Docket #264 Date Filed: 11/14/2022

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re ZOSANO PHARMA CORPORATION, Debtor.	Chapter 11 Case No. 22-10506 (JKS) **Hearing Date: November 18, 2022, 1:30 p.m.** **Objections Due: November 10, 2022, at 4:00 p.m. (extended for UST to November 14, 2022 at 12:00 p.m).** **Related D.I. 232, 261**

UNITED STATES TRUSTEE'S OBJECTION TO CONFIRMATION OF THE CHAPTER 11 PLAN OF LIQUIDATION OF ZOSANO PHARMA CORPORATION

Andrew R. Vara, the United States Trustee for Region 3 ("U.S. Trustee"), by and through his undersigned attorney, hereby files this Objection to Confirmation of the Chapter 11 Plan of Liquidation of Zosano Pharma Corporation (D.I. 232) (the "Plan"), and respectfully states as follows:

PRELIMINARY STATEMENT

1. The Plan should not be confirmed for the following reasons:

- Among the parties that are deemed to release their direct claims against non-debtors are sixteen categories of persons and entities that are merely related to a Releasing Party,[1] or related to an affiliate of a Releasing Party, but who did not consent to give such releases, were not provided with an opportunity to opt-out, and did not even receive notice of the releases;
- The Debtor Release includes what appear to be hidden, non-consensual third-party releases;

[1] Any capitalized term not defined herein has the definition set forth in the Plan.

- Neither the Third-Party Release and the Debtor Releases have exceptions for known or unknown claims of fraud, intentional misconduct, or gross negligence;
- The Plan includes an impermissibly broad exculpation clause that (a) fails to include the necessary temporal scope, and (b) includes a release;
- The Third-Party Release, the Debtor Release and the exculpation clause all include findings of fact that are not appropriate in a Plan; and
- The Plan, and all distributions thereunder, is cast as a settlement that may be approved under Bankruptcy Rule 9019.

2. For these reasons, set forth in more detail below, confirmation of the Plan should be denied.[2]

JURISDICTION, VENUE, AND STANDING

3. This Court has jurisdiction to hear this objection.

4. Pursuant to 28 U.S.C. § 586, the U.S. Trustee is charged with the administrative oversight of cases commenced pursuant to chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"). This duty is part of the U.S. Trustee's responsibility to enforce the bankruptcy laws as written by Congress and interpreted by the courts. *See United States Trustee v. Columbia Gas Sys., Inc. (In re Columbia Gas Sys., Inc.),* 33 F.3d 294, 295-96 (3d Cir. 1994) (noting that U.S. Trustee has "public interest standing" under 11 U.S.C. § 307, which goes beyond mere pecuniary interest); *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898

[2] The U.S. Trustee's counsel has provided comments to Debtor's counsel regarding proposed changes to the Plan other than those addressed in this Objection and anticipates that a resolution on those items will be reached before the hearing. The U.S. Trustee reserves the right to supplement this Objection, or to assert additional objections at the hearing on the Plan, if such modifications are not made. The U.S. Trustee also preserves, reserves and retains any and all rights, duties, obligations and remedies found at law, equity or otherwise to, *inter alia*, revise, augment and/or modify this Objection, and take any necessary discovery.

F.2d 498, 500 (6th Cir. 1990) (describing the U.S. Trustee as a "watchdog").

5. Pursuant to 28 U.S.C. § 586(a)(3)(B), the U.S. Trustee has the duty to monitor plans and disclosure statements filed in chapter 11 cases, and to comment on such plans and disclosure statements.

6. Pursuant to 11 U.S.C. § 307, the U. S. Trustee has standing to be heard with regard to this objection.

FACTUAL BACKGROUND

7. On June 1, 2022 (the "Petition Date"), the Debtor filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware. (the "Court").

