

THE BANKING LAW JOURNAL

VOLUME 120

NUMBER 5

MAY 2003

**HEADNOTE: FROM LETTERS OF CREDIT AND NEW
SECURITIES RULES TO INTERNATIONAL BANKING
ISSUES**

Steven A. Meyerowitz 381

**STANDBY CREDITS DO NOT PROTECT LANDLORDS
FROM THE BANKRUPTCY CODE'S LEASE CAP**

John F. Dolan 383

**NEW CONTOURS OF BANK SECURITIES ACTIVITIES:
THE "DEALER" PUSH-OUT RULES**

Satish M. Kini and Jerome Roche 399

**AN OVERVIEW OF HIPAA'S IMPACT ON HEALTHCARE
CREDIT PRACTICES**

John Casillas and Richard Romero 406

**BANK INFORMATION DISCLOSURE IN CHINA:
EVOLUTION AND ENHANCEMENT**

Jin Chen 417

BANKRUPTCY FOR BANKERS

Howard Seife 459

BANKING BRIEFS

Donald R. Cassling 470

BANKRUPTCY FOR BANKERS

HOWARD SEIFE

DELAWARE BANKRUPTCY COURT'S RULINGS THREATEN USE OF "LOCKUP AGREEMENTS" IN PRENEGOTIATED AND PREPACKAGED PLANS

In a conventional case under chapter 11 of the federal Bankruptcy Code,¹ a debtor files a bankruptcy petition and then negotiates a reorganization plan and solicits votes after the bankruptcy court approves a disclosure statement. In recent years, however, more and more debtors, with the cooperation of their lenders and other creditors, have been relying on "prenegotiated" or "prepackaged" chapter 11 reorganization plans as a method of restructuring their balance sheets more quickly and more economically than in a traditional chapter 11 case. Indeed, the rules of a number of bankruptcy courts, including the United States Bankruptcy Court for the Southern District of New York, specifically contemplate prepackaged chapter 11 cases.

In a renegotiated plan, some or all of the parties in interest negotiate the details of a reorganization plan prior to the filing of a bankruptcy peti-

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tion by the debtor. The debtor then attempts to obtain creditor consent to the plan following bankruptcy, with formal solicitation of votes in favor of the plan taking place after the petition is filed.

With a prepackaged plan, which is authorized under Bankruptcy Code section 1126(b),² a plan proponent negotiates a plan and solicits votes prior to the filing of a petition and before the bankruptcy court holds a hearing to determine the adequacy of the disclosure statement. In these instances, the adequacy of the disclosure is evaluated under “applicable nonbankruptcy law, rule or regulation” or, if there is none, under the “adequate information” standard set forth in section 1125(a)(1).³

One of the tools that has come to be used more and more frequently in prenegotiated and prepackaged bankruptcy cases is known as the “lockup agreement.” The lockup agreement commits a party to vote in favor of a plan along the lines outlined in the lockup agreement. Bankruptcy attorneys and corporate financial advisors favor these documents to give the debtor comfort that the signatories actually will support the provisions of the plan to which they have agreed once the debtor enters bankruptcy.

Although lockup agreements have been used in numerous cases, and although numerous prepackaged and prenegotiated plans have been confirmed over the years, recent decisions by a Delaware bankruptcy judge cast some doubt on the continuing value and validity of these procedures.

In the chapter 11 cases involving Stations Holding Corp.⁴ and NII Holdings, Inc.,⁵ Delaware Bankruptcy Judge Mary F. Walrath ruled that various lockup agreements challenged by the U.S. Trustee had been obtained in violation of the solicitation provisions of the Bankruptcy Code.

These two rulings put in doubt, at least as to chapter 11 cases pending before Bankruptcy Judge Walrath in Delaware, whether lockup agreements obtained after a debtor has entered chapter 11 and before a disclosure statement has been approved are enforceable. Moreover, should Bankruptcy Judge Walrath’s ruling be adopted, or extended, by other courts across the country, it could call into question the viability of prenegotiated and prepackaged bankruptcy cases altogether.

The Statutory Framework

Bankruptcy Code section 1125(b) bars certain solicitation activities. Put differently, section 1125(b) allows, after the filing of a bankruptcy, the solicitation of an acceptance or a rejection of a plan only after an approved disclosure statement has been provided to the creditor. In pertinent part, this section provides that “[a]n 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.”

In a leading decision interpreting section 1125(b), the U.S. Court of Appeals for the Third Circuit decided several years ago, in *Century Glove, Inc. v. First American Bank of New York*,⁶ that the word “solicitation” in section 1125(b) should not be read so broadly so as to “inhibit free creditor negotiations.” According to the Third Circuit, “[t]he purpose of negotiations between creditors is to reach a compromise over the terms of a tentative plan” and “[s]olicitations with respect to a plan do not involve mere requests for opinions.”

