IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

In re	)	Chapter 11
Nortel Networks Inc., *et al.*,	)	Bankruptcy Case No. 09-10138 (KG)
Debtors.	)	Jointly Administered
	)	
	)	
Nortel Networks, Inc., *et al.*,	)	Appeals from the Bankruptcy Court
Appellants and	)	Civil Action No. 15-624 (LPS)
Cross-Appellees.	)	Civil Action No. 15-586 (LPS)
	)	Civil Action No. 15-622 (LPS)
v.	)	Civil Action No. 15-623 (LPS)
Ernst & Young Inc., as Monitor and Foreign	)	Civil Action No. 15-627 (LPS)
Representative of the Canadian Debtors, *et al.*	)	Civil Action No. 15-628 (LPS)
Appellees and	)	Civil Action No. 15-635 (LPS)
Cross-Appellants.	)	Civil Action No. 15-636 (LPS)
	)	Civil Action No. 15-699 (LPS)
	)	Misc. Action No. 15-196 (LPS)
	)	Misc. Action No. 15-197 (LPS)
	)	CONSOLIDATED APPEALS

OPENING BRIEF OF APPELLANT PENSION BENEFIT GUARANTY CORPORATION IN SUPPORT OF APPEAL FROM THE ALLOCATION OPINION

Judith R. Starr, General Counsel

Israel Goldowitz, Chief Counsel
Charles L. Finke, Deputy Chief Counsel
Garth D. Wilson, Assistant Chief Counsel
(DC Bar No. 424922)
Vicente Matias Murrell, Attorney
(MD Bar No. 9806240098)
Marc S. Pfeuffer, Attorney

Office of the General Counsel

Office of the Chief Counsel*
PENSION BENEFIT GUARANTY CORPORATION
1200 K Street, N.W.
Washington, D.C. 20005-4026
Telephone: (202) 326-4020 ext. 3580
Facsimile: (202) 326-4112
murrell.vicente@pbgc.gov

Counsel for Appellant and Cross-Appellee Pension Benefit Guaranty Corporation

December 3, 2015

* Under Local Rule 83.5(f)(1), persons acting as attorneys for the United States or any of its departments, agencies, or officials are not required to associate with Delaware counsel.

CORPORATE DISCLOSURE STATEMENT

Appellant Pension Benefit Guaranty Corporation ("PBGC") is a wholly owned United States government corporation, and an agency of the United States. 29 U.S.C. § 1302(a). Accordingly, PBGC is exempt from the requirement that certain parties file a corporate disclosure statement. *See* Bankruptcy Rule 8012(a).

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Jurisdictional Statement

The Bankruptcy Court had jurisdiction to hear this matter under 28 U.S.C. §§ 157 and 1334. This matter is a core proceeding within the meaning of 28 U.S.C. § 157(b)(2). This Court has jurisdiction under 28 U.S.C. § 158(a)(1), as this matter is on appeal from (i) the U.S. Bankruptcy Court for the District of Delaware's May 12, 2015 order[1] (the "Order"), that court's reasoning being set forth in the allocation trial opinion[2] of that date (the "Opinion"), and (ii) the court's July 6, 2015 memorandum order on motions for reconsideration[3] (the "Reconsideration Order," together with the Order, the "Decision"). PBGC timely filed a notice of appeal under Fed. R. Bankr. P. 8002 on July 23, 2015.[4] This appeal is from a final judgment of the Bankruptcy Court.[5]

Preliminary Statement

The bankruptcy court's "modified pro rata" allocation is unprecedented and not supported by the Bankruptcy Code. The briefs of the U.S. Debtors and the Committee set forth ample grounds for reversal, including (1) the bankruptcy court's misunderstanding of section 541 defining "property of the estate," which does not permit commingling an estate's property with that of its affiliates under the circumstances presented here, (2) the bankruptcy court's misuse of section 105, which is not an independent grant of authority, and (3) the perverse results of the

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[1] Bankr. D.I. 15545.

[2] Bankr. D.I. 15544.

[3] Bankr. D.I. 15830.

[4] Bankr. D.I. 15916. The Official Committee of Unsecured Creditors of Nortel Networks Inc. *et al.* (the "Committee") was the first party to appeal the Decision, filing its notice of appeal on July 9, 2015. Bankr. D.I. 15846. Thus, PBGC's notice of appeal was timely, having been filed 14 days thereafter. Bankr. R. 8002(a)(3).

