Recent Delaware Rulings Highlight Chapter 11's Inherent Flexibility

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Congress designed Chapter 11 to be flexible to promote the twin goals of rehabilitating distressed businesses and maximizing stakeholder returns.[1] Several recent decisions from the U.S. Bankruptcy Court and District Court for the District of Delaware highlight how Chapter 11's inherent flexibility promotes these goals. These decisions include: allowing "horizontal gifting" of an undersecured creditor's collateral to trade creditors through a plan, embracing practical approaches to implementing consensual third-party releases and recognizing that nonconsensual third-party releases are appropriate in extraordinary circumstances, and limiting the appointment of examiners to circumstances where an investigation is appropriate.

HORIZONTAL GIFTING

In *In re Nuverra Environmental Solutions, Inc.*,[2] the Bankruptcy Court confirmed a plan that included horizontal gifting from a secured creditor's collateral to unsecured trade creditors and bondholders. The case involved a capital structure familiar to modern Chapter 11 cases - a fundamentally sound operating business overleveraged with funded debt, including approximately $500 million of senior secured indebtedness, against an undisputed enterprise value of approximately $300 million, and additional funded debt in the form of unsecured bonds.

To facilitate a speedy and efficient reorganization, the debtors and their senior secured lenders negotiated a prepackaged Chapter 11 plan that would convert the secured debt to equity, unimpair trade and other business-related debt, and provide a 4% to 6% recovery to unsecured bondholders. The bondholder class rejected the plan, and one bondholder - holding approximately $450,000 of the $40.4 million aggregate principal amount of the unsecured bonds - objected to the plan on the basis that the disparate treatment of unsecured bonds, at 4% to 6% recovery, versus trade and other business-related claims, at 100% recovery, constituted "unfair discrimination" under Section 1129(b) of the Bankruptcy Code.

The Bankruptcy Court overruled the objection and confirmed the plan. In doing so, the court recognized that the significant difference in recoveries created a presumption of unfair discrimination - but a rebuttable one. Under the facts of the case, the court found that the presumption was rebutted and the facial discrimination in recoveries was not unfair. The court focused on the fact that the recoveries for both classes of unsecured creditors were coming from the secured creditor in the form of a gift. Without the gift, there would be no distribution to any unsecured creditor.

Legislative history and case law indicate that the focus of unfair discrimination is from the view of the affected class and whether it is harmed by the alleged unfair discrimination.[3] Because the affected bondholder class in the *Nuverra* case would have received nothing absent a gift from the secured creditor, the court found that it was not harmed by the disparate recovery received by the trade and other business-related claims.

The Bankruptcy Court also distinguished horizontal gifting from "vertical gifting," which has been rejected elsewhere. Vertical gifting occurs when a senior class gifts a portion of its distribution to a junior class, leapfrogging an intermediate dissenting class that is not paid in full. Courts prohibit vertical gifting because it runs afoul of the Bankruptcy Code's absolute priority rule. Unlike vertical gifting, which invokes the inflexible absolute priority rule, many courts have recognized that unfair discrimination is a flexible standard. Because the Bankruptcy Code does not prohibit all discrimination between classes of the same priority, courts may determine on a case-by-case basis whether alleged discrimination is unfair.

Having found no prohibition on horizontal gifting and that the disparate treatment was not unfair because it did not come at the expense of the dissenting class, the Bankruptcy Court in *Nuverra* confirmed the plan. On appeal, the District Court affirmed the Bankruptcy Court's ruling on the same grounds.

Permitting horizontal gifting in cases like *Nuverra* facilitates reorganizations. In an upside-down capital structure, where secured debt exceeds enterprise value, allowing a horizontal gift to trade creditors ensures that debtors have flexibility to preserve valuable trade creditor relationships. Without the ability to make a horizontal gift, a debtor, even with the support of its secured lender, would be faced with a Hobson's choice: pay nothing under a plan to important trade creditors, thus jeopardizing those relationships, or pay meaningful, co-equal distributions to both trade creditors and unsecured funded debt holders, which might exhaust the limited resources available to the debtor.

