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Commentary

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I. Pre-Petition Solicitations Of Bankruptcy Reorganization Plans

With respect to post-petition solicitations of acceptances of Chapter 11 bankruptcy reorganization plans, the Federal Bankruptcy Code (the "Code") clearly preempts federal and state securities laws in most circumstances. Unfortunately, the Code is almost devoid of guidance in the area of prepetition solicitations of a bankruptcy reorganization plan. Such a prepackaged plan of reorganization is referred to in this article in shorthand as a "prepack". In a prepack, a debtor negotiates the terms of a Chapter 11 reorganization plan with its primary creditors and solicits acceptances from its creditors prior to the bankruptcy filing. Prepacks have not only grown in acceptance but have also become quite prevalent.

Section 1125(g) of the Code provides that prepack acceptances may be solicited before the commencement of a bankruptcy case, if the solicitation complies with applicable non-bankruptcy laws (such as securities laws). In turn, Section 1126(b) of the Code provides that a creditor or interest holder who accepts or rejects a plan of reorganization before the commencement of the bankruptcy case is deemed to have accepted or rejected the plan if the solicitation of the acceptance or rejection was in compliance with any applicable non-bankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with such solicitation, or if there is not any such law, rule, or regulation, such acceptance or rejection was solicited after disclosure to such holder of adequate information. For the prepack acceptances to be valid, Federal Bankruptcy Procedure Rule 3018(b) requires that: (1) the plan must be transmitted to substantially all creditors and equity security holders; (2) a reasonable time must be provided for creditors and security holders to accept or reject the plan; and (3) the solicitation must comply with Code Section 1126(b).

After a petition for bankruptcy has been filed, the bankruptcy court must approve the adequacy of a disclosure statement used in the prepetition solicitation of acceptances of the prepackaged reorganization plan and then confirm the reorganization plan, which typically requires two separate hearings. However, pursuant to Section 105(d)(2)(B)(vi) of the Code, the court may combine the hearing on approval of the disclosure statement with the hearing on confirmation of the plan. By combining the two hearings, the court's confirmation of the prepackaged reorganization plan may be expedited, reducing the time and cost necessary to have the reorganization plan confirmed.

If the solicitation process or disclosures are determined by the bankruptcy court to be inadequate, the court will

likely require that a new solicitation of creditors and interest holders must occur, with all of the resulting delays and expenses. It is important that those parties proposing a prepack comply with federal and state securities laws in preparing the disclosures. Expert securities advice should always be sought to understand the complexities and details of federal and state securities laws.

II. Securities Law Definitions

A. Federal Securities Law Categories Of Parties

The federal securities laws generally divide the universe of parties who may be subject to regulation under such laws into the categories of "issuers," "underwriters," "dealers," and "brokers." The term "issuer" generally means any person who issues or proposes to issue any security. In connection with a pre-petition bankruptcy reorganization plan, the "issuer" for securities law purposes would typically be the debtor. In some cases, however, a plan may call for creation of a new or successor entity that would be deemed to be the issuer of the securities for federal securities law purposes.

The term "underwriter" is generally defined to mean any person who has purchased from an issuer (or an affiliate of the issuer) with the view to, or offers or sells for an issuer (or an affiliate of the issuer) in connection with, the distribution of any security or participates or has a direct or indirect participation in any such undertaking. In the context of a bankruptcy reorganization plan, this definition could include most of a debtor's creditors and security holders who typically intend to resell or dispose of any securities received pursuant to a plan as soon as a market develops after plan confirmation. It also could include anyone soliciting acceptances of a plan, if the solicitation constitutes an "offer" of securities. Any person who participates in the solicitation of acceptances of a pre-petition bankruptcy reorganization plan should consider whether he or she could be deemed an "underwriter" for purposes of federal securities laws.

The term "dealer" generally means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise. The term "broker" generally means any person engaged in the business of effecting transactions in securities for the account of others. These definitions should not have any unusual applications in the context of a pre-petition bankruptcy plan solicitation.

B. Definition Of Security

The term "security" for purposes of both federal and state securities laws is broadly defined to include any note, certificate of indebtedness, bond, stock, certificate of interest or participation in any profit sharing agreement, voting trust certificate, investment contract, fractional undivided interest in oil, gas or other mineral rights or, in general, any interest or instrument commonly known as a "security." Each party involved with a pre-petition solicitation of acceptances of a bankruptcy reorganization plan should review whether any new contract or interest to be executed, issued or distributed in connection with the plan constitutes a security. If so, review should also be made as to whether the security constitutes an "exempt security." The securities exemptions for the Securities Act of 1933, as amended (the "1933 Act"), are found in Section 3(a)(1)-(8) and the exemptions for the Securities Exchange Act of 1934, as amended (the "1934 Act"), are found in Section 3(a)(12). The exemptions provided in 1933 Act Section 3(a)(9), (10) and (11) are considered by the Securities and Exchange Commission (the "SEC") to be transactional exemptions (based upon the type of transaction in which the securities are offered, sold or issued) and not complete exemptions for the securities themselves. In a bankruptcy reorganization context, the most common type of securities exemption under the 1933 Act will be that provided by Section 3(a)(7) for certificates issued by a receiver, trustee or debtor-in-possession under the Code, with bankruptcy court approval.

