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Bankruptcy and Financial Restructuring

September 2014

Catching Judge Sontchi's "Flurry of Opinions"

PARTS 1-3 OF 3

By: Christopher A. Ward, Todd H. Bartels, and Shanti M. Katona

In this Issue:

On August 13, 2014, a hearing was held before The Honorable Christopher S. Sontchi in the United States Bankruptcy Court for the District of Delaware in *In re: Energy Future Holdings Corp., et al*, 14-10979 (CSS). At that hearing, *inter alia*, Judge Sontchi was asked to rule on a discovery protocol and certain discovery disputes regarding a 2004 motion. As part of his ruling, Judge Sontchi stated on the record:

"I'm thinking of issuing a flurry of opinions…once a year. I let people know what I think. And I noted the other day, three out of the last five have been discovery matters. So it's what we do. It's part of the job."

The Court was discussing the increasing number of discovery disputes it is being called upon to decide. Specifically though, the Court was referring to a one-week period between August 8 and August 14, 2014, during which Judge Sontchi issued six separate opinions, a majority of which dealt with discovery disputes in bankruptcy litigation. As these discovery disputes become more commonplace in the bankruptcy arena, Polsinelli provides in chronological order a summary of Judge Sontchi's "flurry of opinions."

1. *In re: Energy Future Holdings Corp., et al*, 14-10979 (CSS) (*CSC Trust Company of Delaware, as Indenture Trustee, v. Energy Future Intermediate Holdings Company LLC and EFIH Finance, Inc.*, Adv. Pro No: 14-50363 (CSS) (Bankr. D. Del. Aug. 5, 2014)

This opinion arose out of a discovery dispute in an adversary proceeding for declaratory relief filed by CSC Trust Company, as Indenture Trustee (CSC) against Energy Future Holdings Corp., *et al.* chapter 11 debtors and debtors in possession (the **EFIH Debtors**). The complaint seeks a declaration from the Court that the EFIH Debtors are obligated to pay a $665.2 million redemption premium in connection with the proposed refinancing of the 10% Notes. CSC argues that the refinancing of the notes within the bankruptcy constitutes an early redemption under the terms of the indentures, which can only be completed if the applicable makewhole premium is paid.

There were three issues before the Court:

(i) Is a discovery request for information regarding a debtor's valuation and solvency relevant within the context of adjudicating a makewhole dispute;

(ii) If so, can this information be obtained from a third-party as opposed to receiving this information from the debtor; and

(iii) Can information be obtained from a creditor and party to a restructuring agreement regarding the intention of a debtor in filing for bankruptcy and refinancing a set of notes in order to determine whether the bankruptcy was intentionally filed in order to avoid the payment of a makewhole premium?

The Court reached the following conclusions:

1) A request for information regarding a debtor's valuation and solvency is relevant, and thus discoverable, in the context of a makewhole dispute, because if a makewhole provision is found to be applicable, the solvency of the debtor will affect how the Court determines the specific amount to be paid;

2) While obtainable from a debtor, information regarding a debtor's valuation and solvency is not obtainable from third parties who have not taken a clear position with regard to the debtor's solvency, and who do not intend to offer expert or other evidence on the issue; and

3) Information regarding the intention of a debtor in filing for bankruptcy and refinancing a set of notes, when garnered from the point of view of a creditor and a party to a restructuring agreement (rather than the debtor itself), is not discoverable, where, as here, the party requesting the discovery has not demonstrated the relevance of this particular information and viewpoint toward the makewhole litigation.

The Court offered the parties three alternatives to allowing discovery on valuation and solvency:

a) The defendants may concede their insolvency solely for purposes of the makewhole litigation;

b) The defendants may waive the right to assert any defense to payment of the makewhole premium based upon insolvency, i.e., that payment should be reduced or not paid based upon equitable principles; and/or

c) The parties may agree to bifurcate the trial such that the issue of solvency and the related discovery will only arise if the Court finds, in the first instance, that the defendants are liable in whole or in part for a makewhole premium.

In reaching its decision, the Court reminded the parties that the "standard for relevance…is construed more loosely in the discovery context than at trial." And that "contract interpretation…is one reserved for trial, and goes to the merits of the dispute; it should not be analyzed through the context of a discovery dispute between the parties." The Court went on to state that while "solvent debtor cases are somewhat of a rarity, the available precedent consistently defers to previously contracted bargains and provisions when dealing with solvent debtors in varying situations." The Court further noted that "[t]his, however, is the main contractual dispute at issue in the Complaint, and cannot be decided from within the context of a discovery dispute." Finally, the Court relayed that "[t]here lacks precedent, however, on the applicability of the Federal Rules of Civil Procedure 45 in adversary proceedings, or how one defines a "nonparty" within an adversary proceeding of a bankruptcy." In so doing, the Court cited a recent decision by Judge Brendan L. Shannon in the Delaware Bankruptcy

Court in *In re the Dolan Company*, where Judge Shannon held that in the sale context, a third party bidder was not entitled to valuation discovery until that party became an active participant in presenting evidence and testimony to the Court regarding the value of the company. *Del.Bankr. 14-10614, Tr. Hr'g (May 2, 2014), D.I. 284, pp. 19-21*.

