YOUNG CONAWAY

DELAWARE BANKRUPTCY UPDATE

In the final quarter of 2021, the Delaware Bankruptcy Court addressed the enforceability of blocking provisions in LLC agreements, a debtor's liability for make whole premiums in chapter 11 cases, whether a complaint may be amended 20 months after it was filed, and whether threatening to take an action can constitute a "live controversy" under Article III of the United States Constitution. In addition, Judge Craig Goldblatt, who was appointed to the Delaware Bankruptcy Court in 2021, issued two opinions addressing the mundane, but always-relevant issue of bar date notification. Each of these decisions is summarized below. Feel free to contact any member of our team for further information about these recent decisions.

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Delaware Bankruptcy Court Denies Motion to Dismiss Chapter 11 Cases; Refusing to Enforce Blocking Provision in Delaware LLC Agreement

In re PWM Management, LLC, et al., Case No. 21-11445 (MFW)
(Bankr. D. Del. Dec. 13, 2021 Bench Ruling and Dec. 20, 2021 Order, Docket No. 253)

In a recent bench ruling issued in the *PWM Management, LLC* chapter 11 cases, the Delaware Bankruptcy Court addressed, among other things, a blocking provision in a Delaware LLC agreement, which obligated a debtor to obtain the consent of its preferred equity holder prior to filing for relief under chapter 11. The preferred equity holder moved to dismiss the chapter 11 cases, asserting that: the debtors lacked the requisite corporate authority to file chapter 11; the chapter 11 cases were filed in bad faith; and the debtors lacked a valid bankruptcy purpose.

The Court denied the motion to dismiss, holding, among other things, that the blocking provision was unenforceable as a matter of federal public policy. Specifically, Judge Walrath compared the circumstances of the chapter 11 cases to those in *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016) and *In re Lake Michigan Beach Pottawattamie Resort, LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016), and determined that the preferred equity holder was principally a creditor because at the time it negotiated for the blocking right, its preferred equity investment possessed the hallmarks of debt (e.g., the preferred equity holder was entitled to a fixed return on investment, had no right to share in profits after the sale of assets, and had rights to foreclose and force a sale of the applicable debtor's primary asset). Given its creditor relationship with the debtors, the Court refused to enforce the preferred equity holder's blocking right.

The Court also held that the debtors filed their chapter 11 cases with a proper purpose. Specifically, Judge Walrath found that the (i) debtors' Chief Restructuring Officer and independent directors exercised their fiduciary duties in deciding to file for chapter 11 to preserve assets for the benefit of all stakeholders, and (ii) debtors were in financial distress given that they faced an imminent cash dominion event that could have led to a forced sale of the debtors' primary asset. Moreover, the Court confirmed that the debtors' need to reject an unfavorable contract and use cash collateral, rather than be forced into cash dominion, were both valid bankruptcy purposes.

Finally, the Court applied the *Primestone* factors, and held that the chapter 11 cases were filed in good faith. *Primestone Inv. Partners v. Vornado PS, L.L.C.*, 272 B.R. 554 (D. Del. 2002). Judge Walrath explained that, notwithstanding that the chapter 11 cases "constitute[d] two single asset cases that are only linked through a guaranteed trigger by the bankruptcy[,]" they were appropriately filed because the chapter 11 cases impact the rights of a significant number of creditors, the debtors operate a legitimate business and incur business-related obligations, and, absent the filing, the debtors would be faced with a cash dominion event that would have caused financial distress. Moreover, the Court determined that the debtors are capable of reorganization and had commenced efforts in furtherance of that goal. The Court also noted that the debtors filed their chapter 11 cases on the eve of a cash dominion event to protect the value of their assets—not merely to "thwart" a single secured creditor.

The Court's decision has been appealed to the United States District Court for the District of Delaware, where it is currently pending.

Judge Owens Holds that a Threatened Action Can Constitute a Live Controversy

Pulsifer v. Miller (In re Creda Software, Inc.), Case No. 20-10919 (KBO)
Adv. Pro. No. 21-51160 (Bankr. D. Del. Dec. 6, 2021).

In *Pulsifer v. Miller*, the Delaware Bankruptcy Court denied t chapter 7 trustee's motion to dismiss an adversary proceeding, holding that a live controversy existed based upon certain threatening actions taken by the Trustee.

The complaint filed by Allen. Pulsifer, the debtor's principal, sought declaratory relief regarding the rights of the parties to cryptocurrency owned prepetition by the debtor. Specifically, Pulsifer sought an order declaring that the trustee and the debtor's estate held no valid claims, rights, or interests in the cryptocurrency, including preference and fraudulent transfer claims. The trustee moved to dismiss, arguing that Article III of the United States Constitution required dismissal because Pulsifer was seeking an advisory opinion. Judge Owens disagreed and held that Pulsifer "alleged a ripe claim."

