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Delaware Bankruptcy Court Confirms Four-Day Prepack

The Delaware Bankruptcy Court's recent confirmation of a prepackaged plan in the chapter 11 case of *HighPoint Resources* demonstrates that, under appropriate circumstances and with careful prepetition planning and execution, a consensual prepackaged plan of reorganization may be confirmed on a highly expedited basis.

On March 14, 2021, HighPoint Resources, a developer of oil and natural gas assets, and certain of its affiliates (collectively, "HighPoint") filed chapter 11 petitions in the Delaware Bankruptcy Court, along with a prepackaged plan of reorganization. Case No. 21-10565 (CSS). Under the plan, only the claims of noteholders and existing equity interests were impaired. All other creditor classes were unimpaired. The plan's primary purpose was to implement a third-party merger by April 1st. Importantly, prior to filing, HighPoint not only completed solicitation (and the voting classes voted overwhelmingly in favor of the plan), but also provided at least 28 days' notice of the proposed confirmation hearing and plan objection deadline, as required by Bankruptcy Rule 2002(b).

On the petition date, HighPoint filed a solicitation procedures motion that sought to schedule for March 18th a combined hearing on confirmation of the plan and final approval of the disclosure statement. That same day, HighPoint also filed its memorandum of law and declarations in support of confirmation and a proposed confirmation order. At the March 16th first day hearing, Judge Sontchi approved the solicitation procedures and confirmation timeline over objections by several government entities, including the U.S. Trustee. Generally, the objections were based on alleged notice and due process issues. In overruling them, Judge Sontchi found that HighPoint acted fairly in providing notice to interested parties prepetition, and that whether the notice was effective was a confirmation issue. He also found it compelling that HighPoint did not shorten any notice periods, that "expense and litigation risk" were "very real concern[s]," and that HighPoint managed to secure a successful merger in an "incredibly challenged industry." He also stated "that the prepackaged plan process . . . is designed to reduce expense and reduce risk."

Two days later, on March 18th, Judge Sontchi confirmed the plan, finding significant support in the record for the two pillars of prepackaged plans—"consent of the creditors and adequate due process"—and made clear that a prepackaged plan is "totally appropriate" and can be confirmed when done in "an affordable way, as long as it respects due process and is consensual and eliminates litigation risk."

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Non-Debtor Third Parties Deemed to Consent to Plan Releases

In the *Town Sports* case, Judge Sontchi joined several other Delaware bankruptcy judges in holding that releases of claims against non-debtor third parties held by creditors and equity holders can be granted under chapter 11 plans when the holder is "deemed" to have consented to the proposed releases by failing to respond to the proposed release. *See In re Town Sports International, LLC, et al.*, Case No. 20-12168 (CSS) Hr'g Tr. (Bankr. D. Del. December 17, 2020).

The plan in *Town Sports* provided that stakeholders would be bound by the third-party releases unless they affirmatively opted out of the releases by returning an opt-out form or a ballot electing an opt-out option. Over the U.S. Trustee's objection, Judge Sontchi approved the releases, explaining that individuals have the freedom to contract, and the bankruptcy process allows for implied consent to such releases. Accordingly, "[y]ou have to read your mail in America and if you have legal rights that you believe you own, you have to take action to preserve them." In confirming the plan he noted that "everybody who cared opted out" and that the debtors cannot be "held in limbo" waiting for affirmative responses. Above all, the bankruptcy court has an obligation to reorganize the affairs of the debtor.

Identifying the "collective action" problem that arises in chapter 11 cases with disparate stakeholders, Judge Sontchi observed that debtors must be able to rely on representative parties like committees and other bankruptcy procedures, like noticing, to successfully take advantage of the Bankruptcy Code. These representative parties facilitate the debtors' ability to reorganize their affairs through a plan, which may include third-party releases, while providing procedural safeguards for creditors.

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Debtors Can Reject Midstream Gathering Agreements

In two 2020 decisions, the Delaware Bankruptcy Court held that upstream producer debtors could reject gathering agreements with midstream pipeline companies because the agreements did not create covenants running with the land. The first of these was Judge Sontchi's October 2020 opinion in *In re Extraction Oil & Gas, Inc.*, 622 B.R. 581 (Bankr. D. Del. 2020), applying Colorado law. Under Colorado law, to create a covenant running with the land: (1) the parties must intend the covenant to run with the land; (2) the covenant must touch and concern the land; and (3) there must be privity of estate. The Court held that, although the dedication and commitment covenants in the midstream agreements contained the requisite express and unambiguous intent to run with the land, they did not touch and concern the land because they dealt with personal property, i.e. crude oil "severed" from the real property. Likewise, the Court held that the covenants did not convey any real property interests and did not create privity of estate.

