SECURITIES LAW EXEMPTIONS FOR PURCHASE AND SALE OF CHAPTER 11 PLAN SECURITIES

For a debtor in chapter 11, a plan of reorganization which deleverages the debtor’s capital structure by exchanging senior secured loans for equity in the reorganized debtor is a not uncommon outcome, and indeed may be the purpose of the bankruptcy filing in the first place. From the debtor’s perspective, and from the perspective of many of the holders of the loans, this may be an entirely positive development. Other investors in the debtor’s bank loans, however, may be less than thrilled at the prospect of holding equity in the reorganized debtor and may seek to sell any equity they receive pursuant to such a plan of reorganization. For such creditors, the ability to resell such “plan securities” as freely as possible will be an important consideration when deciding whether or not to support a plan of reorganization.1 Fortunately for such creditors, section 1145 of the Bankruptcy Code will very often provide creditors desiring to do so with the ability to freely resell plan securities.2

Section 1145 of the Bankruptcy Code provides in pertinent part as follows:

(a) Except with respect to an entity that is an underwriter as defined in subsection (b) of this section, section 5 of the Securities Act of 1933 and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security do not apply to:

(1) the offer or sale under a plan of a security of the debtor, or an affiliate participating in a joint plan with the debtor, or of a successor to the debtor under the plan -

   (A) in exchange for a claim against, an interest in, or a claim for an administrative expense in the case concerning, the debtor or such affiliate; or

   (B) principally in such exchange and partly for cash or property;

(2) the offer of a security through any warrant, option, right to subscribe, or conversion privilege that was sold in the manner specified in paragraph (1) of this subsection, or the sale of a security upon the exercise of such warrant, option, right or privilege;

...


2 Of course, there may be other, non-statutory, restrictions on a creditor’s ability to resell plan securities such as those often found in shareholders’ agreements, i.e., rights of first refusal and similar provisions. Such contractual restrictions on resale are beyond the scope of this memorandum.
(b) (1) Except as provided in paragraph (2) of this subsection and except with respect to ordinary trading transactions of an entity that is not an issuer, an entity is an underwriter under section 2(11) of the Securities Act of 1933, if such entity -

(A) purchases a claim against, interest in, or claim for an administrative expense in the case concerning, the debtor, if such purchase is with a view to distribution of any security received or to be received in exchange for such a claim or interest;

(B) offers to sell securities offered and sold under the plan from the holders of such securities;

(C) offers to buy securities offered or sold under the plan from the holders of such securities, if such offer to buy is -

(i) with a view to distribution of such securities; and

(ii) under an agreement made in connection with the plan, with the consummation of the plan, or with the offer and sale of securities under a plan; or

(D) is an issuer, as used in section 2(11), with respect to such securities.

... 

(b) (3) An entity other than an entity of the kind specified in paragraph (1) of this subsection is not an underwriter under section 2(11) of the Securities Act of 1933 with respect to any securities offered or sold to such entity in the manner specified in subsection (a)(1) of this section.

... 

(c) an offer or sale of securities of the kind and in the manner specified under subsection (a)(1) of this section is deemed to be a public offering.

The requirement that plan securities be issued in exchange, or principally in exchange, for claims against or interests in the reorganized debtor renders section 1145 inapplicable to securities issued to raise “fresh capital.” Such securities must be registered by the issuer (or an alternate exemption from the registration requirements found) and recipients of such securities could not look to section 1145 to allow resale of such securities without registration. The staff of the SEC, in no-action letters, agreed that plan securities could be issued without registration in reliance on section 1145(a)(1)(B) where the cash consideration paid by creditors for plan securities represented a substantial portion of the total consideration for such securities, so long as the value of the claims being exchanged for plan securities exceeded the value of the cash consideration for such plan securities.

Thus, securities received pursuant to a confirmed plan of reorganization entirely or principally in exchange for claims against the reorganized debtor will be exempt from the registration requirements of section 5 of the Securities Act and may be resold without registration so long as the...

3 Section 1145(b)(2) provides that a entity does not become an underwriter merely by virtue of being party to an agreement providing for the matching or combining of fractional interests in plan securities.