C. Definition Of Offer

The term "offer" is generally defined in federal and state securities laws to include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. A bankruptcy reorganization plan usually calls for the issuance of a new security in exchange for an existing interest or claim. Solicitation of acceptances of a plan, therefore, may be considered an "offer" of a security.

SEC Rule 145 deems an "offer" of a security to exist where there is submitted for a vote or consent of security holders of an issuer any "plan or agreement for . . . [a] reclassification of securities of such corporation or other person, other than a stock split, reverse stock split, or change in par value, which involves the substitution of a security for another security . . ." A reclassification or substitution of existing securities for new securities is

a primary component of most bankruptcy reorganization plans. Since a plan must be submitted for acceptance or rejection by security holders, Rule 145 may be applicable absent an appropriate exemption.

D. Definition Of Sale

The term "sale" is generally defined by securities laws to include every contract of sale or disposition of a security or interest in a security for value. The concept of a "sale" of securities cannot be neatly applied to the typical solicitation of acceptances of a bankruptcy reorganization plan. The acceptance of a bankruptcy reorganization plan does not create an express "contract" between two separate parties to "dispose of" a security. In lieu of a "contract," acceptance of a proposed plan is contingent upon ultimate approval of a bankruptcy judge after a complete review of the fairness of the plan and of the adequacy of related disclosure statements. In addition, plan confirmation requires sufficient votes for acceptance of a plan from the applicable classes of claimants and interest holders. However, a creditor or interest holder usually has no ability to alter his or her investment decision after such party indicates his or her acceptance of a plan, unless subsequent to filing of the petition, objections are successfully raised in the bankruptcy proceedings to the terms of the plan or to the adequacy of the disclosure statement pursuant to which the plan acceptances were solicited.

SEC Rule 145 also deems a "sale" of a security to be involved when a "plan or agreement for . . . a reclassification of securities of such corporation or other person, other than a stock split, reverse stock split, or change in par value, which involves the substitution of a security for another security. . . ." is submitted for a vote or consent of security holders of the corporation or other person. In a bankruptcy context, solicitation of acceptances of a bankruptcy plan that is subject to Rule 145 does not always involve a clear "contract" for the disposition of a security between two parties. In many cases, the type of reclassification and business combination subject to Rule 145 simply involves an overall plan for reorganization of the entity or combination of the entity with another entity that must be approved by a minimum vote of security holders of one or both entities. By the terms of the Rule, the SEC has taken the position that a "sale" occurs in this context even though no express "contract for disposition of" a security exists. In this context, however, this paper will later discuss how Rule 145 could be deemed superseded by the provisions of Code Section 1145(a), which provides an exemption from registration for post-petition offers and sales of securities pursuant to a bankruptcy reorganization plan.

Even if a "sale" occurs for purposes of applicable securities laws in connection with a bankruptcy reorganization plan, the timing of the "sale" is less than clear. The "sale" could occur at the point in time when a claimant or interest holder indicates his or her acceptance of the plan, which indeed may be his or her last affirmative act. On the other hand, the "sale" could occur upon post-petition confirmation of the plan. In that event, the "sale" might qualify for the exemption from application of the registration provisions of the 1933 Act and state securities laws provided by Code Section 1145(a).

III. Registration Related Liabilities Under Securities Laws

Section 5 of the 1933 Act requires all offers and sales of securities in interstate commerce to be registered, unless an exemption from registration is available. Specifically, Sections 5(a) and 5(c) of the 1933 Act generally prohibit any person, including broker-dealers, from using the mails or interstate means to sell any security unless a registration statement is in effect or to offer to sell any security unless a registration statement has been filed with the SEC, or an exemption from the registration provisions applies. Under securities laws, the solicitation of a reorganization plan pursuant to which securities would be issued would most likely be deemed an offer to acquire securities and would be subject to the registration requirements of Section 5, unless an exemption from registration is available.

A. Liability For False Registration Statement Or Prospectus

Section 11 of the 1933 Act creates civil liability for any untrue statement of a material fact contained in an effective registration statement, and for any failure to state a material fact required to be stated or needed to make other statements not misleading. Section 11 allows purchasers of a registered security to sue the issuer; its directors or partners, underwriters, every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who are named as having prepared or certified any part of the

registration statement or any report or valuation used in connection with the registration statement; and company officers who signed the registration statement. Obviously, if no registration statement is in effect with respect to the securities offered pursuant to a bankruptcy reorganization plan, which is the usual situation, Section 11 will not be applicable. A claim under Section 11 involves strict liability and does not require proof of scienter or an intent to defraud.

