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Bankruptcy and Financial Restructuring

September 2014

Catching Judge Sontchi's "Flurry of Opinions" Part 1 of 3

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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."

In this first part of a three-part series, Bankruptcy and Financial Restructuring Practice Co-Chair Chris Ward, Shareholder Todd Bartels and Associate Shanti Katona analyze separate discovery disputes from *In re: Energy Future Holdings Corp., et al*, and *In re: Newstarcom Holdings, Inc. et al.*

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."

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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.

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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."

Part two of Polsinelli's three-part series reviewing Judge Sontchi's "flurry of opinions" will be released Thursday, September 4, and will detail *In re: NE OPCO, Inc., et al.,* and *In re: Conex Holdings, LLC, et al.*

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* Law360, March 2014

** The American Lawyer 2013 and 2014 reports

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