According to Pulsifer's complaint, the trustee demanded at the section 341 meeting of creditors that Pulsifer "amicably" turn over the cryptocurrency because Federal and Delaware law required it. Pulsifer further alleged that the parties had engaged in informal and formal discovery concerning the matter and agreed to the terms of a settlement, which the trustee subsequently withdrew from while reserving rights as to any potential claims against Pulsifer. Because of the trustee's actions, Pulsifer contended that he was prevented from obtaining fair value for the sale or use of the cryptocurrency.

In denying the motion to dismiss, the Court held that the trustee "threatened action and behaved in a manner that indicates his threats are real, substantial, and likely to be acted upon in the near future," constituting "a live controversy . . . despite the [trustee's] lack of formal demand or legal action[.]". The Court reasoned that the circumstances giving rise to the trustee's claims against Pulsifer had already occurred, and a ruling from the Court would provide certainty regarding the parties' rights to the cryptocurrency. Moreover, in light of the turnover demand at the 341 meeting and the later settlement proposal, the Court was not persuaded that the Trustee's claims were merely "hypothetical".

The Court's opinion noted that, "[a]lthough unusual, this [was] not the first time that a party threatened with litigation initiated a proceeding to obtain declaratory relief[,]" citing *Barsa v. Theseus Strategy Group, LLC (In re OLD BPSUSH, Inc.)*, No. 19-50726, 2020 WL 6818435, at *1 (Bankr. D. Del. June 30, 2020) ("This adversary proceeding arrived in the Court via an untraditional route. Typically, when a confirmed plan creates a litigation trust, the trustee may pursue litigation, often including claims against former officers and directors. However, the reverse happened here: the current adversary proceeding complaint was filed by former officers and directors against the litigation trustee. In the complaint, the former officers and directors allege that the litigation trustee has threatened to sue them, even though they also allege that their asset preservation efforts were so successful that they obtained "the best possible result for creditors, equity holders, and employees alike."")

Judge Stickles Grants Leave to Amend Complaint to Avoid Fraudulent Transfers 20 Months After Filing Where Defendant Aware of Actual Fraud

Goldberg v. Halbert (In re Woodbridge Group of Companies, LLC),
Case No. 17-12560, Adv. Pro. No. 19-51027 (JKS) (Bankr. D. Del. Dec. 6, 2021)

In *Goldberg v. Halbert*, Judge Stickles of the Delaware Bankruptcy Court recently held that justice required the court to grant leave to amend a fraudulent-transfer complaint 20 months after filing, when the liquidation trustee discovered evidence that the defendant knew of the fraud.

The Woodbridge Group of Companies were part of a Ponzi scheme that had raised over $1 billion by selling fraudulent securities. The Trustee brought 425 adversary complaints against investors who received more than their principal investment in prepetition cash transfers—the "net winners" of the Ponzi scheme—seeking to recover only their fictitious profits and choosing not to pursue repayment of principal, on the assumption that the net winners acted in good faith in receiving principal repayments.

One of those net winners was Kenneth Halbert. Approximately twenty months after the complaint against Halbert was filed, the Trustee moved to amend the complaint, attaching a supporting declaration that included email correspondence between Halbert and the founder of Woodbridge ("Shapiro") and a promissory note between Halbert and an affiliate of Shapiro, which led to the conclusion that Halbert was aware of the "central lie" at the heart of the Ponzi scheme. As a result, the Trustee sought to avoid and recover the principal repayment Halbert had received from Woodbridge in addition to Halbert's fictitious profits.

In determining whether to grant leave to amend, Judge Stickles looked to the factors articulated in *Cureton v. N.C.A.A.*, 252 F.3d 267 (3d Cir. 2001): undue delay, bad faith, substantial or undue prejudice to the opposing party, failure to provide an amended complaint, and futility.

According to Judge Stickles, the trustee's 20-month delay was not undue, even though the documents had been available to him for more than three years, because the court's scheduling order had delayed discovery and the trustee had previously had no reason to scrutinize every single document. The trustee's initial presumption that the net winners acted in good faith was sensible and appropriate, reducing costs, leading to settlements, and protecting the true victims of the Ponzi scheme.

The Bankruptcy Court also found that the trustee did not bring the motion in bad faith. In doing so, Judge Stickles rejected Halbert's attempts to introduce certain statements made during mediation, reasoning that Local Rule 9019-5(d)(i) prohibits parties from divulging oral or written information disclosed during mediation.