B. Liability For Registration Or Prospectus Violations

Section 12(a)(1) of the 1933 Act provides strict liability for any person who offers or sells a security in violation of Section 5 of the 1933 Act. In order to recover, an investor must only show jurisdictional use of the mails or interstate commerce, the lack of the required registration, and the sale of a security by the defendant, without regard to the defendant's awareness of the violation. Section 12(a)(2) of the 1933 Act imposes liability on one who offers or sells a security by means of a prospectus or oral communication making material misstatements or failing to state material facts necessary to make the statements not misleading. However, a seller of securities who did not know and, in the exercise of reasonable care, could not have known of the materially misleading statements or omissions will not be liable under this Section. For both of Sections 12(a)(1) and 12(a)(2), an investor may recover the consideration paid for the security, plus interest, and minus any amount of income received on the security (i.e., rescission of his investment), and an investor who no longer owns the security may recover damages.

C. Liability Of Controlling Persons

Section 15 of the 1933 Act imposes direct liability for violations of Section 11 and Section 12 of the 1933 Act on persons who control violators of those provisions. The 1933 Act does not define the word "control" in Section 15. By rule, the SEC has provided some guidance by defining "control" to mean the direct or indirect possession of the power to direct management and policies of a person, whether through the ownership of voting securities, by contract or otherwise. However, a controlling person may raise an affirmative defense that he or she had no knowledge of or reasonable ground to believe in the existence of the facts under which the liability of the controlled person allegedly arose.

D. State Laws

When applicable, state securities laws relating to registration or qualification of securities offerings must be satisfied in connection with the solicitation of prepacks, and most state securities laws create remedies similar to those created by Sections 11, 12 and 15 of the 1933 Act.

IV. Potential Liability Under The 1934 Act

A. Requirements Under Section 14(a) Of The 1934 Act

The legislative history of Code Section 1126(b) specifically cites Section 14 of the 1934 Act as an example of an applicable non-bankruptcy law relating to the adequacy of disclosure.[2] As a result, any solicitation of prepack acceptances from holders of a class of equity securities that is registered under Section 12 of the 1934 Act must comply with the SEC rules promulgated under Section 14(a) if the plan proponent wants to count prepack acceptances toward plan confirmation. Section 12 of the 1934 Act requires registration for any class of securities registered for trading on a national securities exchange and for any class of "equity securities" held of record by either 2,000 or more persons or 500 or more persons who are not accredited investors and the issuer of which has more than $10,000,000 of total assets. Generally, the SEC has required that a statement must accompany the solicitation of a proxy, consent or authorization and must disclose the specific information required by the SEC's Schedule 14A. An argument can be made that Section 1126(b) of the Code only requires solicitation disclosures to satisfy the disclosure standards of Schedule 14A and Rule 14a-9 and does not require filing of the disclosure statement with the SEC. That section requires compliance with non-bankruptcy laws governing adequacy of disclosure without mention of satisfaction of any regulatory filing and approval requirements.

B. Fraud Liability Under Section 14(a)

SEC Rule 14a-9 prohibits solicitations containing any statement that is false or misleading with respect to any material fact or any statement that omits material facts necessary to make the statements therein not false or misleading. For liability under Rule 14a-9 to exist, court cases have required the false or misleading statement or omission in the solicitation materials to be causally linked to some damage or injury.[3] A security

holder can prove causation under Section 14(a) if security holder approval was necessary for the challenged transaction and if the solicitation was "materially" false or misleading. Courts flexibly tailor remedies for Section 14 violations to the facts and such remedies may include damages or injunctive relief to prevent improper solicitation. In some cases, resolicitation of proxies and new elections have been ordered.

C. No Clear Bankruptcy Code Exemption

Persons who solicit or participate in the solicitation of prepetition acceptances of a bankruptcy reorganization plan may be unable to rely upon Code Section 1125(e) to provide an exemption from Section 14(a) of the 1934 Act or the anti-fraud provisions of applicable securities laws. Section 1125(e) creates safe harbor protection for good faith post-petition solicitors of bankruptcy plan acceptances from potential liability under securities laws but may not be applicable to prepetition solicitations. The safe harbor language as well as the legislative history imply that Section 1125(e) is only intended to apply to post-petition solicitations.[4] Accordingly, prepetition solicitations may be subjected to the proxy statement requirements and other procedures and disclosures meeting the requirements of the SEC's Schedule 14A and Regulation 14A.

