Delaware Bankruptcy Court Confirms the Validity of Plan Support Agreements

May/June 2013

George R. Howard
Mark G. Douglas

Chapter 11 debtors and sophisticated creditor and/or shareholder constituencies are increasingly using postpetition plan support agreements (sometimes referred to as "lockup" agreements) to set forth prenegotiated terms of a chapter 11 plan prior to the filing of a disclosure statement and a plan with the bankruptcy court. Under such lockup agreements, if the debtor ultimately proposes a chapter 11 plan that includes prenegotiated terms, signatories are typically obligated to vote in favor of the plan. As a result, the outcome of voting on a chapter 11 plan is often largely determined even before the bankruptcy court approves the disclosure statement, if sufficient stakeholder constituencies are parties to a lockup agreement.

Such were the circumstances in a recent bankruptcy case in Delaware. In *In re Indianapolis Downs, LLC*, 486 B.R. 286 (Bankr. D. Del. 2013), certain of the debtor's equity holders attempted to thwart confirmation of a prenegotiated chapter 11 plan by arguing that a postpetition lockup agreement among the debtors and a large group of secured creditors violated the plan solicitation requirements of the Bankruptcy Code and that the votes of the signatory creditors should therefore be disallowed, or "designated." The bankruptcy court rejected the argument in an important ruling that may put to rest any lingering doubts about the validity of postpetition lockup agreements.

Lockup Agreements

Lockup agreements are a common feature of out-of-court workouts. They ensure that signatories remain committed, at least contractually, to a negotiated proposal potentially involving many competing creditor or shareholder groups. Without that commitment, the time and resources of workout participants may be wasted if a creditor or a creditor group reneges on an agreement in principle necessary to the success of the workout.

Many successful restructurings begin outside court but ultimately end up as “prepackaged” or “prenegotiated” bankruptcy cases. This is typically the case where the company is able to reach an agreement with some or perhaps even all of its creditors concerning the terms of a restructuring but needs the benefits of the Bankruptcy Code to implement the necessary adjustments to its balance sheet and capital structure. For instance, if a company reaches an agreement with some but not all of its creditors, a bankruptcy filing may be necessary to bind the holdouts to the terms of a proposed restructuring incorporated in a plan of reorganization confirmed by the bankruptcy court. Also, the Bankruptcy Code under certain circumstances allows a reorganizing debtor to issue new securities without complying with the registration requirements imposed by federal securities laws.

If the company strikes a deal with requisite majorities of its creditor constituencies and decides to file for bankruptcy to complete the workout, it can file a prepackaged bankruptcy case. This kind of case involves the solicitation of creditor votes for a restructuring proposal prior to filing a chapter 11 case, as well as bankruptcy-court authorization to have those votes counted in favor of a chapter 11 plan of reorganization. Where such consensus is impossible, but the company is able to get most of its significant creditors on board, it can file a prenegotiated chapter 11 case.

In the latter circumstance, the company will attempt to obtain the participating stakeholders' commitment to support a plan of reorganization with certain specified terms. That commitment most often takes the form of a lockup, or plan support, agreement.

Conflict With Bankruptcy
Disclosure and Solicitation Rules

The relationship between lockup agreements and bankruptcy law is an uneasy one. This is so because the Bankruptcy Code contains rigorous disclosure requirements that must be complied with as part of the plan confirmation process.

Pursuant to section 1125(g) of the Bankruptcy Code, which was added to the Bankruptcy Code in 2005, votes in favor of or against a chapter 11 plan that were obtained prior to the bankruptcy filing will be valid if "solicitation" of the vote complies with applicable nonbankruptcy law. By contrast, section 1125(b) provides that *postpetition* votes in favor of a plan can be solicited only after the creditor or shareholder receives a court-approved disclosure document containing "adequate information," a concept defined in section 1125(a).

If the court determines that a vote was solicited without disclosure of adequate information or under circumstances that are otherwise improper, it has the power under section 1126(e) to "designate," or invalidate, the vote.