Given that many undersecured creditors, like those in *Nuverra*, are already suffering significant losses (approximately $200 million in *Nuverra*), little appetite likely exists to gross up distributions to funded debt holders to a level that would be meaningful to trade creditors. Without the availability of horizontal gifting, more secured creditors may be inclined to exercise remedies and accept liquidation value, leaving nothing for unsecured creditors. This would ensure no discrimination, but would neither do anything for unsecured creditors nor help rehabilitate a business that needs to rely on trade credit going forward.

Conversely, allowing horizontal gifting does not leave any unsecured creditor worse off but does help facilitate rehabilitation by preserving trade creditor relationships. By allowing horizontal gifting, the Bankruptcy Court and the District Court provided a flexible framework for restructuring overleveraged capital structures while preserving and maximizing enterprise value and simultaneously ensuring that no unsecured creditor was left worse off.

THIRD-PARTY RELEASES

The Delaware Bankruptcy Court also has recognized Chapter 11's flexibility when it comes to third-party releases - both consensual and, in extraordinary cases, nonconsensual. For consensual third-party releases, over the last several years, the Delaware Bankruptcy Court has consistently acknowledged the efficacy of properly implemented "opt-out" releases.[4] Acceptable opt-out releases vary based on the particular needs and facts of the case, but typically involve robust disclosure in the notices and ballots for the plan, along with a clear ability to opt out of the release.

Opt-out release structures typically bind any party that is unimpaired and deemed to accept the plan, any party that votes for the plan but does not opt out of the release, and any party that abstains from voting or opting out. In approving the opt-out mechanism, the Bankruptcy Court has noted, among other things, that due process is satisfied because the disclosures and ability to opt out are similar to other legal arenas, such as federal class action lawsuits.

In addition to allowing consensual third-party releases, the Delaware Bankruptcy Court also has approved nonconsensual third-party releases in extraordinary circumstances. The most notable recent example is *In re Millennium Lab Holdings II, LLC*, in which the Delaware Bankruptcy Court addressed its subject matter jurisdiction and constitutional power to approve such releases, as well as the factual and legal predicates for such releases to be granted.

The *Millennium* debtors derived significant revenue from Medicare and Medicaid reimbursements. The debtors knew of, and were cooperating with, long-running investigations into alleged fraudulent Medicare and Medicaid billing practices, yet allegedly failed to disclose the investigations to prospective lenders in a dividend recapitalization transaction. About a year after the dividend recap closed, the debtors, under threat of civil and criminal actions, agreed to an approximately $250 million settlement with the federal government. If the settlement was not paid, the debtors would lose the right to operate in the Medicare system, effectively killing their business.

Unable to satisfy the settlement outside of bankruptcy, the debtors filed a prepackaged Chapter 11 plan under which the equity holders who had received the proceeds of the dividend recap, and were alleged to have known of the investigation, agreed to fund $325 million to satisfy the settlement, provide payment for certain claims, and provide working capital. In exchange for this funding, the plan contained a third-party release of all claims of the affected lenders against the equity holders related to any alleged misconduct, failure to disclose the investigation, or the dividend recapitalization. The affected lenders would own the reorganized debtors under the plan.

Most of the affected lenders accepted the plan, or at least did not object to it. But one lender objected to the plan and argued that the releases were impermissible without its consent. The Bankruptcy Court overruled the objection, holding that the releases were permissible under the circumstances, as they were essential to securing the $325 million contribution from old equity that was necessary to effectuate the plan. Put simply, without the releases, the plan would not have been possible.

In the lender's initial appeal from confirmation of the plan, the Delaware District Court affirmed the Bankruptcy Court's conclusion that it had subject matter jurisdiction over the claims subject to the plan's nonconsensual third-party releases. However, it remanded to the Bankruptcy Court for further findings and conclusions relevant to whether the Bankruptcy Court possessed the authority to finally adjudicate the release of such third-party claims under the plan or whether such claims amounted to so-called *Stern* claims that had to be finally adjudicated by an Article III court.[5]

On remand, the Bankruptcy Court determined that it possessed the constitutional authority to grant nonconsensual third-party releases, emphasizing that its approval of the granting of such releases in the context of confirming a plan of reorganization did not amount to the court's final adjudication of each underlying claim within the scope of such releases.