D. Liability Under 1934 Act Section 18

In a bankruptcy context, any claimant or interest holder who is damaged by a misleading solicitation statement that is filed with the SEC under Section 14(a) of the 1934 Act may have an action for damages caused by reliance upon such solicitation statement pursuant to Section 18 of the 1934 Act, if he were deemed to have "purchased" or "sold" a security "at a price which was affected by such statement." A defendant can defend against such action by proving that the defendant acted in good faith and without knowledge of the misleading statement.

E. Liability Under Rule 10b-5

Rule 10b-5 of the SEC promulgated under Section 10(b) of the 1934 Act is the most general anti-fraud provision in the federal securities laws, and it extends to any fraud in connection with the purchase or sale of a security, whether arising from a registration statement, private negotiations, a corporate report, a proxy or consent solicitation statement, or a tender offer. Federal courts have consistently recognized that investors have a civil remedy for damages under Section 10(b) and Rule 10b-5. However, in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, the United States Supreme Court established that a plaintiff must prove by a preponderance of the evidence that the defendant acted with "scienter," which is a mental state embracing intent to deceive, manipulate or to defraud, in order to recover civil damages under Section 10(b) or Rule 10b-5. These suits may only be brought by actual purchasers or sellers of the securities in question.

The purchaser or seller must also show not only an untrue statement of material fact in connection with the sale of a security, but also that the omission or untrue statement resulted in or caused the plaintiff's damage. Normally, this requires a showing that the plaintiff justifiably relied on the misrepresentations. Under some circumstances, however, the materiality of the omissions or misrepresentations may establish causation.

F. Liability Of Controlling Persons

As with Section 15 of the 1933 Act, Section 20(a) of the 1934 Act imposes liability on any person who has directly or indirectly controlled someone who is liable under any provision of the 1934 Act. However, a controlling person is not liable if he or she can show that he or she acted in good faith and did not induce the other person to commit the violation.

V. Tender Offer Regulation

A prepetition plan solicitation could be deemed a "tender offer" for purposes of the 1968 Williams Act, which amended the 1934 Act to provide the SEC with authority to regulate takeover attempts and tender offers, among other things. The term "tender offer" is not defined in the statute or in the SEC's regulations, but courts have applied the tender offer rules to many transaction structures. In determining whether a tender offer exists, courts have frequently cited eight-factor transaction test derived from the Southern District of New York case *Wellman v. Dickinson,* 475 F. Supp. 783 (S.D.N.Y. 1979). A prepetition plan solicitation by a debtor that involves an exchange of new debt or equity securities for old equity securities of a public debtor might well be considered an "exchange offer" and subject to the tender offer provisions of the Williams Act.

Federal securities laws require the filing of a Schedule TO by any party making an offer to purchase more

than five percent of a company's equity securities that are registered under Section 12 of the 1934 Act. Similarly, when a public company makes a tender offer for a class of its own securities, it also must file a Schedule TO. Therefore, while unlikely, a prepetition plan solicitation could necessitate the filing of a Schedule TO. These laws also contain broad anti-fraud provisions, which expressly prohibit material misrepresentations; material misleading omissions; and fraudulent, deceptive, or manipulative acts or practices in connection with any tender offer or any solicitation of security holders in opposition to or in favor of any such offer.

VI. Transactional Exemptions From Requirements Of 1933 Act Section 5

Because the cost of registration with the SEC of a securities offering for a nearly bankrupt entity can be prohibitive, much attention is usually directed to the possible transactional exemptions from the registration and prospectus requirements of Section 5 of the 1933 Act. These exemptions from registration, however, do *not* affect the applicability of anti-fraud provisions of the securities laws or liability for violations of anti-fraud provisions.

A. Private Offering Exemptions

Section 4(a)(2) of the 1933 Act exempts from the provisions of Section 5 any transaction "by an issuer not involving any public offering." The SEC has promulgated Regulation D to provide a "safe harbor" within the confines of this exemption and the exemption authority in Section 3(b) of the 1933 Act. The exemptions may not be available in a bankruptcy reorganization context due to Code Section 1145(c), which deems an exempt offer and sale of a security under a bankruptcy reorganization plan in exchange for a claim or interest to be a "public offering." Further, if Section 1145(a)(1) is deemed to apply retroactively to exempt a prepetition plan solicitation from the registration requirements, the loss of the private offering exemption would become meaningless. However, as will be discussed, it is unclear whether the exemption provided by Section 1145(a)(1) applies to prepetition solicitations of a bankruptcy reorganization plan, and, accordingly, Section 1145(c) likewise may not be applicable.

B. Limited Offering Exemptions

The 1933 Act provides two types of limited offering exemptions from the provisions of Section 5. These exemptions are set forth in Sections 3(b)(1) and 4(a)(5). The Section 4(a)(5) exemption applies to offers and sales to "accredited investors," subject to a limitation on the aggregate offering price of the securities. This exemption would not be applicable to a reorganization plan involving the issuance of securities in an aggregate amount in excess of the $5,000,000 limit set forth in Section 3(b)(1) of the 1933 Act.

