IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	:	Chapter 11
COLT HOLDING COMPANY, LLC, *et al.*,	:	Case No. 15-11296-LSS
Debtors.	:	**Hearing Date: December 16, 2015, at 9:00 AM** **Objections Due: December 9, 2015, at 4:00 PM**

OBJECTION BY THE INTERNAL REVENUE SERVICE TO THE DEBTORS' SECOND AMENDED JOINT PLAN OF REORGANIZATION UNDER CHAPTER 11 OF THE BANKRUPTCY CODE

The United States, on behalf of its Internal Revenue Service ("IRS"), by and through the undersigned attorneys, in support of its objection to the Second Amended Joint Plan of Reorganization under Chapter 11 of the Bankruptcy Code [Docket No. 675] ("Plan"), avers as follows:

1. On June 14, 2015, the debtors filed voluntary bankruptcy petitions seeking relief under Chapter 11 of the Bankruptcy Code.

2. IRS is a creditor and party in interest. IRS has asserted an unsecured priority and general unsecured, pre-petition claim against Colt Security, LLC in the amount of $11,259.24.

3. The IRS objects to the third party non-debtor limitation of liability, exculpation, injunction and release provisions set forth in Section 10 of the Plan. The Plan injunction provisions violate the Anti-Injunction Act, I.R.C. Section 7421(a). See American Bicycle Association v. United States, 895 F.2d 1277 (9th Cir. 1990); United States v. Prescription Home

Health Care, Inc., 316 F.3d 542 (5th Cir. 2002); In re Plainwell, Inc., 2004-2 USTC Paragraph 50, 393 (D. Del. 2004). The Plan currently defines parties to be released as a "Released Party" which means, collectively, (a) all Persons engaged or retained by the Debtors in connection with the Chapter 11 Cases (including in connection with the preparation of, and analyses relating to, the Plan and the Disclosure Statement); (b) the Debtors and Reorganized Debtors; (c) the Term Loan Agent; (d) the DIP Agents; (e) the Term Loan Lenders; (f) the DIP Lenders; (g) the Consortium, and each member of the Consortium; (h) all Holders of Senior Notes to the extent such Holders vote to accept the Plan; (i) the Sciens Group and any other direct or indirect Holders of Equity Interests in Colt Defense LLC; (j) NPA and VALNIC Capital Real Estate Fund I LLC; (k) the Senior Notes Indenture Trustee, (l) each Holder of a Claim or Equity Interest who either votes to accept the Plan or is conclusively presumed to have accepted the Plan; (m) the Committee; (n) all Persons engaged or retained by the parties listed in (b) through (m) of this definition in connection with the Chapter 11 Cases (including in connection with the preparation of and analyses relating to the Plan and the Disclosure Statement); and (o) any and all affiliates, officers, directors, partners, employees, members, managers, members of boards of managers, advisors, attorneys, actuaries, financial advisors, accountants, investment bankers, agents, professionals, and representatives of each of the foregoing Persons and Entities (whether current or former, in each case, in his, her, or its capacity as such). Correspondingly, the release and injunction provisions of the Plan extend its protections to the Released Parties. While the Third Circuit stopped short of adopting a *per se* rule that a non-debtor release in a reorganization plan is not permissible (as other circuits have done), it held that, at most, such a provision could only be valid in "extraordinary" cases. Gillman v. Continental Airlines (In re Continental Airlines), 203 F.3d 203, 212 (3d Cir. 2000). At minimum, Continental held that such a nonconsensual

release of non-debtor entities must contain all of the following "hallmarks": "fairness, necessity to the reorganization, and specific factual findings to support these conclusions." Id. at 214; see also In re: Wash. Mut., Inc., 442 B.R. 314, 351-52 (Bankr. D. Del. 2011) (collecting cases). This Court has interpreted Continental's holding on non-debtor releases to mean that "limiting the liability of non-debtor parties is a *rare thing that should not be considered absent a showing of exceptional circumstances* in which several key factors are present." In re Genesis Health Ventures, Inc., 266 B.R. 591, 608 (Bankr. D. Del. 2001) (emphasis added). This Court has previously held that a non-Debtor release over a creditor's objection "would not pass muster." Wash. Mut., 442 B.R. at 352 ("This Court has previously held that it does not have the power to grant a third party release of a non-debtor."). Where this Court has even contemplated approval of a non-consensual release, it has required the following factors be present to justify the "rare" release: "(1) the non-consensual release was necessary to the success of the reorganization, (2) the releasees have provided a critical financial contribution to the debtor's plan, (3) the releases' financial contribution is necessary to make the plan feasible, and (4) the release is fair to the non-consenting creditors, i.e., whether the non-consenting creditors received reasonable compensation in exchange for the releases." In re Tribune Co., 464 B.R. 126, 177-78 (Bankr. D. Del. 2011); see also Genesis Health Ventures, 266 B.R. at 607-09. 52. Here, setting aside the question of whether the Debtors have made such a showing against all creditors generally (and they have not), the Debtors make no adequate showing of a single factor, let alone all of the Tribune / Genesis factors, that justifies the extraordinary release of non-Debtors with respect to their potential liability to the IRS.

