IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
Richmond Division

In re:	Chapter 11
GUITAR CENTER, INC., *et al.*,[1]	Case No. 20-34656 (KRH)
Debtors.	(Jointly Administered)

OBJECTION OF THE UNITED STATES TRUSTEE TO CONFIRMATION OF THE PLAN AND RELATED RELIEF

John P. Fitzgerald, III, Acting United States Trustee for Region 4 (the "United States Trustee"),[2] through counsel, in furtherance of the duties and responsibilities set forth in 28 U.S.C. §§ 586(a)(3) and (5) and pursuant to 11 U.S.C. § 307, the Federal Rules of Bankruptcy Procedure, and the Local Bankruptcy Rules for this District, hereby files this objection to the confirmation of the Joint Pre-Packaged Chapter 11 Plan of Reorganization of Guitar Center, Inc. *et al*. filed on November 22, 2020 (the "Plan"). *See* ECF Doc. No. 16. In support of his objection, the United States Trustee states:

[1] A complete list of each of the Debtors in these chapter 11 cases may be obtained on the website of the Debtors' claims and noticing agent at http://cases.primeclerk.com/guitarcenter. The location of Debtor Guitar Center, Inc.'s principal place of business and the Debtors' service address in these chapter 11 cases is 5795 Lindero Canyon Rd., Westlake Village, CA 91362.

[2] Unless otherwise defined herein, capitalized terms shall have the definition assigned to them in the Disclosure Statement or the Plan.

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PRELIMINARY STATEMENT

The Debtors' plan to emerge from Chapter 11 provides insufficient time for the parties-in-interest, governmental agencies, and the Court to evaluate or object to the Plan. While the Bankruptcy Code authorizes pre-packaged plans in which much of the activity precedes the filing of the Chapter 11 petition, the Code does not authorize debtors to ignore basic principles of due process in violation of the rights of creditors and other stakeholders.

The Debtors ask this Court to approve confirmation of their Prepackaged Plan and Disclosure Statement less than a month after the cases filed. But the parties in interest have a deadline to object to the Plan and Disclosure Statement of a mere 19 days – without even taking into account the intervening weekends and holidays. In addition, parties in interest will not have access to the Plan Supplement, containing crucial information, until three days before the deadline to object to confirmation.

The Plan in its current form is unconfirmable as certain contains provisions fail to comply with applicable provisions of the Bankruptcy Code.

- The Plan contains overbroad and impermissible release, injunction and exculpation provisions.
- The Plan contains an improper designation of certain classes as "unimpaired" and improperly denied entities included in such classes of claims the right to vote.
- The Plan may contain an impermissible request for approval of certain Management Incentive Plan provisions and assumption of Benefit Programs which violate Section 503(c) of the Bankruptcy Code.

JURISDICTION, VENUE & CONSTITUTIONAL AUTHORITY TO ENTER A FINAL ORDER

1. The Court has jurisdiction to consider this matter under 28 U.S.C. §§ 157 and 1334. This is a core proceeding under 28 U.S.C. § 157(b)(1). Venue is proper in this district under 28 U.S.C. § 1408. The Court has constitutional authority to enter a final order in this matter. If it

is determined that the bankruptcy judge does not have the constitutional authority to enter a final order or judgment in this matter, the United States Trustee consents to the entry of a final order or judgment by this Court in this matter.

2. John P. Fitzgerald, III is the acting United States Trustee for Region 4, which includes Richmond, under 28 U.S.C. § 581(a)(7). Pursuant to 11 U.S.C. § 307, the United States Trustee has standing to appear and be heard on any issue in a case or proceeding under the Bankruptcy Code.

3. Pursuant to 28 U.S.C. § 586(a)(3), the United States Trustee is statutorily obligated to monitor the administration of cases commenced under the Bankruptcy Code, 11 U.S.C. § 101 *et seq*. Specifically, he is charged with several supervisory responsibilities in reorganization bankruptcy cases under chapter 11 of the Bankruptcy Code, including monitoring plans and disclosure statements filed in chapter 11 cases. 28 U.S.C. § 586(a)(3)(B).

FACTUAL BACKGROUND

I. General Background

4. On November 21, 2020 (the "Petition Date"), Guitar Center, Inc. and certain of its affiliated companies (collectively, the "Debtors") commenced voluntary cases under Chapter 11 of the Bankruptcy Code. ECF Doc. No. 1. The Debtors are authorized to continue to operate their business and manage their properties as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code.

5. By order entered on November 24, 2020, the Court authorized joint administration of the cases for procedural purposes. ECF Doc. No. 63.

6. To date, no trustee or examiner has been appointed in these chapter 11 cases.

7. On the Petition Date, the Debtors filed voluminous documents along with the Plan and Disclosure Statement, including a restructuring support agreement (the "RSA"). See Declaration of Tim Martin of Guitar Center, Inc. in Support of Chapter 11 Petitions and First Day Motions (the "Martin Declaration"), ECF Doc. No. 19.