4 8 Collier on Bankruptcy 16th ed. rev. ¶1145.02[1][a] at 1145-20. Such an exemption might well be found in section 364(f) of the Bankruptcy Code or in section 4(2) of the Securities Act. Id.

recipient of such securities is not determined to be an “underwriter” as that term is defined in section 1145(b) of the Bankruptcy Code.6 A creditor may be found to be an underwriter (and accordingly unable to resell plan securities absent an effective registration statement or availability of another exemption under the Securities Act) if such creditor, acting outside the scope of its normal trading activities, acquires claims against the debtor with a view toward distributing the securities received in exchange for such claims, offers to sell plan securities on behalf of the holders of such securities or offers to buy plan securities from the holders of such securities if such offer is with a view to distribution of such securities. Courts have noted, however, that the purpose of section 1145 is to “encourage reorganization and to relieve bankrupt entities of the strict requirements of securities law so long as adequate disclosure is made”7 and that accordingly, the exception for “underwriters” found in section 1145(b) should be limited to “real” underwriters (i.e., those engaged in a distribution of securities to the public) rather than “technical” underwriters.8 The positions taken by the staff of the SEC in no-action letters reflects this remedial purpose.9

While the determination of whether an entity is an underwriter for purposes of section 1145(b) is fact intensive, there are certain activities that a creditor could undertake while trading in a debtor’s bank debt which would raise the possibility that such creditor might be found to be an underwriter with respect to plan securities issued by the debtor. Accordingly, these activities should be subjected to careful scrutiny.10 Such activities would include (i) transactions in the debtor’s bank debt that fall outside the scope of the creditor’s ordinary trading activities, (ii) preparation or use of any special information or marketing documents in connection with the sale of plan securities, (iii) receipt or payment of any special compensation in connection with the sale of plan securities, (iv) entry into any agreements, whether written or oral, with other entities regarding the coordinated purchase and sale of plan securities or (v) any activities which could result in ownership of a significant portion of the reorganized debtor’s voting equity or otherwise lead to a finding that the creditor was in control of the reorganized debtor at the time of the resale of plan securities. With respect to sections 1145(b)(1)(A-C), the key considerations are whether the transactions entered into by the creditor are within the scope of that creditor’s ordinary trading transactions and whether these transactions indicate that the creditor is engaged in a distribution of securities to the public. With respect to section 1145(b)(1)(D), the key consideration is whether a creditor could be considered to be in control of the reorganized debtor.

**Ordinary Trading Transactions**

The staff of the SEC has identified in no-action letters several factors which might prevent a transaction from being considered an ordinary trading transaction. These factors include

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6 Section 1145 is a “transaction exemption” rather than a “securities exemption,” and subsequent resales of plan securities would thus require a separate exemption. However, the effect of section 1145(b)(3), which provides that only entities described in section 1145(b)(1) are underwriters for purposes of section 2(a)(11) of the Securities Act, combined with section 1145(c), which provides that a distribution in the kind and manner referred to in section 1145(a)(1) is a public offering will render any subsequent sales of plan securities by non-section 1145 underwriters eligible for the section 4(1) exemption for transactions by any person other than an issuer, underwriter, or dealer. 8 Collier on Bankruptcy 16th ed. rev. ¶1145.03[2] at 1145-28; ¶1145.04 at 1145-40.

7 In re Amarex, Inc., 53 B.R. 12, 14 (Bankr. W.D. Okla. 1985); In re Kenilworth Systems Corp., 55 B.R. 60, 62 (Bankr. E.D.N.Y. 1985) (section 1145(b) “promotes creditor acceptance of reorganization plans by allowing certain creditors to accept a reorganization with a view to reselling securities obtained under the plan”).


10 In the event that multiple series of plan securities are issued, a creditor’s status as an underwriter should be examined on a series by series basis.
Concerted action by recipients of plan securities in connection with the sale of plan securities, or concerted action on behalf of one or more such recipients in connection with such sales by distributors;

Use of informational or marketing documents concerning plan securities prepared or used to assist in the resale of plan securities, other than the debtor’s disclosure statement, supplements thereto, if any, and documents filed with the SEC by the debtor pursuant to the 1934 Act, such as its annual and quarterly reports on Forms 10-K and 10-Q; and

Special compensation to brokers and dealers in connection with the sale of plan securities designed as a special incentive to resell plan securities, i.e., compensation beyond ordinary-course compensation paid pursuant to arms-length negotiations between a seller and a broker for transacting in the securities.\(^{11}\)

Accordingly, any sales of plan securities by a creditor that involved coordinated selling along with other recipients of such securities or that involve co-coordinated action taken at the request of other recipients of the plan securities may prevent resale of plan securities and should be carefully scrutinized, particularly if they are outside the scope of ordinary trading transactions. Similarly, any use of documents (including emails) prepared by a creditor to facilitate the sale of such securities (as opposed to documents prepared by the debtor and filed with the bankruptcy court such as a disclosure statement) should be carefully scrutinized, as should any compensation arrangements for brokers, salespeople, etc. that could constitute a special payment or incentive in connection with such sales.