8. On June 16, 2022, the U.S. Trustee filed the *Statement that Unsecured Creditor's Committee Has Not Been Appointed* (D.I. 57)**.**

9. The Debtor filed the Disclosure Statement Motion on August 31, 2022, which sought approval of (i) the Disclosure Statement filed at D.I. 179; and (ii) certain procedures concerning the solicitation of votes on the plan of reorganization.

10. At a hearing on October 6, 2022 the Court approved the Disclosure Statement and solicitation procedures (D.I. 227).

RELEVANT PLAN PROVISIONS

Releases

11. The Plan's Debtor Release provides, in relevant part:

> **Releases by the Debtor** As of the Effective Date, pursuant to section 1123(b) of the Bankruptcy Code, for good and valuable consideration, on and after the Effective Date, ***each Released Party*** (other than the Debtor) ***is deemed released and discharged by the Debtor and the Estate from any and all claims and Causes of Action, whether known or unknown,*** including any derivative claims, asserted on behalf of the Debtor, ***that the Debtor or the Estate would***

> ***have been legally entitled to assert*** in their own right (whether individually or collectively) or ***on behalf of the Holder of any Claim against, or Interest in, the Debtor or other Entity, based on or relating to, or in any manner arising from, in whole or in part, the Debtor*** (including the management, ownership, or operation thereof, or otherwise), any securities issued by the Debtor and the ownership thereof, the Debtor's in- or out-of-court restructuring efforts, any Avoidance Actions, intercompany transactions, the Chapter 11 Case, the formulation, preparation, dissemination, negotiation, or Filing of the Disclosure Statement, the Sale, the Sale Documents, the Plan, the Plan Supplement, or any restructuring transaction, contract, instrument, release, or other agreement or document created or entered into in connection with the Sale, the Sale Documents, the Plan, the Plan Supplement, the Chapter 11 Case, the Filing of the Chapter 11 Case, the pursuit of Confirmation, the pursuit of the Sale, the pursuit of consummation, the administration and implementation of the Plan, including the distribution of property under the Plan or any other related agreement, or upon any other related act or omission, transaction, agreement, event, or other occurrence or omission taking place on or before the Effective Date. . . .
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> . . . .
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> The Plan shall be deemed a motion to approve the settlements contained herein pursuant to Bankruptcy Rule 9019 with respect to the Debtor Releases provided in Article IX.B of the Plan, and ***entry of the Confirmation Order*** shall constitute the Bankruptcy Court's approval, pursuant to Bankruptcy Rule 9019, of the Debtor Releases, which includes by reference each of the related provisions and definitions contained in the Plan, and further, ***shall constitute the Bankruptcy Court's finding that the Debtor Releases are: (a) in exchange for the good and valuable consideration provided by the Released Parties, including, without limitation, the Released Parties' contributions to facilitating the restructuring and implementing the Plan; (b) a good faith settlement and compromise of the claims released by the Debtor Releases; (c) in the best interests of the Debtor and all Holders of Claims and Interests; (d) fair, equitable, and reasonable; (e) given and made after due notice and opportunity for hearing; and (f) a bar to the Debtor, the Estate, and the Liquidating Trustee asserting any claim or Cause of Action released pursuant to the Debtor Releases.***

Plan § IX.B (emphasis added).

12. The Plan includes a provision setting forth Releases by Holders of Claims (the "**Third-Party Releases**"), which provides in relevant part:

> **Releases by Holders of Claims** As of the Effective Date, each ***Releasing Party is deemed to have released and discharged each Released Party***

