

Not Enough Hospitality to All Creditors?

PSA Denied Between Innkeepers USA Trust and Lehman ALI Inc.

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Plan support agreements (PSAs)—otherwise known as “lock-up” agreements—are generally pre-petition contracts between debtors and creditors entered in connection with pre-negotiated¹ chapter 11 cases whereby the parties agree to support a particular plan of reorganization. PSAs have been the subject of numerous reported decisions.² However, courts have often been forced to focus on their validity in light of the disclosure and solicitation requirements of § 1125 of the Bankruptcy Code rather than on their underlying merits.

In *Innkeepers USA Trust*, the Bankruptcy Court for the Southern District of New York recently issued a decision founded not on procedural considerations, but on the reasonableness of a PSA’s substantive provisions and the manner in which the pre-petition solicitation process should be conducted.³ The case dealt with the motion of Innkeepers USA Trust and its affiliated debtors and debtors in possession to assume a pre-petition PSA with Lehman ALI Inc. The debtors contended that the PSA represented the best means to provide creditors with recoveries.⁴ Several creditors did not concur, and several objections were filed.⁵ Applying a standard of review that fused both elements of the business-judgment rule and heightened scrutiny, the court denied approval of the PSA on several grounds, including the debtors’ lack of transparency and failure to engage more creditors from within their existing capital structure.

The PSA

The PSA at issue in *Innkeepers* featured a plan term sheet that granted Lehman 100 percent of the shares in the reorganized debtors’ issued and yet-to-be-issued common stock in satisfaction

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of Lehman’s approximately \$238 million secured mortgage claims.⁶ The prospective plan’s terms were extremely favorable to Lehman as it was to obtain “all equity in all [92] of the Debtors, notwithstanding that Lehman [was] secured by collateral of only [20] of the Debtors.”⁷ Contrarily, other secured lenders were to receive modified secured notes in amounts less than the original notes (albeit for not less than the value of the underlying collateral securing their debts).⁸

The PSA also set forth several termination events that were closely scrutinized by the court due to their sweeping nature. The court emphasized that

a heightened-scrutiny standard due to the perceived involvement of insiders.¹² These competing standards of review could have proven dispositive given the relative leniency of the business-judgment standard as compared to heightened scrutiny,¹³ but the significance of this distinction was mooted by the court’s finding that the debtors’ failed to satisfy their burden of assumption under either standard.¹⁴ Rather than simply rule that the debtors failed to meet their burden under the business-judgment rule, the court set forth an analysis that combined elements of both standards.

First, the court examined whether the assumption of the PSA was a disinterested business decision. It ruled that it was not because the debtors’ parent corporation, the Apollo Investment Corp., had played a central role in negotiations and sought to benefit from the PSA either directly or through a side deal with Lehman.¹⁵

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these triggers included events outside of the debtors’ control.⁹ Moreover, the occurrence of a termination event would not only have granted Lehman the right to terminate the PSA and cease the use of its cash collateral, but it would also have forced the debtors to allow either stay relief in Lehman’s favor or a § 363 sale of the properties securing the debtors’ mortgage loan agreement with Lehman.¹⁰

The Ruling

Given that *Innkeepers* arose in the context of a motion to assume an executory contract pursuant to § 365(a), the pivotal determination to be made (or so it seemed) was the applicable standard for reviewing the debtors’ attempted assumption of the PSA. The debtors contended that the assumption of a contract by a debtor is subject to review under the business-judgment standard,¹¹ whereas their adversaries urged the court to apply

Specifically, Apollo was slated to receive 50 percent of the new equity in the debtors by way of the PSA, a fact which may have been concealed from creditors.¹⁶

Second, the court reviewed whether the PSA was entered into with due care, a component of the business-judgment rule that relates to the “fair process” prong of heightened scrutiny.¹⁷ In holding that the debtors had not exerted due care, the court found that the debtors failed to solicit competing offers prior to entering into the PSA¹⁸ and failed to disclose the potential PSA to their other secured creditors during the pre-petition period, and that the court also scrutinized the PSA’s provision, which prevented either party from supporting a varying plan of reorganiza-

¹ For a brief discussion on the differences between “pre-negotiated” and “prepackaged” chapter 11 cases, see Kurt A. Mayr, “Unlocking the Lockup: The Revival of Plan Support Agreements under New § 1125(g) of the Bankruptcy Code,” *Morton Bankr. L. & Prac.*, Vol. 15, n.1.

² See 7 *Collier on Bankruptcy* § 1125.05[1][b] (16th ed. 2009).