Section 3(b)(1) of the 1933 Act authorizes the SEC to establish an exemption for small or limited offers or sales of securities, subject to a $5,000,000 aggregate offering price limit. Pursuant to this authorization, the SEC has promulgated Rule 504 of Regulation D, which will be discussed below in further detail.

If Section 1145(c) applies in the context of a prepetition solicitation of exchanges of securities, a prepack solicitation may be deemed a public offering and an issuer would be prevented from relying on the exemptions provided by Sections 3(b)(1) or 4(a)(5) of the 1933 Act.

C. Exchange Offer Exemptions

Section 3(a)(9) and (10) of the 1933 Act provide exemptions from the provisions of Section 5 for certain types of exchanges by the issuer of a new security for one or more outstanding securities, claims, or property interests of the issuer. Section 3(a)(9) and (10), however, specifically exclude any security actually exchanged in a bankruptcy case under the Code. Section 306(b) of the Bankruptcy Reform Act amended these sections to exclude securities exchanged in a case under the Code. The legislative history explains that the exclusion was added because these securities are covered by Section 1145. As a consequence, it appears that Congress intended to avoid dual exemptions under both the Code and the 1933 Act. As a result, to the extent that Code Section 1145(a)(1) or (2) apply, securities offered in connection with a bankruptcy reorganization plan will not be exempted by way of Section 3(a)(9) or (10).

A qualifying prepetition "exchange offer" of securities under a prepackaged reorganization plan to existing security holders, which would include holders of the debtor's note instruments and other securities, but would exclude open account creditors, would appear to be exempt under Section 3(a)(9), unless otherwise deemed to be exempted by Section 1145(a)(1) or (2). Because the exemption provided by Section 3(a)(10)

requires a fairness hearing before a court or agency, that exemption has limited usefulness in a prepetition plan solicitation, unless one takes the position that the subsequent bankruptcy plan hearing satisfies the hearing requirement. However, if Section 1145(a) is interpreted to apply retroactively to "exchange offers" pursuant to prepetition solicitations of acceptances of a bankruptcy reorganization plan, that section should then also supersede the exemptions provided by Section 3(a)(9) and (10) of the 1933 Act.

Most states have adopted the Uniform Securities Act, which provides an equivalent to Section 3(a)(9) of the 1933 Act for exchange offers to existing security holders. This exemption provides that an issuer need not register any securities issued in any transaction pursuant to an offer to existing security holders of the issuer if (1) no commissions or other remuneration (other than a standby commission) is paid or given directly or indirectly for soliciting any security holder in the state, or (2) the issuer first files a notice specifying the terms of the offer and the security administrator for the state does not by order disallow the exemption within the next five full business days.

D. Section 3(a)(7) Exemption

Section 3(a)(7) of the 1933 Act exempts from the provisions of the 1933 Act "certificates issued by a receiver or by a trustee or debtor-in-possession in a case under title 11 of the United States Code, with the approval of the court." The SEC has not promulgated any rules pursuant to this section. However, based on a no-action letter by the SEC,[5] the "certificates" referred to in Section 3(a)(7) are interpreted by the SEC to mean, in a bankruptcy context, certificates of indebtedness issued by a trustee or debtor-in-possession to obtain post-petition credit or financing. That no-action letter states that the position of the SEC is that "certificates" covered by Section 3(a)(7) are limited to certificates of indebtedness of a receiver, trustee or debtor-in-possession issued in return for unsecured credit or debt during the pendency of the bankruptcy proceeding.

The SEC's interpretation is supported by the provisions of the pre-1978 Bankruptcy Act. Bankruptcy Act Section 393(a)(1) provided that the provisions of Section 5 of the 1933 Act do not apply to "any security issued by a receiver, trustee, or debtor-in-possession pursuant to" Section 344 of Chapter XI of the Bankruptcy Act. Section 393(a)(2) of the Bankruptcy Act, a predecessor provision to Code Section 1145(a), exempted offers and sales of securities pursuant to a Chapter XI plan from the provisions of Section 5 of the 1933 Act.

E. Fraud Exemptions

It is clear that the exemptions from the provisions of Section 5 contained in Sections 3 and 4 of the 1933 Act, and the Rules of the SEC promulgated thereunder, do not affect the applicability of the anti-fraud provisions of the 1933 and 1934 Acts. Thus, absent other applicable Code exemptions, a defrauded "purchaser" of a security acquired under a plan will have a civil cause of action pursuant to Section 12(a)(2) and Rule 10b-5, whether or not the security was exempted from registration by the provisions of Section 5 of the 1933 Act. An argument can be made that the safe harbor provisions of Section 1125(e) should be retroactively applied to protect any prepack solicitors from liability under the anti-fraud provisions of the 1933 Act and 1934 Act. However, as this article previously discussed, the legislative history and the express terms of Section 1125(e) do not indicate an intent to expand its coverage retroactively to prepetition solicitations.

