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How To Negotiate A Ch. 11 Plan Support Agreement

Law360, New York (October 16, 2013, 4:37 PM ET) -- Before initiating a Chapter 11 proceeding to implement an agreed-upon restructuring, a company will seek binding assurances from the creditors who the company negotiated with that such creditors will support the proposed transaction.

In order to "lock up" the support, the company and those creditors often enter into a plan support agreement, which also is referred to as a "restructuring support agreement" or a "lockup agreement." The plan support agreement generally provides that the creditors will support and not vote against the proposed restructuring. In turn, the company agrees to prosecute the plan on the agreed-upon terms within an agreed-upon time frame, typically with certain interim milestones.

Attached to the plan support agreement is an exhibit that is either a term sheet that sets forth the proposed, revised capital structure or a substantially completed version of the proposed plan of reorganization. As with any contract, it must be tailored to the specific requirements of the company, its creditors and the factual circumstances.

The Parties

The company, acting through its board of directors, and a group of creditors will negotiate and ultimately execute the plan support agreement. In order to obtain court approval of a plan of reorganization, the debtor must have at least one impaired, accepting class vote in favor of the plan pursuant to Section 1129(a)(8) of the Bankruptcy Code.

Often, the company will negotiate the terms of a restructuring with a class of creditors that will not be paid in full or reinstated under the plan. The debt instrument or security held by such creditors is often referred to as the fulcrum security in the capital structure because it is the security or debt instrument that will be at least partially converted into the equity of the reorganized company.

To determine which security is the fulcrum security, the company and its advisors will need to estimate (but not conduct a formal valuation process with respect to) the value of the company and determine which security or debt instrument likely will equitize.

For example, if a class of secured creditors is undersecured (i.e., the value of the secured creditor's collateral is less than the amount of its claim), the secured creditor may be the holder of the fulcrum security if its lien covers substantially all of the company's assets.

If a subordinated or unsecured group of creditors is out of the money (i.e., the value of the enterprise is insufficient to repay any portion of their claim), it will not serve the prospective debtor's goal to obtain an impaired accepting class by entering into negotiations with them.

Equity, on the other hand, especially for closely or privately held companies, may be required by parties to the negotiations to be a party to the plan support agreement. Although equity is "out of the money" if the company is insolvent, the holders of equity likely control the company through the board of directors.

A creditor group that is entering into a plan support agreement with a closely or privately held company will want to consider having equity holders as a party to the agreement to avoid the board, which has the power to bind the company, from resigning and leaving the equity holders free to take contrary positions through a new board because they are not party to the plan support agreement.

The Obligations

The parties to the plan support agreement generally agree to specific obligations regarding the restructuring process. Certain obligations relate only to the company, which typically prosecutes the plan, while other such obligations relate only to the creditor as the stakeholders and voting parties in the restructuring.

Obligations of Both Parties

The company and the creditors who execute the plan support agreement will need to agree affirmatively to support the proposed restructuring and all the terms thereof. For a prenegotiated restructuring, the plan support agreement is typically executed shortly before the company files for Chapter 11 and memorializes, in term-sheet format, the terms of the restructuring.

For a prepackaged plan, the plan support agreement is typically executed before the company begins soliciting votes on the proposed plan, which is done without court approval.

Company-Specific Provisions

There are typically numerous provisions in a plan support agreement pursuant to which the company agrees to take certain actions. The company usually agrees to file the Chapter 11 cases in an agreed-upon jurisdiction, to seek approval of agreed-upon first-day motions, to file a plan of reorganization that implements the agreed-upon restructuring term sheet, to solicit votes and to prosecute the agreed-upon form of plan.

Although the prospective debtor is agreeing to support the plan, based on applicable case law, a board cannot enter into an agreement that impedes its ability to discharge its fiduciary duties. Generally, a board has a fiduciary duty to maximize the value of the company for stakeholders.

By entering into the plan support agreement, the board must have come to a determination that the transaction embodied in the plan support agreement term sheet will permit it to discharge its fiduciary duty. However, circumstances can change materially.