[5] 28 U.S.C. §§ 157(b)(1), 158(b)(1).

allocation, which are anything but "fair and equitable." PBGC adopts fully, but will not repeat here, each reason for reversal, legal or equitable, set forth in those briefs. Instead, PBGC will highlight two issues: (i) the bankruptcy court's failure to follow basic tenets of corporate separateness, which impairs PBGC's statutory joint-and-several claims, and (ii) the court's disregard of one of its own prior orders approving a settlement between PBGC and the largest of the U.S. Debtors.

Statement of Issues

PBGC adopts fully the issues raised by the Debtors-Appellants (collectively, the "U.S. Debtors"), and in this brief addresses only the following:

1. Whether the bankruptcy court erred in adopting a "modified pro rata" allocation methodology that as a matter of law improperly treated PBGC's statutory claims, which are joint and several. This question of law is subject to de novo review on appeal.
2. Whether the bankruptcy court erred in requiring a "modified pro rata" allocation that as a matter of law improperly treated (a) the sales of Nortel Government Solutions Incorporated ("NGS") and DiamondWare, Ltd. ("DiamondWare"), two non-debtors, and (b) the stipulation between Nortel Networks Inc. ("NNI") and PBGC establishing a PBGC lien, thereby abrogating one of the court's own prior orders. This question of law is subject to de novo review on appeal.

Statutory Background

PBGC is the wholly owned United States government corporation that administers the nation's pension termination insurance program established by the Title IV of the Employee Retirement Income Security Act of 1974 ("ERISA").[6] PBGC's insurance program protects

[6] 29 U.S.C. § 1302; 29 U.S.C. §§ 1301-1461.

participants covered by private-sector, defined benefit pension plans.[7] PBGC serves as both statutory trustee of the terminated plan and federal guarantor of benefits payable under the plan.[8]

PBGC is funded by (1) insurance premiums paid by employers that sponsor PBGC-insured plans, (2) assets from terminated plans, (3) recoveries from companies formerly responsible for the plans, and (4) investment earnings from the above monies.[9] PBGC is essentially self-financing, and receives no funds from general tax revenues.[10] The United States is not responsible for the agency's obligations.[11] Since 1974, PBGC has become responsible for almost 1.5 million people in nearly 4,800 terminated plans, making payments of $5.7 billion to retirees in fiscal year 2015.[12] PBGC took responsibility for 65 additional plans in fiscal year 2015, and its total deficit as of September 2015 was $76.3 billion.[13]

When an underfunded pension plan terminates, a contributing sponsor[14] of the plan and each member of a contributing sponsor's controlled group[15] become jointly and severally liable to PBGC for certain claims. Only two of PBGC's claims are relevant to this appeal.

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[7] *See* 29 U.S.C. § 1321.

[8] *See PBGC v. LTV Corp.*, 496 U.S. 633, 637-38 (1990).

[9] *See* PBGC Ann. Rep. (2015) at 10, http://www.pbgc.gov/documents/2015-annual-report.pdf.

[10] *Id.*

[11] 29 U.S.C. § 1302(g)(2).

[12] PBGC Ann. Rep. (2015) at 2.

[13] *Id.* at 23.

[14] 29 U.S.C. § 1301(a)(13).

[15] 29 U.S.C. § 1301(a)(14); 29 C.F.R. § 4001.2

The first is PBGC's claim for the plan's unfunded benefit liabilities.[16] This amount is the shortfall between the plan's benefit liabilities and the plan's assets as of its termination date.[17] This claim is generally the largest claim PBGC asserts when an underfunded plan terminates. This liability is joint and several for any entity that is, on the plan termination date, a contributing sponsor of the plan or a member of a contributing sponsor's controlled group.[18] Additionally, a contributing sponsor and members of its controlled group can be subject to a statutory lien in favor of PBGC with respect to the unfunded benefit liabilities.[19]

The second is PBGC's claim for termination premiums, which arise for certain terminated plans.[20] The premium rate is equal to $1,250 per plan participant per year for three years.[21] This liability is joint and several for any entity that is, on the plan termination date, a contributing sponsor of the plan or a member of a contributing sponsor's controlled group.[22]

The amount of benefits payable to participants in a terminated plan is determined by the plan's terms, subject to the limitations in Title IV, and PBGC's regulations thereunder. PBGC pays benefits to participants provided by the plan, to the extent they are guaranteed.[23] PBGC pays guaranteed benefits regardless of the plan's funded level. Subject to certain statutory

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[16] 29 U.S.C. § 1362(b).