F. Regulation D

The SEC has promulgated a safe harbor series of rules known as "Regulation D" pursuant to the provisions of Sections 3(b)(1) and 4(a)(2) of the 1933 Act. Regulation D is only available to the issuer and not to any affiliate of the issuer or any other person for resales of the issuer's securities. Rule 504 was promulgated pursuant the authority granted in Section 3(b)(1) and provides an exemption from the provisions of Section 5 of the 1933 Act for limited offers and sales of securities not exceeding $5,000,000 in the aggregate for a 12-month period. Rule 506 is a safe harbor provision for the private offering exemption in Section 4(a)(2) and provides an exemption from registration for limited offers and sales to sophisticated purchasers without regard to the dollar amount of the offering. In general, securities acquired in a Regulation D transaction have the status of "restricted securities" acquired in a private offering under Section 4(a)(2) of the 1933 Act.

However, it is questionable whether a prepack solicitation can satisfy the private nature of a Regulation D offering when Code Section 1145(c) deems the securities issued under such a plan to be issued in a "public

offering." As previously discussed, a retroactive applicability of the exemptions provided by Section 1145(a) to a prepetition solicitation would remove the necessity of attempting to comply with Regulation D.

G. Integration

The SEC has espoused the view that certain securities offerings must be "integrated" (*i.e.,* combined) for purposes of determining whether claimed exemptions are actually available. This integration policy is particularly troublesome in the context of a bankruptcy reorganization plan that envisions an overall plan or scheme involving all of the claimants and interest holders of a debtor. It is likely that all of the offers and sales of securities pursuant to a single reorganization plan would be integrated for purposes of determining whether any transactional exemptions are available.

VII. Bankruptcy Code Exemptions

The Code does not expressly provide exemptions from the registration provisions of Section 5 of the 1933 Act (and similar state laws) for prepetition solicitations of acceptances of bankruptcy reorganization plans. Arguments might be made that certain Code exemptions should be applied to such prepack solicitations. However, these arguments are unlikely to win, because the Code has specifically differentiated prepetition solicitations from post-petition situations.

A. Code Section 1125(d)

Code Section 1125(d) provides that the determination of whether a disclosure statement, which is required for solicitation of an acceptance or rejection of a plan after the commencement of the bankruptcy case, contains adequate information "is not governed by any otherwise applicable non-bankruptcy law, rule, or regulation." The SEC or any state securities commission is granted a right by this section to appear at any hearing regarding the adequacy of information in the disclosure statement, but may not appeal from or seek review of the bankruptcy court's order approving a disclosure statement. This section was amended by the Bankruptcy Amendments and Federal Judgeship Act of 1984 to clarify that the disclosure statement referenced in this section is the disclosure statement required to be delivered to holders of claims or interests from whom acceptances or rejections of a plan are solicited after the commencement of the bankruptcy case under Section 1125(b) of the Code. It is doubtful that Section 1125(d) can be used to displace non-bankruptcy law, rule, or regulation with respect to the adequacy of information in a disclosure statement used in a prepetition solicitation.

B. Code Section 1125(e) "Safe Harbor"

Section 1125(e) of the Code creates a "safe harbor" for plan solicitors and participants. If a plan solicitor or participant acts "in good faith and in compliance with the applicable provisions of" the Code, the solicitor or participant is protected from both the registration and anti-fraud provisions of federal and state securities laws. The words "in compliance with the applicable provisions of" could be interpreted to limit the safe harbor to only post-petition solicitations. The legislative history of Code Section 1125(e) appears to limit the section's protection to actions taken during the "pendency" of the reorganization case. A court would have to ignore the basic rationale for this safe harbor in order to apply its provisions retroactively to prepetition solicitations and disclosure documents. Therefore, this provision appears to have little value in exempting prepetition solicitations from applicable securities laws.

C. Code Section 1145(a) Exemption

Section 1145(a) is the primary source of exemption from the registration provisions of applicable securities laws for securities issued in a bankruptcy case, other than the limited post-petition exemptions provided by Code Section 1125(d) and (e) and Section 364. Section 1145(a) of the Code creates an exemption from the registration provisions of Section 5 of the 1933 Act and all applicable state securities laws. Many of the issues raised in this article could be resolved if Section 1145(a) were interpreted to exempt prepetition solicitations from the registration provisions of Section 5 of the 1933 Act and applicable state securities laws. Unfortunately, neither the legislative history nor the section itself expressly addresses whether the exemption can extend to prepetition solicitations of a plan acceptance or rejection.

