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Chapter 11 Bankruptcy and Restructuring Strategies

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Prenegotiated Chapter 11 Plans: Developing a Strategy to Streamline Chapter 11 Proceedings

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Introduction

The time, expense, and uncertainty of traditional Chapter 11 proceedings are the forces that have prompted many troubled businesses and their creditors to consider alternatives to traditional plans of reorganization as a means of implementing a restructuring. A traditional Chapter 11 plan process takes a minimum of two months from the time the debtor files its plan of reorganization with the bankruptcy court until the court holds a confirmation hearing. Moreover, as a result of the inherent risks of the Chapter 11 process, debtors are increasingly seeking to minimize those dangers by reaching agreement with as many of their creditors as possible before commencing their reorganization proceedings. Debtors are understandably wary of what are now referred to as "free fall" Chapter 11 cases, ones filed where the debtor has no agreement in place with any creditor constituency.

Because of the time involved, debtors and their creditors are also concerned about risks built into the plan confirmation process. While a plan is being formed, the plan consensus may unravel. Also, the additional time in Chapter 11 is unnecessary if all creditor constituencies are supportive of a proposed plan, and the additional time spent in Chapter 11 increases the legal and other professional fees incurred, and may distract the attention of the debtor's management from running the business.

Prepackaged Plans

Since the Bankruptcy Code became effective in 1979, it has always contained a provision permitting the bankruptcy court to consider a prepackaged plan of reorganization. 11 U.S.C. § 1126(b). A fully prepackaged plan is one in which all classes of impaired creditors have accepted a plan of reorganization in a solicitation that complies with applicable bankruptcy and non-bankruptcy law and is completed prior to the commencement of the debtor's Chapter 11 case. The debtor then uses the bankruptcy court to formally confirm its plan of reorganization, which can occur in three to four months.

There have been many prepackaged bankruptcies. Some have worked exactly as intended, but in other cases the prepackaged plans have been derailed, usually by creditors who are unhappy with their treatment and who challenge either the solicitation process or the provisions of the plan of reorganization.

Reaching agreement with creditors, drafting a plan and disclosure statement, and soliciting and obtaining acceptances can be a complex procedure, one that often takes months and can be expensive. Moreover, if the debtor has publicly traded securities, the consent solicitation materials often must comply with both the "adequate disclosure" requirements of Section 1125 of the Bankruptcy Code and the applicable federal securities laws, as discussed below.

For all of these reasons, completing a fully prepackaged plan of reorganization often fails or is impracticable. The reasons why prepackaged plans flounder are diverse. Sometimes a single creditor class refuses to accept the plan and has to be crammed down. In other cases, the debtor's business deteriorates and the debtor needs the protections of Chapter 11 earlier than anticipated. Sometimes an adverse litigation result will lead to a Chapter 11 filing. In other cases, there simply may not be time to complete the work of developing a plan and soliciting acceptances.

The Uses of Prepackaged Plans

Prepackaged plans may not be suitable for all debtors in need of financial restructuring. Prepackaged plans work best for debtors who only need a balance sheet restructuring, and where the plan will focus on reorganizing bank debt, bonds, and equity securities. On the other hand, prepackaged plans may not be feasible when a debtor has numerous creditors, or when the creditors are unrepresented by a trustee or committee.

Prepackaged plans can also be difficult when a debtor has substantial trade or employee claims, or when the debtor requires a substantial operational reorganization, such as rejecting executory contracts or exiting from a portion of its business.

Prenegotiated Plans

In cases where the debtor lacks the time or ability to complete a fully prepackaged case, one attractive alternative is the prenegotiated plan, in which one or more classes of creditors agree on their substantive treatment under a plan of reorganization, and typically agree to support a plan that contains such treatment and no other. The most common names for such agreements are plan support agreements or lock-up agreements.

Here is how one court defined the term "lock-up":

> [A] "lock-up" refers to an agreement between a creditor and a debtor (or prospective debtor) in which the creditor becomes legally bound to vote for a plan so long as certain key plan provisions are included. Parties enter into lock-up agreements to bind each other to a deal, even when the underlying restructuring documents remain to be drafted and executed… If the creditor did not ultimately vote for the plan, the creditor is deemed to breach the lock-up agreement and become subject to specific performance remedies and injunctive relief.

Official Comm. of Unsecured Creditors of New World Pasta Co. v. New World Pasta Co., 322 B.R. 560, 568 (M.D. Pa. 2005) (citing Daniel DeFranceschi, *Delaware Bankruptcy Court Announces Bright-Line Rule for Use of Lock-Up Agreements in Chapter 11 Cases*, AM. BANK. INST. J. (Feb. 16, 2003)).