8. On November 13, 2020, the Debtors and their key stakeholders executed the RSA outlining the key terms of the Plan and comprehensive debtor in possession financing arrangements. *See* Martin Declaration at ¶ 4. The RSA provides for, among other things: (a) an equity infusion of up to $165 million, from a consortium of parties including the Debtors' existing equity sponsor and two co-investors; (b) $375 million in Debtor-in-Possession financing provided by certain of its existing noteholders and ABL lenders; (c) and a potential capital raise of $335 million in new secured notes. *Id.* at ¶ 8. The Debtors have commenced these chapter 11 cases to implement the RSA and "prepackaged" chapter 11 Plan which was supported by major stakeholders. *Id.*

II. Restructuring Pursuant to Prepackaged Plan

9. As set forth in the RSA and as summarized in the Martin Declaration, the Debtors and the parties in support of the RSA agreed to mutually support confirmation of the Plan and the consummation of the restructuring transactions, which contemplate, among other things:

- the entry into the $325 million Term DIP Facility, which will be refinanced with the proceeds of the New Common Equity investment, the New First Lien Debt and/or the New ABL Facility, with Claims arising from the Term DIP Facility to be repaid in full in cash on the Effective Date;
- the entry into the $50 million ABL DIP Facility, which will be refinanced with the proceeds of the New ABL Facility, with any Claims arising from the ABL DIP Facility to be repaid in full in cash on the Effective Date;
- the entry, upon emergence from the Chapter 11 Cases, into the $375 million New ABL Facility;

- the issuance, upon emergence from the Chapter 11 Cases, of the $335 million New First Lien Debt;

- the issuance, upon emergence from the Chapter 11 Cases, of $160 million in new preferred equity of the reorganized company (the "New Preferred Equity") to satisfy, along with an aggregate $450 million cash distribution, Secured Notes Claims (whose holders may further elect to participate in a "cash out" option for up to $30 million of their New Preferred Equity);

- the issuance, upon emergence from the Chapter 11 Cases, of $2 million in new junior preferred equity of the reorganized company (to the holders of prepetition Unsecured Notes;

- the $165 million New Common Equity investment by the Investor Support Parties (subject to reduction in accordance with the Restructuring Support Agreement) in exchange for: (a) 100% of the common equity of the Reorganized Company, to be issued upon emergence from the Chapter 11 Cases and subject to dilution by a new management incentive plan, new warrants and all subsequent issuances of common equity; and (b) new warrants to purchase New Common Equity;

- the satisfaction of Prepetition ABL Claims by the Effective Date;

- the satisfaction of Superpriority Secured Notes Claims by the Effective Date; and

- the unimpairment of General Unsecured Claims.

10. The Plan provides that the holders of specific classes of Claims and Interests are presumed to accept or deemed to reject the Prepackaged Plan (collectively, the "Non-Voting Holders"). *See* Plan at Art. II.B and II.C. Specifically, the Plan provides that holders of Claims in Class 1 (Other Priority Claims), Class 2 (Prepetition ABL Claims), Class 3 (Superpriority Secured Notes Claims), Class 5 (Other Secured Claims Claims), and Class 7 (General Unsecured Claims) are unimpaired. Class 10 (Existing Common Equity) will receive nothing on account of their Interests, and so will be deemed to reject the Plan. *Id.* Classes 8 (Intercompany Claims) and 9 (Intercompany Interests) are either unimpaired or deemed to reject as well. *Id.* Thus, holders of Claims and Interests in each of the above-mentioned "unimpaired" Classes are

conclusively presumed to accept or reject the Plan and, therefore, are not entitled to vote. *Id.* Accordingly, Class 4 (Secured Notes Claims) and Class 6 (Unsecured Notes Claims) are the only two classes entitled to vote under the Plan. *Id.*

Releases and Exculpation Provisions

11. The Plan provides for broad releases and exculpations. Specifically, Article IX.B.2 of the Plan provides for the following third-party releases:

> **Releases by Holders of Claims and Interests of the Debtors**
>
> As of the Effective Date, each Releasing Party is, and is deemed to have released and discharged each Debtor, Reorganized Debtor, and Released Party[3] from any

[3] In turn, the terms "Released Parties" and "Releasing Parties" are defined in Article I.A.135 and I.A.136 of the Plan as follows:

> 135. "**Released Parties**" means, collectively, and in each case solely in its capacity as such: (a) the Creditor Support Parties; (b) the Investor Support Parties; (c) the Trustees under the Indentures; (d) the DIP Secured Parties; (e) the Term DIP Commitment Parties; (f) the Prepetition ABL Agent and the Prepetition ABL Lenders; (g) the New ABL Agent and the New ABL Lenders; (h) all holders of Claims and Interests who vote to accept the Plan; (i) all holders of Claims in voting classes who abstain from voting on the Plan <u>and</u> who do not opt out of the releases provided by the Plan; (j) all holders of Claims in voting classes who vote to reject the Plan <u>and</u> who do not opt out of the releases provided by the Plan; (k) with respect to each of the Debtors, the Reorganized Debtors, and each of the foregoing entities in clauses (a) through (j), each such Entity's current and former predecessors, successors, Affiliates (regardless of whether such interests are held directly or indirectly), subsidiaries, direct and indirect equity holders, funds, portfolio companies, management companies; and (l) with respect to each of the Debtors, the Reorganized Debtors, and each of the foregoing Entities in clauses (a) through (k), each of their respective current and former directors, officers, members, employees, partners, managers, independent contractors, agents, representatives, principals, professionals, consultants, financial advisors, attorneys, accountants, investment bankers, and other professional advisors. Each of the Released Parties shall be referred to as a "Released Party." Notwithstanding the foregoing, any holder of a Claim or Interest that objects to the Plan (and thereby opts out of the releases) or otherwise opts out of the releases shall not be a "Released Party."
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> 136. "**Releasing Party**" means, collectively, and in each case solely in its capacity as such: (a) the Creditor Support Parties; (b) the Investor Support Parties; (c) the Trustees under the Indentures; (d) the DIP Secured Parties; (e) the Term DIP Commitment Parties; (f) the Prepetition ABL Agent and the Prepetition ABL Lenders; (g) the New ABL Agent and the New ABL Lenders; (h) all holders of Claims and Interests who vote to accept the Plan; (i) all holders of Claims in classes that are deemed to accept the Plan; (j) all holders of Claims in voting classes who abstain from voting on the Plan <u>and</u> who do not opt out of the releases provided by the Plan; (k) all holders of Claims in voting classes who vote to reject the Plan <u>and</u> who do not opt out of the releases provided by the Plan; (l) all other holders of Claims and Interests to the fullest extent permitted by law; (m) with respect to each of the foregoing entities in clauses (a) through (l), each such Entity's current and former predecessors, successors, Affiliates (regardless of whether such interests are held