Only a month later, Judge Owens issued a similar opinion in *In re Southland Royalty Co. LLC*, 623 B.R. 64 (Bankr. D. Del. 2020). The Court applied Wyoming law, which generally has the same core elements for a covenant to run with the land described in *Extraction*. As in *Extraction*, the Court found that the parties intended the dedication provision in the midstream agreement to run with the land through express language. But Judge Owens also found that the dedication did not touch and concern the land because it affected severed personal property, not real property. And the dedication did not create privity of estate because it created exclusivity only over extracted resources, not any interest in real property.

Notably, the *Southland* Court addressed an issue that did not come up in *Extraction*, holding that the debtor could sell its assets free and clear of the defendant's interests *regardless* of whether the midstream agreements contained a covenant running with the land. Section 363(f) of the Bankruptcy Code provides five criteria to do so, any of which is sufficient. The Court ruled that section 363(f)(1) applied because Wyoming law permitted the property to be sold free and clear. The Court also held that section 363(f)(5) applied because Wyoming law gives broad remedial discretion to a court to enforce covenants, including by awarding damages.

Both of these cases discuss many more issues than those described here. But in short, both cases carefully scrutinized the dedication language of the midstream agreements and permitted the debtors to reject them, since those dedication provisions did not create covenants that touch and concern the land and did not convey real property interests to the midstream providers.

Common Interest Doctrine Protects Privileged Communications Shared Among Plan Proponents, But Only to the Extent of Their Shared Common Legal Interests

On February 23, 2021, in *In re Imerys Talc America, Inc.* ("Imerys"), Case No. 19-10289 (LSS) (Bankr. D. Del. Feb. 23, 2021), Judge Silverstein held that the "common interest doctrine" can protect from disclosure certain privileged communications exchanged among joint plan proponents. But Judge Silverstein cautioned that "context matters," and concluded that the common interest doctrine is not available when parties' interests concerning certain issues related to the jointly proposed plan are more adverse than aligned.

The common interest doctrine is an exception to the general rule that, when a party shares information otherwise covered by the attorney client privilege or work product doctrine with a third party not jointly represented, the privilege can be waived. To invoke the common interest doctrine, a party must establish that (1) the communication was made by separate parties in the course of a matter of substantially similar legal interest, (2) the communication was designed to further that effort, and (3) the privilege has not otherwise been waived.

Two prior Delaware opinions discussed the common interest doctrine in the context of plan related discovery: *In re Leslie Controls, Inc.* (Judge Sontchi) and *In re Tribune, Co.* (Judge Carey). Judge Silverstein reinforced the guideposts established in those cases, echoing Judge Sontchi's observation in *Leslie Controls* that parties engaged in plan negotiations can sometimes share common legal interests, and embracing former Judge Carey's cautionary note in *Tribune* that the common interest doctrine does not necessarily extend to all communications shared among plan proponents. Additionally, Judge Silverstein found a Southern District of New York case, *In re Quigley Co., Inc.* (Judge Bernstein), instructive for recognizing that plan proponents can simultaneously share common and adverse interests. Ultimately, Judge Silverstein clarified that:

1. The common interest doctrine can, but does not always, apply in the plan context.
2. Parties can simultaneously share a common legal interest with respect to some issues but not others.
3. To the extent that parties share a common legal interest, the common interest doctrine only protects communications that are in furtherance of that common legal interest, and not those implicating unrelated or adverse interests.

Concerning parties who share common and adverse interests simultaneously, Judge Silverstein found that plan proponents share a common legal interest with respect to maximizing total recoveries available under a plan and confirming the plan itself. However, plan proponents have adverse legal interests with respect to the apportionment of recoveries under a plan. In other words, there is a distinction between the "size of the pie" and the "pieces of the pie."

Unpaid or Underpaid Oil and Gas Lease Royalties are General Unsecured Claims

On March 11, 2021, the Delaware Bankruptcy Court issued a bench ruling sustaining Ursa Piceance Holdings LLC, *et al*.'s first omnibus objection to the classification of certain claims, thereby reclassifying claims asserted by oil and gas lease royalty holders as general unsecured claims. Case No. 20-12067 (BLS) (Bankr. D. Del. Mar. 11, 2021).