Plan support agreements thus fill the gap between a fully prepackaged plan of reorganization and entering a Chapter 11 case with no agreement concerning plan issues. In addition to reducing the time and expense of Chapter 11, a prenegotiated plan may have additional benefits for a debtor, including reducing the negative publicity of an extended Chapter 11 proceeding, easing the level of customer, vendor, and employee disruption, and sending a message to the debtor's market that the debtor will emerge promptly from Chapter 11 with its business intact. One benefit of a prenegotiated plan is that when the debtor commences its case, it can make a public announcement about the intended result of the restructuring, thus minimizing the impact of the filing on customers, vendors, and employees.

In this chapter, we will review the most common provisions of plan support agreements and some of the issues that arise in negotiating them. Then we will consider the statutory framework concerning solicitation of acceptances of a plan of reorganization. We will also discuss the case law on the subject, and see why some plan support agreements failed to deliver their intended results. From these perspectives, we will conclude by developing a strategy for ensuring that a proposed plan support agreement is approved by a bankruptcy court.

Plan Support Agreement Provisions

Plan support agreements vary in their length and complexity, but all of them need to address several key issues: the agreement to vote for an acceptable plan, an agreement to bind subsequent holders of claims, termination provisions, fiduciary duty "outs," and, in the case of post-petition agreements, a "no solicitation" clause.

Agreement to Vote for a Plan

In a plan support agreement, the parties agree to vote in favor of a specific plan of reorganization, often referred to as a qualified plan, and, having voted, they agree not to withdraw their votes for such a qualified plan. For a plan support agreement to be meaningful, it has to be agreed to by creditors holding claims that would be sufficient to bind the class in a plan of reorganization under the Bankruptcy Code. In other words, the claimants must hold a minimum of 66 and 2/3 percent in amount of such claims, and they must represent at least a majority in number of such claims. 11 U.S.C. § 1126(c).

For example, if there were $300 million in claims in a class that was held by thirty-five creditors, the plan would be accepted if creditors holding in excess of $200 million in claims accepted the plan and at least eighteen of the thirty-five creditors held that amount of debt.

<u>Plan Flexibility</u>

One of the most critical negotiating points in developing a plan support agreement is how specific or how flexible the definition of a qualified plan will be. That issue may depend in part on how many classes of creditors the debtor has reached agreement with, and how many classes are still unresolved. The issue may also be influenced by how high or low the agreeing class is in the debtor's capital structure, and where the unresolved classes rank in the capital structure.

An example illustrates some of the issues. Assume a senior secured class of debt of $100 million, and a plan that provides for such class to receive new debt with a face amount of $80 million and 50 percent of the common stock of the reorganized debtor. If the holders of senior secured claims believe that such an allocation pays them in full, they may be indifferent to the allocations to junior classes.

On the other hand, if the reason the senior class is being asked to convert $20 million of debt to equity is to fund a cash payment to unsecured trade creditors, they may object, arguing that unsecured creditors should only be permitted to receive equity. Each case will obviously have its own facts and its own negotiating dynamic, but a few general observations apply. If the debtor has only reached agreement with one class of creditors, it will want to retain the greatest possible flexibility to reach agreements with other classes. Similarly, creditors with senior claims will often want rights of approval over settlements with junior classes, unless those settlements are limited to allocations of common equity.

Trading Restrictions

In today's market, where claims against distressed debtors trade frequently, debtors need assurance that if they reach an agreement with a class of creditors, that agreement will not be abrogated by subsequent buyers of the claims in that class. Plan support agreements thus typically provide that no creditor can sell or otherwise transfer its claim unless its transferee agrees in writing to be bound by the terms of the original plan support agreement.

For a debtor, the protection of the trading restrictions is obvious. Without such a clause, an agreement with a class of creditors is at risk of disappearing if a significant percentage of claims in the class are sold. While it may seem counterintuitive, the trading restrictions also benefit creditors because they provide a continuing mechanism for the sale of claims. Under many senior credit agreements, the agent banks have the right to approve the transfer of claims arising under that credit agreement, and borrowers may also sometimes have limited approval rights over the identity of transferees.

Assume a case where the senior debt class had entered into a plan support agreement with no trading restrictions, and one where a participant lender wanted to sell its claim. Unless the buyer were prepared to be bound by the plan support agreement, the agent bank would have a legitimate basis for denying approval of the transfer, particularly if that transfer meant that, with respect to that class of claims, the class would no longer be an accepting class for plan of reorganization purposes.