Section 1145(a), however, specifically does not exempt "underwriters" from compliance with applicable securities laws. True creditors and interest holders who take securities under a plan with a view to further resale are not considered "underwriters" for purposes of the Code or the 1933 Act due to the provisions of Section 1145(b). Section 1145(b)(3) specifically excludes any claimants or interest holders insofar as they receive securities under a plan in conformance with Code Section

1145(a)(1) from the definition of "underwriter" appearing in Section 2(a)(11) of the 1933 Act. As a result, these claimants or interest holders may resell the securities in reliance on the exemption provided in Section 4(a)(1) of the 1933 Act for transactions by a person other than an issuer, underwriter, or dealer. If a debtor wants to raise fresh capital by issuing new equity securities or by selling the stock of a subsidiary, the securities laws continue to apply because Code Section 1145 generally only applies to securities issued under a plan of reorganization. Affiliates and other controlling persons of the issuer are not entitled to any exemption pursuant to Section 1145(a) from applicability of securities laws to the offer or sale of securities in connection with a plan, nor are such parties excluded from the 1933 Act Section 2(a)(11) underwriter definition by action of Section 1145(b)(3). Presumably, resales by affiliates and controlling persons of securities of the debtor obtained under a plan could be made in accordance with SEC Rule 144. Controlling persons and affiliates of the debtor should review Rule 144 before reselling securities received under a plan.

To confirm a plan under Code Section 1129, the bankruptcy court must determine that there are sufficient "acceptances" of the plan. Under Code Section 1126(b), any holder that has purportedly accepted or rejected a plan pursuant to a pre-petition solicitation shall have *effectively* accepted or rejected such plan *only if* the solicitation (i) was in compliance with applicable non-bankruptcy law, rule, or regulation governing the adequacy of disclosure, or (ii) was not subject to any such law, rule, or regulation and was made after disclosure of adequate information, as defined in Code § 1125(a). Thus, it would seem prudent to seek an explicit order of the bankruptcy court that a prepetition solicitation was made in compliance with any applicable non-bankruptcy law, rule, or regulation or that no such law, rule, or regulation was applicable, and that adequate information was provided. Such an order may well provide some protection against subsequent claims by the SEC or the solicited parties that the prepetition solicitation was made in violation of applicable securities laws since, as interested parties, they would have had the opportunity to object at the confirmation hearing.

D. Lack Of Damages

A defendant in an action for violations of securities laws attributable to a prepetition solicitation could argue that the plaintiff's damages were not "caused" by the prepetition solicitation. Other arguable elements of causation of plaintiff's damages are: (1) the plaintiff's failure to exercise its rights to appear, be heard and object in the post-petition bankruptcy proceedings; (2) acceptance of the plan by other claimants and interest holders; and (3) confirmation of the plan and approval of the disclosures made in the prepetition solicitations by an independent bankruptcy judge. With respect to this latter point, it should be noted that, under Code Section 1126(b), if the bankruptcy court were to find that a prepetition solicitation was made in violation of applicable non-bankruptcy laws, rules, or regulations, the court should disregard any acceptances or rejections so obtained in considering whether or not to confirm the plan. If so disregarded, these violations could hardly be deemed a cause of any damage suffered by a claimant, and, presumably, a re-solicitation of acceptances and rejections of the plan would have to occur during the bankruptcy proceedings.

E. Conditional Offer

A defendant in an action for violations of securities laws could argue that the prepetition solicitation of acceptances or rejections of the reorganization plan constituted only a conditional offer of securities. The offer is contingent upon ultimate confirmation of the plan by the bankruptcy judge and receipt of sufficient plan acceptances from other claimants and interest holders. The argument is that this contingent offer does not constitute a true "offer" for purposes of securities laws. SEC Rule 145 appears to contradict this argument for most plans. In addition, the SEC's position in the context of other types of transactions, for example tender offers, is that contingent offers to sell securities must first be registered with the SEC.

F. Public Policy

The legislative history of the Code expresses a public policy and desire by Congress to supersede the registration provisions of applicable securities laws with the special provisions and exemptions of the Code to the extent they apply to bankruptcy reorganization plans under the Code. This expression of general intention would tend to support a broader reading of Code Section 1145(a) to exempt the prepetition solicitation of acceptances of a bankruptcy reorganization plan.

VIII. Recent Developments

Several bankruptcy courts have adopted guidelines similar to the local court guidelines established by

Southern District of New York ("SDNY") with respect to prepetition solicitation of prepackaged bankruptcy reorganization plans.[6] These local guidelines elucidate aspects of prepack procedure that are not articulated in the Code or Regulations. The purpose of these guidelines is to facilitate expeditious and cost-effective bankruptcies. Accordingly, prepacks in the SDNY can be confirmed as soon as 30 days from the bankruptcy filing.