4. IRS objects to the Plan to the extent it fails to preserve the setoff and recoupment rights of the IRS. Confirmation of a plan does not extinguish setoff claims when they are timely

asserted. United States v. Continental Airlines (In re Continental Airlines), 134 F.3d 536, 542 (3d Cir. 1998), cert. denied, 525 U.S. 929 (1998). Like other creditors, the United States has the common law right to setoff mutual debts. "The government has the same right which belongs to every creditor, to apply the unappropriated moneys of his debtor, in his hands, in extinguishment of the debts due to him." United States v. Munsey Trust Co. of Washington, D.C., 332 U.S. 234 (1947) (citing Gratiot v. United States, 40 U.S. (15 Pet) 336, 370, 10 L.Ed. 759 (1841)); see also Amoco Prod. Co. v. Fry, 118 F.3d 812, 817 (D.C. Cir. 1997). This right – "which is inherent in the federal government – is broad and 'exists independent of any statutory grant of authority to the executive branch.'" Marre v. United States, 117 F.3d 297, 302 (5th Cir. 1997) (quoting United States v. Tafoya, 803 F.2d 140 (5th Cir. 1986)). Hence, the United States can setoff mutual prepetition debts and claims as well as postpetition debts and claims. Zions First Nat'l Bank, N.A. v. Christiansen Bros. (In re Davidson Lumber Sales, Inc.), 66 F.3d 1560, 1569 (10th Cir. 1995); Palm Beach County Bd. Of Pub. Instruction (In re Alfar Dairy, Inc.), 458 F.2d 1258, 1262 (5th Cir.), cert. denied, 409 U.S. 1048 (1972); Mohawk Indus., Inc. v. United States (In re Mohawk Indus., Inc.), 82 B.R. 174, 178-79 (Bankr. D. Mass. 1987). The Plan makes no provision for these rights. Such treatment is impermissible, because Section 553 of the Bankruptcy Code preserves the right of setoff in bankruptcy as it exists outside bankruptcy, Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 18 (1995), neither expanding nor constricting it, United States v. Maxwell, 157 F.3d 1099, 1102 (7th Cir. 1998). "[T]he government of the United States suffers no special handicap under § 553 of the Bankruptcy Code," id. at 1103, that alters this principle. Moreover, because "[s]etoff occupie[s] a favored position in our history of jurisprudence," Bohack Corp. v. Borden, Inc., 599 F.2d 1160, 1164 (2d Cir. 1979), courts do not interfere with its exercise absent "the most compelling circumstances."

Niagara Mohawk Power Corp. v. Utica Floor Maintenance, Inc. (In re Utica Floor Maintenance, Inc.), 41 B.R. 941, 944 (N.D.N.Y. 1984); see also New Jersey Nat'l Bank v. Gutterman (In re Applied Logic Corp.), 576 F.2d 952 (2d Cir. 1978) ("The rule allowing setoff ... is not one that courts are free to ignore when they think application would be unjust."). Compelling circumstances generally entail criminal conduct or fraud by the creditor. In re Whimsy, Inc., 221 B.R. 69 (S.D.N.Y. 1998). No such compelling circumstances are present here, and accordingly, the Plan must provide for and preserve the government's setoff rights. Failure to do so violates section 1129(a)(1). ("The court shall confirm a plan only if ... the plan complies with the applicable provisions of this title".)

5. If the IRS priority tax claims are not paid in full in cash on the Effective Date, the IRS objects to Sections 2.2 and 6.12 of the Plan to the extent these provisions fail to comport with 11 U.S.C. Section 1129(a)(9)(C) and Section 511 by not providing for the payment of an adequate rate of interest from the Effective Date on such claims.

6. The IRS objects to the discharge provisions in the Plan to the extent it discharges debts described in 11 U.S.C. Section 1141(d)(6).

7. The IRS objects to Section 11 of the Plan to the extent that it provides for the retention of exclusive jurisdiction over matters involving the IRS. See 28 U.S.C. 1334(b). "Retention of jurisdiction provisions will be given effect, assuming there is bankruptcy court jurisdiction. But neither the bankruptcy court nor the parties can write their own jurisdictional ticket. Subject matter jurisdiction "cannot be conferred by consent" of the parties. Coffin v. Malvern Fed. Sav. Bank, 90 F.3d 851, 854 (3d Cir. 1996). Where a court lacks subject matter jurisdiction over a dispute, the parties cannot create it by agreement even in a plan of reorganization." Resorts International, Inc., v. Price Waterhouse & Co., LLP, 372 F.3d 154, 161 (3d Cir. 2004).

WHEREFORE, IRS respectfully requests that the Court deny confirmation of the Plan and grant such other and further relief as the Court deems necessary and just.

CHARLES M. OBERLY, III
United States Attorney

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Dated: December 9, 2015

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of this OBJECTION BY THE INTERNAL REVENUE SERVICE TO THE DEBTORS' SECOND AMENDED PLAN OF REORGANIZATION UNDER CHAPTER 11 OF THE BANKRUPTCY CODE was served on the on the electronic service list and on the following on December 9, 2015, in the manner indicated below at the following address:

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