By incorporating the trading restrictions into the plan support agreement, the debtor receives assurance that its agreement with the class of creditors will not evaporate as a result of claim transfers. Prospective claim buyers and sellers benefit because they know that neither the debtor nor the agent can block the transaction so long as the buyer agrees to be bound by the plan support agreement.

Specific Performance

It is common for plan support agreements to provide for specific performance in the event of a breach of the agreement, as opposed to money damages. The argument for such relief is that the parties expressly agreed to support a qualified plan, and that if the qualified plan fails to be confirmed as a consequence of a party's breach of the plan support agreement, money damages will be both difficult to quantify and less than complete relief.

Termination Provisions and Fiduciary Duties

The termination provisions in plan support agreements vary widely and reflect the particular circumstances of each case. Debtors typically favor tighter termination provisions because they often fear the loss of support from a major creditor constituency, although sometimes debtors want the ability to terminate a plan support agreement if they believe a more attractive plan alternative has presented itself.

Creditors are more often the parties who are seeking the right to be able to terminate the plan support agreement on the occurrence of specified events. For example, creditors who are concerned with a struggling debtor's performance may wish to terminate a plan support agreement if the debtor suffers a material adverse change to its business or fails to meet its projections. In those events, creditors may be concerned that they are locked into a disadvantageous reorganization plan and may wish to be free to consider alternatives.

Similarly, creditors sometimes put time limits on their agreements, meaning that they only remain bound if the debtor can achieve plan confirmation within an agreed timeframe, failing which, they wish to be free to reconsider the deal and its alternatives.

Duties to Creditors

One difficult issue in negotiating a termination provision is dealing with fiduciary duties, because debtors have fiduciary duties to their creditors. Thus, debtors often argue that if, after they have entered into a plan support agreement, a better alternative presents itself, they should be free to terminate the plan support agreement and pursue the alternative.

Typically, creditors seek to resist such provisions, although, as discussed below, the absence of a fiduciary out was one factor that led the bankruptcy court in *In re Innkeepers USA Trust*, 442 B.R. 227 (Bankr. S.D.N.Y. 2010) to deny approval of the plan support agreement in that case.

For debtors, the issue is particularly vexing. If they fail to retain a strong fiduciary out, the court may fail to approve the plan support agreement. On the other hand, from the perspective of creditors, the existence of a robust fiduciary out reduces the certainty that the agreed plan will be confirmed. To creditors, a plan support agreement with a strong fiduciary out gives the debtor a guaranteed floor and an option to go find a better deal. While that may be a proper discharge of a debtor's fiduciary obligations, it undercuts creditors' interest in agreeing in advance to a deal for fear of being re-traded.

For example, consider a plan support agreement that provides that the senior creditors agree to convert $200 million in pre-petition debt into $100 million in new notes and retain 100 percent of the equity, based on a $180 million valuation of the company. Under this plan, both unsecured creditors and existing equity received no distributions.

Now assume a competitor offers to buy the company, offering to pay the senior creditors with $125 million in notes, $75 million in cash, and leaving $25 million in value for unsecured creditors. Assume some additional facts: the new offer is subject to antitrust clearance and a financing out, and the competitor has a less-than-stellar reputation in the industry.

Even though the second transaction looks more attractive to all parties, including the secured creditors, they may worry about the level of risk associated with all of the contingencies, even though the overall economics of the second deal may be superior. The second proposal also puts the debtor in a dilemma. It may be concerned about the same risks posed by the second offer, but it may worry that failing to pursue it opens it to arguments that it is disregarding its fiduciary obligations. On the other hand, pursuing the more uncertain second alternative runs the risk that the whole plan negotiating process goes into freefall and the debtor has no agreement on a plan. Finally, under these facts, there can be little doubt that the unsecured creditors will prefer the second alternative, since even a long-shot plan is superior to being wiped out under a plan.

<u>No Solicitation Provision</u>

Because votes to accept a plan may only be solicited after a disclosure statement has been approved (11 U.S.C. § 1125(b)), careful debtors put a provision in the plan support agreement stating that the agreement does not constitute a solicitation.

<u>Statutory Framework for Soliciting Plan Acceptances</u>

In a Chapter 11 case that is not prepackaged or prenegotiated, the debtor first negotiates a restructuring plan with its creditors, then files a plan and disclosure statement with the bankruptcy court. Under the Bankruptcy Code and the Bankruptcy Rules, a hearing on a disclosure statement must be held on a minimum of twenty-eight days' notice, and the same time interval must elapse for a hearing on confirmation of a Chapter 11 plan. 11 U.S.C. § 101 *et seq.; Fed. R. Bankr. Pro.* 2002(b).