If, for example, the value of an enterprise changes over time, the creditor group that was the fulcrum security may no longer be. Such a change in the underpinnings of a deal could require the board to act in a manner that may not be consistent with the terms of the plan support agreement. The plan support agreement must permit the board this required flexibility.

While the inclusion of a "fiduciary out" is typical, the terms pursuant to which the board may exercise the right vary. In the more lenient formulation, if the board determines that the exercise of its fiduciary duty requires it to terminate the plan support agreement, it may do so.

In the more stringent formulation, the board may need to obtain a written opinion of counsel or obtain other reports from its advisors to support its determination regarding changed circumstances and may need to provide prior notice to the creditors before acting.

Creditor-Specific Provisions

If multiple creditors are entering into an agreement with the company, each creditor will want to enter into the plan support agreement severally, and not jointly, to avoid becoming a guarantor for the other creditor signatories to the plan support agreement.

Creditors typically agree to support the Chapter 11 cases, to not object to the agreed-upon first day relief, to refrain from taking any action that would impede the agreed-upon restructuring process, and to not propose or otherwise prosecute an alternative restructuring.

With respect to voting, prior to the enactment of Section 1126(b) of the Bankruptcy Code, parties to plan support agreements were careful to avoid invalid solicitations because courts had held that absent a court-approved disclosure statement pursuant to Section 1125 of the Bankruptcy Code, solicitation of votes was not permitted.

To address this issue, creditors agreed to negative covenants (e.g., not to vote against the plan, not to object to the plan, not to solicit negative votes) and affirmative covenants other than voting for the plan. With the enactment of Section 1126(b) of the Bankruptcy Code, for true prepackaged plans, as long as the solicitation otherwise complies with applicable law, there is no concern.

For prenegotiated plans, typically the plan support agreement will provide an affirmative obligation to vote, with saving language that states that the plan support agreement is not a solicitation of votes for the plan and that no such solicitation can occur until a disclosure statement has been approved. Alternatively, the same result can be achieved with the use of negative and affirmative covenants.

Milestones/Termination

Creating a timeline for the progression of the restructuring is important to ensure that the timing expectations of the parties are met. An agreed-upon schedule mitigates concerns about parties binding themselves for an undetermined period of time to the terms of the plan support agreement.

Typically, a plan support agreement contains certain key milestones, such as a date by which: (1) the Chapter 11 cases must be initiated; (2) the disclosure statement must be approved; (3) the plan must be confirmed; and (4) the plan must become effective by its terms.

Other typical termination events include: (1) an outside date by which the agreement terminates by its own terms; (2) a material breach of the agreement; (3) the acceleration of obligations or termination of commitments under any post-petition financing; or (4) the exercise of the board’s fiduciary duty.

If the creditors who are signatories to the plan support agreement are prepetition secured lenders, they may seek a provision that terminates their required support if their prepetition liens are challenged by the company in the Chapter 11 cases.

The termination provisions typically permit the nonbreaching party to terminate the agreement under specified circumstances. If there is a large creditor group such as a lending syndicate or a group of noteholders, the plan support agreement may permit the administrative agent to extend certain deadlines (e.g., the date by which the bankruptcy cases must be initiated) for up to a specified number of days so that the approval of the entire group is not required for short, desirable extensions.

Representations About Ownership of the Claims and Transfer Restrictions

Pursuant to Section 1126(a) of the Bankruptcy Code, a holder of a claim or interest allowed under Section 502 of the Bankruptcy Code may vote to accept or reject a plan. The Bankruptcy Code defines a "claim" as a right to payment, meaning that in order to vote, the creditor must be the beneficial, not record, holder of the claim.

For securities held through a custodian (e.g., Depositary Trust Co.), the beneficial holder and not the record holder has the right to vote the claim.

In the plan support agreement, each creditor should represent severally (and not jointly) that it has the right to vote the claim. Without such a representation, one of the main purposes of the plan support agreement could be frustrated. In addition, during the pendency of a case, creditors may decide to sell their claims against the company to a third party.

The plan support agreement should provide for a mechanism that permits for the sale of claims so long as the purchaser of the claim agrees to take on the obligations of the plan support agreement. Without imposing a transfer restriction, the creditor could cleanse the claim of the plan support agreement obligations by selling it, thereby losing desirable support through claims trading.