[17] 29 U.S.C. §§ 1301(a)(18), 1362(b)(1)(A).

[18] 29 U.S.C. § 1362(a).

[19] 29 U.S.C. § 1368.

[20] 29 U.S.C. § 1306(a)(7).

[21] 29 U.S.C. § 1306(a)(7)(A), (C).

[22] 29 U.S.C. § 1307(e)(2).

[23] 29 U.S.C. §§ 1322(a), (b), 1361.

limitations, this includes payment of all nonforfeitable benefits under the plan's terms at the time it terminated.[24]

PBGC may also pay certain benefits beyond the guaranteed amount. Section 1322(c) provides that a plan's participants will generally share a portion of PBGC's recoveries for its claim for unfunded benefit liabilities.[25]

Statement of the Case

U.S. Debtors' bankruptcy filings, foreign affiliates' insolvency cases, and NNI's Pension Plan

On January 14, 2009, NNI and fourteen affiliates filed petitions under Chapter 11 in the U.S. Bankruptcy Court for the District of Delaware.[26] On January 14, 2009, other Nortel affiliates commenced insolvency proceedings in Canada.[27] Still other Nortel affiliates became subject to insolvency proceedings that commenced that day in the U.K.[28] On July 14, 2009, Nortel Networks (CALA) Inc., filed its petition in the court below, bringing the total number of U.S. Debtors to sixteen.[29] NNI is the direct or indirect parent of the other U.S. Debtors, and all U.S. Debtors are members of NNI's controlled group.[30] When it filed its Chapter 11 petition,

[24] 29 U.S.C. §§ 1301(a)(8), 1322.

[25] 29 U.S.C. § 1322(c); *see also* 29 U.S.C. § 1362(b).

[26] Op. at 3.

[27] *Id.* at 4.

[28] *Id.* at 4-5.

[29] *Id.* at 3, nn. 3, 4.

[30] *See* Bankr. D.I. 3, ¶ 22; Bankr. D.I. 1639, ¶ 11.

NNI was a contributing sponsor of the Nortel Networks Retirement Income Plan ("Pension Plan"), a defined benefit pension plan covered under Title IV's termination insurance program.[31]

Termination of the Pension Plan

In July 2009, PBGC filed a complaint in the United States District Court for the Middle District of Tennessee seeking to terminate the Pension Plan.[32] The litigation was resolved by an agreement between PBGC and the Pension Plan administrator that terminated the Pension Plan, effective July 17, 2009, and named PBGC as the Pension Plan's statutory trustee.[33] PBGC became obligated to pay lifetime benefits to about 22,000 participants of the terminated Pension Plan.[34]

Summary of PBGC's claims

On September 29, 2009, PBGC filed proofs of claim, asserting joint-and-several liability against each of the U.S. Debtors.[35] As amended on July 7, 2014, PBGC's claims assert liability in the following approximate amounts:

1. Unfunded benefit liabilities: $625 million.[36]
2. Termination premium: $83 million.[37]

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[31] Bankr. D.I. 1313, ¶ 11.

[32] Case No. 09-cv-00657; Bankr. D.I. 1313, ¶ 12; 29 U.S.C. § 1342.

[33] 29 U.S.C. §§ 1301(a)(1), 1342(b)(3); Bankr. D.I. 1313, ¶ 12; Bankr. D.I. 1313-3, ¶ 2; Bankr. D.I. 1406; Bankr. D.I. 1639, ¶ 10.

[34] 29 U.S.C. § 1322; Bankr. D.I. 1313, ¶ 11.

[35] Bankr. D.I. 1639, ¶ 11.

[36] POC 8763.

[37] POC 8762.