Moreover, in practice, the actual time periods employed will depend on the bankruptcy court's calendar and the length of time necessary to solicit votes from creditors, and will often be significantly longer. In a traditional Chapter 11 case, the solicitation of acceptances of a plan of reorganization cannot take place until the bankruptcy court has approved a disclosure statement that contains "adequate information" on which creditors can base their votes. 11 U.S.C. §§1125(a), 1125(b).

Pre-Petition Disclosure and Solicitation

Bankruptcy Code § 1126(b) governs the solicitation of acceptances of a plan of reorganization prior to the commencement of a Chapter 11 bankruptcy case. The issue of solicitation is critical to the validity of a pre-petition plan support agreement, because if the court finds the plan support agreement to be an invalid solicitation, the agreement may not be enforced. Section 1126(b) provides, in pertinent part, that:

> a. holder of a claim or interest that has accepted or rejected the plan before the commencement of the case under this title is deemed to have accepted or rejected such plan, as the case may be, if—
>
> 1. the solicitation of such acceptance or rejection was in compliance with any applicable nonbankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with such solicitation; or
> 2. if there is not any such law, rule, or regulation, such acceptance or rejection was solicited after disclosure to such holder of adequate information as defined in section 1125(a) of this title.

Bankruptcy Rule 3018(b) further provides that:

> An equity security holder or creditor whose claim is based on a security of record who accepted or rejected the plan before the commencement of the case shall not be deemed to have accepted or rejected the plan pursuant to § 1126(b) of the Code unless the equity security holder or creditor was the holder of record of the security on the date

> specified in the solicitation of such acceptance or rejection for the purposes of such solicitation. A holder of a claim or interest who has accepted or rejected a plan before the commencement of the case under the Code shall not be deemed to have accepted or rejected the plan if the court finds after notice and hearing that the plan was not transmitted to substantially all creditors and equity security holders of the same class, that an unreasonably short time was proscribed for such creditors and equity security holders to accept or reject the plan, or that the solicitation was not in compliance with § 1126(b) of the Code.

An Unreasonably Short Time

There is little law on what constitutes an "unreasonably short time" for purposes of Rule 3018(b). One court has held that thirteen days is too short. See *In re Southland Corp.*, 124 B.R. 211, 227 (Bankr. N.D. Tex. 1991). Because Rule 2002(b) provides that creditors must have at least twenty-eight days to consider a disclosure statement, some commentators have suggested that twenty-eight days is the appropriate length of time. See *5 Norton Bankr. L. & Prac.* 3d § 97:28. In the Southern District of New York, the local rules applicable to prepackaged cases contain presumptive voting guidelines. The rule presumes twenty-one days to be reasonable for publicly traded securities, fourteen days for securities that are not publicly traded and for debt for borrowed money that is not evidenced by a publicly traded security, and twenty-one days for all other claims and interests.

Accepting or Rejecting a Plan

In addition to Rule 3018(b)'s requirement that reasonable notice be given to creditors and equity security holders, courts have held that "only the holder of a claim, or a creditor, or the holder of an interest, may accept or reject a plan. If the record holder of a debt is not the owner of a claim, or a true creditor, he may not vote validly to accept or reject, unless he is an authorized agent of the creditor." *Southland*, 124 B.R. at 227.

The emphasis on ensuring that the actual beneficial holders of claims are allowed to vote flows from the way securities are registered on Wall Street.

For a typical corporate debt issue, the record holder of the securities will be the depository trust company or some similar institution, with transfers of beneficial interests in the securities being recorded on that institution's books. But the record holder, the depository trust company, typically has no economic interest in the securities. To ensure that the proper parties in interest have an opportunity to vote requires that the solicitation materials be provided to the actual holders of the bonds at issue.

Following the court's decision in *Southland*, Subsection (e) was added to Bankruptcy Rule 3017, governing court consideration of a disclosure statement, to provide that at the hearing on a disclosure statement, the court "shall consider the procedures for transmitting the documents and information…to beneficial holders of stocks, bonds, debentures, notes, and other securities." *Fed. R. Bankr. P.* 3017(e). Accordingly, plan proponents should be prepared to demonstrate that it was the actual beneficial holders of claims that were solicited and voted for the plan, or that the beneficial holders authorized the record holders to vote on their behalf.