³ *In re Innkeepers USA Trust*, 2010 WL 5300870 (Bankr. S.D.N.Y. Dec. 20, 2010). This case can also be found at 2010 Bankr. LEXIS 4887.

⁴ *Id.* at **1, 4.

⁵ *Id.* at **1.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.* at **1, 5-6.

¹⁰ *Id.*

¹¹ See *Innkeepers USA Trust*, Case No. 10-13800 (SCC), Docket Entry No.

15 (Debtors’ Motion) at 11.

¹² See, e.g., *Id.* at Docket Entry No. 271 (Objection of TriMont Real Estate Advisors Inc.) at 8-9.

¹³ Whereas the lenient business-judgment standard can potentially “shield...corporate decision makers and their decisions from judicial second-guessing,” the application of heightened scrutiny subjects a transaction to an examination of integrity of process, fairness of price, and whether fiduciary duties were discharged. *Innkeepers*, 2010 WL 5300870 at *2.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.* at *4.

¹⁷ *Id.* at *2.

¹⁸ In fact, the debtors expressly told their investment banker not to engage in marketing. *Id.* at **2-3.

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tion.¹⁹ In addition, the court inquired as to whether the PSA obtained a “fair price” and ruled that the debtors had not sufficiently determined the value of the shares being transferred.²⁰ Furthermore, the court questioned the PSA’s timing and apparent haste into which it was entered.²¹

Third, the court analyzed whether the debtors acted in good faith, a consideration relevant under both the business-judgment rule and heightened scrutiny.²² In this regard, the court focused on the lack of transparency as evidenced by the creditors’ inability to become involved in a negotiating process dominated by

Lehman.²³ The court also emphasized the failure to disclose either specifics of the plan-term sheet or critical information, such as the potential transfer of new equity to Apollo.²⁴

Fourth, the court considered the purported benefits in assuming the PSA and found minimal benefit to the estates notwithstanding the debtors’ contentions that assets and cash flow would be freed through equitizing Lehman’s secured debt.²⁵ Under the court’s view, notwithstanding any of the purported advantages gained by this equitization, Lehman was simply given too much power over the debtors’ bankruptcy cases, particularly given the PSA’s broad range of termination events and the restrictions

placed on the debtors’ ability to seek alternative competitive proposals.²⁶ With regard to the termination events, the court made a critical distinction that “[i]f the Termination Events merely triggered the loss of Lehman’s ‘support’ for the proposed restructuring, this would be typical of many plan support agreements...however, such events also trigger a termination of the consensual use of Lehman’s cash collateral and, in certain instances, a lifting of the stay.”²⁷

Lastly, the court questioned whether the debtors’ fiduciary duties of care and loyalty had been satisfied. The PSA’s “fiduciary out” ostensibly assured that the debtors and their directors could take or refrain from taking any action in order to comply with fiduciary obli-

¹⁹ The PSA’s “lock-up” provision featured language providing that “[n]either party to the PSA shall, directly or indirectly, seek...any restructuring, plan of reorganization...other than as set forth in the Plan Term Sheet and the Plan.” See Debtors’ Motion, *supra*, at n.1, Ex. B. at 7.

²⁰ The court noted that the value of the new equity would be at least \$215 million, well above the \$150 million to \$190 million estimate provided by the debtors’ investment banker, Moelis & Company LLC. *Innkeepers*, 2010 WL 5300870 at *3.

²¹ The court even appeared to delve into the propriety of the debtors’ decision to enter into any PSA, stating that “it is difficult to understand what the rush is” and also that “[t]he Debtors have not set forth justification as to why, at this very early stage in the cases, the Debtors need to lock themselves into the [PSA].” *Id.* at *4. The court further observed that the debtors’ operations were generally doing well. *Id.*

²² *Id.*

²³ The court was clearly concerned that “the testimony of Mr. Bellinson [the debtors’ chief restructuring officer] on these points reveals only that Lehman wielded great power in the negotiations and that Mr. Bellinson seems to have succumbed to virtually all of their demands.” *Id.* at *3.