Based on this analysis, Judge Sontchi held that "[i]nformation regarding the EFIH Debtors' valuation and solvency is relevant and discoverable at this stage of the proceedings, as there remains a possibility that the Court will require the solvency information in the future in order to properly address the payment of makewhole premiums if the indentures are fond to provide for such premiums. This relevancy only applied to the EFIH Debtors though, as the PIK Noteholders or the Ad Hoc Committee had not yet taken a position or offered evidence regarding the solvency of the EFIH Debtors in connection with the makewhole litigation. The Court was clear that despite its ruling, "discovery as to the solvency may be deferred (or possibly eliminated) if the EFIH Debtors agree to waive any claim that any allowed makewhole premium be reduced or not paid under equitable principles or the parties agree to bifurcate the trial."

2. *In re: Newstarcom Holdings, Inc. et al.*, 08-10108 (CSS) (*George L. Miller, as Chapter 7 Trustee of the Estates of NewStarcom Holdings, Inc., et al. v. American Capital, Ltd., et al.* (Adv. No. 10-50063 (CSS)) (Bankr. D. Del. Aug. 6, 2014)

In this adversary proceeding Judge Sontchi addressed the discoverability of post-sale financial data to aid in the determination of an asset's value as of the sale date. The dispute arose from the purchase of one of the debtor's subsidiaries, Matco Electric Corporation ("**Old Matco**"), by some of its former officers shortly before its parent company, NewStarcom Holdings, Inc., filed for Chapter 7 protection. The Trustee filed the adversary proceeding against the former officers ("**the New Matco Defendants**"), alleging that they breach their fiduciary duties in purchasing Old Matco for $2 million when its true value was in excess of $15 million.

During discovery, the Trustee served a request for production of documents on the New Matco Defendants seeking, *inter alia*, all of New Matco's tax returns, profit and loss statements, balance sheets, valuations and other financial documents for the time period after the sale of Old Matco. The New Matco Defendants objected to producing the documents on the grounds that the request was not relevant to the dispute and was unlikely to lead to the discovery of admissible evidence, was overly broad and unduly burdensome, and was not limited by date. In response to the Trustee's motion to compel, Judge Sontchi first addressed the "relevancy" objection. While recognizing the broad scope of discovery under Federal Rule of Civil Procedure 26(b)(1), as applicable in adversary proceedings under Federal Rule of Bankruptcy Procedure 7026, he noted that the party seeking the discovery bears the burden of showing it relates to the subject matter of the litigation that is defined by the claims and defenses. The Trustee's position was that "subsequent events which provide evidence of the value of the property on the valuation date can be taken into account, and used by valuators and [c]ourts as confirmatory data to a valuation." In support of his argument, the Trustee relied heavily on *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1064 (3d Cir. 1992) and *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 614 (Bankr.D.Del.2001). In contrast, the New Matco Defendants claimed that the data was completely irrelevant because – from a liability standpoint – their acts and omissions should be evaluated based on information available to them at the time of the sale.

In denying the Trustee's motion to compel, the Court stated that "[t]here lies a thin line between using confirmatory data appropriately, as in *Moody* and *Genesis*, and utilizing post-sale financial information to criticize forecasts (and thereby the decisions which relied on them) with the benefit of hindsight." The Court went on to state that the post-sale valuation was of little use to the case before it because "any connection between the accuracy of the [income] projections and the cause of action at issue, is too attenuated to be relevant."

3. *In re: NE OPCO, INC., et al.*, 13-11483 (CSS) – (Bankr. D. Del. Aug. 8, 2014)

Judge Sontchi held in this opinion that claims relating to the purchase of assets pursuant to a section 363 sale free and clear of all liens may not survive depending on when the claims arose. Before the Court was a motion (the "**Motion**") filed by Cenveo Corporation and Cenveo, Inc. (collectively, "**Cenveo**") seeking to enforce a previously entered sale order and injunction, and address employment discrimination claims filed by a former employee, Paul Torres ("**Torres**"), against Cenveo relating to employment and termination prior to the sale closing.