<u>The Effect of Section 1125(g)</u>

Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the proponent of a prepackaged plan was required to complete the process of soliciting and obtaining acceptances of its plan prior to filing its petition. However, Bankruptcy Code Section 1125(g), enacted as part of the 2005 amendments to the Bankruptcy Code, now authorizes post-petition continuation of the solicitation of votes on a Chapter 11 plan based on a pre-petition disclosure statement. Bankruptcy Code Section 1125(g) serves, among other purposes, to prevent a few recalcitrant creditors from disrupting an otherwise consensual process by filing an involuntary bankruptcy petition while a debtor is in the process of soliciting votes on its plan of reorganization. Previously in such an instance, a debtor would no longer be able to continue soliciting votes once it filed its Chapter 11 petition.

The common source of applicable non-bankruptcy law referred to in Section 1126(b) and Rule 3018(b) consists of securities laws and regulations. Thus, if a prepackaged plan does not involve an offer to buy or sell securities within the meaning of federal securities laws, a debtor's solicitation of acceptances is not governed by applicable non-bankruptcy law, but rather a debtor's disclosures must contain "adequate information" pursuant to Section 1125(a). In this instance, a disclosure statement should be scrutinized the same as if it had been submitted following the petition date.

On the other hand, if a pre-petition plan does involve an offer to buy or sell securities, disclosure and solicitation can often be complicated and burdensome. For instance, because the Bankruptcy Code does not specify the contents of pre-petition disclosure, a plan proponent might be required to comply with all state and federal securities laws, state corporate law, and the rules and regulations of the stock exchanges. If the debtor's proposed plan of reorganization contemplates a cancellation of an existing class of securities and the issuance of new securities, the pre-petition solicitation must comply with the applicable rules regarding exchange offers. The two most common forms of exchange offers are registered exchange offers and offers exempt from registration under Section 3(a)(9) of the Securities Act of 1933, as amended.

Registered Exchange Offer

In a registered exchange offer, the debtor will prepare and file with the Securities and Exchange Commission (SEC) a registration statement on Form S-4 covering the new securities being offered. The registration process requires substantial public disclosure and can be expensive and time-consuming because the registration statement is subject to review by the SEC.

Registered exchange offers may be necessary in situations where bonds are widely distributed or are not held by holders eligible to purchase new debt in a private placement. In addition, new bonds in a registered exchange offer are freely transferable, which provides bondholders with greater liquidity than with privately placed bonds. Exchange offers combined with prepackaged plans of reorganization are typically undertaken as registered exchange offers, at least for companies with publicly traded securities.

For both the registered exchange offering and the exempt offering described below, the anti-fraud rules of the federal securities laws apply, meaning that the solicitation materials must contain sufficient information about the debtor and the terms of the exchange so as to allow the holder of securities to make an informed decision about whether to accept the offer.

Section 3(a)(9) Exchange Offer

A Section 3(a)(9) exchange offer is made pursuant to Section 3(a)(9) of the Securities Act of 1933, which provides for an exemption from registration for any security exchanged by an issuer with its existing securities holders if no payment is made by the issuer for solicitations made in connection with the offer; the old bonds and the new bonds and any equity offered in the exchange are all offered by the same issuer, and there are limited interpretive exceptions for substantially identical issuers and other specific fact situations; and bondholders are not required to contribute cash or other property, other than the old bonds in exchange for the new bonds.

However, cash or other considerations can be offered by the issuer with the new bonds. New securities issued in a Section 3(a)(9) exchange offer are restricted securities for resale purposes only if the old securities were restricted. The prohibition on payments for solicitation prevents an issuer from hiring an investment banker where the banker's fees depend on the success of the offer. These limitations can impede communications with bondholders and make it more difficult to persuade them to tender their securities, which is always a difficult process. A Section 3(a)(9) exchange offer avoids SEC registration and review, thus allowing faster completion of an offer than in a registered exchange. Such an offer can also be made to individuals and unsophisticated investors.

What Constitutes a Solicitation?

The case law involving plan support agreements is mixed. There are some cases that address litigation settlement agreements and debtor-in-possession and cash collateral arrangements where such agreements have been objected to as lock-up agreements. *See In re Texaco, Inc.*, 81 B.R. 813, 815 (Bankr. S.D.N.Y. 1988) (a litigation settlement agreement that included a provision not to "vote for, consent to, support, or participate in the formulation of any other plan" does not constitute a solicitation where no disclosure statement had been filed and no vote sought); *New World Pasta*, 322 B.R. at 569-570 (a provision in a debtor-in-possession credit agreement that required the debtor-in-possession to file a disclosure statement in a form acceptable to lenders holding at least two-thirds in dollar amount of the loans and majority in number of the lenders in the lending group was not a lock-up agreement since such provision "contains no such restriction on how any creditor must vote").

