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EDITOR'S NOTE: ON THE DOCKETS
Steven A. Meyerowitz

THE DEBTOR'S REJECTION POWER: HOW IS IT CONSTRAINED AND CAN A COUNTERPARTY CONSTRAIN IT?
James A. Croft

U.S. SUPREME COURT PRESERVES BANKRUPTCY COURT POWER TO HEAR DISPUTES
Michael L. Cook, Lawrence V. Gelber, and David M. Hillman

FIFTH CIRCUIT FINDS UNDERSECURED CREDITOR WAIVED RIGHT TO CREDIT BID
Michael L. Cook

DELAWARE COURT OF CHANCERY DECISION CLARIFIES FIDUCIARY ISSUES IN INSOLVENT COMPANY CONTEXT
Mark S. Chehi, John K. Lyons, and Ana Lucía Hurtado

OAK ROCK FINANCIAL DISTRICT COURT ADDRESSES THE APPLICABLE LEGAL STANDARD FOR TRUE PARTICIPATION AGREEMENTS
Jason W. Harbour and Shannon E. Daily

S.D.N.Y. AFFIRMS *MPM SILICONES'* "PRIME PLUS" FORMULA FOR CRAMDOWN INTEREST RATES, LIKELY HARMING CREDITOR RECOVERIES
Craig M. Price, Michael Friedman, and Franklin H. Top, III

THE *ENERGY FUTURE HOLDING CORP.* DECISION: VALIDATING TENDER OFFERS AND LIMITING THE APPLICATION OF CONFIRMATION REQUIREMENTS IN BANKRUPTCY SETTLEMENTS
Andrew I. Silfen, Jeffrey N. Rothleder, and Ronni N. Arnold

INSURANCE COVERAGE CLAIMS ARE "NON-CORE," NEW JERSEY BANKRUPTCY COURT CONFIRMS
Stuart I. Gordon and Frank Misiti

THE 2014/2015 GRADUAL REFORM OF THE SPANISH INSOLVENCY ACT: HOW IT AFFECTS THE BUSINESS OF INVESTORS IN DISTRESSED DEBT
Jesús Varela, Julio Parrilla, and Antonio García

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The *Energy Future Holding Corp.* Decision: Validating Tender Offers and Limiting the Application of Confirmation Requirements in Bankruptcy Settlements

Andrew I. Silfen, Jeffrey N. Rothleder, and Ronni N. Arnold*

This article discusses a recent Delaware District Court decision that stands for the proposition that a settlement can be approved when two separate classes of noteholders receive a disparate effective recovery, despite the fact that such holders were within the same creditor class and such disparate treatment may not be approved in the context of a contested confirmation.

A recent Delaware District Court decision concerning an appeal of a bankruptcy settlement clearly provides support for the use of tender offers or other exchange, or settlement mechanics permitted under applicable federal securities laws prior to and outside a plan of reorganization. In essence, this decision permits debtors to utilize exchange offers to repurchase outstanding securities at a discount, or obtain more favorable terms during a bankruptcy proceeding and prior to confirmation of a plan of reorganization.

CASE SUMMARY

On April 29, 2014, Energy Future Holding Corporation and its subsidiaries (the "Debtors") filed for Chapter 11 bankruptcy relief. At the time of the filing, one of the Debtors, Energy Future Intermediate Holdings, LLC ("EFIH"), had three funded debt constituencies, including $4 billion of first lien notes comprised of a $3.5 billion class of 10 percent notes due 2020 (the "10 Percent Notes") and a $500 million class of 67/8 percent notes due 2017 (the "67/8 Percent Notes"). Both series of notes contain make-whole provisions that protect the noteholders (the "First Lien Noteholders") from premature redemption by requiring EFIH to pay a redemption premium in the event that it redeems the notes prior to maturity.

Concurrent with the bankruptcy filing, the Debtors, including EFIH, filed a Restructuring Support and Lock-up Agreement ("RSA") that encompassed several agreements, one of which was a settlement between the Debtors and

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certain of the First Lien Noteholders. This settlement was initiated by the Debtors through a tender offer to all First Lien Noteholders. Under the terms of the settlement, the First Lien Noteholders would be compensated with new value of 105 percent of their outstanding principal and 101 percent of the accrued interest. In exchange, the noteholders agreed to release their disputed make-whole claims. The First Lien Noteholders who did not accept the tender offer retained their rights to litigate the validity of their make-whole claims.

In the bankruptcy case, the Debtors sought approval of this settlement pursuant to Bankruptcy Rule 9019. The United States Bankruptcy Court for the District of Delaware approved the settlement with the participating First Lien Noteholders and, in so doing, found that the settlement was fair and reasonable in accordance with the requirements of Bankruptcy Rule 9019 and applicable law. Subsequently, most of the RSA was withdrawn by the Debtors with only the settlement with the First Lien Noteholders remaining.

Delaware Trust Company, indenture trustee for the 10 Percent Notes, appealed the bankruptcy court's approval of the settlement with the First Lien Noteholders on several grounds. Specifically, Delaware Trust challenged the settlement on the grounds that i) the use of a tender offer was improper for a bankruptcy settlement; ii) the settlement provided a disparate effective recovery on the make-whole claims of the two noteholder classes and, thus, violated Section 1123(a)(4) of the Bankruptcy Code; and iii) the settlement constituted an impermissible *sub rosa* plan.

The United States District Court for the District of Delaware affirmed the bankruptcy court's approval of the proposed settlement and responded to Delaware Trust's three separate contentions.