Disputed sale of Enterprise Solutions Business

On July 20, 2009, the U.S. Debtors filed a motion for an order authorizing a sale to Avaya, Inc. ("Avaya") of the Enterprise Solutions Business ("Enterprise Sale"), subject to certain bidding procedures, under section 363 of the Bankruptcy Code.[38] The assets to be sold included stock held by NNI of two non-debtors who were members of NNI's controlled group, and thus potentially subject to joint-and-several liability to PBGC: (i) NGS, and (ii) DiamondWare (collectively "Non-Debtor Subsidiaries").[39] Additionally, the Non-Debtor Subsidiaries could have been subject to a statutory lien in favor of PBGC with respect to the Pension Plan's unfunded benefit liabilities.[40] On July 28, 2009, PBGC filed a limited objection to the proposed sale on the grounds that any sale of assets of the Non-Debtor Subsidiaries exceeded the scope of section 363.[41] On September 16, 2009, the bankruptcy court issued an order authorizing the Enterprise Sale.[42] The order permitted the transfer of assets owned by the U.S. Debtors (including equity interests in the Non-Debtor Subsidiaries) free and clear of all liens, but subject to a carve-out for any assets owned by non-debtor entities.[43]

[38] Bankr. D.I. 1131.

[39] *Id.* at 13; Bankr. D.I. 1639, ¶¶ 9, 11-12.

[40] *Id.* ¶¶ 11-12.

[41] Bankr. D.I. 1195.

[42] Bankr. D.I. 1514.

[43] *Id.* ¶ 39.

Settlement establishing PBGC lien

Under the provisions of the proposed sale, Avaya required the U.S. Debtors to transfer the assets, including shares of the Non-Debtor Subsidiaries, free and clear of any liens and claims.[44] On October 8, 2009, the U.S. Debtors sought to settle the dispute by moving for an order under Bankruptcy Rule 9019 approving a stipulation with PBGC.[45] PBGC agreed under the terms of the settlement to release and waive against the Non-Debtor Subsidiaries any claim, lien, interest, or obligation for joint-and-several liability, and NNI agreed to grant PBGC a lien on the proceeds of the Enterprise Sale that were allocated to the sale of the shares of the Non-Debtor Subsidiaries.[46] On October 13, 2009, the bankruptcy court approved NNI's stipulation with PBGC.[47]

Value of the NGS and DiamondWare assets

The Canadian Debtors' expert estimated the equity value of NGS and DiamondWare at $111 million, which he proposed to allocate to the U.S. Debtors.[48] At the time of the Enterprise Sale, the U.S. Debtors maintained NGS and DiamondWare on their books and records at a combined value of nearly $332 million.[49]

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[44] *Id.* ¶ 13.

[45] Bankr. D.I. 1639.

[46] *Id.* ¶¶ 16-17; Bankr. D.I. 1639-3, ¶¶ 2-3.

[47] Bankr. D.I. 1658.

[48] TR00042 (Green Report) at Ex. D.

[49] Bankr. D.I. 15611, ¶ 34. *See also* Bankr. D.I. 729, Ex. A.

Summary of Argument

When an underfunded pension plan terminates, Congress provided PBGC with joint-and-several claims against a contributing sponsor of the plan and members of a contributing sponsor's controlled group. The bankruptcy court's allocation ruling is contrary to law, because it effectively disregards corporate separateness, impairing PBGC's assertion of joint-and-several liability. By reducing the amount PBGC collects, the Decision harms participants of the Pension Plan, who share a portion of PBGC's recoveries, and the sponsors of ongoing pension plans, i.e., the premium payers who support the financially strained pension insurance program.

In declaring that court-approved settlements would be included in the allocation, but then failing to do so with the proceeds from the sale of NGS and DiamondWare, the bankruptcy court contradicted itself. The bankruptcy court's premise for modified pro rata allocation also cannot be squared with the facts peculiar to NGS and DiamondWare, two non-debtor entities wholly owned by NNI. Moreover, the Decision effectively nullifies the bankruptcy court's own prior order approving a stipulation between NNI and PBGC, which established a lien in favor of PBGC.

Standard of Review

Legal conclusions of the bankruptcy court "are subject to plenary review by the district court and are considered *de novo* on appeal."[50]

[50] *In re Continental Airlines*, 177 B.R. 475, 478 (D. Del. 1993).

Argument

I. The bankruptcy court erred in adopting a modified pro rata allocation methodology that as a matter of law improperly treated PBGC's joint-and-several claims, unjustly diminishing PBGC's recovery.

Setting aside a bedrock principle of corporate and bankruptcy law, the bankruptcy court adopted a methodology that allocates the debtors' estate assets among multiple debtors without taking into account what each of them owned and sold. Instead, the bankruptcy court allocated assets based solely on the amount of certain, but not all, claims against each debtor. Whether it be labeled "modified pro rata" allocation or "substantive consolidation," the result is the same: corporate disregard. Acknowledging its result to be "extraordinary,"[51] the bankruptcy court attempted at great length to distinguish its methodology from that of substantive consolidation.