Precisely what constitutes "solicitation" of a vote on a plan and, more specifically, whether negotiations accompanying a lockup agreement qualify as solicitation, are unclear. In keeping with a series of court decisions beginning with the bankruptcy court's ruling in *Trans World*

Airlines, Inc. v. Texaco, Inc. (In re Texaco, Inc.), 81 B.R. 813 (Bankr. S.D.N.Y. 1988), these kinds of agreements have generally not been deemed to run afoul of the Bankruptcy Code's solicitation requirements. *See*, *e.g.*, *In re Heritage Organization, L.L.C.*, 376 B.R. 783 (Bankr. N.D. Tex. 2007); *In re Kellogg Square Partnership*, 160 B.R. 336 (Bankr. D. Minn. 1993). Among other reasons, courts have noted that lockup agreements typically contain provisions allowing signatories to back out of their commitments where their fiduciary obligations require it or the plan actually proposed by the debtor is materially different from what was agreed upon.

However, in a pair of unpublished bench rulings handed down in 2002, Delaware bankruptcy judge Mary F. Walrath held that postpetition lockup agreements violate section 1125(b), and she consequently designated the votes of the signatories under section 1126(e). *See In re Station Holdings Company, Inc.*, No. 02-10882 (MFW) (Bankr. D. Del. Sept. 30, 2002) [document no. 177]; *In re NII Holdings, Inc.*, No. 02-11505 (MFW) (Bankr. D. Del. Oct. 22, 2002) [document no. 367]. Both cases involved prepackaged chapter 11 plans, but certain supporting creditors signed lockup agreements postpetition. Although the summary rulings do not contain any legal analysis, the transcripts of the proceedings indicate that Judge Walrath laid particular emphasis on the absence of any provision in the lockup agreements allowing the signatories the right to change their votes if the information contained in the disclosure statement turned out to be different from what they had received previously. The judge stated, "I never want to see another lockup agreement like this cited to me as being appropriate."

Another Delaware bankruptcy judge (Brendan L. Shannon) recently revisited this issue in *Indianapolis Downs*.

Indianapolis Downs

Indianapolis Downs, LLC, and Indiana Capital Corp. (collectively, the "debtors") operate a combined horse-racing track and casino—a "racino"—in Shelbyville, Indiana. The debtors filed for chapter 11 protection in April 2011 in Delaware after their out-of-court restructuring efforts failed. After months of negotiations during the bankruptcy cases, the debtors and two major secured creditor groups agreed to proceed on a dual-track path, seeking to explore a sale of the debtors' assets for an amount sufficient to muster the support of major creditors, while at the same time pursuing a recapitalization plan if the sale efforts failed.

This strategy was memorialized in a restructuring support agreement (the "RSA"). The RSA included, among other things: (i) specific terms of a dual-track chapter 11 plan, including the financial terms of, and creditor treatment under, potential sale or recapitalization transactions; (ii) the requirement that the debtors propose a chapter 11 plan within a specified time frame; (iii) a prohibition upon any party to the RSA proposing, supporting, or voting for a competing plan; and (iv) the requirement (enforceable by an order of specific performance) that signatories vote "yes" for a plan which complied with the RSA. By its terms, the RSA was binding upon execution by its nondebtor signatories but became binding upon the debtors only upon approval by the court of a disclosure statement. The RSA also expressly stated that it was not intended to be a solicitation of a plan for purposes of section 1125 of the Bankruptcy Code.

The debtors filed the RSA with the bankruptcy court and, on the same day, filed their proposed disclosure statement and accompanying plan. The court approved the disclosure statement, and the debtors solicited the votes of all eligible stakeholders on a proposed plan, which conformed to the terms of the RSA and contemplated a sale of substantially all of the debtors' assets for approximately $500 million.

Senior management and certain holders of the debtors' equity and debt instruments (the "Equity Objectors") objected to the debtors' proposed plan. The Equity Objectors argued that negotiation and execution of the RSA amounted to an improper postpetition solicitation of votes in contravention of section 1125(b) of the Bankruptcy Code and that such improper solicitation warranted designating the votes of the signatory creditors pursuant to section 1126(e). The Equity Objectors did not argue, however, that votes in favor of the plan had been procured in bad faith or that the RSA had been negotiated in bad faith.