Decisions Regarding Solicitation

The majority of courts interpret the term "solicitation" narrowly. "The terms 'solicit and solicitation,' as used in § 1125(b) of the Bankruptcy Code, must be interpreted very narrowly to refer only to a specific request for an official vote either accepting or rejecting a plan. The terms do not encompass discussions, exchanges of information, negotiations, or tentative arrangements that may be made by the various parties in interest in a bankruptcy case which may lead to the development of a disclosure statement or plan or information to be included therein. If these activities were prohibited by § 1125(b), meaningful creditor participation in Chapter 11 cases would cease to exist." *In re Snyder*, 51 B.R. 432, 436 (Bankr. D. Utah 1985).

The Third Circuit Court of Appeals also interprets "solicitation" narrowly. "We agree with the district court that 'solicitation' must be read narrowly. A broad reading of § 1125 can seriously inhibit free creditor negotiations. All parties agree that [a creditor] is not barred from honestly negotiating with other creditors about its unfiled plan… The purpose of negotiations between creditors is to reach a compromise over the terms of a tentative plan. The purpose of compromise is to win acceptance for the plan. We find no principled, predictable difference between negotiation and solicitation of future acceptances. We therefore reject any definition of solicitation which might cause creditors to limit their negotiations." *Century Glove Inc. v. First American Bank of New York (In Re Century Glove Inc.)*, 860 F.2d 94, 101-02 (3d Cir. 1988).

In *In re Kellogg Square P'ship.*, 160 B.R. 336 (Bankr. D. Minn. 1993), the court held that an agreement to vote in favor of a plan as part of a settlement reached post-petition involving an executory contract did not constitute a "solicitation." "Ultimately, for the purposes of §§ 1125(b) and 1126(e), the act by which the Debtor 'solicited' District Energy's vote must be deemed to have taken place after the Court approved the amended disclosure statement, and only when the Debtor's plan and disclosure statement and a ballot were actually presented to District Energy in the formal process specified by § 1125(b)." *Id.* at 340. The *Kellogg* court further noted that this "avoids a chill on debtors' post-petition negotiations with their creditors, one which otherwise might prove devastating to the reorganization process." *Id.*

Prior to the enactment of Section 1125(g) of the Bankruptcy Code, there were two unreported bench rulings in Delaware by Judge Mary Walrath relating to lock-up agreements that caused concern about the enforceability of post-petition voting agreements. In *In re Stations Holding Co.*, No. 02-10882, 2011 WL 2345050, (MFW), (Bankr. D. Del. September 25, 2002), the US trustee sought to designate votes of a creditor who signed a lock-up agreement post-petition. The US trustee sought similar relief in *In re NII Holdings, Inc.*, 288 B.R. 356 (Bankr. D. Del. 2002).

In each case, the bankruptcy court granted the US trustee's designation request, effectively invalidating the agreements. Judge Walrath appeared to be persuaded by the argument that the specific performance remedy provided for in each agreement effectively rendered the lock-up agreement a vote on the plan because the specific performance remedy meant the locked-up party would be unable to get out of its obligation to vote for the plan.

The bankruptcy court held that, when the lock-up agreement was signed post-petition, the lock-up agreement was "tantamount to votes to accept a Chapter 11 plan," which was solicited post-petition, without a court-approved disclosure statement in violation of Section 1125(b) of the Bankruptcy Code. The enactment of Section 1125(g) of the Bankruptcy Code, which permits the continuation of post-petition solicitations of acceptances when the process was begun pre-petition, was intended in part to make it clear that such post-petition lock-up agreements were permissible if entered into as part of a pre-petition solicitation effort.

More recently, some debtors have sought bankruptcy court authority to assume plan support agreements under Section 365 of the Bankruptcy Code. In *In re MES International, Inc.*, Case No. 09-14109 (PJW) (Bankr. D.

Del. Dec. 18, 2009) (Docket No. 144), the debtors filed a motion on the first day of their Chapter 11 case seeking an order authorizing them to assume a pre-petition plan support agreement with their noteholders. The prenegotiated plan was attached to the plan support agreement. The plan support agreement was presented as an executory contract where the noteholders would be obligated to perform, even without the debtors' moving to assume the plan support agreement, though the debtors would not be obligated to perform absent an assumption.

