

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF SOUTH CAROLINA**

In re:

CAFÉ HOLDINGS CORP., *et al.*

Debtors.

Case No. 18-05837-hb

Chapter 11

**OBJECTION OF UNITED STATES TRUSTEE TO DEBTORS'
MOTION (1) AUTHORIZING THE DEBTORS TO OBTAIN POST-PETITION
FINANCING, GRANTING SENIOR POSTPETITION SECURITY INTERESTS AND
ACCORDING SUPERPRIORITY ADMINISTRATIVE EXPENSE STATUS PURSUANT
TO SECTIONS 364(C) AND 364(D) OF THE BANKRUPTCY CODE,
(2) AUTHORIZING THE USE OF CASH COLLATERAL, (3) GRANTING
ADEQUATE PROTECTION, (4) MODIFYING THE AUTOMATIC STAY,
AND (5) GRANTING RELATED RELIEF**

The United States Trustee (the “UST”), by and through his counsel, hereby files this objection to the Debtors’ Motion for a Final Order Authorizing the Debtors to Obtain Post-Petition Financing, Granting Senior Post-Petition Security Interests and According Superpriority Administrative Expense Status Pursuant to Sections 364(c) and 364(d) of the Bankruptcy Code, (2) Authorizing the Use of Cash Collateral, (3) Granting Adequate Protection, (4) Modifying the Automatic Stay, and (5) Granting Related Relief (the “DIP Motion”). The UST files this objection pursuant to the authority granted to her by 28 U.S.C. § 586 and 11 U.S.C. § 307.¹

In support of the Objection, the UST respectfully states:

SUMMARY

The Debtors have made clear that they are not in a position to reorganize, and that the focus of these Chapter 11 cases will be on the liquidation of the Debtors’ assets. Atalaya Capital Management, LP and some of its affiliates (collectively, “Atalaya”), which bought the first lien debt on November 13, 2018 – two days before the cases filed bankruptcy – will be the primary

beneficiary of the liquidation. Atalaya is now owed approximately \$10 million and has offered to lend the Debtors \$3.2 million to fund the bankruptcy proceedings, while acting as stalking horse bidder for the Debtors' assets. With a lot at stake, Atalaya is now dictating to the Debtors the terms on which it is willing to extend post-petition financing.

The UST generally does not object to the Debtors' request for the use of cash collateral or the approval of debtor-in-possession financing. The relief sought in the DIP Motion, however, proposes several significant benefits to Atalaya which, if permitted, would force upon other creditors the costs of liquidating Atalaya's collateral, would grant a lien on avoidance actions which proceeds should be preserved for the benefit of other creditors, and would bind a later appointed trustee to the agreement between Atalaya and the Debtors. Accordingly, the Objection raised is limited to certain provisions in the proposed order approving the DIP Motion that should be modified for the protection and interest of all parties in interest in order to comply with the Bankruptcy Code, Bankruptcy Rules, and the Local Bankruptcy Rules. For the reasons set forth below and as set forth at the first day hearing, the UST requests that:

- Atalaya should not be granted a lien on avoidance actions.
- The waiver of the Debtors' claims and rights pursuant to 11 U.S.C. § 506(c) should not be permitted.
- Atalaya should not be granted a superpriority administrative expense claim with priority over any other indebtedness and over all other administrative expenses or charges against property of the estate, with recourse to all prepetition and postpetition property of the Debtors and all proceeds thereof.
- The relief granted in the DIP Motion should not be binding on a later appointed trustee.
- The budget should be revised to include payments related to the appointment of a consumer privacy ombudsman, to the extent the Court orders the UST to appoint one.

¹ Further reference to Title 11 U.S.C. § 101, *et. seq.* will be by section number only.

GENERAL BACKGROUND

1. On November 15, 2018 (the “Petition Date”), the Debtors each filed a voluntary petition in this Court for relief under Chapter 11 of the Bankruptcy Code. The Debtors continue to manage and operate their businesses as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code. The Chapter 11 cases are being jointly administered for procedural purposes.

2. On November 28, 2018, the Office of the UST appointed a committee of general unsecured creditors.

3. On the Petition Date, the Debtors filed the DIP Motion, seeking entry of an order authorizing the Debtors to obtain secured post-petition financing from Atalaya in the aggregate amount of \$3.2 million. The DIP financing appears to be structured to provide the Debtors with just enough funding to permit them to consummate a quick sale of their assets under 11 U.S.C. § 363 – with Atalaya acting as the stalking horse bidder and credit bidding all or a portion of its debt.