Through his work as a NE Opco machine adjuster, Torres was injured on the job in May, 2013. In June, 2013, he underwent surgery and was released to return to work on September 13, 2013. On September 12, 2013, the NE Opco and its related debtors sought and the Court approved a sale whereby Cenveo purchased various NE Opco assets free and clear of all liens, claims, and encumbrances. Pursuant to the terms of the sale order, Cenveo expressly assumed certain liabilities, however, liabilities relating to employment, including termination, of an employee were excluded and remained with the debtors. In September, Torres received an employment termination notice, effective September 13, 2013. On September 16, 2013, Cenveo closed the sale pursuant to the APA.

Torres sought redress through a state court employment discrimination action against the debtors and Cenveo. In response, Cenveo filed the instant Motion seeking to bar and enjoin Torres' claims against Cenveo pursuant to the sale order. While acknowledging the expressly excluded liabilities within the sale order, Torres, nevertheless, objected to the Motion and alleged employment discrimination against Cenveo based on Cenveo's conduct in "wrongfully terminating or wrongfully failing to hire" Torres after the sale order was entered by the Court. See *Objection of Paul Torres* [Docket No. 667, *2]. Torres argued that based on the timeline, Torres has direct claims against Cenveo and should not be enjoined by the section 363(f) free and clear provisions within the sale order.

Applying *In re Trans World Airlines*, 322 F.3d 283 (3d Cir. 2003), that successor liability claims may be barred by section 363(f)'s free and clear provisions; relying on *In re Christ Hospital*, 2014 WL 2135942 (Bankr. D. N.I. May 22, 2014), that successor liability for claims and interests stemming from an asset purchase may be barred by section 363(f); and finding that Torres' pre-closing claims against Cenveo related to Cenveo's imminent purchase of the debtors' assets, the Court ultimately barred Torres from asserting his pre-closing claims against Cenveo. In contrast, the Court noted that it could not enjoin Torres' claims against Cenveo for any post-closing action under the sale order's 363(f) provisions.

4. *In re: Conex Holdings, LLC, et al.*, 11-10501 (CSS) (*Charles A. Stanziale, Jr., in his capacity as the Chapter 7 Trustee of Conex International, LLC, f/k/a Conex International Corporation v. Heico Holdings, Inc., et al.*) (Bankr. D. Del. Aug. 8, 2014)

Before the Court was a motion to dismiss a complaint for, *inter alia*, for breach of fiduciary duty for failure to meet the pleading requirements under *Twombly* and *Iqbal*. In this adversary proceeding, the Chapter 7 Trustee filed suit against the former officers and directors of Conex

International for fraudulent transfer, receipt of preferential payments, piercing the corporate veil, breach of fiduciary duty, and deepening insolvency. The allegations arose out of $246 million leverage buyout conducted in 2007. The Chapter 7 Trustee alleges in the Complaint that the directors and officers of Conex became the directors and officers of Heico, the purchaser, and as a result of this transaction rendered Conex insolvent, which in and of itself was a breach of fiduciary duty as well as led to the deepening insolvency of the company. The Chapter 7 Trustee named each officer and director of Conex individually (the "**Individual Defendants**") in the Complaint.

The Individual Defendants filed a motion to dismiss the Complaint pursuant to Federal Rule of Civil Procedure 12(b)(6), which is made applicable to the adversary proceeding by Bankruptcy Rule 7012. The Individual Defendants argued that the heightened pleading standards enunciated by the United States Supreme Court in *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*, required a plaintiff to plead more than the possibility of relief in order to survive a motion to dismiss.

In his opinion, Judge Sontchi sets forth the standard of review for motions to dismiss under Rule 12(b)(6) as follows: "After *Iqbal*, the Third Circuit has instructed the Court to conduct a two-part analysis. First, the factual and legal elements of a claim should be separated. The [court] must accept all of the complaint's well-pleaded facts as true, but may disregard any legal conclusions. The court must then determine whether the facts alleged in the complaint are sufficient to show that the plaintiff has a plausible claim for relief. The Third Circuit has further instructed that some claims will demand relatively more factual detail to satisfy this standard, while others require less." *Opinion* at 11-12 (internal citations omitted).

The main count at issue in the motion to dismiss was breach of fiduciary duty. "Under Texas law, which was applicable here, corporate directors owe three fiduciary duties: the duties of obedience, loyalty, and due care. In order to state a claim for breach of fiduciary duty a plaintiff must allege the existence of a fiduciary duty, breach of the duty, causation, and damages." *Opinion* at 13. In their motion to dismiss, the Individual Defendants argued that the complaint lacked specific factual allegations to sustain a claim for breach of fiduciary duty. In particular, the Individual Defendants argued that the complaint did not alleged what each individual defendant did in connection with the proposed transfers and that the Chapter 7 Trustee grouped all of the Individual Defendants together as "Officers and Directors" in making his allegations. Moreover, Conex was an LLC without any officers or directors, thereby voiding the allegations in their entirety (the proper allegation would have been against the Members and the Board of Managers under LLC law).