and all Causes of Action, including any derivative claims asserted on behalf of the Debtors, that such Entity would have been legally entitled to assert (whether individually or collectively), based on or relating to, or in any manner arising from, in whole or in part:

- the Debtors, the Debtors' in- or out-of-court restructuring efforts, intercompany transactions, the formulation, preparation, dissemination, negotiation, or filing of the Restructuring Support Agreement, the DIP Facilities, the New ABL Facility, the Prepetition ABL Loan Documents, the Disclosure Statement, or the Plan;

- any restructuring, contract, instrument, release, or other agreement or document (including providing any legal opinion requested by any Entity regarding any transaction, contract, instrument, document, or other agreement contemplated by the Plan or the reliance by any Released Party on the Plan or the Confirmation Order in lieu of such legal opinion) created or entered into in connection with the Restructuring Support Agreement, the DIP Facilities, the New ABL Facility, the Prepetition ABL Loan Documents, the Disclosure Statement, or the Plan;

- the Chapter 11 Cases, the DIP Facilities, the Prepetition ABL Loan Documents, the Disclosure Statement, the Plan, the filing of the Chapter 11 Cases, the pursuit of confirmation of the Plan, the pursuit of consummation of the Plan, the administration and implementation of the Plan, including the issuance or distribution of securities pursuant to the Plan, or the distribution of property under the Plan or any other related agreement;

- any securities issued by the Debtors, the ownership thereof, and the assertion or enforcement of rights and remedies thereunder against the Debtors; any Avoidance Actions; and the Indentures; or

- any other act or omission, transaction, agreement, event or other occurrence taking place on or before the Effective Date, in each case related to the foregoing clause (i) through (iv).

Notwithstanding anything to the contrary in the foregoing, the releases set forth above do not release (i) any post-Effective Date obligations of any party or Entity under the Plan, any Restructuring Transaction, or any document, instrument, or agreement (including those set forth in the Plan Supplement) executed to implement the Plan or (ii) the rights of any holder of allowed Claims to receive distributions under the Plan.

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directly or indirectly), subsidiaries, direct and indirect equity holders, funds, portfolio companies, management companies; and (n) with respect to each of the foregoing Entities in clauses (a) through (m), each of their respective current and former directors, officers, members, employees, partners, managers, independent contractors, agents, representatives, principals, professionals, consultants, financial advisors, attorneys, accountants, investment bankers, and other professional advisors. Each of the Releasing Parties shall be referred to as a "Releasing Party."

12. Article IX.A of the Plan, provides for the following exculpation provisions:

Exculpation

Except as otherwise specifically provided in the Plan, no Exculpated Party[4] shall have or incur, and each Exculpated Party is hereby released and exculpated from any Cause of Action for any Claim related to any act or omission in connection with, relating to, or arising out of, the Chapter 11 Cases, the formulation, preparation, dissemination, negotiation, filing, or termination of the Restructuring Support Agreement and related prepetition transactions, the Disclosure Statement, the Plan, or any Restructuring Transaction, contract, instrument, release, or other agreement or document (including providing any legal opinion requested by any Entity regarding any transaction, contract, instrument, document, or other agreement contemplated by the Plan or the reliance by any Exculpated Party on the Plan or the Confirmation Order in lieu of such legal opinion) created or entered into in connection with the Disclosure Statement or the Plan, the filing of the Chapter 11 Cases, the pursuit of confirmation of the Plan, the pursuit of consummation of the Plan, the administration and implementation of the Plan, including the issuance of securities pursuant to the Plan, or the distribution of property under the Plan or any other related agreement, except for claims related to any act or omission that is determined in a final order to have constituted actual fraud, willful misconduct, or gross negligence, but in all respects such Entities shall be entitled to reasonably rely upon the advice of counsel with respect to their duties and responsibilities pursuant to the Plan. The Exculpated Parties have, and upon completion of the Plan shall be deemed to have, participated in good faith and in compliance with the applicable laws with regard to the solicitation of, and distribution of, consideration pursuant to the Plan and, therefore, are not, and on account of such distributions shall not be, liable at any time for the violation of any applicable law, rule, or regulation governing the solicitation or such distributions made pursuant to the Plan.

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[4] Article I.A.64 of the Plan defines "Exculpated Parties" as follows:

"**Exculpated Parties**" means, collectively, and in each case solely in its capacity as such: (a) the Debtors and Reorganized Debtors; (b) the Creditor Support Parties; (c) the Investor Support Parties; (d) the Trustees under the Indentures; (e) the DIP Secured Parties; (f) the Term DIP Commitment Parties; (g) with respect to each of the foregoing entities in clauses (a) through (f), each such Entity's current and former predecessors, successors, Affiliates (regardless of whether such interests are held directly or indirectly), subsidiaries, direct and indirect equity holders, funds, portfolio companies, management companies; and (h) with respect to each of the foregoing Entities in clauses (a) through (g), each of their respective current and former directors, officers, members, employees, partners, managers, independent contractors, agents, representatives, principals, professionals, consultants, financial advisors, attorneys, accountants, investment bankers, and other professional advisors. Each of the Exculpated Parties shall be referred to as an "Exculpated Party."