4. On November 19 and 20, 2018, the Court conducted hearings on various first day motions and entered an Interim Order granting the DIP Motion on an interim basis, with some limitations (the “Interim Order”). *See* ECF Doc. No. 70. The Interim Order provides for, among other things:

- a. A lien on the proceeds of any causes of action that could be brought pursuant to sections 544, 545, 547, and 548 of the Bankruptcy Code, or any applicable state fraudulent transfer statutes (the “Avoidance Actions”), subject to entry of a final order. *See* Interim Order at ¶ 6 (“Subject to entry of the Final Order, the DIP Collateral shall include proceeds of (and property received in respect of) Avoidance Actions.”).

- b. A postpetition superiority administrative expense claim against each of the Debtors with recourse to all prepetition and postpetition property of the Debtors and all proceeds thereof under sections 503 and 507 of the Bankruptcy Code against the Debtor's estates. *See* Interim Order at ¶ 9.A; *see also* Interim Order at ¶ 4 ("the DIP Facility Funds advanced pursuant to the terms of this Inter Order . . . shall be allowed administrative expenses of the Debtors' estates, which shall have priority in payment over any other indebtedness . . . including, without limitation, those specified in Bankruptcy Code sections . . .506(c).
- c. A waiver of the rights under 11 U.S.C. § 506(c) to surcharge Atalaya's collateral. *See* Interim Order at ¶ 15 ("Subject to the entry of the Final Order, effective as of the time of commencement of the Debtor's bankruptcy cases on the Petition Date: (A) each of the Debtors waives irrevocably all claims and rights, if any, it or its estate might otherwise assert against the Pre-Petition Collateral or DIP Collateral pursuant to Bankruptcy Code sections 506(c), 105(a) or any other applicable law"); *see also* Interim Order at ¶¶ 4, 9(B).
- d. A binding effect of the final order on any successor trustee to the Debtors. *See* Interim Order at ¶ 31 ("The Initial Order shall be binding upon and inure to the benefit of the DIP Agent, the DIP Secured Parties, the Pre-Petition ACM Secured Parties, the Debtors, and subject other entry of the Final Order, their respective successors and assigns, including, without limitation, any trustee, responsible officer, examiner, estate administrator or representative, or similar person appointed in a case for the Debtors under any chapter of the Bankruptcy Code.").

ARGUMENT

The DIP Motion should be denied, unless the overreaching provision of the DIP facility agreement and proposed order are stricken. In order to obtain post-petition financing under 11 U.S.C. § 364(d), a debtor bears the burden of proving that (i) it is unable to obtain unsecured credit, (ii) the proposed credit is necessary to preserve the assets fo the estate, and (iii) the terms of the financing are fair, reasonable, and adequate. 11 U.S.C. § 364(d); *In re Ames Dept. Stores, Inc.*, 115 B.R. 34, 37 (Bankr. S.D.N.Y. 1990). Post-petition financing also should not be authorized if its primary purpose is to benefit a creditor over the estate. *See Ames Dep't Stores*, 115 B.R. at 27; *In re Tenney Village Co., Inc.*, 104 B.R. 562, 568 (Bankr. D.N.H. 1989) (denying

secured financing agreement where execution of agreement would violate debtor's fiduciary obligations to estate, and bank would disarm debtor of all weapons against bank for benefit of estate). Here, the Debtors have had unequal bargaining power in negotiations in that, being low in cash flow, they have been at the mercy of Atalaya for the continuing funding of the Debtors' operations. If the proposed DIP lenders continue to use their leverage over the Debtors, certain of the provisions they seek to include in the final DIP Order could cause significant harm to other creditors and parties in interest.