The Court ultimately concluded "that the Trustee has failed to assert a facially plausible claim and has not met the pleading requirements under *Twombly* and *Iqbal*. Specifically, the Trustee has failed to provide facts with any specificity to support how any of the Individual Defendants breached any fiduciary duty recognized under Texas law. Trustee's allegations constitute mere conclusory statements." *Opinion* at 15. In reaching its decision, the Court relied upon precedent that a breach of fiduciary duty action must identify which officers were involved in the transaction. *See Kaye v. Lone Star Fund V (U.S.), L.P.*, 453 B.R. 645 (N.D. Tex. 2011); *In re Troll Communications, LLC*, 385 B.R. 110 (Bankr. D.Del. 2008); and *Bank of America, N.A. v. Knight*, 725 F.3d 815 (7th Cir. 2013).

Finally, the Court found that the "Trustee has not provided any specific facts as to which transactions a particular defendant authorized, nor did the Trustee allege what authority any particular defendant had to approve such transactions. Similar to *Troll Communications*, the allegations are 'vague and lack sufficient detail about which

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officers, if any, knowingly participated. This is not a close question." *Opinion* at 16 (*citing Troll*). The Court also noted it is black letter law in both Texas and Delaware that there is not a viable cause of action for Deepening Insolvency. *See In re Vartec Telecom, Inc.*, 335 B.R. 631 (Bankr. N.D.Tex 2005) and *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006).

In reaching its decision, however, other than the Deepening Insolvency Count, which was stricken with prejudice, the Court permitted the Chapter 7 Trustee 30 days to amend its complaint to include the specificity needed to overcome the heightened pleading requirements of *Twombly* and *Iqbal*. It is still to be seen if the Chapter 7 Trustee can file an amended complaint that will pass muster.

5. *In re Vaso Active Pharmaceuticals, Inc.*, 10-10855 (CSS) (*Jeoffrey L. Burtch, Avoidance Action Trustee v. John J. Masiz and Joseph F. Frattaroli*) (Bankr. D. Del. Aug. 11, 2014)

In this case Judge Sontchi held judgment debtor Joseph Frattaroli ("**Frattaroli**") in contempt of court for his failure to respond to written discovery served on him by Avoidance Action Trustee Jeoffrey Burtch (the "**Trustee**") in aid of execution of a judgment. The decision arose out of an adversary proceeding in which Judge Sontchi previously entered a final judgment in favor of the Trustee and against Frattaroli, finding that certain transfers made to Frattaroli were fraudulent conveyances. *Opinion* at 2-3.

After the Court entered the final judgment, the Trustee served interrogatories and requests for production of documents on Frattaroli to discover the extent of his assets and liabilities. Frattaroli did not respond to the written discovery. The Trustee then filed a motion to compel the discovery responses and requested an order that Frattaroli show cause why he should not be held in contempt for failing to respond to the requests. *Opinion* at 3-4.

In response to the Court's order granting the Trustee's motion, Frattaroli's counsel served limited responses to the interrogatories and document requests which included Frattaroli's personal balance sheet and a statement of pre-tax total income but did not provide the level of detail requested by the Trustee. Frattaroli's counsel also stated in the interrogatory answers that he lacked "sufficient information to formulate any (additional) response" and that the responses provided were "solely based upon information and documents which were in the possession of [counsel]. Despite multiple requests to Mr. Frattaroli no information or documents were received from him to aid in these responses." *Opinion* at 4-5.

After the Court granted counsel leave to withdraw his representation of Fratteroli, the Trustee filed another motion to find Frattaroli in contempt and requesting his arrest and detention to ensure compliance with the Court's order on the motion to compel. In addressing the motion, Judge Sontchi first identified three source of authority for the Court to enter sanctions: (1) Federal Rule of Civil Procedure 37, as made applicable by Federal Rule of Bankruptcy Procedure 7037; (2) 11 U.S.C. sec. 105; and (3) the inherent power of the federal courts to sanction parties who have "acted in bad faith, vexatiously, wantonly, or for oppressive reasons." *Opinion* at 5.