Management Incentive Plan and Benefit Programs

13. The Plan and Disclosure Statement include provisions regarding the implementation of a "Management Incentive Plan"[5] as well as the assumption of "Compensation and Benefit Programs."[6] *See* Plan at Art. IV.J and V.G. More specifically, the Plan provides:

> **Management Incentive Plan**
> On or after the Effective Date, the Reorganized Debtors shall adopt and implement the Management Incentive Plan on terms and conditions reasonably acceptable to the Reorganized Debtors and each of the Investor Support Parties (and, solely to the extent the MIP will have an adverse economic impact on the New Preferred Equity, the Required Secured Notes Support Parties), in each case with respect to the amount and form of the equity granted.

See Plan at Art. IV.J.

14. Moreover, as to the Benefit Programs, the Plan contemplates that they will all be assumed on the Effective Date:

> **Compensation and Benefit Programs**

[5] Article I.A.87 of the Plan defines "**Management Incentive Plan**" as:

> [T]he Management Incentive Plan to be implemented with respect to Reorganized Guitar Center on or after the Effective Date, reserving exclusively for directors and management employees a pool of shares of new common stock (or equivalent equity units) representing 10-12% of the New Common Equity (calculated on a fully diluted basis), with the final amount of such pool being reasonably acceptable to the Debtors and each of the Investor Support Parties.

See Plan at Art.I.A.87.

[6] The term "**Benefit Programs**" is broad and encompasses the following:

> all contracts, agreements, arrangements, policies, programs and plans for employee compensation, including bonuses, incentive, retention, reimbursement, health care benefits, disability benefits, deferred compensation benefits, travel benefits, vacation and sick leave benefits, employment agreements, savings, severance benefits, retirement benefits, welfare benefits, relocation programs, life insurance and accidental death and dismemberment insurance.

See Plan at Art. I.A.27.

> On the Effective Date, all Benefit Programs as in effect as of immediately prior to the Effective Date shall be deemed to be, and shall be treated as, assumed executory contracts under this Plan and, on the Effective Date, shall be assumed pursuant to sections 365 and 1123 of the Bankruptcy Code.

ARGUMENT

The Plan in its current form cannot be confirmed because the assumption of insider benefit programs violates section 1129(a)(1), the proposed third-party releases and exculpation clauses are overly broad, and relevant information is missing. Confirmation should be denied. Alternatively, the Court should strike the offending provisions from the Plan and require the debtors provide additional information.

I. Legal Framework

Approval of a disclosure statement is appropriate only if it provides “adequate information” so that “a hypothetical investor typical of the holders of claims or interests” in the case can make an informed decision on whether they should support a proposed chapter 11 plan. *See* 11 U.S.C. § 1125(a), (b); *see also In re Mohammad*, 596 B.R. 34, 39 (Bankr. E.D.Va. 2019). “Adequate information” has been described as “all information that is reasonably necessary to permit creditors and parties-in-interest to fairly and effectively evaluate the plan.” *In re Robert’s Plumbing & Heating, LLC*, No. 10-23221, 2011 WL 2972092, at * 2 (Bankr. D. Md., July 20, 2011). “The determination of whether the disclosure statement has adequate information is made on a case by case basis and is largely within the discretion of the bankruptcy court.” *Menard–Sanford v. Mabey* (*In re A.H. Robins Co.*), 880 F.2d 694, 696 (4th Cir. 1989).

The debtors bear the burden of “proving the adequacy of its disclosure statement.” *In re Bellows*, 554 B.R. 219, 225 (Bankr. D.Alaska 2016); *see also In re American Capital Equipment, LLC*, 688 F.3d 145, 155 (3d Cir. 2012) (citations omitted).

In turn, the Court must find that each applicable provision of section 1129 is satisfied to

confirm a chapter 11 plan. *See In re Aspen Village at Lost Mountain*, 609 B.R. 555, 563 (Bankr. N.D.Ga. 2019); *see also In re Experient, Corp*., 535 B.R. 386, 400-01 (Bankr. D.Colo. 2015). To that end, courts have a duty “to undertake an independent evaluation of the debtor's plan to determine if it complies with section 1129 even in the absence of an objection by a creditor.” *In re Gyro-Trac (USA), Inc*., 441 B.R. 470, 477 (Bankr. D.S.C. 2010) (citations omitted); *see also In re South Beach Securities, Inc*., 606 F.3d 366, 371-72 (7th Cir. 2010).

The Debtors bear the burden to “demonstrate by a preponderance of the evidence that its plan meets all the requirements of the Code.” *In re Byrd Foods, Inc*., 253 B.R. 196, 199 (Bankr. E.D.Va. 2000) (citations omitted); *see also In re Mohammad*, 596 B.R. 34, 39 (Bankr. E.D.Va. 2019) (citations omitted).