Following an unprecedented path, the bankruptcy court insisted that it was "not ordering a distribution scheme," but merely "directing an allocation among the Estates for the Estates to distribute in an appropriate manner."[52] The bankruptcy court even quoted with approval a passage of the Third Circuit's opinion in an earlier Nortel appeal: "It appears that the largest claimants are pension funds in the U.K. and the United States, representing pensioners who are undoubtedly dependent, or who will become dependent, on their pensions."[53]

But make no mistake. Despite the bankruptcy court's professed solicitude for dependent U.S. pensioners, the Decision does them no favors. To the contrary, the court's methodology undeniably diminishes PBGC's recovery—which is shared in part with Pension Plan

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[51] Op. at 111.

[52] *Id.* at 102.

[53] *Id.* at 113 (quoting *In re Nortel Networks, Inc.*, 669 F.3d 128, 143 (3d Cir. 2011)).

participants.[54] Far from protecting U.S. pensioners, the Decision leaves them worse off by reducing amounts available to pay participants' benefits under Title IV. Lessening PBGC's recoveries also adds to the burden on another group of PBGC's stakeholders, the sponsors of ongoing pension plans who support the financially stressed insurance program through their annual premiums.[55]

In summary, in addition to the injury PBGC shares with all other unsecured creditors of the U.S. Debtors, the Decision dilutes the joint-and-several claims that Congress intended to fund PBGC's recoveries from a terminated plan's sponsor and members of the sponsor's controlled group. Although each debtor will nominally be treated as a separate entity for distribution purposes, modified pro rata allocation requires creditors of one entity to effectively "share" that entity's assets with "all creditors of all [other] entities."[56] Because this contravenes the Bankruptcy Code and Third Circuit law, the Decision cannot stand.

II. The bankruptcy court erred in requiring a modified pro rata allocation that as a matter of law improperly treated (a) the sale of NGS and DiamondWare, and (b) the settlement stipulation between NNI and PBGC establishing a PBGC lien, thereby abrogating one of the court's own prior orders.

The bankruptcy court denied it was adopting pro rata distribution, declaring: "Implementation of a pro rata distribution would further prejudice creditors by unwinding the effect of Court-approved settlements . . . ."[57] No less than eight times in the Opinion, the bankruptcy court declared that "settlements" would be "honored," "recognized," given

[54] 29 U.S.C. § 1322(c).

[55] 29 U.S.C. § 1306(a)(1)(3).

[56] *In re Owens Corning*, 419 F.3d 195, 206 (3d Cir. 2005).

[57] Op. at 105.

"validity," or "included" in its modified pro rata allocation.[58] Yet in a glaring oversight in this "gargantuan" proceeding,[59] the bankruptcy court failed to allocate to the U.S. Debtors any of the proceeds from the Enterprise Sale attributable to NGS and DiamondWare.

NGS and DiamondWare were non-debtors, wholly owned by NNI. Thus, they were members of NNI's controlled group. Given that the Pension Plan had recently terminated, and that NGS and DiamondWare as non-debtors were not protected by the automatic stay,[60] PBGC could have asserted statutory liens in favor of PBGC against the assets of NGS and DiamondWare.[61] Doing so would have made the Enterprise Sale unacceptable to the proposed purchaser Avaya. After PBGC filed a limited objection to the Enterprise Sale, PBGC and NNI negotiated a proposed resolution. NNI moved under Rule 9019 to settle the dispute by stipulation. PBGC agreed under the stipulation to release and waive against the Non-Debtor Subsidiaries any claim, lien, interest, or obligation for joint-and-several liability; NNI agreed to grant PBGC a lien on the proceeds of the Enterprise Sale that were allocated to the sale of the shares of the Non-Debtor Subsidiaries. The bankruptcy court approved the stipulation.[62]

In disregarding its own order of October 13, 2009, the bankruptcy court lost sight of the procedural history. The court flatly contradicted its own pronouncement that "settlements" approved by the court would be "included" in the allocation.[63] And the effect—to give the

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[58] *Id*. at 60, 62, 63, 93, 102 (twice), 107, 112.