The plan support agreement provided that the noteholders had the option to terminate the plan support agreement if approval of the motion to assume was not granted by the bankruptcy court. The debtors argued that the assumption of the plan support agreement satisfied the "business judgment" test because the plan was the best possible outcome for all stakeholders, after an exhaustive consideration by the debtors of alternatives. The bankruptcy court approved the assumption of the plan support agreement.

<u>The *Innkeepers USA Trust* Case</u>

In a recent case, however, the Bankruptcy Court for the Southern District of New York refused to approve the debtor's proposed assumption of a plan support agreement. On July 19, 2010, Innkeepers USA Trust and its subsidiaries filed for protection under Chapter 11, and the cases were jointly administered by Judge Shelley C. Chapman. *In re Innkeepers USA Trust*, 442 B.R. 227 (Bankr. S.D.N.Y. 2010).

The primary assets of Innkeepers consisted of approximately seventy hotels. Innkeepers' ultimate parent was Apollo Investment Corporation. The majority of the hotels were collateral for two secured parties, Lehman ALI and Midland Loan Services, a special servicer. Lehman's approximately $220 million claim was secured by twenty hotels, while Midland's approximately $825 million claim was secured by another forty-five hotels. The Midland hotels were not cross-collateralized with the Lehman hotels. The remaining hotels had different secured creditors.

Prior to filing for Chapter 11, Innkeepers entered into a plan support agreement under which Lehman would receive 100 percent of the equity in all ninety-two of the debtors, even though Lehman had a security interest in only twenty of the debtors, in exchange for its entire claim, while Midland and other secured lenders would be crammed down. In a side agreement, Lehman agreed to sell 50 percent of its 100 percent equity interest to Apollo for $107.5 million. After filing, Innkeepers moved to assume the plan support agreement pursuant to 11 U.S.C. § 365.

Midland, along with other secured creditors, objected to the assumption of the plan support agreement, arguing that, among other things, the plan contemplated by the plan support agreement violated the debtors' fiduciary duties and was not a bona fide exercise of the debtors' business judgment. Specifically, Midland argued that Apollo was involved in the negotiation of the plan support agreement, though it was not a signatory, and pointed out that one of the conditions set by Lehman in assuming the plan support agreement was that it would be able to sell 50 percent of its interest to Apollo.

Innkeepers argued that because Apollo was not a party to the plan support agreement and because Apollo's equity interest in Innkeepers would be wiped out by the plan, the fact that Lehman had determined to enter into a separate agreement whereby it would sell a portion of the equity to Apollo was not relevant to the motion to assume the plan support agreement. Midland also argued that Innkeepers had not exercised proper business judgment by entering into the plan support agreement without first marketing the assets to determine their value, and that the business judgment rule did not apply because Apollo stood on both sides of the transaction, and therefore heightened scrutiny should be applied. Midland further argued that the fiduciary out imbedded in the plan support agreement was illusory, as it only permitted Innkeepers to consider other offers if those offers were better for Lehman, rather than for the entire creditor constituency.

After extensive discovery and an evidentiary hearing on the motion to assume the plan support agreement, Judge Chapman issued a strongly worded opinion decision in which she denied the motion. The court said that while it believed that Innkeepers' decision to assume the plan support agreement should be evaluated under a standard of heightened scrutiny rather than business judgment, it was unnecessary to decide the issue because Innkeepers' decision to assume the plan support agreement did not even meet the business judgment standard. *In re Innkeepers USA Trust*, 442 B.R. 227.

Judge Chapman found that the negotiations surrounding the plan support agreement did not constitute a disinterested business transaction, because the evidence showed that months prior to the bankruptcy filing, Apollo intended to receive equity as part of the transaction contemplated by the plan support agreement. 442 B.R. at 231. Judge Chapman also held that she could not conclude that the plan support agreement was entered into with due care because the deal contemplated in the plan was not marketed, and because Innkeepers' investment banker was told not to pursue other bidders or transactions. *Id.* at 232. Further, Judge Chapman found that the plan support agreement prohibited Innkeepers from even engaging in discussions relating to alternative transactions. *Id.* at 232.

The bankruptcy court also found that Innkeepers had not acted in good faith in entering into the plan support agreement, noting, among other things, that "the intention for Apollo to end up with half of the debtors' equity which has been on the table since April has been, at best, downplayed and, at worst, obfuscated from parties-in-interest." *Id.* at 233. Judge Chapman further held that Innkeepers had not complied with its fiduciary duties in pursuing the plan support agreement, emphasizing in particular that the fiduciary out was flawed and prohibited Innkeepers from taking actions consistent with their fiduciary obligations. *Id.* at 233-235.