Recent prepacks have been confirmed by courts weeks or, in some instances, days after filing for Chapter 11 relief. In December 2016, Roust Corporation filed for Chapter 11 relief in SDNY, and confirmed its prepack after seven days.[7] In February 2019, FullBeauty Brands filed for Chapter 11 relief, the bankruptcy court confirmed the plan within approximately 24 hours, and FullBeauty exited Chapter 11 three days after.[8] In May 2019, Sungard Availability Services filed for Chapter 11 relief, confirmed its plan the very next day and consummated the plan within two days.[9] However, it should be noted that certain factors are required to attain the aforementioned timing success of prepacks. These factors include, but are not limited to: uncomplicated capital and debt structure; less operational issues (FullBeauty operated entirely online without physical stores); cooperative vendors; and almost unanimous support. Therefore, extreme caution is recommended in attempting to solicit prepack acceptances of a bankruptcy reorganization plan.

IX. Conclusion

The typical prepack solicitation does not fit neatly into the classic securities law definitions. For the most part, the Code and its legislative history lend little guidance as to what securities laws are applicable to a prepack solicitation. However, the legislative history to Code Section 1126(b) does clarify that at least the requirements of Section 14(a) of the 1933 Act, if applicable, will need to be satisfied to count prepetition acceptances for purposes of post-petition plan confirmation. Several arguments can be made for exemption of prepetition solicitations from the registration provisions of federal and state securities laws. Although securities laws provide many exemptions from the application of the registration provisions, these exemptions may have limited usefulness or, in fact, be unavailable due to the concept of "integration," the exclusions of bankruptcy-related securities from the exemptive provisions of Section 3(a)(9) and (10) of the 1933 Act, and the prescription contained in Section 1145(c) that securities issued under a plan are deemed issued pursuant to a public offering. Retroactive applicability of the exemptions provided by Section 1145(a) could resolve some apparent issues. However, with no concrete answers, the only wise choice in most instances would be to comply with the securities law registration requirements or satisfy the standards for any applicable exemption from such registration requirements.

Few good arguments can be put forth to avoid applicability of the anti-fraud provisions of securities laws to prepetition solicitations. Nevertheless, any claimant in an action based upon a securities law violation may have difficulty showing causation. Of particular concern to officers, directors, and controlling persons of a troubled debtor is the possibility of secondary liability as a controlling person, aider, or abettor for a debtor's primary violation of applicable securities laws.

While prepacks have become increasingly popular, extreme caution is recommended in attempting to solicit, prior to the filing of the bankruptcy petition, of acceptances of a prepackaged bankruptcy reorganization plan due to the complex legal framework discussed in this article.

Endnotes

1. Copyright reserved 2020 by Daryl B. Robertson and Nicholas O'Brien. This paper is derived from a paper having the same title prepared in 2002 by Daryl B. Robertson. This paper contains numerous revisions, updates and supplements from the 2002 paper. The 2002 paper was derived in part from a paper prepared in 1987 by Daryl B. Robertson and Lawrence D. Robinson titled "Application of Securities Laws to Pre-Petition Solicitation of Acceptances of a Reorganization Plan." Daryl B. Robertson substantially revised, updated and supplemented the 1987 paper to prepare the 2002 paper. The authors want to thank summer associate Inara Bandali for her contributing research and comments to this paper and Gregory Hesse for his review and comments.

2. H.R. Rep. No. 95-595 (1977).

3. *See, e.g., Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991); *Wilson v. Great Am. Indus, Inc.*, 979 F.2d 924, 931 (2nd Cir. 1992).

4. *See* H.R. Rep. No. 95-595 (1977).

5. SEC No-Action Letter to Sequential Information Systems, Inc. date November 4, 1972.

6. *See* Procedural Guidelines for Prepackaged Chapter 11 Cases, as incorporated by Local Rule 3018-2 of the United States Bankruptcy Court for the Southern District of New York. For examples of other local court guidelines, *see* Local Bankruptcy Rules for the Southern District of California, Appendix D4 (Guidelines for Prepackaged Chapter 11 Cases); Southern District of Indiana Bankruptcy Court General Order No. 03-11 (Procedures for Prepackaged Chapter 11 Cases); and Bankruptcy Court for Southern District of Florida Guidelines for Prepackaged Chapter 11 Cases.

7. *In re Roust Corp., et al.*, Case No. 16-23786 (Bankr. S.D.N.Y. Jan. 10, 2017).

8. *In re FullBeauty Brands Holdings Corp., et al.*, Case No. 19-22185 (Bankr. S.D.N.Y. Feb. 3, 2019).

9. *In re Sungard Availability Services Capital, Inc., et al.*, Case No. 19-22915 (Bankr. S.D.N.Y. May 1, 2019). ■

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