> ***from any and all claims, Claims and Causes of Action, whether known or unknown,*** including any derivative claims, asserted on behalf of the Debtor (or its Estate), 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 Debtor*** (including the management, ownership or operation thereof, or otherwise), any securities issued by the Debtor and the ownership thereof, the Debtor's in- or out-of-court restructuring efforts, the Chapter 11 Case, the formulation, preparation, dissemination, negotiation, or Filing of the Disclosure Statement, the Sale, the Sale Documents, the Plan, the Plan Supplement, or any restructuring transaction, contract, instrument, release, or other agreement or document created or entered into in connection with the Sale, the Sale Documents, the Plan, the Plan Supplement, the Chapter 11 Case, the Filing of the Chapter 11 Case, the pursuit of Confirmation, the pursuit of the Sale, the pursuit of consummation, the administration and implementation of the Plan, including distribution of property under the Plan or any other related agreement, or upon any other related act or omission, transaction, agreement, event, or other occurrence or omission taking place on or before the Effective Date. . . .
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> . . . .
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> ***Entry of the Confirmation Order*** shall constitute the Bankruptcy Court's approval of the releases described in Article IX.C of the Plan, which includes by reference each of the related provisions and definitions contained in this Plan, and, further, ***shall constitute the Bankruptcy Court's finding that each release described in Article IX.C of the Plan is: (a) consensual; (b) essential to the Confirmation of the Plan; (c) given in exchange for the good and valuable consideration provided by the Released Parties; (d) in the best interests of the Debtor and its Estate; (e) fair, equitable, and reasonable; (f) given and made after due notice and opportunity for hearing; and (g) a bar to any of the Releasing Parties asserting any claim, Claim or Cause of Action released pursuant to Article IX.C of the Plan.***

Plan § IX.C (emphasis added).

13. The Plan defines **Releasing Parties**, which are the parties who will be deemed to give the Third-Party Releases, as follows:

> "**Releasing Parties**" or "**Releasing Party**" means, individually and collectively, (a) each Holder of a Claim (i) that does not opt out of the releases, or (ii) File an objection to such releases; and (b) as to each of the Entities in the foregoing clause (a), ***each such Entities' and their Affiliates' current and former officers, directors, principals, members, partners, managers, employees, agents, advisory board members, financial advisors, attorneys, accountants, investment bankers, consultants, representatives***

> ***and all other professionals and Retained Professionals (in each case as to the foregoing Entities and their Affiliates in clause (a), solely in their capacity as such).*** The term "Releasing Party" shall not include the Holder of an Interest, solely in such capacity.

Plan § I.A.70 (emphasis added).

14. The Plan defines **Released Parties**, who are the recipients of both the Debtor Releases and the Third-Party Releases, as follows:

> "**Released Parties**" or "**Released Party**" means, collectively, and in each case, in its capacity as such the Debtor, the Debtor's current and former directors, managers, officers, employees, agents, advisory board members, financial advisors, partners, attorneys, accountants, investment bankers, consultants, representatives, and other professionals, equity holders (regardless of whether such interests are held directly or indirectly), predecessors, successors, and assigns; provided, however, that any Entity or Person that opts out of the third-party release under Article IX.C of the Plan or otherwise objects to Confirmation of the Plan shall not be deemed a "Released Party" under this Plan.

Plan § I.A.69 (emphasis added).

Exculpation Provision

15. The Plan includes an Exculpation provision, which provides in relevant part:

> **Exculpation** Except as otherwise specifically provided in the Plan, ***no Exculpated Party shall have or incur liability for, and each Exculpated Party[3] is released and exculpated*** from any Cause of Action for any claim or Claim related to any act or omission in connection with, relating to, or arising out of, the Chapter 11 Case, the formulation, preparation, dissemination, negotiation, or Filing of the Debtor's in- ***or out-of-court restructuring efforts***, the Sale, the Sale Documents, the Plan, the Plan Supplement, or any restructuring transaction, contract, instrument, release, or other agreement or document created or entered into in connection with the Sale, the Sale Documents, the Plan, the Plan Supplement, the Chapter 11 Case, the Filing of the Chapter 11 Case, the pursuit of Confirmation, the pursuit of the Sale, the pursuit of consummation, the administration and implementation of the

[3] The definition of Exculpated Parties is limited to (a) the Debtor, (b) the Debtor's directors and officers during the Chapter 11 Case, and (c) the Retained Professionals. *See* Plan § I.A.32. The U.S. Trustee does not object to such definition, as it is limited to estate fiduciaries.