In initially discussing the bankruptcy courts' contempt powers, Judge Sonchti recognized the distinction between civil contempt and criminal contempt. Civil contempt "is coercive and looks to the future" and is designed force a party's compliance with court orders. Criminal contempt, on the other hand, "punishes past behavior and affords no . . . opportunity to repent or change one's mind." Judge Sonchti noted that "bankruptcy courts possess no criminal jurisdiction, and thus do not have the authority to impose punishments appropriate to findings of criminal contempt." *Opinion* at 7-9. While the sanctions available to the

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bankruptcy courts upon a finding of civil contempt are "'many and varied,'" the courts are to "apply the least coercive sanction . . . reasonably calculated to win compliance with its orders." *Opinion* at 9-10 (*citing In the Matter of Grand Jury Impaneled January 21, 1975*, 529 F.2d 543, 551 (3d Cir. 1976)).

Addressing Frattaroli's specific conduct in the case, Judge Sonchti found that the Trustee met his burden of establishing, by clear and convincing evidence, all of the elements necessary for a finding of civil contempt as articulated by the Third Circuit in *Marshak v. Treadwell*, 595 F.3d 478, 485 (3d Cir. 2009). First, a valid order existed that required compliance by Frattaroli. Second, Frattaroli had both constructive and direct knowledge of the Court's order as evidenced by his former counsel's statements that he had informed Frattaroli of his obligations under the order as well as the potential consequences of non-compliance with it. Third, Frattaroli clearly did not comply with the order by fully or timely responding to the discovery. *Opinion* at 10-12.

Finally, the Court addressed the appropriate sanction given the finding of civil contempt. While the Trustee sought incarceration, Judge Sonchti again noted the "Third Circuit's guidance of applying the least coercive sanction reasonably calculated to win compliance." *Opinion* at 15. Accordingly, he stated that he would enter an order again compelling the discovery responses, imposing a monetary sanction and requiring Frattaroli to appear before the Court at a specific date and time, "with a secondary sanction of incarceration if compliance is not forthcoming." *Opinion* at 15-16. The Court's separate Order of August 11, 2014, reflects the amount of the monetary sanction to be paid by Frattaroli to the Trustee is $20,000. It remains to be seen whether Frattaroli will fail to comply with the Court's order, necessitating his arrest and incarceration.

6. *In re: Proliance International, Inc., et al.*, 09-12278 (CSS) (*George L. Miller v. JNJ Logistics LLC)* (Bankr. D. Del. Aug. 14, 2014)

In line with *Wahoski v. American & Efrid, Inc. (In re Pillowtex Corp.)*, 416 B.R. 123 (Bankr. D. Del. 2009), the Delaware Bankruptcy Court again broke from the Third Circuit's position in *New York City Shoes, Inc. v. Bentley Intern'l, Inc. (In re New York City Shoes, Inc.*, with respect to the subsequent new value defense. In the instant matter, this Court held that a defendant's preference exposure may be reduced by both paid and unpaid subsequent new value.

In this adversary proceeding, the chapter 7 trustee (the "**Trustee**") filed suit against Defendant JNJ Logistics LLC's ("**JNJ**") seeking the return of nearly $548,035.66 in alleged preference payments. Before the Court are cross-motions for partial summary judgment regarding the validity of JNJ's asserted subsequent new value defense in the amount of $222,045.11 for invoices that were paid prior to the debtors' petition date. JNJ argues that the Court should accept the subsequent advance approach adopted by Judge Carey in *Pillowtex* and allow JNJ's preference liability be reduced by both paid and unpaid subsequent new value. In contrast, the Trustee urges the Court to follow *New York City Shoes* and find that JNJ's preference liability can only be reduced by unpaid subsequent new value.

Relying on its earlier rulings in *In re Sierra Concrete Design, Inc.*, 463 B.R. 302 (Bankr. D. Del. 2012) and *In re Vaso Active Pharm.*, 500 B.R. 384 (Bankr. D. Del. 2013), the Court held that paid new value can be used to offset preference claims under section 547(c)(4). The Court moved away from *Pillowtex*, which allowed a creditor to apply a subsequent payment as new value so long as the subsequent payment is not unavoidable, and ultimately held that the defense may comprise both paid and unpaid subsequent new value regardless of whether subsequent new value has been paid by a payment that is itself avoidable.

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For More Information

For questions, please contact the authors of this alert:

- Christopher A. Ward | 302.252.0922 | cward@polsinelli.com
- Todd H. Bartels | 816.572.4418 | tbartels@polsinelli.com
- Shanti M. Katona | 302.252.0924 | skatona@polsinelli.com

To contact another member of our Bankruptcy and Financial Restructuring law team, click here or visit our website at www.polsinelli.com > Services > Bankruptcy and Financial Restructuring > Related Professionals.

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* Law360, March 2014

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