Developing a Plan Support Agreement Strategy

In developing a plan support agreement strategy, a debtor and its advisors need to consider the composition and identity of the debtor's creditor body and the goals of the proposed reorganization to determine the key creditor groups with whom the debtor should seek to enter into plan support agreements.

The key constituency for any debtor is its senior-most class of creditors. If the debtor has an agreement with that class, it always has the option of seeking to confirm a cram-down plan under Section 1129(b) of the Bankruptcy Code. If the debtor has second-lien or unsecured bond debt, those groups of creditors are, in descending order, the next logical targets. If trade creditors or employee claims are not going to be affected by the reorganization, it is a waste of time and money to include them in the process.

But balanced against the benefits of reaching an agreement with all classes of creditors are risks of delay and expense. The debtor will be incurring extraordinary costs while it seeks to negotiate these arrangements, and during that time there is always a risk that management may have its attention distracted by protracted restructuring negotiations. Thus, while each case will have its own dynamic, a solid agreement with the senior secured creditors gives the debtor the minimum support it needs to commence a prenegotiated Chapter 11 case.

As described above, one of the toughest negotiations concerning a plan support agreement is defining what constitutes a qualified plan and how much latitude the debtor will have in negotiating subsequent settlements with junior creditor classes. While clearly the debtor will want to have the highest degree of flexibility it can retain for such negotiations, as a practical matter, the debtor cannot risk losing the support of its senior creditors and eventually will have to live within whatever guidelines they establish.

Negotiations over plan support termination events can also be arduous. Typically creditors want the right to be able to terminate a plan support agreement if the debtor's business performance deteriorates beyond its projections. Here the debtor has to negotiate firmly to keep the deal in place. All participants in a restructuring know that when a business is struggling, it can often experience a myriad of problems as its operational and financial condition become apparent to its industry. Trade credit can dry up, customers can become skittish about placing new orders, and receivables may not be paid on schedule. Debtors should be cognizant of such risks in negotiating what constitutes a material adverse change and leave themselves as much breathing room as they can.

Finally, debtors must insist on a meaningful fiduciary out. As shown by the *Innkeepers Trust* case, bankruptcy courts are highly concerned with ensuring that debtors properly discharge their fiduciary duties to their creditors. Thus, courts will look with disfavor on contractual provisions that preclude a debtor from being able to consider alternative or competing plan proposals, even if consideration of those proposals calls into doubt the viability of a plan support agreement. Thus, debtors need to insist, at a minimum, that they be permitted to respond to any alternative plan proposal or bid, notwithstanding the existence of a plan support agreement, and that they be allowed to provide access to due diligence information to prospective participants in the plan process. Although it may seem counterintuitive, creditors are also better served by allowing the debtor to have such an ability. In the absence of such a provision, creditors opposing a plan support agreement will simply re-raise the successful arguments from *Innkeepers Trust* and ask the court to deny approval of the plan support agreement at issue.

Conclusion

Prenegotiated plans are often a bridge between a fully prepackaged plan of reorganization and a so-called "free fall" bankruptcy. Often they result because the debtor and its creditors do not have the time or resources necessary to complete the bankruptcy solicitation process before commencing a Chapter 11 case. If planned for properly, however, a successful prenegotiated plan can provide great practical benefit to debtors:

1. They avoid the need for pre-bankruptcy solicitations that comply with both the Bankruptcy Code and state and federal securities laws.
2. They can be accomplished more quickly than non-bankruptcy solicitations.
3. They allow the debtor to make a public announcement about the intended result of its Chapter 11 case when it files, thus reducing the impact of the filing on customers, vendors, and employees.

Key Takeaways

- Because of the time, expense, and complexity of Chapter 11 proceedings, a client may find that a prepackaged or prenegotiated settlement works better than traditional proceedings.
- Plan support agreements usually provide for specific performance in the event of a breach of the agreement, as opposed to money

damages. The parties expressly agree to support a qualified plan. If the plan is not confirmed because of a party's breach of the plan support agreement, money damages are both difficult to quantify and less than complete relief.

- Votes to accept a qualified plan may only be solicited after a disclosure statement has been approved, so careful debtors put a provision in the plan support agreement stating that the agreement does not constitute a solicitation to avoid violating the Bankruptcy Code.
- In developing a plan support agreement strategy, a debtor and its advisors need to consider the composition and identity of the debtor's creditor body and the goals of the proposed reorganization to determine the key creditor groups, in particular the most senior groups, with whom the debtor should seek to enter into plan support agreements.

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