> Plan, including the distribution of property under the Plan or any other related agreement, or upon any other related act or omission, transaction, agreement, event, ***or other occurrence or omission taking place on or before the Effective Date,*** except for claims related to any act or omission that is determined in a Final Order by a court of competent jurisdiction to have constituted actual intentional fraud, willful misconduct, or gross negligence of such Person, but in all respects such Entities shall be entitled to reasonably rely upon the written advice of counsel with respect to their duties and responsibilities pursuant to the Plan. . . .
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> ***The Exculpated Parties have, and upon Confirmation 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 votes 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 of acceptances or rejections of the Plan or such distributions made pursuant to the Plan.***

Plan § IX.D (emphasis added).

Settlement Provision

16. The Plan also includes a provision titled Compromise and Settlement of Claims, Interests, and Controversies:

> **Compromise and Settlement of Claims, Interests, and Controversies** Pursuant to sections 363 and ***1123 of the Bankruptcy Code and Bankruptcy Rule 9019,*** and ***in consideration for the distributions and other benefits provided pursuant to this Plan***, ***the provisions of this Plan shall constitute a good faith compromise of all Claims, Interests,*** and controversies relating to the relative legal, equitable, and contractual rights of the Holders of Claims and Interests with respect to distributions from the Debtor's Estate. The entry of the Confirmation Order shall constitute the Bankruptcy Court's approval of all compromises and settlements embodied in the Plan, as well as a finding by the Bankruptcy Court that such compromises and settlements are in the best interests of the Debtor, its Estate, and Holders of Claims and Interests, and are fair, equitable, and reasonable.

Plan § IX.A (emphasis added).

LEGAL ARGUMENT

17. In *In re Genesis Health Ventures, Inc.*, 266 B.R. 591 (Bankr. D. Del. 2001), this Court held that the plan proponent bears the burden of proof with respect to confirmability of a plan: "The Code imposes an independent duty upon the court to determine whether a plan satisfies each element of § 1129, regardless of the absence of valid objections to confirmation." *Id.* at 599. Here, the Debtor fails to meet these standards, for the reasons set forth below.

I. The Plan Cannot Be Confirmed Because it Extinguishes Direct Claims Against Non-Debtors Held by Parties Related to the Releasing Parties, Without Their Consent, Right to Opt-Out, or Notice

18. The Plan imposes Third-Party Releases on all Releasing Parties, which definition includes sixteen categories of persons and entities that are merely related to the main Releasing Parties, or to their affiliates (the "Related Releasing Parties"). Such Related Releasing Parties include, for example, the employees and professionals of each creditor who falls under the definition of Releasing Party, as well as the employees and professionals of each *affiliate* of each creditor who falls under the definition of Releasing Party. Such Related Releasing Parties also include those who may fall under such broad and vaguely defined categories as "agents," "consultants," "representatives" and "other professionals" of Releasing Parties.

19. The releases to be imposed on the Related Releasing Parties are not limited to claims they could assert derivatively through the Releasing Party to which they relate. Nor are they limited to claims that the party to whom they relate could release on their behalf under agency law. Rather, the broad release language also covers direct claims held by each Related Releasing Parties against each Released Party, as long as such claims is "based on or relating to, or in any

manner arising from, in whole or in part, the Debtor." *See* Plan, § IX.D. [4]

20. It does not appear that the Debtor has obtained affirmative consent from any of the Related Releasing Parties to waive their direct claims against non-debtors. Nor is there a mechanism by which Related Releasing Parties could have opted out of, or otherwise avoided, giving such releases. Thus, the Third-Party Releases to be forced on the Related Releasing Parties are non-consensual.

21. The Plan can be confirmed only if the proposed non-consensual releases of the Related Releasing Parties satisfy the standards set forth in *In re Continental Airlines*, 203 F.3d 203 (3d Cir. 2000), and *Millennium Lab Holdings II,* 945 F.3d 126 (3rd Cir. 2019), *cert. denied sub nom. ISL Loan Tr. v. Millennium Lab Holdings,* 19-115, 2020 WL 2621797 (U.S. May 26, 2020). In *Continental*, the Court described "hallmarks of permissible non-consensual releases" to be "fairness, necessity to the reorganization, and special factual findings to support these conclusions" (*Id.* at 214). In *Millennium Labs,* the Court reiterated that there are "exacting standards that must be satisfied if such releases and injunctions are to be permitted." *Id.* at 139.