THE PRE-CONFIRMATION SETTLEMENT THROUGH A TENDER OFFER WAS NOT IMPROPER

First, Delaware Trust argued that the Debtors' use of a tender offer to accomplish the settlement was improper. The Debtors achieved the settlement by making a tender offer to all existing First Lien Noteholders to exchange the existing notes for new debt obligations to be issued under a new $5.4 billion debtor-in-possession financing facility. Delaware Trust, on behalf of the holders of the 10 Percent Notes, asserted that that the Debtors' use of a tender offer was impermissible because the Securities and Exchange Commission ("SEC") and securities laws play limited roles in bankruptcy cases, and therefore it was improper for the Debtors to invoke a SEC-governed process instead of seeking judicial approval to initiate the settlement offer.

The district court disagreed. The district court opined that pre-confirmation

settlements are favored in bankruptcy in order to minimize litigation and expedite the administration of the bankruptcy estate, and that the Bankruptcy Code does not impose any restrictions on a debtor's ability to propose pre-confirmation settlements. Contrary to Delaware Trust's arguments, the district court stated that the fact that the SEC's oversight in Chapter 11 cases is relatively limited does not suggest that it is improper for a debtor to utilize a process that complies with securities laws. Indeed, according to the district court, a debtor in bankruptcy is not necessarily relieved of its obligations under the securities laws except in those limited circumstances outlined in Section 1145 of the Bankruptcy Code.

The district court also disagreed with Delaware Trust's contention that a Chapter 11 debtor can only accomplish a class-wide debt exchange with unequal treatment of creditors through a plan noting that, among other things, i) there was no evidence of insider dealing, coercion of noteholders, or control by outside creditor groups; ii) the First Lien Noteholders were offered at least 100 percent of their undisputed principal and interest; and iii) most importantly, that noteholders that did not opt in to the settlement preserved their right to litigate the disputed make-whole claims. In summary, the district court found that plans of reorganization are not the exclusive mechanism to exchange debt or pay off existing creditors in Chapter 11 but, rather, settlements, no matter how they are achieved, can be used to accomplish the same goal so long as they satisfy the requirements of Bankruptcy Rule 9019.

THE PRE-CONFIRMATION FIRST LIEN SETTLEMENT DID NOT HAVE TO COMPLY WITH SECTION 1123(A)(4) OF THE BANKRUPTCY CODE

Second, Delaware Trust argued that although the settlement offer provided an equivalent five percent premium to holders of both the 10 Percent Notes and the 67/8 Percent Notes, the amount that each class received compared to the maximum potential value of its respective make-whole claim was unequal, as the amount of outstanding principal varies between the two classes. As a result, Delaware Trust asserted that because the two noteholder classes received different effective recoveries on their make-whole claims, Section 1123(a)(4) of the Bankruptcy Code, which mandates that creditors of the same class must receive equal treatment in Chapter 11, was violated.

In disagreeing with this argument, the district court stated that, by its express terms, Section 1123(a)(4) of the Bankruptcy Code applies only to confirmation of a plan. The district court declined to adopt the reasoning of the Fifth Circuit, which has held that a bankruptcy court erroneously approved a debtor's pre-confirmation settlement with a junior creditor because it violated the

absolute propriety rule. The district court stated that it was not bound by the Fifth Circuit's decision, and that analogous arguments that other confirmation rules should apply to pre-confirmation settlements have also failed in the District of Delaware. The district court further noted that, even if Section 1123(a)(4) of the Bankruptcy Code applied to a pre-confirmation settlement, the settlement with the First Lien Noteholders did not violate that provision, as Section 1123(a)(4) of the Bankruptcy Code allows creditors to agree to less favorable treatment. Moreover, although neither the Bankruptcy Code nor the legislative history precisely define the standards of equal treatment, courts have interpreted the same treatment requirement to mean that all claimants in a class must have the same opportunity for recovery. Here, all First Lien Noteholders, had the same opportunity to opt into the settlement. Therefore, the settlement did not violate Section 1123(a)(4) of the Bankruptcy Code.

THE FIRST LIEN SETTLEMENT DID NOT CONSTITUTE AN IMPROPER *SUB ROSA* PLAN

Finally, Delaware Trust argued that the proposed settlement constituted an improper *sub rosa* plan. The district court quickly dismissed this argument because the RSA was withdrawn by the Debtors, and the settlement with the First Lien Noteholders—which is all that remained of the RSA—did not effectively dictate the terms of a prospective Chapter 11 plan by either i) disposing of all claims against the estate; or ii) restricting creditors' rights to vote. Therefore, the settlement was not an improper *sub rosa* plan. The district court also disagreed with Delaware Trust's contention that the *sub rosa* argument should be evaluated at the time the Bankruptcy Court approved the first lien settlement, noting that Appellants did not cite any legal authority to support this proposition.

Delaware Trust has appealed this decision to the United States Court of Appeals for the Third Circuit.

THOUGHTS

This decision offers an alternative path for obtaining pre-confirmation settlements with key funded debt constituencies during Chapter 11. Indenture Trustees and holders should be aware of the issues as well as the possibility or use of pre-confirmation settlements and settlements utilizing federal securities laws to satisfy the claims of public debt holders. Under this decision, such settlements are not subject to the protections or restrictions imposed by the plan confirmation and disclosure process under the Bankruptcy Code and, thus, may be easier to effectuate prior to confirmation. This decision stands for the proposition that a settlement can be approved when two separate classes of

noteholders receive a disparate effective recovery, despite the fact that such holders were within the same creditor class and such disparate treatment may not be approved in the context of a contested confirmation.