According to Judge Stickles, granting leave to amend would also not unduly prejudice Halbert: even if his potential liability were increased, his rights, defenses, and ability to conduct discovery would be unchanged.

Finally, the Bankruptcy Court held that amending the complaint would not be futile because the claims in the amended complaint would relate back to the date of the original filing: the claims in both the original and the amended complaint arose from Halbert's investment in the Ponzi scheme; the confirmation order put Halbert on notice that all transfers from Woodbridge could have been made with fraudulent intent; and Shapiro's signature on the promissory note should have made Halbert aware of the fraud, putting him on notice that the original complaint could be revised to claw back principal payments.

**Judge Dorsey Confirms Debtors' Ability to
Avoid Make-Whole Payment Through Reinstatement**

In re Mallinckrodt plc, Case No. 20-12522 (JTD) (Bankr. D. Del. Nov. 5, 2021)

In *In re Mallinckrodt plc,* Judge Dorsey of the Delaware Bankruptcy Court overruled the confirmation objection of a group of first lien noteholders who sought to collect a make-whole premium (the "Applicable Premium") arising from a single event of default—the debtors' bankruptcy. Judge Dorsey sided with the debtors, who argued that the noteholders were not entitled to the premium because the plan will reinstate the notes so that the holders will be paid what they are owed on the original maturity date with all of the terms of the applicable notes remaining intact.

Judge Dorsey cited to the leading Third Circuit precedent on make-whole premiums, I*n re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016) ("EFH") which was decided in the context of a debtor's refinancing of its notes, rather than reinstatement. In EFH, the Third Circuit held that the make-whole at issue was enforceable because the debtor had voluntarily filed for bankruptcy and thus triggered the "optional" redemption premium. In reaching its conclusion, the court noted that, in bankruptcy, the debtor "had the option, per its plan of reorganization, to reinstate the accelerated Notes' original maturity date under Bankruptcy Code § 1124(2) rather than paying them off immediately." *Id*. at 255.

In *Mallinckrodt*, the debtors did just that, and they cited *EFH* in support of their argument that Section 1124(2) permits the reinstatement of an obligation notwithstanding any contractual provisions requiring an acceleration of any claim or interest after the occurrence of default.

The noteholders countered that section 1124(2) applies only to a "default that gives rise to acceleration of a creditor's claim," and that the debtors' failure to pay the make-whole premium "did not give rise to any entitlement 'to demand or receive accelerated payment.'" Specifically, section 6.02 of the first lien indenture provided that, "upon the acceleration of the notes in connection with an event of default, an amount equal to the Applicable Premium or optional redemption premium, as applicable, that would have been payable in the optional redemption of the notes at the time of the occurrence of such acceleration will become and be immediately payable with respect to all notes," and the additional amount was "deemed to be principal of the notes and interest shall accrue on the full principal amount of the notes (including the Applicable Premium or such other premium) from and after the applicable triggering event." Therefore, the noteholders argued, the make-whole obligation was a new obligation that was simply "the byproduct of acceleration of the unpaid principal and interest" triggered by the filing.

Judge Dorsey disagreed. "What the noteholders are saying, in effect, is that despite the fact that the debtors are proposing to reinstate their notes and will pay the notes in full as originally contemplated with all terms remaining intact, they are entitled to extract what amounts to a penalty and, if allowed, a windfall solely because the debtors filed for bankruptcy protection. . . . That is precisely the type of situation Section 1124(2) is intended to address."

Judge Dorsey also cited the "strong public policy" underlying Section 1124. As Congress noted in passing Section 1124, "The holder of a claim or interest who, under the plan, is restored to his original position when others receive less or get nothing at all is fortunate indeed and has no cause to complain." In sum, "[s]ince Section 1124(2) rolls back the clock to the time before the asserted default, the applicable premium is not triggered and is not, therefore, due and owing."

Judge Goldblatt on Bar Date Compliance

In two recently-issued opinions, Judge Craig Goldblatt, who was appointed to the United States Bankruptcy Court for the District of Delaware in 2021, weighed in on the enforceability of bar dates.

In re: Cyber Litigation Inc., Case No. 20-12702 (CTG), 2021 WL 5047512 (Bankr. D. Del. Oct. 28, 2021)

In *Cyber Litigation*, Judge Goldblatt held that the bar date for filing proofs of claim cannot be enforced against a creditor who did not receive timely notice of the bar date by mail, even if that creditor received timely notice of the bar date by email. Based on the underlying facts, Judge Goldblatt held that email notice satisfied the requirements of due process. However, it did not satisfy the "mandatory requirements" of Bankruptcy Rule 2002(a)(7), which requires the debtor to give "all creditors . . . at least 21 days' notice by mail of . . . the time fixed for filing proofs of claims[.]" (emphasis added). Judge Goldblatt concluded that "fairly read, the term 'notice by mail' does not include email."