22. In *Genesis Health Ventures,* 266 B.R. 591 (Bankr. D. Del. 2001), this Court elaborated that, under *Continental*, fairness of a release is determined by examining whether non-consenting non-debtors are receiving reasonable consideration in exchange for the release. *Id.* at 608; *see also In re Spansion, Inc.*, 426 B.R. 114, 144 (Bankr. D. Del 2010). Here, the Related Releasing Parties are receiving no consideration whatsoever in exchange for the releases to be imposed on them, because they are not themselves creditors or interest holders of the Debtor.[5]

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[4] The part of the definition of "Releasing Parties" that covers the Related Releasing Parties uses the qualifier "in their capacity as such." Plan, Art. I.A.70. It is not clear what that phrase means in this context.

[5] Nor is there anything in the record to indicate that this case presents the kind of "extraordinary circumstances" that would meet the high threshold necessary for approval of non-consensual third-

23. In addition to the lack of consent, none of the Related Releasing Parties will have received the Solicitation Package, a Ballot, the Confirmation Hearing Notice, or any other document that would have alerted them that the Plan will strip away their rights to pursue their direct claims against numerous non-debtors, including the Debtor's current and former directors, officers, employees, agents, and others. Plan § I.A.70. The Related Releasing Parties did not receive any such notice because they are not parties in interest in this Case, but are merely related to a creditor of the Debtor that falls within the definition of "Releasing Party."

24. In *Folger Adam Security, Inc. v. DeMatteis/MacGregor*, 209 F.3d 252 (3d Cir. 2000), the Third Circuit stated that "[d]ue process requires 'notice reasonably calculated, under all the circumstances, to apprize interested parties of the pendency of the action and afford them an opportunity to present their objections.'" *Id.* at 265 (citations omitted).

25. The Debtor did not provide notice to the Related Releasing Parties that is "reasonably calculated, under all the circumstances, to apprize [them] of the pendency of the action and afford them an opportunity to present their objections," with regard to being compelled to give releases to non-debtors. *Id.* In fact, no notice was provided at all, nor could there be because the identity and contact information of the Related Releasing Parties of the Debtor's creditors would not be known to the Debtor.

26. The Plan should not be approved unless it is modified so that no Third-Party Releases are imposed on Related Releasing Parties. *See In re Boy Scouts of America and Delaware BSA, LLC*, Case No. 20-10343 (LSS), 2022 WL 3030138, at * 128 (Bankr. D. Del. July 29, 2022)

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party releases. *See In re Tribune Company*, 464 B.R. 126, 178 (Bankr. D. Del. 2011) (interpreting *Continental* to allow non-consensual releases only in "extraordinary cases"); *Genesis*, 266 B.R. at 608 (referencing "the extraordinary circumstances required to meet even the most flexible test for third-party releases").

(Court was unable to find that the 22 categories of "Related Releasing Parties" received notice, and because Court had concluded that "a request for opt-out consent must be grounded in adequate notice, it is inconsistent to permit releases from persons who do not receive notice by virtue of creditor (or shareholder) status."); *see also Joel Patterson v. Mahwah Bergen Retail Group, Inc.*, 636 B.R. 641, 660 (E.D. Va., 2022 (in vacating the Bankruptcy Court's order confirming the plan, the District Court noted that "[t]he Bankruptcy Court did not order that any notice or opt-out forms be sent to all of the Releasing Parties, including the current and former employees, consultants, accountants or attorneys of Debtors, their affiliates, lenders, creditors or interest holders.").

27. Because the Plan would impose a release in favor of non-debtors on Related Releasing Parties without their knowledge, consent, or ability to opt-out, the Plan should not be confirmed.