²⁴ The debtors’ failure to share information led one objector to contend that “the PSA breed contempt rather than fostering negotiations.” *Id.* at *5.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.* at *6. This distinction is significant because prevailing case law holds that creditors must be provided with certain ways out of PSAs, otherwise “the locked-up creditors could be forced to vote in favor of the plan regardless of the circumstances,” thereby stripping creditors of Bankruptcy Code protections. See *Collier, supra*, at n.2, ¶ 1125.05(1)(b).

gations.²⁸ Glaringly, the PSA featured an exception to this provision, which negated the fiduciary out with regard to acts impacting the PSA's "plan milestones" unless doing so was aimed at providing Lehman with a higher and better recovery.²⁹ The court found this provision offensive to the debtors' fiduciary duties, and thus, the PSA could not be approved.³⁰

Analysis

Although *Innkeepers* was a bench decision that did not feature dissertations on governing Code provisions or case law, it raises factors for courts to apply when reviewing any PSA. Central to the lessons learned is the court's emphasis on the debtors' lack of transparency and failure to meaningfully work with creditors other than Lehman. Aside from the PSA's one-sided plan-term sheet, these circumstances played a primary role in the court's findings that the debtors failed to exert due care or exhibit good faith. As noted by the court, "[t]his is not what chapter 11 is supposed to be about."³¹

Inherently, a PSA entered into in connection with a prenegotiated chapter 11 case should strive to be the product of open negotiations between a debtor and its entire body of creditors. Formulating a PSA as a collaborative effort aids in ensuring that the advanced plan-term sheet has sufficient creditor backing. In *Innkeepers*, the court observed that "the PSA only 'locks up' approximately \$200 million of the total \$1.4 billion in secured debt in these cases—the support of only one creditor among the critical mass of creditors needed to support a successful restructuring in these cases."³² Therefore, a PSA should seek to advance a plan term sheet that has the support of this "critical mass of creditors." Stated otherwise, a lock-up agreement should be designed to lock-up more than a single dominant creditor.

Furthermore, the failure to work collaboratively can result in a finding that fiduciary duties have not been satisfied. Fiduciary obligations compel debtors to abstain from favoring one creditor or group of creditors over others. For instance, by not working with the creditors for each estate, the debtors in *Innkeepers* had not fulfilled their fiduciary obligations in accordance with the

court's prior *Adelphia* decision, under which the debtors and their directors in a multi-debtor case owed fiduciary duties to the creditors of each bankruptcy estate.³³ The court observed, in applying *Adelphia*, that the debtors had failed "to maximize the value of each of the Debtors' estates, particularly [72] of the [92] Debtors who do not count Lehman as one of their creditors."³⁴ Clearly, debtors cannot merely engage one creditor to the detriment of other parties in their capital structure.

Nevertheless, *Innkeepers* is not free from potential criticism. Notably, the court appeared to disfavor PSA provisions prohibiting the parties from supporting a competing agreement or plan of reorganization. In discussing the debtors' failure to engage other creditors aside from Lehman, the court observed that "the PSA specifically prohibits such negotiations by providing that neither party to the PSA shall directly or indirectly seek, solicit, negotiate...any restructuring or plan of reorganization other than as set forth in the plan term sheet."³⁵

²⁸ *In re Adelphia Communications Corp.*, 336 B.R. 610, 669-71 (Bankr. S.D.N.Y. 2006).

²⁹ *Innkeepers*, 2010 WL 5300870 at *7.

³⁰ *Id.* at *3.

Inherently, this type of provision appears essential to a pre-petition plan support agreement's goal of locking up support. As previously noted by the Southern District of New York in *Trans World Airlines*, "[i]f [a creditor] were free to support another plan while [the debtor's] plan was still capable of being approved, the negotiations [between the debtor and creditor] would be meaningless."³⁶ The *Trans World Airlines* court also observed that "[t]he fact that [the creditor] has agreed not to 'vote for, consent to, support or participate in the formulation of any other plan' does not violate the solicitation requirements under 1125(b)," and thus, "[s]uch a *carte blanche* agreement as to future unfiled plans does not offend 11 U.S.C. § 1125(b)."³⁷ Therefore, in order to reconcile the validity of these clauses with *Innkeepers*' central holding, it should have been stated that *Innkeepers*' mandate to actively negotiate with all parties is operative up until a plan support agreement featuring such a clause is entered into. Ultimately, this is a minor critique to an otherwise insightful decision. ■

³⁶ *Trans World Airlines Inc. v. Texaco Inc. (In re Texaco Inc.)*, 81 B.R. 813, 815 (Bankr. S.D.N.Y. 1988).

³⁷ *Id.* at 815-16 (emphasis in original).

²⁸ *Innkeepers*, 2010 WL 5300870 at *6.

²⁹ *Id.* (discussing exception to "fiduciary out," § 25(c) of PSA).

³⁰ In discussing § 25(c), the court stated that "I am aware of no other court-approved [PSA] which contains such a provision." *Id.*

³¹ *Id.* at *5.

³² *Id.* at *7 (emphasis added).