would have 1 vote for Class A directors and 1,000 votes for the Class B director. Under this structure, the Committee argued that the terms of its plan complied with the change-in-control provisions of the credit agreement because Mr. Young, who would be given all of the Class B stock, would have over 82% of the vote – far in excess of the 40% requirement. The Committee arrived at this figure by comparing the total number of votes Mr. Young would be entitled to vote (i.e. 500,500,000) to the total number of votes all Class A shareholders would be entitled to vote (i.e. 105,000,000). Thus, the Committee relied on the idea that Mr. Young's retention of 82% of the absolute number of votes would suffice to avoid a default under the change-in-control provisions, even though, as a result of the two tiers of directors and stock, Mr. Young retained much less than the required 40% of the actual voting power.

Disagreeing with the Committee's contentions, the bankruptcy court, applying New York law to interpret the credit agreement, found that the plain meaning of the change-in-control provisions required that the Young group retain the power to elect over 40% of the entire board of directors and not just over 40% of the votes. Under the Committee's proposed terms, Mr. Young would have the ability to control less than 15% of the entire board. The bankruptcy court found that the clear intent of the change-in-control provisions was to preclude third parties from obtaining more control than the Young group and management. Accordingly, the bankruptcy court held that reinstatement of the Senior Secured Debt pursuant to the Committee's plan was impermissible since the plan resulted in defaults under the change-in-control provisions of the pre-petition credit agreement that were not cured.

The bankruptcy court also denied confirmation of the Committee's Plan for failure to meet the requirement under Bankruptcy Code Section 1129(a)(11) that the plan be feasible. Applying the "reasonable likelihood of success" standard for feasibility and looking at expert valuations and projections, the bankruptcy court found that the Committee's plan was not feasible because the Committee failed to establish that the reorganized Debtors could satisfy the Senior Secured Debt upon maturity in November 2012 through either a sale or a refinancing.

Lastly, the bankruptcy court found that the Committee's Plan violated the absolute priority rule because the Committee failed to produce sufficient evidence showing that the distribution of equity to Mr. Young, while general unsecured creditors were not paid in full, was outweighed by the value of the benefits conferred by reinstatement of the Senior Secured Debt. Thus, ultimately, the Committee in *Young Broadcasting* was unable to establish that reinstatement was a beneficial bargain for the estate.

Lessons Learned

Young Broadcasting has lessons for both lenders and debtors. For lenders, it highlights the importance of clearly drafted change-in-control provisions which can be used as a weapon to guard against an unfavorable reinstatement in a chapter 11 bankruptcy case. For debtors and other plan proponents, *Young Broadcasting* establishes some clear limits on the gamesmanship that can be played with change-in-control provisions in a reinstatement under Bankruptcy Code Section 1124(2). Though the *Charter Communications* case indicates that it may be possible to separate the economic interest from the voting interest, *Young Broadcasting* shows that it may not be possible to separate the actual number of votes from the underlying voting power and avoid a change-in-control default. The equitable considerations at play in *Young Broadcasting* also highlight the importance of clearly establishing the economic benefits to be obtained by the estate from the reinstatement.

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