This issue arose in the context of the debtor's motion to disallow a $343,000 claim filed by its largest unsecured creditor, Hansen Networks, as untimely. The parties stipulated that the bar date notice was not sent to Hansen Networks' last known address, but was instead mailed to a previous address of David Hansen, the principal of Hansen Networks. The bar date notice was also sent to an email address that Mr. Hansen actively used. Hansen acknowledged his use of the email address, including for recent communications related to the bankruptcy case, but denied ever seeing the bar date notice.

The Court explained that, for a bar date to be enforceable, a creditor must "receive sufficient notice to satisfy the constitutional requirements of due process" and the debtor must comply with the procedural requirements of the Bankruptcy Rules.

The Court concluded that the email notice to Mr. Hansen satisfied due process and was at least as good as mail notice "in terms of its likelihood of reaching the intended recipient." This was particularly true given "the remote work environment brought on by the global pandemic, the well-publicized challenges faced by the U.S. Postal Service, and the increased reliance on electronic communications." Nonetheless, the Court concluded that the debtor failed to comply with the Bankruptcy Rules because "a creditor is entitled to receive notice of the bar date by mail, at the address required by Bankruptcy Rule 2002(g)."

The Court further concluded that the debtor's failure to provide notice in accordance with Bankruptcy Rule 2002 was not harmless error under Bankruptcy Rule 9005. To show harmless error, the debtor had to demonstrate that Hansen obtained "actual, subjective knowledge of the bar date." Hansen testified that he was not aware of the bar date and would have filed a timely proof of claim if he was, given the significant amount of money at issue. The Court concluded that this testimony was in accord with "ordinary common sense." Accordingly, the Court refused to enforce the bar date and overruled the claim objection.

In re Promise Healthcare Grp., LLC, Case No. 18-12491 (CTG), 2021 WL 4528461
(Bankr. D. Del. Oct. 4, 2021)

In contrast to Cyber Litigation, Judge Goldblatt held that electronic service of the bar date notice was adequate in Promise Healthcare. Prior to selling substantially all of their assets in the chapter 11 cases, the debtors operated acute care and skilled nursing facilities. One of the patients in the debtors' facilities, Amparo Figueroa, asserted that she was injured due to the debtors' alleged post-petition negligence.

Figueroa sought and obtained relief from the automatic stay, thereby permitting her to liquidate her claim in state court to the extent of available insurance. Unbeknownst to Figueroa, the debtors did not have insurance covering this claim, and, in the process of sorting this out, the administrative claims bar date passed without Figueroa filing a claim. Upon learning of the debtors' lack of insurance coverage, Figueroa filed a motion requesting authorization to file a late administrative claim, arguing that she did not receive proper notice of the administrative claim bar date and, alternatively, her failure to file a timely claim was the result of excusable neglect.

Figueroa acknowledged that her counsel received electronic notice of the administrative claims bar date through the CM/ECF system but argued that notice was nevertheless inadequate because the debtors did not serve a "courtesy copy" of the notice as required under the local rules. Judge Goldblatt rejected this argument and concluded that the notice provided to Figueroa comported with the requirements of due process as well as the federal and local bankruptcy rules. Both Bankruptcy Rule 9036 and Local Rule 5005-4 provide that service may be accomplished on registered CM/ECF users by filing with the Court's electronic-filing system. By registering with CM/ECF, counsel to Figueroa (and thus Figueroa) consented to electronic service. Although the debtors failed to serve a courtesy copy of the bar date notice on Figueroa's counsel as required by the local rules, Judge Goldblatt concluded that nullifying the administrative claims bar date was "too draconian a remedy" for the debtors' non-compliance with this rule and held that the administrative claim bar date applied to Figueroa.

Nevertheless, Judge Goldblatt found that Figueroa established excusable neglect and permitted her to assert an administrative claim. Noting that it was a close call, the Court was ultimately persuaded by Figueroa's argument that the debtors were on notice of Figueroa's claim as the result of her motion for relief from stay, which provided all of the same information that would have been included in a motion to allow an administrative expense claim. This, combined with the post-confirmation trust's failure to present any evidence that it would be prejudiced if the claim were permitted to be filed—which Judge Goldblatt noted was the strongest argument that could be made in response to Figueroa's request to file a late claim—tipped the scale in favor of allowing Figueroa to assert a tardy administrative claim under the Pioneer factors.