Delaware Bankruptcy Court Announces Bright-line Rule for Use of Lock-up Agreements in Chapter 11 Cases

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The U.S. Bankruptcy Court for the District of Delaware has issued bench rulings in two recent cases, *In re NII Holdings Inc.* and *In re Stations Holdings,* which together establish a bright-line rule for the use of lock-up agreements in connection with voting on a chapter 11 plan. Simply put, the court ruled that votes to accept a reorganization plan cast by a party that signed a lock-up agreement prior to the petition date may be counted for plan confirmation, while votes cast by parties who entered lock-up agreements post-petition and prior to the court having approved a written disclosure statement may not be counted. In the latter cases, the court found that the post-petition lock-up agreements violated §1125(b) of the Bankruptcy Code because they amounted to post-petition solicitation of acceptances of a chapter 11 plan without a court-approved written disclosure statement having been provided in advance to the locked-up parties.

As a result, the votes cast by these locked-up parties to accept the chapter 11 plan were not counted (*i.e.,* "designated") for purposes of plan confirmation.[2] Significantly, the court refused to designate an identical lock-up agreement fully executed prior to the commencement of the chapter 11 case because it had no jurisdiction over the pre-petition lock-up agreement, and therefore allowed the votes of the locked-up party in support of the plan to be counted for plan confirmation. Though not controlling precedent, these bench rulings provide bright-line guidance for practitioners attempting to prenegotiate chapter 11 cases.[3] The clear message to take from these recent bench rulings is that if you intend to use lock-up agreements in a pre-negotiated case,[4] make sure to have fully executed lock-up agreements in hand prior to filing the case.

Lock-up Agreements Defined

Generally in the context of pre-negotiated chapter 11 cases, lock-up agreements are negotiated by sophisticated parties that provide for a commitment to support a particular restructuring, subject to various terms and conditions. In a typical prenegotiated case, the debtor and the most significant stakeholders, often the holders of large blocks of institutional debt, will negotiate the key terms of a proposed restructuring, prior to filing the chapter 11 case.

Daniel J. DeFranceschi

Usually, lock-up agreements are agreed to and fully executed prior to filing the chapter 11 case, together will the terms of the proposed restructuring. Such agreements are a valuable component of a prenegotiated case as the debtor and other stakeholders know the basic parameters of the restructuring going into the case. Indeed, prenegotiating a chapter 11 case will remove much of the inherent uncertainty associated with the chapter 11 process. Such cases are commenced with the significant restructuring terms already agreed to, along with the necessary support and financing to complete the restructuring. 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. Typical operative language in a lock-up agreement provides that a significant stakeholder agrees to support a restructuring plan subject to various terms and conditions.[5] These lock-up agreements are typically contingent on many events, such as the drafting and court approval of a disclosure statement, the drafting of an actual plan that is satisfactory to the locked-up parties, and that the debtor suffer no material adverse changes during the pendency of the chapter 11 case. The actual agreement of the locked-up party to vote on the plan is contingent on satisfaction of all the terms and conditions negotiated into the lock-up agreement.

The Timing Issue Under the Code

The Code provides that the date the case is commenced is critical. Thus, the Code states that "an acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement, approved after notice and a hearing, by the court as containing adequate information..." 11 U.S.C. §1125(b). *See, also,* Fed. R. Bankr. P. 3017 and 3018. Pre-petition, however, §1126(b) of the Bankruptcy Code provides 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 non-bankruptcy 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 §1125(a) of this title..." 11 U.S.C. §1126(b). Both sections attempt to ensure that the actual votes for or against the plan are based on the requisite information having been made available to the stakeholder.

If the court determines that votes have been solicited in violation of these sections, the court may designate the entity casting such vote and not count such vote for purposes of plan confirmation. *See* 11 U.S.C. §1126(c), (d) and (e). *See, also, In re Kellogg Square Partnership,* 160 B.R. 336, 339 n.2 (Bankr. D. Minn. 1993).

The Delaware Court's Bench Rulings

In each of the recent bench rulings, the party seeking designation of the locked-up parties, and disallowance of their votes on the plan, was particularly concerned with the specific performance remedy and injunctive relief provisions of the lock-up agreements. Those provisions essentially stipulated that a breach of the lock-up agreement could not be compensated by money damages, and

continued on page 55

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2 In each of these cases, the court confirmed the chapter 11 plans presented by these debtors.

3 Bench rulings are decisions of the court issued verbally from the bench without a written opinion of the court. Bench rulings are not controlling precedent, but do provide practitioners with useful guidance in navigating through cases.