Judge Shannon rejected the claimants' arguments that, under Colorado law, unpaid or underpaid royalties were not property of the estate but, rather, were held in trust for the claimants' benefit. The royalty contracts did not indicate or permit an inference that the debtors were holding funds in trust exclusively for the benefit of the claimants, and the Court refused to impose a constructive trust under the facts of the case.

Similarly, in another recent bench ruling in *In re Southland Royalty Company, LLC,* interpreting New Mexico law, Judge Owens reclassified asserted secured claims held by oil and gas lease royalty holders to general unsecured claims. Case No. 20-10158 (KBO) (Bankr. D. Del. Jan. 19, 2021). Without deciding whether the monies owed were actually property of the estate, the *Southland* Court provided that, to the extent claimants have unpaid or underpaid oil and gas lease royalty claims against the estate for monies which are property of the estate, those claims are general unsecured in nature.

The *Ursa* holding expands on unresolved issues from *Extraction* and *Southland* by specifically finding that, where oil and gas royalty contracts do not provide for an express or statutory trust, and where a constructive trust cannot be imposed, unpaid or underpaid royalties related to those contracts are property of the estate, and claims held on account of such royalties should be afforded general unsecured status.

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Section 546(e) Safe Harbor: Debtors Can Participate

In *Kravitz v. Samson Energy Co., LLC (In re Samson Resources Corp.)*, Case No. 15-11934 (BLS), 2020 WL 7700693 (Bankr. D. Del. Dec. 23, 2020), Judge Shannon of the Delaware Bankruptcy Court held that a debtor can be a "financial participant" within the meaning of the safe harbor provision of section 546(e) of the Bankruptcy Code, splitting from the Southern District of New York's contrary holding.

The trustee of the Samson settlement trust brought an adversary proceeding against certain of the debtors' former shareholders and other parties to avoid and recover various transfers effectuated in connection with a prepetition leveraged buyout, including $6.3 billion in cash paid to the former shareholders in exchange for their stock. The defendants moved for summary judgment, asserting that the transfers were protected by section 546(e), which exempts from avoidance actions those transfers by or to (or for the benefit of) a "financial participant" in connection with a securities contract.   Conversely, the trustee filed a cross-motion for summary judgment on the grounds that the defendants' affirmative defense based on section 546(e) was inapplicable. As it was uncontested that the dispute involved a securities contract, the only issue before the court with respect to the application of the 546(e) safe harbor provision was whether the debtor parties to the stock purchase agreement constituted financial participants.

A financial participant is defined by section 101(22A) of the Bankruptcy Code to include an entity that, at the time it enters into a securities contract, has one or more of the required agreements (including securities contracts and swap agreements) "with the debtor *or any other entity (other than an affiliate)*" (emphasis added) with a total gross dollar value of not less than $1 billion in notional or actual principal amount outstanding or has gross mark-to-market positions of not less than $100 million. The defendants asserted that, at the time the stock purchase agreement was entered into, the debtors had the requisite agreements in type and amount. But the trustee took the position that a debtor, even if it had the requisite agreements, is excluded from the definition of financial participant. The trustee's position was supported by the Southern District of New York's ruling in the fraudulent conveyance litigation in connection with the Tribune Company's leveraged buyout, in which the court held that the definition of financial participant excludes debtors because a contrary statutory interpretation would render the language "with the debtor" redundant.

Judge Shannon rejected that interpretation and held that the plain language of the definition of financial participant does not exclude debtors because the definition provides that the participant can have the requisite agreement with a non-debtor entity. He stated that, if Congress wanted to exclude debtors from the definition, it knew how to do so, and gave examples of the more limited definitions of "swap participant" and "repo participant" that each exclude debtors by requiring the participant to have a requisite agreement "with the debtor." The court's ruling embraces a broader interpretation of section 546(e) that likely will result in increased insulation from avoidance actions for transfers surrounding leveraged buyouts and similar transactions, especially in the oil and gas industry where companies are often involved with large swap agreements and other derivative contracts.

Commercial Rent Tax is a Property Tax, Not an Excise Tax

A recent ruling from Judge Walrath in *In re SGR Winddown*, Case No. 19-11973 (MFW), 2021 WL 112166 (Bankr. D. Del. Jan. 8, 2021), provides helpful guidance to chapter 11 debtors who lease commercial property in Manhattan. Under the New York City Administrative Code, a "Commercial Rent Tax" is imposed on any lease (with annual gross rent of at least $250,000) of real property south of 96th Street that is used, or intended to be used, for commercial purposes. In *SGR Winddown*, Judge Walrath held that these Commercial Rent Taxes were not excise taxes (entitled to priority status because they came due within the three-year priority window under section 507(a)(8)(E) of the Bankruptcy Code) but were instead property taxes entitled to priority status only if they were last due within one year before the petition date (under section 507(a)(8)(B)).