This is not to say, however, that creditors cannot increase their positions, even substantially, in loans that may be converted to plan securities or cannot subsequently sell plan securities received in exchange for an increased position to multiple buyers. Sales of plan securities, even sales by entities who may be “accumulators” and “distributors” under section 1145(b)(1)(A) - (C) should constitute ordinary trading transactions, and thus be exempt from registration requirements, if the issuer, post-bankruptcy, is a reporting company, and the sale is executed on a national exchange or in the over the counter market.\(^{12}\)

**View Toward Distribution**

The determination of whether a creditor purchased or offered to purchase a claim against a debtor with a view toward distribution of plan securities should be made at the time such loans are purchased (or such offer is made).\(^{13}\) Thus, to the extent a creditor purchased or offered to purchase bank loans prior to a debtor’s commencement of a bankruptcy case, it will have a strong argument that such claims were not purchased with a view toward distribution of plan securities. A creditor may similarly have a strong argument with respect to any loans purchased prior to the filing of a plan of reorganization which contemplates the issuance of plan securities. Such a creditor would presumably be able to argue convincingly that its purchase of bank loans was made not with a view toward distribution, but with a view toward receiving payment in full of the loan (or a subsequent resale of the loan). The creditor’s intent in purchasing a claim is, of course, a fact specific inquiry, and unusual circumstances, such as the presence of significant speculation regarding possible conversion of claims to securities even prior to the filing of a plan of reorganization, could be

\(^{11}\) 8 Collier on Bankruptcy, 16th ed. rev., ¶ 1145.03[3][d] at 1145-33.


construed to suggest that loans were purchased with a view toward distribution. Nonetheless, in general, a creditor should only be found to have acquired claims with a view toward distribution if that creditor acquired its claim as part or an organized effort to distribute plan securities to the public. So long as the factors identified in the discussion of “ordinary trading transactions” (i.e., group selling or buying, special selling documentation and special selling compensation) are not present, a creditor should not be considered to have acquired its claims with a view towards distribution and accordingly should be able to resell plan securities without registration.

Control

Section 2(a)(11) of the Securities Act includes within the definition of “issuer” persons controlling, controlled by, or under common control with the issuer, thus rendering such “control persons” subject to the registration requirements of section 5 of the Securities Act (and rendering them ineligible for the section 4(1) exemption for transactions by entities other than issuers, underwriters or dealers). Responding to concerns that the SEC would consider holders of as little as 1% of the reorganized debtor’s equity to be issuers under this definition, Congress enacted section 1145(b)(1)(D) to clarify that only persons truly exercising control over the reorganized debtor would be excluded from section 1145’s exemption. It appears from the legislative history that Congress assumed that holders of more than 10% of the equity securities of a reorganized debtor would be considered to be in “control” of the reorganized debtor, and thus an “issuer” subject to the registration requirements of section 5. Although there is little support under the Securities Act for such a bright line test, this legislative history and subsequent staff interpretations indicate that a holder of less than 10% of the reorganized debtor’s equity, absent other indicia of control, should not be considered an “issuer” for purposes of section 1145(b)(1)(D). While mere ownership of more than 10% of the reorganized debtor’s equity will not necessarily result in the holder of such plan securities being considered to be an underwriter for purposes of section 1145(b), substantial ownership of a reorganized debtor’s equity securities in conjunction with other relationships, such as board membership or officer positions, which would convey upon a creditor the power to direct the affairs of the reorganized debtor may result in that creditor’s being deemed an issuer for purposes of section 1145 and thus unable to resell plan securities without registration. Accordingly, any situation in which a creditor receives more than 10% of a reorganized debtor’s equity should prompt a closer review.

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14 Id., citing Fortgang and Mayer, 12 Cardozo L. Rev. at 61. For example, a creditor who had participated in the negotiation of a plan calling for issuance of securities might have difficulty arguing that it acquired the loans with a view toward payment in full (though such knowledge would not, in and of itself, cause the creditor to be considered to have purchased with a view toward distribution). Maintenance of proper information blocking procedures, however, should ameliorate this concern.


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