The bankruptcy court rejected the Equity Objectors' argument, adopting a narrow interpretation of "solicitation" in section 1125(b). In accordance with the ruling of the Third Circuit Court of Appeals in *Century Glove, Inc. v. First Am. Bank of New York*, 860 F.2d 94 (3d Cir. 1988), the bankruptcy court held that the term "solicitation" in section 1125(b) must be interpreted narrowly to avoid interference with negotiations during a bankruptcy case. The court also cited favorably to *Heritage Organization*, where the court concluded that the votes of creditors who had signed a term sheet embodying key economic terms of a chapter 11 plan should not be designated because "the term 'solicitation' should be construed very narrowly, in deference to a clear legislative policy encouraging negotiations among creditors and stakeholders in Chapter 11 cases." Finally, the bankruptcy court cited to *Kellogg Square* for the proposition that "solicitation" occurs only when a plan, disclosure statement, and ballot are actually presented. Relying on this narrow interpretation of "solicitation," the bankruptcy court in *Indianapolis Downs* concluded that the RSA was not an improper solicitation because it required creditors to vote in favor of a plan only if and when a plan conforming to the terms of the RSA was proposed in accordance with section 1125(b).

The bankruptcy court also articulated three broad policy considerations that warranted rejecting the arguments made by the Equity Objectors. First, the court noted that "creditor suffrage is a bedrock component of Chapter 11" and that it would be inconsistent with this principle to discount or ignore the votes of significant creditor constituencies in favor of a heavily negotiated chapter 11 plan in the absence of any showing of bad faith.

Second, the bankruptcy court explained that the requirements of section 1125 are designed to prevent a debtor from seeking approval of a plan before the parties in interest have sufficient information to make an informed decision. In the instance of the parties to the RSA, all of whom were sophisticated financial parties represented by experienced professionals, there was no such concern.

The court flatly rejected the Equity Objectors' assertion that provisions in the RSA requiring the signatories to vote in favor of a conforming plan and providing for the remedy of specific performance amounted to solicitation. According to the court, the specific performance provision in the RSA was appropriate because the parties "were entitled to demand and rely upon assurances that accepting votes would be cast."

Lastly, the court emphasized that the right of creditors to vote on a plan is a critical feature of chapter 11 that should be infringed upon only in exceptional circumstances. Given the lack of any showing of bad faith, the bankruptcy court concluded that the Equity Objectors failed to satisfy the heavy burden of proof required to designate the votes of the RSA's signatory creditors.

The bankruptcy court also distinguished *Station Holdings* and *NII Holdings*. According to the court, "These two pre-packaged cases present a markedly different factual and procedural context than the case at bar, . . . [and] the two-page orders entered in those cases do not contain any legal analysis . . . [such that], consistent with this Court's practice, [they] are of only the most limited (if any) precedential value." The court also wrote that "[a]t a minimum, there was no question in those cases that the act in question was a 'solicitation' of a specific ballot relating to a filed plan."

The bankruptcy court denied the motion to designate RSA signatory votes, writing:

> In summary, the Court observes that the filing of a Chapter 11 petition is an invitation to negotiate. Congress has carefully calibrated the Chapter 11 process—using the automatic stay, exclusivity, the right of secured creditors to adequate protection and a host of other statutory provisions—to provide stakeholders with leverage or bargaining chips to advance their respective agendas. The purpose, at bottom, is to permit parties to have a voice and to make their own economic decisions. Each case requires an analysis into its particular facts and circumstances to permit a court to determine whether there is material risk to the important interests sought to be protected by the Bankruptcy Code's disclosure requirements. But consistent with the holding in *Century Glove*, courts must be chary of construing those disclosure and solicitation provisions in a way that chills or hamstrings the negotiation process that is at the heart of Chapter 11. When a deal is negotiated in good faith between a debtor and sophisticated parties, and that arrangement is memorialized [as] a written commitment and promptly disclosed, § 1126 will not automatically require designation of the votes of the participants.

Conclusion and Implications

Indianapolis Downs is consistent with the approach taken by most courts outside Delaware. By embracing a narrow interpretation of "solicitation," particularly in large, complex chapter 11 cases involving sophisticated and well-represented parties, these courts promote dialogue, negotiation and, in many cases, consensus among the debtor and its various stakeholders concerning the terms of a chapter 11 plan. Without such flexibility, the chapter 11 process can be more protracted, costly, and difficult. *Indianapolis Downs* has therefore been hailed as a positive development in both Delaware and other districts.