II. The Debtor Release Contains a Hidden Non-Consensual Third-Party Release.

28. The Plan's Debtor Release renders the Plan unconfirmable because it includes a hidden non-consensual third-party release. Section IX.B of the Plan provides that the Debtor shall release claims not only on behalf of itself and its Estate, but also "on behalf of the holder of any Claim or Interest in the Debtor or other Entity." Plan § XI.B. The claims this language is intended to release are unclear. It does not appear to be a release of claims that could be asserted derivatively on behalf of the Debtor, because a separate clause of the Debtor Release covers derivative claims. The Debtor's release of claims "on behalf of the holder of any Claim or Interest in the Debtor or other Entity" is sufficiently vague that it could be interpreted to be a release of direct claims of holders of Claims or Interests, or "other Entit[ies]." If so, it would act as a non-consensual third-party release.

III. The Plan is Not Confirmable Because Neither the Third-Party Releases or the Debtor Releases Have Exceptions for Fraud, Willful Misconduct or Gross Negligence.

29. There is another aspect of the Debtor Release and the Third-Party Release that renders the Plan unconfirmable. Neither of these releases make an exception for actual fraud, willful misconduct, or gross negligence. This is objectionable for at least three reasons. First, the Bankruptcy Code bars debtors from being discharged for claims of fraud and willful misconduct. *See* 11 U.S.C. § 523(a)(2, 4, 6). Non-debtor parties should not be released from claims as to which a debtor could not be discharged. *See In re Purdue Pharma, L.P.*, No. 21-cv-7532, 2021 WL 5979108 at *62 (S.D.N.Y. Dec. 16, 2021). [6]

30. Second, through the Debtor Release, the Debtor is releasing, among others, all of its directors, officers and employees from all claims, whether known or unknown. If, for example, it is later learned that an officer, manager or employee of the Debtor misappropriated Debtor funds at any time up to the Effective Date, it appears that any claim based on such misappropriation would be released under the Plan. The Debtor has the burden to establish how the release of its claims against the Released Parties, including but not limited to claims for known and unknown fraud, willful misconduct, and gross negligence of its employees and the other Released Parties, meet the requirements of *In re Zenith Electronics Corp.*, 241 B.R. 92, 110 (Bankr. D. Del. 1999), and *In re Master Mortgage Inv. Fund, Inc.,* 168 B.R. 930, 937-38 (Bankr. W. D. Mo. 1994).

[6] Although the current definition of Released Party includes the Debtor, Debtor's counsel has agreed to remove the Debtor from that definition. If that change is not made, the Debtor Releases and the Third-Party Releases would effectively be providing the Debtor with a discharge of claims or which it would not be entitled to a discharge even if it was reorganizing, which it is not. *See* 11 U.S.C. §§ 523(a)(2, 4, 6), and 1141(d)(3).

31. Third, the Debtor Release and Third-Party Release release claims against certain fiduciaries of the estate, such as the Debtor's directors and officers, and professionals retained by the Debtor. All such fiduciaries are entitled to an exculpation, but such exculpation must carve out claims of fraud, intentional misconduct and gross negligence, as the Exculpation provision does. However, because the Debtor Release and Third-Party Release do not have carve-outs for fraud, intentional misconduct and gross negligence, these estate fiduciaries are getting through the release provisions of the Plan what they are not entitled to receive by way of exculpation. As recognized by this Court in *Washington Mutual*, parties who are fiduciaries of the estate are receiving exculpations, and therefore receipt by such parties of releases are "unnecessary, duplicative and ***exceed the limits of what they are entitled to receive***" under the exculpations. *Washington Mutual,* 442 B.R. at 350 (emphasis added); *see also Genesis*, 266 B.R. at 606–07 (in rejecting a debtor's release of its directors, officers and employees, the Court held that, "the officers, directors and employees have been otherwise compensated for their contributions, and the management functions they performed do not constitute contributions of 'assets' to the reorganization.").