The controversy in that case arose after August 1, 1986, the date Century Glove filed its reorganization plan, along with a draft of the disclosure statement. Taking exception to the plan and arguing that Century Glove’s largest claimed assets were speculative lawsuits, First American Bank (“FAB”) presented a written alternative plan to the unsecured creditors’ committee. FAB advised the committee that it would seek court approval to present its plan as soon as possible. Nevertheless, the committee rejected FAB’s plan in favor of that of the debtor. On December 2, 1986, the bankruptcy court approved Century Glove’s disclosure statement. A copy of the plan, the disclosure statement, and a sample ballot then were sent to Century Glove’s creditors entitled to vote on the plan’s acceptance.

Between December 12 and December 17, 1986, an attorney for FAB, John Bloxom, telephoned attorneys representing several of Century Glove’s creditors. Among these creditors were Latham Four Partnerships and Bankers Trust New York Corporation (“BTNY”). Bloxom sought to find out what

these creditors thought of the debtor's plan and to convince them to vote against it. He said that while there was no other plan approved for presentation, and thus no other plan "on the table," FAB had drafted a plan and had tried to file it. The creditors' attorneys then asked for a copy of the plan, which FAB provided. The copies were marked "draft" and covering letters stated that they were submitted to the creditors for their comments. The draft did not contain certain information necessary for a proper disclosure statement, such as who would manage Century Glove after reorganization.

BTNY had made a preliminary decision on September 12, 1986 to reject Century Glove's plan. It reaffirmed this decision on December 15 when it received a copy of Century Glove's plan and disclosure statement and, on December 17, counsel for BTNY prepared its ballot rejecting Century Glove's plan. FAB and Latham Four also voted to reject Century Glove's plan.

After receiving these rejections, Century Glove petitioned the bankruptcy court to designate, or invalidate, the votes of FAB, Latham Four and BTNY under Bankruptcy Code section 1126(e), which allows a bankruptcy court to set aside any vote that was not made or solicited "in good faith or in accordance with the provisions of this title." Century Glove argued that FAB had acted in bad faith in procuring these rejections.

The bankruptcy court held that FAB had "clearly violated" section 1125(b). Although a disclosure statement had been filed and distributed, the bankruptcy court found that FAB had violated this section by providing copies of its draft plan to Latham Four and BTNY. The bankruptcy court held invalid Latham Four's vote. It allowed the vote of BTNY, however, finding that the creditor had proved it had not relied on FAB's statements in deciding to reject Century Glove's plan. The court declined to bar FAB from participating further in the reorganization, finding such a sanction "too harsh," but instead ordered FAB to pay for "all costs incurred by [Century Glove] in prosecuting" its motions. The amount of these damages was not specified.

On appeal, the district court affirmed the bankruptcy court ruling allowing BTNY's vote, but reversed the designation of Latham Four and the imposition of monetary sanctions against FAB. The district court disagreed that section 1125(b) required approval for all materials accompanying a solicitation, and found such a reading in conflict with the Bankruptcy Code's policy of fostering free negotiation among creditors. Therefore, the district court

concluded, the bankruptcy court had erred in finding that FAB had improperly solicited rejections of the Century Glove plan.

The district court next considered whether FAB had improperly sought acceptance of its own plan. The district court found that, to facilitate negotiations, communications between creditors should not easily be read as solicitations. Because FAB's attorney had not made a specific request for an official vote, the district court found that FAB's actions "may only be fairly characterized as part of FAB's negotiations." The district court then reversed the designation and sanction orders of the bankruptcy court, finding that FAB had not solicited acceptances within the meaning of the Bankruptcy Code. Century Glove appealed to the U.S. Court of Appeals for the Third Circuit.

Third Circuit Ruling

In its decision, the Third Circuit focused on the district court's decision holding that FAB had not violated section 1125(b) and reversing the bankruptcy court's imposition of costs.

As the appellate court observed, there was no question that, at the time of FAB's solicitations, Latham Four and BTNY had received a summary of Century Glove's reorganization plan and a bankruptcy court-approved statement disclosing adequate information. It then examined whether, as Century Glove asserted, FAB was required to get bankruptcy court approval before it could disclose additional materials in seeking rejections.

The appellate court found that Century Glove's interpretation of section 1125(b) — that only approved statements could be communicated to creditors — was incorrect. As the Third Circuit observed, section 1125(b) does not limit the facts that a creditor may receive, but only the time when a creditor may be solicited. In the Third Circuit's opinion, rather than limiting the information available to a creditor, section 1125(b) seeks to guarantee a minimum amount of information to the creditor when asked for its vote. In other words, it stated, the provision sets a floor, not a ceiling. Thus, the circuit court found that section 1125 does not on its face empower a bankruptcy court to require that all communications between creditors be approved by the court.