Typically, the plan support agreement includes a joinder, which the purchaser must execute for the transfer to be deemed to be valid. Absent execution of the joinder, the plan support agreement provides that the trade is deemed void ab initio.

Specific Performance

The plan support agreement typically provides for specific performance as a remedy for any breach. Before the initiation of the Chapter 11 cases, state law is applicable.

After the Chapter 11 cases are initiated, it is questionable whether the creditors can seek to compel the debtor to perform under the plan support agreement because the plan support agreement is a prepetition executory contract, which the debtor could reject.

To remedy this issue, parties have sought to have the debtor assume the plan support agreement pursuant to Section 365 of the Bankruptcy Code at the start of or early in the Chapter 11 cases.

Although courts generally favor plan support agreements because they foster consensus, courts are reluctant to allow the debtor to assume a plan support agreement before the confirmation hearing because it locks in the results of the case without fulfilling all of the statutory requirements of a Chapter 11 plan confirmation process. Instead, courts have favored the debtor prosecuting the plan rather than imposing it through an assumed plan support agreement.

Continued Banking Practices

For banks and other large institutions that are involved in financing companies, it is common to include a provision in the plan support agreement that permits such entities to continue to provide banking services or debt or equity financing to the company or any potential acquirer of the company.

While the bank is agreeing to use its claims against the company to support the proposed plan, the bank will not want to be restricted from engaging in its other lines of business. For example, an institution that is a lender in a prepetition credit facility also may be a potential source of capital for a bidder for the business.

Under the plan support agreement, the institution will agree to use its claims to support the plan; however, this provision allows it to provide financing to a potential bidder in a process that may be inconsistent with the transaction proposed in the plan support agreement.

Amendments

The amendment section of the plan support agreement provides the minimum number of creditors (or amount of claims) that is required to amend the agreement. For amendments that adversely affect one creditor differently than all other creditors, that particular creditor typically must consent.

For all other provisions, typically if a majority or supermajority of the creditors signing the plan support agreement agree to a change, all dissenting or nonvoting creditors are bound to the change. By way of example, if 70 percent of the holders of claims in a class execute a plan support agreement and the amendment provision only requires a simple majority to approve an amendment, an amendment approved by more than 35 percent of the claims in a class can bind an entire class.

Plan Term Sheet

The plan term sheet, which is an exhibit to the plan support agreement, sets out in detail the form of the restructuring transaction, the treatment of claims, governance-related issues, releases and exculpations, and other material provisions of the proposed restructuring.

Classification and Treatment of Claims and Interests

Section 1122 of the Bankruptcy Code requires claims to be classified with claims and interests that are substantially similar to other claims and interests in the same class. Accordingly, the term sheet should define the classes of claims and interests that will be used in the proposed plan of reorganization.

If a company has secured, unsecured, trade and subordinated debt and preferred and common equity, typically, each type of claim and interest will be classified separately. For example, if a debtor issues multiple bonds on a pari passu basis, such bonds may be classified together; however, secured debt, trade debt, and preferred and common equity may each be classified separately.

In classifying claims, unless debtors are being substantively consolidated, generally, corporate separateness should be respected. There are exceptions, if, for example, particular debtors are co-obligors on a particular instrument and such instrument is the only liability of the debtors.

An additional consideration in developing a classification scheme is the different legal entitlements between classes of creditors. For example, if a debtor is the issuer of two notes, between which there is a subordination agreement, separate classification may be appropriate.

Post-petition financing, known as debtor-in-possession (DIP) financing, requires repayment in full in cash on the effective date of the plan unless the lender agrees otherwise. Certain financing agreements may require other or additional forms of payment (e.g., restructured debt or equity).

Although technically, the DIP financing is not required to be classified pursuant to Section 1122 of the Bankruptcy Code because it is an administrative expense, it should be accounted for in the term sheet.

Section 1129(a)(9) of the Bankruptcy Code requires that all administrative expense and certain priority claims be paid in full on the effective date of the plan. Although these classes are technically not required to be classified, such claims should be accounted for in the term sheet.