4 The term "pre-negotiated" case used herein refers to cases where, prior to filing the chapter 11 petitions, the debtor and some creditor constituency have reached an agreement on the terms of a restructuring to be effectuated in a chapter 11 case, but the debtor has not actually solicited and obtained sufficient votes to confirm the plan prior to filing. In the later circumstances, more typically referred to as a "pre-packaged" case, the parties actually solicit and obtain votes to accept a plan prior to filing the chapter 11 case. In such cases, the debtor will need to comply with the appropriate disclosure requirements of §1126(b) of the Code.

5 While debtors typically try to lock up the necessary support for the proposed restructuring, the various other stakeholders involved, who are often agreeing to significant concessions on their claims and are agreeing to provide new financing for the restructuring, will also demand that each party execute a lock-up agreement to secure the commitment of each party involved.

permitted specific performance of the agreement upon a breach. For example, if the locked-up party failed to vote to accept the plan, as otherwise agreed to in the lock-up agreement, the debtor could seek a court order requiring the locked-up party to vote to accept the plan. In each of these cases, the party opposing the lock-up agreements argued that this specific performance remedy effectively rendered the lock-up agreement a vote on the plan on the theory that due to the specific performance remedy, the locked-up party would be unable to get out of its obligation to vote in favor of the plan. In each case, the court announced a simple, bright-line rule regarding the use of lock-up agreements.

In the first of these bench rulings, *In re Stations Holding Co. Inc.*, Case No. 02-10882 (MFW), the court designated entities that executed lock-up agreements several months after the chapter 11 case was filed. In that case, the lock-up agreements evidenced support of a plan that provided for the sale of the debtors' assets to a third party. The proposed purchaser in *Stations Holdings* required the execution of the lock-up agreements to foster its efforts to raise capital for the transaction. The court ruled that the lock-up agreement in that case constituted the solicitation of a vote on a plan. According to the court, "solicitation," as used in §1125(b) of the Code, means asking for a vote. *See In re Snyder,* 51 B.R. 432, 437 (Bankr. D. Utah 1985). The court determined that pursuant to the lock-up agreement, a vote on the plan was sought by the debtor. Because the solicitation occurred post-petition, and in the absence of an approved written disclosure statement, §1125(b) of the Code was violated. Accordingly, the court designated these entities, and their votes in favor of the plan would not be counted for plan confirmation.

In the other recent Delaware lock-up case, *NII Holdings Inc.*, Case No. 02-11505 (MFW), the court ruled that certain lock-up agreements that were executed as of several days after the commencement of the chapter 11 case violated §1125(b). As in *Stations Holding,* the court ruled that such post-petition lock-up agreements violated §1125(b) because the agreements were tantamount to votes to accept a chapter 11 plan that were solicited after the commencement of the case and without a court-approved written disclosure statement. Following a "bright-line" rule, the court held that post-petition lock-up agreements of this kind were impermissible under the Bankruptcy Code. As such, the court designated the parties to the post-petition lock-up agreements, and the votes of such parties to accept the plan were not counted for plan confirmation.

Pre-petition Lock-up Agreements Are Permissible

The *NII Holdings* court also considered an identical lock-up agreement that was fully executed and received by the debtor and the locked-up creditor *prior* to the commencement of the chapter 11 case. Such pre-petition execution is the more typical scenario for lock-up agreements. The pre-petition locked-up creditor ultimately cast a post-petition vote to accept the plan, after the solicitation of a written disclosure statement and pursuant to court-approved solicitation procedures. It was argued that this lock-up agreement violated §1126(b) of the Code. *However, again following a bright-line approach, the court determined that it did not have jurisdiction over those agreements because the debtors were not seeking to use the pre-petition lock-up agreement as a vote in favor of the reorganization plan.* Accordingly, the court refused to designate the party to the pre-petition lock-up agreement, and such party's votes were counted for plan confirmation. As the execution of lock-up agreements pre-petition is the most usual approach in pre-negotiated cases, this ruling provides solid support for the continued viability of pre-negotiated chapter 11 cases in Delaware.

The court also made clear in the *NII Holdings* case that its ruling should not chill negotiations over consensual chapter 11 plans. Indeed, the court acknowledged the policy in the Third Circuit of encouraging negotiations among the parties. *See In re Century Glove Inc.*, 860 F.2d 94 (3d Cir. 1988). *See, also, Kellogg Square,* 160 B. R. at 339-340. By reading §§1125(b) and 1126(b) in the manner it did, essentially recognizing the line in the sand at the commencement of the chapter 11 case drawn by Congress in the Code, the court's ruling should be read by practitioners as clear guidance to fully execute lock-up agreements prior to filing the pre-negotiated chapter 11 case. In doing so, practitioners should avoid further bankruptcy court scrutiny of such agreements and should be in a position to file the chapter 11 case with all of the benefits typically sought with a pre-negotiated filing. ■