The Third Circuit also pointed out that Century Glove's argument pro-

vided no means to distinguish predictably between mere interpretations of the approved information, and additional information requiring separate approvals. Therefore, under Century Glove's argument, to be safe, a creditor must seek prior court approval for every communication with another creditor (or refrain from communication), whether soliciting a rejection or an acceptance. The Third Circuit stated that Congress could hardly have intended such a result: it would multiply hearings, expense and delay, at a time when efficiency was greatly needed.

The Third Circuit then examined the bankruptcy court's decision that FAB had violated section 1125(b) because it was seeking support for its plan, which had not yet been filed. As the Third Circuit noted, the district court had concluded that solicitations barred by section 1125(b) include only the "specific request for an official vote," and not discussions or negotiations regarding a plan before its presentation. The Third Circuit agreed, and held, that "solicitation" in section 1125(b) must be read narrowly. A broad reading of section 1125 could "seriously inhibit free creditor negotiations," the appellate court found. Thus, FAB could not be barred from honestly negotiating with other creditors about its unfiled plan, the Third Circuit stated. The appellate court added that the purpose of negotiations between creditors is to reach a compromise over the terms of a tentative plan, and that the purpose of compromise is to win acceptance of the plan. It then found no principled, predictable difference between negotiation and solicitation of future acceptances. The Third Circuit therefore rejected any definition of solicitation that might cause creditors to limit their negotiations.

Accordingly, the Third Circuit held that a party does not solicit acceptances when it presents a draft plan to another creditor for consideration, but does not require that creditor's vote. Applying this definition, it found that FAB had not solicited acceptances of its plan.

The Kellogg Square Ruling

Several years after the Third Circuit imposed a narrow definition of the word "solicitation" in section 1125(b) in *Century Glove*, a bankruptcy court in Minnesota applied that ruling in a case involving what one might characterize as a "lockup agreement."

*In re Kellogg Square Partnership*⁷ involved a debtor, Kellogg Square Partnership, that owned a large parcel of developed commercial real estate in downtown St. Paul, Minnesota. When Kellogg Square entered chapter 11, the Prudential Insurance Company of America was its single largest creditor.

One of Kellogg Square's other creditors was District Energy St. Paul, Inc., a non-profit corporation that generated hot water for seasonal heating purposes for the owners of large buildings in downtown St. Paul. During the pendency of its chapter 11 case, Kellogg Square reached an agreement with District Energy under which the hot water delivery agreement between the parties would be modified. District Energy also would be entitled to a claim for approximately \$57,000, and agreed to vote in favor of Kellogg Square's plan.

After Kellogg Square put forth a reorganization plan and the bankruptcy court approved its disclosure statement, District Energy cast a ballot accepting Kellogg Square's plan. Prudential asked the bankruptcy court to reject District Energy's ballot, "on the grounds that the acceptance was not solicited or procured in good faith or in accordance with the provisions of the Bankruptcy Code." Prudential argued that Kellogg Square had violated section 1125(b) because it obtained District Energy's agreement to accept its plan before it had presented the final version of its disclosure statement to the bankruptcy court for approval and because it had used a preliminary draft of its amended disclosure statement and, possibly, other materials, to induce District Energy to make that agreement.

The bankruptcy court rejected Prudential's analysis. It declared that the law "should favor settlements" and said that bankruptcy courts should apply this maxim so as to encourage the formulation of reorganization plans that incorporate consensual arrangements between plan proponents and creditors and other parties in interest.

Importantly, the bankruptcy court found that District Energy's agreement to accept the debtor's plan, made postpetition but before approval of the disclosure statement, remained executory until District Energy actually filed its accepting ballot with the clerk of the court. In the bankruptcy court's view, neither the recitation in the disclosure statement nor the parties' execution of the written memorandum constituted an acceptance of the plan as such. Indeed, the bankruptcy court emphasized, had the final, court-approved disclosure statement revealed information that materially affected

District Energy's interests, and had Kellogg Square previously failed to disclose that information to District Energy, District Energy would have had a right under general, nonbankruptcy law to repudiate the agreement via rescission and then to cast a rejecting ballot.

The bankruptcy court found that limiting the reach of section 1125(b) avoided a chill on debtors' postpetition negotiations with their creditors, which otherwise might prove devastating to the reorganization process. As the bankruptcy court noted, promoting a consensual process in reorganization will have the broader benefit of preserving the resources of both debtors and creditors; it will encourage the making of arrangements earlier in the case, it will reduce the likelihood that the plan and disclosure statement will undergo several redrafts after an initial hearing under section 1125(b), and it should thereby reduce the burden on the state of administrative-expense claims that are incurred in connection with such redrafting.