Within each class of claims, the term sheet should provide for the treatment that each class of claims will receive. In the most general terms, claims can be treated in one of two ways:

- *Unimpaired* — Pursuant to Section 1124 of the Bankruptcy Code, a claim is unimpaired if either: (a) it leaves unaltered the legal, equitable and contractual rights to which such claim entitles the holder; or (b) it cures any contractual defaults, reinstates the maturity of the claim as it existed prior to the default, compensates the holder of the claim for any damages incurred as a result of any reasonable reliance on such contractual provision or applicable law, or compensates the holder for any actual pecuniary loss caused by a default on a nonmonetary obligation. Reinstatement means that the debtor must cure past defaults and continue to perform under the original terms of the agreement, leaving the nondebtor counterparty to the contract with the benefit of the original bargain.

- *Impaired* — Section 1124 of the Bankruptcy Code defines a claim as impaired if it is not unimpaired. If a holder of a claim does not receive the benefit of such holder's original bargain, such claim is impaired. A claim will be deemed impaired if the terms of the instrument are modified, if the holder of the claim receives a distribution of restructured debt or equity, or if the holder of the claim receives no distribution at all.

Prepackaged and prenegotiated plans are most effective in financial restructurings rather than operational restructurings. Accordingly, the company and key financial creditors will seek to limit or avoid any impact of a Chapter 11 filing on trade creditors.

To effectuate this goal, the company will either seek relief from the bankruptcy court to pay all trade claims in the ordinary course of business without regard to the automatic stay and its effects or make trade creditors whole immediately upon emergence.

Voting of Claims

In order to obtain court approval of a plan of reorganization, there must be at least one impaired, accepting class that votes in favor of the plan pursuant to Section 1129(a)(8) of the Bankruptcy Code. Every class of claims does not have the right to vote. Pursuant to Section 1126 of the Bankruptcy Code, the holder of a claim or interest allowed under Section 502 of the Bankruptcy Code is entitled to vote to accept or reject the plan.

If, however, a class of claims is deemed not to be impaired, pursuant to Section 1126(f) of the Bankruptcy Code, the class of claims is deemed to have voted to accept the plan. Conversely, if a class of claims or interests does not receive or retain any property under the plan, such class is deemed to have voted to reject the plan pursuant to Section 1126 (g) of the Bankruptcy Code.

In order to ensure that the classification scheme provides for this result, the plan term sheet should provide whether each class of creditors is impaired and has the right to vote.

Other Term-Sheet Provisions

The plan term sheet should also cover other significant plan provisions. Important provisions to consider for inclusion are:

- *Executory Contracts* — Pursuant to Section 365 of the Bankruptcy Code, a debtor must determine which executory contracts to assume and reject. If there are certain material contracts that supporting creditors or the company want to ensure are treated in a particular way, such a schedule can be attached to the plan support agreement. Otherwise, a plan term sheet will provide for a mechanism in the plan for a company to make a determination with respect to executory contracts.

- *Management Compensation* — As part of the process, if management is to be provided post-effective date equity, the plan term sheet should attach a separate term sheet for such a plan.

- *Avoidance Actions* — An important asset of any Chapter 11 estate is the Chapter 5 avoidance actions (i.e., preferences and fraudulent conveyance claims and the trustee's strong arm power claims) and the state law analogs. The plan term sheet should provide for how such actions will be treated and whether they will be retained by the company, distributed to a litigation trust for the benefit of certain creditors, released or provided for in a different manner.

- *Governance* — The plan term sheet should provide for the general composition of a board of directors, for the type of election process for directors, and an agreement to agree upon the form of relevant corporate governance documents.

- *Releases and Exculpation* — Participants in a restructuring often will seek releases for their participation in the restructuring process from one another. In addition, the parties to the plan support agreement may seek to compel other creditors and holders of interests to grant them a nonconsensual release, which is known as a third-party release. The case law has continued to trend towards disallowing third-party releases unless there are unusual circumstances. An exculpation provision generally provides that the parties named in the provision cannot be held liable unless they were grossly negligent or engaged in willful misconduct.