32. Accordingly, unless the Debtor Release and Third-Party Release include exceptions for claims arising from fraud, intentional misconduct and gross negligence, the Plan should not be confirmed.

IV. The Debtor Release and Third-Party Release Inappropriately Include Findings of Fact

33. Both the Debtor Release and Third-Party Release include, at the end of the provision, a paragraph stating that the entry of the Confirmation Order shall constitute the Bankruptcy Court making certain findings of fact relating to such releases, which findings are then specified. *See* Plan, §§ IX.B and IX.C. Findings of fact are not appropriately included in a Plan.

If the Debtor wishes to propose finding of fact relating to releases, it may include the same in its proposed confirmation order, provided the Debtor submits evidence to support the proposed findings.

V. The Proposed Exculpation Provision Is Overly Broad

34. The exculpation provision set forth in Section IX.D of the Plan is overbroad and inconsistent with controlling case law, because it (a) is not limited to actions and omissions taking place between the Petition Date and the Effective Date of the Plan, (b) includes language that turns the Exculpation into a non-consensual third-party release, and (c) includes what amount to findings of fact that are not appropriate in a plan.

35. First, the temporal scope of the Exculpation provision in Section IX.D is overly broad in that it is not limited to actions and omissions taking place during the bankruptcy case. Rather, it extends back to pre-petition activity that cannot be covered by a plan exculpation provision, and expressly covers the Debtor's "out-of-court restructuring efforts." *See Wash. Mut*., 442 B.R. at 350 (exculpations cover "actions in the bankruptcy case," not before the case was filed) (citing *PWS,* 228 F.3d at 246). In considering the U.S. Trustee's objection to the temporal scope of the exculpation clause in *In re Mallinckrodt PLC*, 639 B.R. 837 (Bank. D. Del. 2022), this Court recently held that exculpation "only extends to conduct that occurs between the Petition Date and the effective date," and ordered the debtors to strike contrary language from the exculpation provision. *Id*. at 883.

36. Second, the exculpation provision also includes a "release" of the Exculpated Parties, which includes various non-debtor parties. Because that release is binding on all holders of claims and equity interests, regardless of how they vote on the Plan or whether they opt out of giving Third-Party Releases (if they are permitted to do so), such release constitutes an

impermissible non-consensual third-party release. The "release" language should also be eliminated because it conflates two distinct concepts. Exculpation is an acknowledgment of the standard of care owed by estate fiduciaries, while a non-consensual release of claims held by third parties is only permissible in limited, extraordinary circumstances under Third Circuit law. *Compare In re PWS Holding Corp*., 228 F.3d 224, 245 (3d Cir. 2000) ("However, we believe that [the exculpation provision], which is apparently a commonplace provision in Chapter 11 plans, does not affect the liability of these parties, but rather states the standard of liability under the Code ….") with *In re Continental Airlines*, 203 F.3d 203, 214 (3d Cir. 2000) (proposed non-consensual release "[did] not pass muster under even the most flexible tests for the validity of non-debtor releases," as "the hallmarks of permissible non-consensual releases—fairness, necessity to the reorganization, and specific factual findings to support these conclusions—[were] all absent.").

37. Third, the exculpation provision includes what amount to findings of fact that the Debtor could have proposed for inclusion in a confirmation order, but which are not appropriate to include in a plan – namely, that "[t]he Exculpated Parties have, and upon Confirmation 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 votes 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 of acceptances or rejections of the Plan or such distributions made pursuant to the Plan."

38. Based on the foregoing, this Court should deny confirmation of the Plan unless the Exculpation provision is modified to (a) be limited to actions and omissions taking place between the Petition Date and the Effective Date of the Plan, (b) omit the "release" language, and (c) omit the findings of fact.