The taxing authority argued that excise taxes are "'imposed upon a particular use of property or upon the exercise of a right or privilege'"—i.e., entering into a lease for the purpose of operating a business in the designated area of Manhattan. The debtors argued that the Commercial Rent Taxes were property taxes because they were based on the passive ownership of a leasehold interest, not on the "act" of leasing real property for commercial use.

Judge Walrath agreed with the debtors, holding that "an excise tax is imposed not on the ownership of property but on its actual use or on an activity." And under the New York City Administrative Code, Commercial Rent Tax is due as long as the tenant pays rent; that is, the tax is owed whether the tenant uses the property or not. Accordingly, because the claim for Commercial Rent Tax fell outside the one-year priority period under section 507(a)(8)(B), the court ordered that the claim be reclassified as a general unsecured claim.

Bankruptcy Law Does Not Square with Triangular Setoffs

In line with fundamental Bankruptcy Code principles favoring equitable treatment among all creditors and a "compelling body of precedent", the Third Circuit recently held that triangular setoffs violate the mutuality requirements of Bankruptcy Code Section 553 and are presumptively invalid. *In re: Orexigen Therapeutics, Inc.,* No. 20-1136 (3d Cir. 2021). The holding agrees with rulings by the Second, Fifth and Seventh Circuits and placed particular reliance on the "well-reasoned" decision by Judge Shannon of the Delaware Bankruptcy Court in *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009).

The Orexigen debtors and their distributor, McKesson, were parties to a distribution agreement that expressly permitted McKesson and its affiliates to set-off, recoup, and apply any amounts owed to Orexigen against any and all amounts owed by Orexigen to McKesson or any of its affiliates. At the time Orexigen filed for bankruptcy, McKesson owed Orexigen approximately $7 million, but if permitted to set-off debts Orexigen owed to McKesson's affiliates, McKesson would owe Orexigen nothing.

McKesson argued that the word "mutual" in section 553 is a non-limiting adjective, simply "meant to invoke an understanding of how state law setoff rights generally operate." However, relying on Judge Shannon's "sound" analysis in *SemCrude*, the Third Circuit disagreed, concluding that section 553(a)'s mutuality requirement does not merely limit but, rather, completely prohibits triangular setoffs and that parties cannot "contract around" it. The Third Circuit noted Congress's clear intent for mutuality to be limited to those debts owed from a debtor to a specific creditor, and that specific creditor's debts owed back to the debtor.

As a matter of policy, the Third Circuit noted that its holding "promotes predictability in credit transactions". In addition, the Third Circuit suggested that McKesson could have protected itself through other means, such as by contracting with Orexigen itself or by perfecting a security interest in the Orexigen accounts receivable.

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Supreme Court Holds Retention of a Debtor’s Property Does Not Violate Automatic Stay

In a unanimous decision, the Supreme Court recently held that mere retention of a debtor’s property seized prepetition does not constitute an act, under section 362(a)(3) of the Bankruptcy Code, to exercise control over property of the bankruptcy estate. *Chicago v. Fulton*, 592 U.S. ___, 141 S. Ct. 585 (2021). This opinion settles contravening views among the Circuits, siding with the minority view, followed in the Third Circuit. In *In re Denby-Peterso*n, the Third Circuit declared that “a secured creditor does not have an affirmative obligation under the automatic stay to return a debtor’s collateral to the bankruptcy estate immediately upon notice of the debtor’s bankruptcy.” *In re Denby-Peterson*, 941 F.3d 115, 119 (3d Cir. 2019).

Justice Sotomayor wrote a concurring opinion emphasizing that the Court’s holding does not address whether such retention may violate other provisions of the Bankruptcy Code, such as sections 362(a)(4) and 362(a)(6). These provisions stay “any act to create, perfect, or enforce any lien against property of the estate,” and “any act to collect, assess, or recover a claim against [a] debtor” that arose before the bankruptcy case, respectively. *See* 11 U.S.C. §§ 362(a)(4), (6). Accordingly, while the Supreme Court has clarified that violation of section 362(a)(3) of the Bankruptcy Code requires an affirmative act, creditors withholding a debtor’s property could be in violation of other automatic stay provisions.