Timing of Execution of the Plan Support Agreement

Obtaining signatures for a plan support agreement can be deemed to be a form of solicitation, which implicates Section 1125 of the Bankruptcy Code.

Generally, in order to solicit a plan, a plan proponent must solicit based on a disclosure statement that provides "adequate information," which Section 1125(a)(1) defines as "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."

With respect to a plan support agreement, the timing of the execution of the plan support agreement is critical. Under the Bankruptcy Code and relevant case law, different rules apply depending on when the plan support agreement is executed relative to the filing of the bankruptcy.

Prior to filing a Chapter 11 case, courts have noted that plan support agreements are enforceable. In certain jurisdictions, however, the execution of a post-petition plan support agreement (without bankruptcy court approval or a court-approved disclosure statement) may violate Section 1125(b) of the Bankruptcy Code as an improper solicitation.

Section 1125(b) of the Bankruptcy Code provides that "[a]n acceptance or rejection of a plan may not be solicited after the commencement of the case ... unless, at the time of or before such solicitation, there is transmitted to such holder the plan or summary of the plan, and a written disclosure statement approved ... by the court as containing adequate information."

In Delaware, for example, once a Chapter 11 case is initiated, the plan proponent cannot enter into a plan support agreement without a court-approved disclosure statement. Nonetheless, even in Delaware, Section 1125(g) of the Bankruptcy Code permits the continued voting on a prepackaged plan once the Chapter 11 cases have been initiated.

Voting on a Prepackaged Plan

Voting on a prepackaged plan takes place prior to the filing of the Chapter 11 cases. To create a safe harbor for such a process, Congress enacted Section 1125(g) of the Bankruptcy Code to specifically address prepackaged plan voting.

Section 1125(g) provides that "an acceptance or rejection of the plan may be solicited from a holder of a claim or interest if such solicitation complies with applicable nonbankruptcy law and if such holder was solicited before the commencement of the case in a manner complying with applicable nonbankruptcy law."

In order to solicit a prepackaged plan, pursuant to Section 1126(b), a plan proponent must either solicit votes "in compliance with any applicable nonbankruptcy law, rule or regulation governing the adequacy of disclosure in connection with such solicitation" or "if there is not any such law, rule or regulation, such acceptance or rejection was solicited after disclosure to such holder of adequate information as defined in Section 1125(a) ...."

While a disclosure statement with "adequate information" under the standards of the Bankruptcy Code may not be required if other applicable law addresses solicitation, plan proponents often nonetheless draft and solicit based on a document that otherwise complies with Section 1125(a) of the Bankruptcy Code.

Who Must be Solicited and Length of Solicitation Period

To account for trading activity in claims and interests, Federal Rule of Bankruptcy

Procedure 3018(b) requires that the plan proponent establish a record holding date for the solicitation. Only the holders of record as of that date are permitted to vote on the plan. Only those creditors that the plan proposes to impair need to be solicited.

In order for votes on a prepackaged plan to be binding once the Chapter 11 case has been initiated, the plan proponent must provide a voting period that is not an unreasonably short time. The reasonableness of the voting period will depend on the facts and circumstances of the particular situation.

For example, if a debtor has a limited number of creditors who are engaged in the restructuring process, a shorter period will be permissible. For widely held issuances, a longer solicitation will be required.

The Procedural Guidelines for Prepackaged Chapter 11 Cases in the Southern District of New York provide specific guidance for what is deemed to be a reasonable time period. For publicly traded securities on a national securities exchange, a 21-business day voting period, measured from the date of commencement of mailing, is presumptively reasonable.

For securities that are not publicly traded and for debt claims, a 10-business day voting period, measured from the date of commencement of mailing, is presumptively reasonable. Finally, for all other claims and interests, a 21-business day voting period, measured from the date of commencement of mailing, is presumptively reasonable.

The SDNY Guidelines are summarized as follows:

Gross Receipts	**Requisite Voting Period (measured in days from the commencement of mailing of the ballots)**
Publicly traded securities on a national securities exchange	21 business days
Securities that are not publicly traded	14 business days
Debt claims, which are not securities	14 business days
All other claims and interests	21 business days

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