VI. Plan Itself Is Not a Settlement

39. Confirmation also should be denied unless Section IX.A of the Plan is omitted. That provision casts the entire Plan as a Rule 9019 settlement, providing that, "[p]ursuant to sections 363 and 1123 of the Bankruptcy Code and Bankruptcy Rule 9019, and in consideration for the distributions and other benefits provided pursuant to this Plan, the provisions of this Plan shall constitute a good faith compromise of all Claims, Interests, and controversies relating to the relative legal, equitable, and contractual rights of the Holders of Claims and Interests with respect to distributions from the Debtor's Estate." Plan § IX.A (emphasis added).

40. Section IX.A of the Plan references section 1123(b)(3)(A) of the Bankruptcy Code, which allows a plan proponent to "provide for [] the settlement or adjustment of any claim or interest *belonging to the debtor or to the estate*." 11 U.S.C. § 1123(b)(3)(A) (emphasis added). Thus, section 1123(b)(3) only allows a debtor to settle claims it has against others; it does not allow a debtor to settle claims that creditors and interest holders may have against it, which is what Section IX.A of the Plan seeks to do. *See Varela v. Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.)*, 293 B.R. 489, 496 (B.A.P. 9th Cir. 2003) ("The only reference in [section 1123(b)] to adjustments of claims is the authorization for a plan to provide for 'the settlement or adjustment of any claim or interest *belonging* to the debtor or to the estate.' . . . It is significant that there is no parallel authorization regarding claims *against* the estate.") (emphasis in original) (quoting section 1123(b)(3)(A)) (internal citation omitted). The resolution of claims *against* the Debtor is governed by sections 1129 and 1141.

41. In addition, while a plan may incorporate one or more negotiated settlements, a plan is not itself a settlement. Sending a plan to impaired creditors for a vote is not the same thing as parties negotiating a settlement among themselves.

42. A "settlement" is "an agreement ending a dispute or lawsuit." Black's Law Dictionary (10th ed. 2014). An "agreement" is "a mutual understanding between two or more persons about their relative rights and duties regarding past or future performances; a manifestation of mutual assent by two or more persons." *Id.*

43. Approval of settlements is governed by Fed. R. Bankr. P. 9019, which provides that, "[o]n motion by the trustee [or chapter 11 debtor in possession] and after notice and a hearing, the court may approve a compromise or settlement." But, because a "settlement" requires an agreement between the settling parties, Rule 9019 governs only parties that have entered into an express settlement agreement; it is not a blanket provision allowing general "settlements" to be unilaterally imposed upon broad swaths of claimants that have no formal agreement with any party to "settle" their claims.

44. The decision of whether to approve a settlement under Rule 9019 is left to the sound discretion of the bankruptcy court, which "must determine whether 'the compromise is fair, reasonable, and in the best interest of the estate.'" *Wash. Mut., Inc.*, 442 B.R. at 338 (quoting *In re Louise's, Inc*., 211 B.R. 798, 801 (D. Del. 1997)).[7] In contrast, chapter 11 plans are subject to the many requirements of Bankruptcy Code sections 1123 and 1129.

45. What may be permissible under a negotiated settlement agreement that is considered "fair, reasonable, and in the best interest of the estate" outside of the plan context is different from what may be permissible under a plan.

[7] The standard for approval of a settlement under Rule 9019 is guided by the following criteria: "(1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors." *Myers v. Martin (In re Martin)*, 91 F.3d 389, 393 (3d Cir. 1996) (citations omitted).

46. Here, Section IX.A purports to treat the Plan itself as if it were a Rule 9019 "settlement." In addition, Section IX.A is not limited to the settlement of claims belonging to the Debtor or the estate, and therefore proposes a settlement that cannot be approved under section 1123(b)(3)(A). In light of the foregoing, the Plan cannot be confirmed as long as it provides that the treatment of claims against the Debtor, or the Plan itself, is a "settlement" for purposes of section 1123(b)(3)(A) and Rule 9019.

WHEREFORE, the U.S. Trustee requests that this Court issue an order denying confirmation of the Plan and/or granting other relief that this Court deems appropriate and just.

Respectfully submitted,

ANDREW R. VARA
UNITED STATES TRUSTEE
REGIONS 3 AND 9

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Dated: November 14, 2022