A. The Creditors That the Debtors Describe As “Unimpaired” May, In Fact, Be Impaired

Under the Bankruptcy Code, classes of creditors not impaired by a Plan are deemed to have accepted the Plan. 11 U.S.C. § 1127(f). However, whether a creditor is, in fact, “impaired” under a plan requires more than a simple determination as to whether the creditor is to be paid in full under the plan. *See In re Chassix Holdings*, 533 B.R. 64, 81 (Bankr. S.D.N.Y. 2015). In *Chassix*, the court stated that “it is difficult to understand how . . . a creditor” can be described as unimpaired if, in exchange for payment of its claim, that creditor “must release a claim against a third party under a plan. . . .” noted, [m]any courts have held that . . . an impaired class of creditors also is presumed to have consented to any third-party releases. . . .” *Id.* Under *Chassix*, then, “unimpaired creditors should not be deemed to have consented to the third-party releases set forth in the Plan.” *Id.*; *see also In re Genco Shipping & Trading Ltd.,* 513 B.R. 233, 270 (Bankr. S.D.N.Y. 2014) (classifying parties as unimpaired “does not mean that they should be somehow automatically deemed to grant a release. . . .”). In other words, full payment to a creditor is not the end-all be-all to a determination of whether a creditor is impaired. *See*

Chassix, 533 B.R. at 81. Accordingly, before the Debtors rush to the conclusion that little or no post-petition notice is required to confirm a plan in a prepackaged case, they must reckon with the fact that confirmation of a Chapter 11 plan requires an opportunity for all parties-in-interest to be heard on all of the plan's provisions.

Here, the members of "unimpaired" classes are deemed to accept the Plan – without being afforded sufficient opportunity to review the voluminous papers filed in this case – including the third-party release and exculpation provisions. Specifically, with respect to the release provisions, injunction and exculpation provisions, these Non-Voting Holders are being deprived of their rights against third parties on a non-consensual basis. This fact calls into question whether they are, in fact, "unimpaired". *See Chassix,* 533 B.R. at 81.

Moreover, the Disclosure Statement fails to adequately describe the proposed third-party releases as it relates to "unimpaired" creditors. *See In re Lower Bucks Hosp*., 471 B.R. 419, 459-60 (Bankr. E.D.Pa. 2012) (third-party release disclosures inadequate where the debtor "failed to provide the [creditors] with any information regarding the merits or value of the claims against [a third party] that would be released by the plan.").

B. The Third-Party Releases and the Exculpation Provisions Do Not Satisfy 11 U.S.C. §§ 1129(a)(1) and 1129(a)(3)

The Disclosure Statement and Plan contain provisions for the release and exculpation of various non-debtor parties by other non-debtor parties. *See* Plan at Art. IX.A and IX IX.B.2. The Debtors have not demonstrated the appropriateness of these provisions.

The provisions contemplated for in the Plan cause many holders of claims or interests to release and hold harmless non-debtor parties from any liability for anything occurring prior to the Effective Date <u>unless</u> they opt-out of such releases or are deemed to reject the Plan. More specifically, the Plan appears to (1) indicate that those that are deemed to accept the Plan or vote

in favor of the Plan are also deemed to have consented to the third party releases; (2) require that those in voting classes who reject the Plan expressly opt-out of the releases; and (3) require that, in order not to be deemed as having consented to the third party releases, to the extent anyone is entitled to vote, they should return a ballot clearly opting out. *See supra* fn. 3.

Although there is no *per se* prohibition against imposing releases of non-debtors by other non-debtors, those releases are not appropriate in every case, or even in most cases. *See In re A.H. Robins Co., Inc.*, 880 F.2d 694, 702 (4th Cir. 1989). Whether such releases and exculpatory clauses are appropriate is dependent upon the facts and circumstances of each case. *Behrmann v. National Heritage Foundation*, 663 F.3d 704, 711 (4th Cir. 2011). Approval of non-debtor releases and exculpatory clauses "should be granted cautiously and infrequently." *Id.* at 712.

In *Behrmann*, the Fourth Circuit enumerated several factors that should be considered in determining whether third-party releases are appropriate, including but not limited to the following:

> (a) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate;
>
> (b) The non-debtor has contributed substantial assets to the reorganization;
>
> (c) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;
>
> (d) The impacted class, or classes, has overwhelmingly voted to accept the plan;
>
> (e) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction;
>
> (f) The plan provides an opportunity for those claimants who choose not to settle to recover in full;
>
> (g) The bankruptcy court made a record of specific factual findings that

support its conclusions;

(h) A close connection between the causes of action against the third party and the causes of action against the debtor; and

(i) The plan of reorganization provides for payment of substantially all the claims affected by the injunction.[7]

To approve third-party releases, the bankruptcy court must "find facts sufficient to support its legal conclusion that a particular debtor's circumstances entitle it to such relief." *Behrmann*, 663 F.3d at 706-07. Indeed, in *Behrmann*, the Fourth Circuit reversed the bankruptcy court's legal conclusion that the releases at issue there were "essential" and "integral" to the transactions contemplated in the plan because the Court failed to support its conclusions with concrete factual findings. *Id.* at 708, 712-13 (record citations omitted).[8] On remand, the bankruptcy court, applying the factors set forth in the *Behrmann* opinion, determined that the facts did not support allowing the releases. That finding was affirmed by both the District Court and the Fourth Circuit. *National Heritage Foundation, Inc. v. Highbourne Foundation*, 760 F.3d 344, 347, 352 (4th Cir. 2014). Thus, a plan containing such release provisions cannot be confirmed in the absence of a significant evidentiary presentation demonstrating facts supporting such relief. *Behrmann*, 663 F.3d at 713.

1. The Proposed "Opt-Out" Procedure Regarding the Releases is Insufficient to Demonstrate Consent

The Debtors appear to be taking the position that the third-party releases described in the

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[7] The Fourth Circuit compiled this non-exhaustive list from *Class Five Nev. Claimants v. Dow Corning Corp.* (*In re Dow Corning Corp.*), 280 F.3d 649, 658 (6th Cir. 2002), and *In re Railworks Corp.*, 345 B.R. 529, 536 (Bankr. D. Md. 2006). The Fourth Circuit described these factors as "instructive." *Behrmann*, 663 F.3d at 712.