Once again, the objecting lender appealed to the Delaware District Court, which affirmed the Bankruptcy Court's holding that it had the authority to approve nonconsensual third-party releases in context of confirming the plan. The District Court noted that while the impact of the plan's settlement of such causes of action via the granting of the releases was to extinguish certain state law rights, the releases represented a plan settlement of such causes of action rather than a ruling on the merits of each of them.

These rulings highlight the flexibility of Chapter 11 to resolve seemingly intractable circumstances. Indeed, without the releases, the court recognized that the *Millennium* debtors would not have reorganized.

APPOINTMENT OF AN EXAMINER

In another recent ruling, the Delaware Bankruptcy Court recognized that appointment of an examiner is only mandatory where there exists a need for an investigation that warrants the estate incurring the cost and potential delay of appointing an examiner. In *In re EV Energy Holdings, L.P.*,[6] the Bankruptcy Court held, consistent with many prior rulings, that the language of Section 1104(c) of the Bankruptcy Code should not be construed to mandate the appointment of an examiner in every case in which a debtor's funded unsecured debt exceeds $5 million, unless there has been some threshold showing by the movant of actual need for an independent party to undertake such an investigation.

As the court recognized, strict adherence to the seemingly "mandatory" language of Section 1104(c) would result in absurd circumstances where an examiner was appointed - often at significant cost or delay - even when the Bankruptcy Court found there was nothing for an examiner to do. By limiting appointment of an examiner to only those cases where an investigation is appropriate, debtors and their constituents are spared unnecessary expense and delay.

CONCLUSION

Congress designed Chapter 11 to be flexible to promote rehabilitating businesses and maximizing stakeholder returns. Recent rulings from the Delaware Bankruptcy Court and District Court highlight how Chapter 11's flexibility facilitates value-maximizing reorganizations and avoids unnecessary expense and delay. As capital structures, debt markets, and cases continue to evolve, Chapter 11's flexibility continues to meet the goals of rehabilitating businesses and maximizing returns to stakeholders.

[1] See, *e.g.*, H.R. Rep. No. 95-595, 409 ("In reorganization cases, there is frequently great uncertainty. Therefore the need for flexibility is greatest.").

[2] See Transcript of Record, Case No. 17-10949 (KJC) (Bankr. D. Del. July 21, 2017) (D.I. 362), *aff'd* 590 B.R. 75 (D. Del. 2018).

[3] "The analysis for determining whether the discriminatory treatment is unfair should be viewed by its effect on the dissenting class." *In re Tribune Media Co.*, 472 B.R. 223 (Bankr. D. Del. 2012) *aff'd in part, vacated in part*, No. 12-CV-1072 GMS, 2014 WL 2797042 (D. Del. June 18, 2014), *aff'd in part, rev'd in part sub nom. In re Tribune Media Co.*, 799 F.3d 272 (3d Cir. 2015); see also, H.R. Rep. No. 95-595, 417 ("The criterion of unfair discrimination is not derived from the fair and equitable rule or from the best interests of creditors test. Rather it preserves just treatment of a dissenting class from the class's own perspective.").

[4] See *In re Gen. Wireless Ops., Inc.*, 2017 WL 5461361 (Bankr. D. Del. Oct. 26, 2017) (approving "opt-out" third-party releases as consensual); *In re Abeinsa Holding, Inc.*, 562 B.R. 265, 285 (Bankr. D. Del. 2016) (same); *In re Indianapolis Downs, LLC*, 486 B.R. 286, 306 (Bankr. D. Del. 2013) (same); *In re Spansion, Inc.*, 426 B.R. 114 (Bankr. D. Del. 2010) (same).

[5] See *Stern v. Marshall*, 546 U.S. 462 (2011) (holding that the Bankruptcy Court did not have the constitutional authority to enter a final judgment on a state law counterclaim that would not be

resolved in the process of ruling on a creditor's proof of claim).

[6] See Transcript of Record at 196:21-197:6, *In re EV Energy Partners, L.P.*, Case No. 18-10814 (CSS) (Bankr. D. Del. May 16, 2018) (D.I. 252).

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