[59] *Id.* at 1.

[60] 11 U.S.C. § 362.

[61] 29 U.S.C. § 1368.

[62] Bankr. D.I. 1658.

[63] Op. at 112.

purchaser Avaya its consideration for the Enterprise Sale, but to deny the seller and PBGC the benefit they expected from the bargain—pulled the rug out from under the U.S. Debtors and PBGC.

After the bankruptcy court issued its allocation opinion, the U.S. Debtors moved for reconsideration upon two specific issues, one of which was this precise question:

> **NGS/DiamondWare Allocation.** The Court's decision not to allocate to the U.S. Debtors any of the Lockbox proceeds attributable to the sale of NGS and DiamondWare . . . even though (i) each of these was a non-integrated, non-debtor entity, the equity of which was sold by NNI as part of the Enterprise sale; (ii) in 2009, this Court entered an order granting to the PBGC a lien on that portion of the Enterprise proceeds attributable to the equity of each of NGS and DiamondWare, and (iii) the Canadian Debtors' own expert acknowledged the U.S. Debtors' entitlement to the full proceeds of such sales in his allocation calculation.[64]

Confronted in the motion for reconsideration with these inconsistencies, and reminded of its insistence that "settlements" would be "honored" and "recognized," the bankruptcy court offered only a one-sentence non sequitur: "the allocation is not ownership based."[65] Thus, the bankruptcy court refused to allocate to the U.S. Debtors proceeds attributable to the NGS and DiamondWare sales, implicitly vitiating PBGC's lien.

The court was wrong. Its earlier order expressly contemplated that an allocation be made to the U.S. Debtors for the value of the proceeds from sale of the NGS and DiamondWare shares, and that PBGC would have a lien on those proceeds. No debtor would have sold property of its estate without an expectation that it would receive the corresponding sale proceeds. And PBGC would never have forgone asserting liens on the

[64] Bankr. D.I. 15611 at 4.

[65] Reconsideration Op. at 4.

assets of NGS and DiamondWare before the Enterprise Sale closed without an expectation that it would have an enforceable property interest in those same proceeds.

The bankruptcy court may have "honored," "recognized," and "included" other "settlements" in the Decision, but it failed to accord such treatment to NNI and PBGC. The court's allocation to debtors other than NNI of the Enterprise Sale proceeds attributable to NGS and DiamondWare—exclusive NNI assets upon which PBGC obtained a court-ordered lien under a settlement approved under Rule 9019—was inconsistent with its own prior order.

Conclusion

For the reasons herein and in the briefs of the U.S. Debtors and the Committee, this Court should reverse the Decision of the bankruptcy court.

If this Court affirms part of the Decision, it should nevertheless reverse in part with instructions upon remand that the bankruptcy court (1) exclude the proceeds of the Enterprise Sale from the so-called "Lockbox" funds allocated to the various estates, and instead allocate and pay them directly to NNI, and (2) recognize and enforce PBGC's lien against those assets.

Date: December 3, 2015

Respectfully submitted,

/s/ Vicente Matias Murrell

Office of the General Counsel
JUDITH R. STARR
General Counsel

Office of the Chief Counsel*
ISRAEL GOLDOWITZ
Chief Counsel
CHARLES L. FINKE
Deputy Chief Counsel
GARTH D. WILSON
Assistant Chief Counsel
(DC Bar No. 424922)
VICENTE MATIAS MURRELL
(MD Bar No. 9806240098)
MARC S. PFEUFFER
Attorneys

PENSION BENEFIT GUARANTY CORPORATION
1200 K Street, N.W.
Washington, D.C. 20005-4026
Telephone: (202) 326-4020 ext. 3580
Facsimile: (202) 326-4112
murrell.vicente@pbgc.gov

Counsel for Appellant and Cross-Appellee
Pension Benefit Guaranty Corporation

*Under Local Rule 83.5(f)(1), persons acting as attorneys for the United States or any of its departments, agencies, or officials are not required to associate with Delaware counsel.

Certificate of Compliance

In accordance with Bankruptcy Rule 8015(a)(7)(C), I certify that this brief contains 25 or fewer pages, excluding the parts exempted by Bankruptcy Rule 8015(a)(7)(B)(iii), and therefore complies with the length requirements established by the order of this Court dated November 2, 2015. D.I. 27.

December 3, 2015 /s/ Vicente Matias Murrell