[8] According to the Fourth Circuit, the Bankruptcy Court's conclusions were "meaningless in the absence of specific factual findings explaining" them. *Behrmann*, 663 F.3d at 713. Thus, among the Fourth Circuit's instructions to the Bankruptcy Court on remand was, "to set forth specific factual findings supporting its conclusions." *Id.*

Disclosure Statement and Plan are consensual under the circumstances. Under the Plan, the Disclosure Statement, and the Scheduling Order, the third-party releases would be effective against any creditor or interest holder that (a) is deemed to accept the Plan (b) is in a voting class but abstains from voting on the Plan and does not opt out of the releases; and (c) who votes to reject the Plan and does not opt out of the third party releases.

Although some courts have permitted third-party releases in a chapter 11 plan based upon consent alone, the Fourth Circuit does not appear to be one of those courts. In *Behrmann,* the Fourth Circuit stated that consent is one fact that the Court should consider in determining whether to permit third party releases. *Behrmann*, 663 F.3d at 712 ("No case has tolerated nondebtor release absent the finding of circumstances that may be characterized as unique."). Even those cases that have allowed third-party releases based upon consent alone have varied on what is required to demonstrate consent. What courts have made clear, however, is that releases of non-debtors must be accompanied by the releasing creditors' "unambiguous" consent. *See In re Congoleum Corp.*, 362 B.R. 167, 194 (Bankr. D.N.J. 2007) (quoting *In re Arrowmill Dev. Corp.*, 211 B.R. 497, 507 (Bankr. D.N.J. 1997) (for a release to be consensual, the creditor must have "unambiguously manifested assent to the release of the nondebtor from liability on its debt.")); *see also In re SunEdison*, 576 B.R. 453 (Bankr. S.D.N.Y. 2017); *In re Chassix Holdings, Inc.,* 533 B.R. 64 (Bankr. S.D.N.Y. 2015). In other words, silence is not consent when a party has no duty to speak. *See SunEdison*, 576 B.R. at 458; *In re Washington Mutual, Inc.*, 442 B.R. 314, 355 (Bankr. D. Del. 2011) (holding that mere "opt out" procedures were insufficient, particularly with respect to creditors who did not return ballots); *In re Oneida Ltd.*, 351 B.R. 79, 94 (Bankr. S.D.N.Y. 2006); *In re Arrowmill Dev. Corp.,* 211 B.R. at 507.

More recently, the court in *In re Chassix Holdings, Inc.* mentioned above was faced with

a similar issue and ultimately held that the releases would only apply to (a) any holder of a claim who voted to accept the plan and (b) any holder of a claim who voted to reject the plan but who affirmatively elected to provide the releases by checking the appropriate box on the ballot form – or, in other words, "opted in" the releases. 553 B.R. at 82. With respect to creditors who were entitled to vote but abstained, the court noted:

> [U]nder the circumstances of this case it would be inappropriate to treat such inaction as a "consent" to third party releases. . . . The relatively small recoveries that were initially proposed, and the widely-publicized fact that other creditor groups had endorsed the proposed Plan, could easily have prompted an even higher-than-usual degree of inattentiveness or inaction among affected creditors in these cases. Furthermore, many creditors may simply have assumed that a package that related to the Debtors' bankruptcy case must have related only to the dealings with the Debtors and would not affect their claims against other parties. Charging all inactive creditors with full knowledge of the scope and implications of the proposed third party releases, and implying a "consent" to the third party releases based on the creditors' inactions, is simply not realistic or fair, and would stretch the meaning of "consent" beyond the breaking point.

Id. at 80-81; *see also In re Emerge Energy Services LP,* No. 19-11563, 2019 WL 7634308, at *23 (Bankr. D.Del. Dec. 5, 2019) ("[T]he Court cannot on the record before it find that the failure of a creditor or equity holder to return a ballot or Opt-Out Form manifested their intent to provide a release. Carelessness, inattentiveness, or mistake are three reasonable alternative explanations.").

The "opt out" procedures are also problematic in that creditors may be "caught asleep at the switch." If a creditor is truly consenting to the release provisions, then that creditor will have no problem "opting in" to the provision. As discussed above, *Behrmann* makes clear that third-party releases are to be approved only in extraordinary circumstances. Such releases are the exception, not the rule. If, however, the Court permits such releases by consent alone, and particularly by consent manifested merely by the failure to opt-out, those provisions will become

the norm and will be included in every chapter 11 plan. Indeed, if the Court allows confirmation of plans including such provisions based solely on the failure to affirmatively "opt out," there is no reason for a debtor to ever leave such a provision out of the plan since that debtor is likely to get at least a few creditors to inadvertently "consent" to the releases. What renders the opt-out process even less consensual in this case is the fact that, as set forth above, the Debtors have sought to shorten substantially the deadline to vote on the Plan. Moreover, some creditors, such as landlords whose leases are rejected, may be deemed to consent to the Third Party Releases without even knowing if their lease is to be assumed or rejected. If the Court is inclined to allow releases by consent alone, the Court should follow those courts that require strict evidence of actual consent by the affected parties. Said differently, the United States Trustee requests that the third-party releases be deemed consensual only by parties that have voted to accept the Plan.