As a matter of these basic principles, then, Kellogg Square's negotiation with District Energy did not constitute "solicitation" within the contemplation of section 1125(b). Kellogg Square therefore did not violate that section by obtaining District Energy's support for its plan in the way it did, and as early as it did.⁸

The Delaware Rulings

The two decisions by Delaware Bankruptcy Judge Walrath arose in similar situations. In the *Stations Holding* case, the U.S. Trustee challenged lockup agreements that provided that the executing creditor or equity holder agreed that "it shall timely vote...[its claim]...to accept the Plan" and "shall not elect on its ballot to preserve any claims...that may be affected by the release provide for under the Plan." According to the U.S. Trustee, each of the lockup agreements he challenged had been obtained by Stations Holding after it had entered bankruptcy, but without distribution of a disclosure statement, and provided that they could be specifically enforced in an action for an injunction. The U.S. Trustee argued that the process of obtaining agreements from creditors "binding" them to vote in favor of a plan, coupled with obtaining their stipulation that the agreements could be specifically enforced, could only be reasonably understood as requesting their official vote, in vio-

lation of section 1125(b).

Stations Holding challenged the U.S. Trustee's position. It argued that after it had entered chapter 11, it had executed a merger agreement with Gray Communications Systems, Inc., and that Gray wanted assurances from Stations Holding's constituents entitled to vote on a reorganization plan that they would accept the merger agreement and the plan. Gray thus requested that Stations Holding enter into lockup agreements pursuant to which certain creditors agreed to support the plan on certain conditions simultaneously with the execution of the merger agreement. Stations Holding emphasized that the effectiveness of the lockup agreements was conditioned on the bankruptcy court's approval of the disclosure statement; the creditors had no obligation to vote to accept the plan until they received the plan and disclosure statement; creditors had no obligation to vote to accept the plan if it contained different terms than those contained in the three-page term sheet they had received; and the lockup agreement's enforceability was conditioned on Stations Holding's compliance with Bankruptcy Code section 1125.

The bankruptcy court agreed with the U.S. Trustee and found that the lockup agreements violated the Bankruptcy Code. It ruled that despite *Century Glove*, it could not interpret "solicit" narrowly enough to not invalidate the lockup agreements at issue. According to the bankruptcy court, the term "solicitation" means asking for a vote; because Stations Holding was able to get the creditors to agree to vote, the lockup agreements were not appropriate without a disclosure statement. The court found compelling the fact that the parties to the lockup agreements could not change their vote, as the agreements were binding and enforceable through injunctive relief. In other words, the bankruptcy court held that these lockup agreements constituted improper solicitation of a vote on a plan, and had to be designated pursuant to Bankruptcy Code section 1126(e).

Simply put, the Delaware bankruptcy court found that the *Century Glove* decision and its progeny only would protect lockup agreements obtained prepetition. The bankruptcy court reached a similar result in the NII Holdings case.

Conclusion

The Delaware court's decisions put in jeopardy the burgeoning use of lockup agreements in prepackaged and prenegotiated chapter 11 cases — at least in Delaware. That is unfortunate because prepackaged and prenegotiated plans serve important purposes, including reducing costs and reducing the burdens on bankruptcy courts. An agreement to vote in the future on a plan is not equivalent to actually voting on the plan; much could happen in the interim. The negotiations that take place prior to and during a bankruptcy case may be less effective without a debtor's ability to rely on lockup agreements in anticipation of a formal vote solicitation. Banks, other creditors, debtors and their counsel and advisers should closely examine developments in this area, and may have to consider alternatives to the use of post-petition lockup agreements.

Notes

¹ 11 U.S.C. section 101 *et seq.*

² 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.”

³ Section 1125(a)(1) defines “adequate information” to mean “information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan.”

⁴ Case Number 02-10882 (MFW) (Bankr. D. Del.).

⁵ Case Number 02-11505 (MFW) (Bankr. D. Del.).

⁶ 860 F.2d 94, 101 (3d Cir. 1988).

⁷ 160 B.R. 336 (Bankr. D. Minn. 1993).

⁸ *See, also, In re Texaco Inc.*, 81 B.R. 813 (Bankr. S.D.N.Y. 1988) (involving stipulation between chapter 11 debtor and major judgment creditor, in which creditor agreed that it would not “vote for, consent to, support or participate in the formulation of” any plan other than the debtor’s; concluding that execution of stipulation did not constitute either solicitation of creditor’s vote for debtor’s plan, or actual vote by creditor: “the solicitation of [the creditor’s] vote must await the approval of the [debtor’s] disclosure statement”).