Moreover, the scope of the release is unlimited, and would include claims for fraud, breach of fiduciary duty, willful misconduct, and violations of various laws and regulations, including securities laws. Section 523(a) of the Bankruptcy Code excepts from discharge a variety of debts, including debts for fraud, breach of fiduciary duty, willful misconduct, and violations of securities laws. *See* 11 U.S.C. §§ 523(a)(2), (a)(4), (a)(6) and (a)(19). Thus, a bankruptcy court is not authorized by section 105(a) to grant to a ***non- debtor*** the protections that Congress has expressly denied to the debtor, who has subjected all of its assets to the jurisdiction of the bankruptcy court. For these reasons the third-party releases and exculpation provisions should be stricken.

2. The Debtors Are Unlikely to Be Able to Satisfy the Behrmann Factors

The debtors have not established that the third-party release provisions satisfy the *Beherman* factors. This is a fact-intensive inquiry that requires the support of an extensive

evidentiary record. *Behrmann,* 663 F.3d at 712-13. At this point, the Court has not yet held such an evidentiary hearing and the Debtors have not had an opportunity to present any evidence. Moreover, neither the Plan nor the accompanying disclosure statement discuss how the releases meet the requirement articulated by the Fourth Circuit case law. Based on the record existing in this case, it does not appear that the Debtors could present sufficient evidence to satisfy the *Behrmann* test.

Among other things, neither the disclosure statement nor the Plan – or any other documents filed to date for that matter – support the fact that there exists an identity of interest between the Debtors and the myriad of Released Parties. Second, it is not clear how each party being released has contributed substantial assets to the Debtors' reorganization. Third, the third party releases, as discussed at length above, impact all classes – including the Non-Voting Holders. Moreover, even if the impacted claimants do vote overwhelmingly to support the Plan, the Fourth Circuit has counseled that this factor is marginal at best. *Highbourne Foundation*, 760 F.3d at 350. "Creditor support does not make up for the fact that most of the other ... factors weigh against enforcing the Release Provision." *Id.* As to the remaining factors under *Behrmann*, the Plan does not envision paying all of the classes impacted by the releases in full nor does it provide an opportunity for those claimants who choose not to settle to recover in full.

Thus, the United States Trustee submits that the third party release provisions are impermissible as a matter of law under applicable Fourth Circuit case law. To the extent the Court is inclined to allow releases by consent alone, the UST requests that the Court follow those courts that require strict evidence of actual consent by the affected parties.

3. *The Exculpation Clauses are Impermissibly Broad*

The exculpation clause here is impermissibly broad on its face because, *inter alia*, (i) it is

too broad in respect to who is exculpated (for example, it exculpates entities such as the Creditor Support Parties and the Investor Support Parties and all their current and former predecessors, successors and affiliates); (ii) it does not provide an exception allowing for suits against the exculpated parties where prior court approval is obtained; (iii) it extends to prepetition acts; and (iv) it does not include protection from the breaches or violations of the Exculpated Parties' professional responsibilities.

This Court has previously held that exculpation provisions are permissible only if they are "properly limited and not over broad." *In re National Heritage Foundation, Inc.*, 478 B.R. 216, 234 (Bankr. E.D.Va. 2012), *aff'd, National Heritage Foundation v. Highbourne Foundation*, 760 F.3d 344 (4th Cir. 2014). This Court adopted a multiprong test in evaluating whether a proposed exculpation clause is appropriate including: (a) narrowly tailored to meet the needs of the bankruptcy estate; (b) limited to parties who have performed necessary and valuable duties in connection with the case; (c) limited to acts and omissions taken in connection with the bankruptcy case; and (d) must not purport to release any pre-petition claims. *Id.*

Here, the proposed exculpation clause is not narrowly tailored to meet the needs of the bankruptcy estates and is not limited to parties who have performed necessary and valuable duties in connection with the cases. The exculpation extends to actions taken or omitted regarding prepetition transactions beyond those related to the solicitation of the Plan and does not limit the exculpated actions to ones that occurred post-petition. *See supra* at ¶ 12. For example, exculpated acts extend to the formulation, preparation, dissemination, negotiations of the Restructuring Support Agreement "and related prepetition transactions". The Disclosure Statement and Plan do not describe or disclose what transactions are covered under the phrase "related prepetition transactions."

Furthermore, the term "Exculpated Parties" extends to parties that may be neither creditors nor professionals and may involve people who had no direct involvement with any action taken during the pendency of the bankruptcy proceedings. *See* Plan ¶ 1(A)(64). The Plan also proposes to exculpate the "Reorganized Debtors" which will not be in existence until after the Effective Date of the Plan. As this Court previously recognized "exculpation is appropriate when it is solely limited to fiduciaries who have served a debtor through a chapter 11 proceeding." *See In re Health Diagnostic Laboratory, Inc*., 551 B.R. 218, 232-33 (Bankr. E.D.Va. 2016) (citations omitted); *In re Alpha Natural Resources, Inc*., 556 B.R. 249, 260 (Bankr. E.D.Va. 2016); *see also In re Fraser's Boiler Service, Inc*., 593 B.R. 636, 642 (Bankr. W.D.Wash. 2018); *In re Washington Mutual, Inc.*, 442 B.R. 314, 348 (Bankr. D. Del. 2011)("[These parties] have not done anything yet for which they need a release. They will not even come into existence until the Plan is confirmed.").

Thus, under the Fourth Circuit standards, these entities have no place in an exculpation clause. Accordingly, the exculpation provision should be amended and limited to fiduciaries that have served in these chapter 11 cases.

4. The Release and Exculpation Clauses Contain no Carve-Out for Governmental Claims

To the extent that the Court allows for any releases or exculpation to the Debtors, the United States Trustee requests that language carving out governmental claims from the proposed releases be included. At a minimum, the Debtors must add language to the Disclosure Statement and Plan substantially in the form set forth below:

> Nothing in this Plan discharges, releases, precludes, or enjoins: (i) any liability to any Governmental Unit that is not a Claim; (ii) any Claim of a Governmental Unit arising on or after the Effective Date; (iii) any police or regulatory liability to a Governmental Unit on the part of any Entity as the owner or operator of property after the Effective Date; or (iv) any liability to a Governmental Unit on the

> part of any Person other than the Debtors. Nor shall anything in the Plan enjoin or otherwise bar a Governmental Unit from asserting or enforcing, outside this Court, any liability described in the preceding sentence. Nothing in this Plan divests any tribunal of any jurisdiction it may have law to adjudicate any defense based on this paragraph of the Plan.

C. The Plan Violates Section 503(c)

The Plan and Disclosure Statement include provisions regarding the implementation of a "Management Incentive Plan" as well as the assumption of "Compensation and Benefit Programs." *See* Plan at Art. IV.J and V.G. Accordingly, if this Court confirms the Plan, then on the Effective Date, the Debtors/Reorganized Debtors will (a) assume existing benefit programs – including bonus, incentive, and severance plans and (b) adopt a Management Incentive Plan ("MIP").

As to the MIP, the Plan here requires that the Reorganized Debtors shall adopt and implement the MIP, following the Effective Date. *See* Plan at Art. IV.J. The MIP reserves 10-12% of the New Common Equity for directors and management employees. While a reorganized debtor's board may normally offer bonuses to employees after bankruptcy for future work without implicating section 503(c), the critical difference here is that the Plan authorizes the MIP and eliminates any discretion by the new board of the Reorganized Debtors not to implement the MIP. Moreover, there is no clarity as to whether the board of the Reorganized Debtors is constituted by the members of the present board or whether the present board is really the one proposing and implementing the MIP which will only go into effect upon the "Effective Date".

The MIP and Compensation and Benefit Programs implicate section 503(c), which cannot be circumvented through the proposed assumption process. *See In re Foothills Texas, Inc.*, 408 B.R. 573, 585 (Bankr. D. Del. 2009) (denying motion to assume pre-petition

employment agreements under section 365 because they did not comply with section 503(c)). Thus, "[i]f the Court determines that an employee is an insider and that the program proposed is primarily retentive, then a plan must meet the requirements of section 503(c)(1)." *In re Residential Capital, LLC*, (*ResCap I*), 478 B.R. 154, 169 (Bankr. S.D.N.Y. 2012) (citations omitted); *see also In re TCI 2 Holdings, LLC*, 428 B.R. 117, 171-72 (Bankr. D.N.J. 2010).

Moreover, section 365 cannot be interpreted as overriding the specific requirements of section 503(c). To be sure, the Supreme Court has admonished lower courts that a specific bankruptcy statute prohibiting certain actions may not be contravened by more general permissive provisions when "Congress has enacted a comprehensive scheme and has deliberately targeted specific problems with specific solutions." *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 645, 132 S.Ct. 2065, 182 L.Ed.2d 967 (2012). The Debtors may not employ the general provisions of section 365 to override the specific provisions of section 503(c).

Consequently, the Plan may not be confirmed absent a showing by the Debtors that the MIP and Compensation and Benefit Programs comply with the applicable provisions of section 503(c). *See Czyzewski v. Jevic Holding Corp.*, __ U.S. __, 137 S.Ct. 973, 979, 197 L.Ed. 2d 398 (2017) (It is not within the province of the court to "deviate from the procedures 'specified by the Code,' even when they sincerely 'believ[e] that ... creditors would be better off[.]") (citations omitted).

D. Provisions Which Require Amendments, Clarifications, or Additional Information.

The UST also objects to the following provisions in the Disclosure Statement and Plan and requests the following information be provided to parties in interest:

1. Management: The Disclosure Statement and Plan fails to provide information regarding

the identity of whom the operation, management, and control of the debtor will be assigned to. Failure to provide information regarding the management and control of the debtor renders the proposed Plan unconfirmable. *See* 11 U.S.C. § 1129(a)(5)(A-B); *see also In re Star Ambulance Service, LLC*, 540 B.R. 251, 261 (Bankr. S.D.Tex. 2015). In the Plan Supplement filed on December 7, 2020, the Debtors include a placeholder for the identity of the new officers and directors, but it is not clear as to when that information will be publicly provided. *See* ECF Doc. No. 183.

2. Timing: Compressing the twenty-eight (28) days' notice requirement for the disclosure statement and the plan to a combined nineteen (19) day notice until the objection deadline, may inhibit creditors' ability to evaluate and protect their rights.

Absent additional disclosures and information, confirmation should be denied.

CONCLUSION AND RESERVATION OF RIGHTS

Considering the foregoing, the Plan cannot be confirmed in its current form. Confirmation should be denied. Alternatively, the Court should strike the offending provisions from the Plan. The United States Trustee reserves his rights to object to other deficiencies at the hearing to the extent the Plan, Disclosure Statement, or Plan Supplement are amended in any way.

Respectfully Submitted,

Dated: December 10, 2020

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CERTIFICATE OF SERVICE

I, , hereby certify that, on **December 10, 2020**, a true copy of the foregoing was delivered via electronic mail pursuant to the Administrative Procedures of the CM/ECF System for the United States Bankruptcy Court for the Eastern District of Virginia to all necessary parties.

/s/Nicholas S. Herron
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