A. Atalaya Should Not Be Granted a Lien on Avoidance Actions

Pursuant to the Interim DIP Order, Atalaya seeks to obtain liens on the recoveries from avoidance actions. *See supra* at ¶ 4.a. The UST objects to the grant of these liens. The recovery actions permitted under Chapter 5 of the Bankruptcy Code were enacted to ensure equality of payment to unsecured creditors. *See Mellon Bank v. Glick (In re Integrated Testing Products Corp.)*, 69 B.R. 901, 905 (D.N.J. 1987) (although preference action recovery might have been subject to creditors' security interest, to allow secured creditor the right to those recoveries would "frustrate the policy of equal treatment of creditors under the Code and would contradict the plain meaning of section 551 of the Bankruptcy Code."); *In re Sapolin Paints, Inc.*, 11 B.R. 930, 937 (Bankr. E.D.N.Y. 1981) ("the power to avoid a preference is one which is to be exercised in the interests of securing equality of distribution among creditors."). Recoveries under Chapter 5 are to be shared on a *pro rata* basis among unsecured creditors. The purpose of the avoidance provisions is defeated if a secured creditor – such as Atalaya – is granted liens on Chapter 5 recoveries.

Bankruptcy Rule 4001(c)(xi) as well as Local Bankruptcy Rule 4001-4(H) identify the grant of a lien on avoidance actions as an extraordinary provision. The DIP Motion, however,

provides no explanation as to the need for granting the DIP Lenders a lien on the avoidance actions, especially when it appears that there is no possible recovery to any creditors – aside Atalaya – in these Chapter 11 proceedings short of some “gifting” and possible avoidance actions. This Court has not allowed such liens in prior cases and these Chapter 11 proceedings should be no exception. *See In re Bi-Lo, LLC*, Case No. 09-02140(HB) (Bankr. D.S.C. April 16, 2009), Final Order (A) Approving Senior Secured Superpriority Postpetition Financing, (B) Authorizing Use of Cash Collateral, (C) Granting Liens and Providing Superpriority Administrative Expense Status, (D) Granting Adequate Protection and Modifying Automatic Stay, at ¶ 6. *See also In re The Merit Group, Inc.*, Case No. 11-03216(HB) (Bankr. D.S.C. June 10, 2011), Final Order Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364, and 507(I) Approving Post-Petition Financing, (II) Authorizing Use of Cash Collateral, (III) Granting Liens and Providing Superpriority Administrative Expense Status, (IV) Granting Adequate Protection, and (V) Modifying the Automatic Stay, at ¶5(b).

B. The Section 506(c) Waiver Should Not Be Granted

As set forth above, the Interim DIP Order provides for a waiver of the rights under 11 U.S.C. § 506(c) to surcharge Atalaya’s collateral, subject to the entry of a final order. *See supra* at ¶4.b. Recognizing the unequal bargaining power inherent in negotiations leading to proposed post-petition financing, courts have often rejected attempted waivers of surcharge rights under section 506(c) of the Bankruptcy Code. *See In re Colad Group, Inc.*, 324 B.R. 208, 224 (Bankr. W.D.N.Y. 2005) (refusing to approve postpetition financing agreement in form proposed when it included, among other things, a section 506(c) waiver). As a general rule, administrative costs of reorganization may not be charged against the collateral of a secured creditor; however, section 506(c) provides an exception to allow a surcharge for reasonable and necessary expenses where

the trustee has “(1) incurred the expenses in preserving or disposing of the debtors’ property, and (2) benefitted the secured creditor by its actions.” *In re Kivitz v. CIT Group/Sales Finance, Inc.*, 272 B.R. 332 (D. Md. 2000) (citing *In re Visual Indus., Inc.*, 57 F.3d 321, 325 (3rd Cir. 1995)).

The reason for the rules is to prevent a windfall to the secured creditors in that unsecured creditors should not bear the cost of protecting property from which they will receive no benefit.

Id.

Consistent with these authorities, Bankruptcy Rule 4001(c)(x) and Local Bankruptcy Rule 4001-4(b)(1)(C) also identify a waiver of section 506(c) as an overreaching provision and generally not acceptable. The UST thus requests that any waiver of 11 U.S.C. § 506(c) be struck from the Final DIP Order or, at a minimum, the UST requests that the Final DIP Order specify that the section 506(c) waiver is effective only during the period in which the Debtors are authorized to use cash collateral or borrow funds (see LBR 4001-4(b)(1)(B)).

C. Atalaya Should Not Be Granted a Superpriority Claim Over Avoidance Actions and Section 506(c) Claims

As set forth above, the Interim DIP Order provide that, pursuant to §§ 363 and 364(c) and (d), the DIP Facility funds would be allowed administrative expense status with priority over “any other indebtedness and/or obligations now in existence or incurred hereafter by the Debtors and over all administrative expenses or charges against property arising in the Debtor’s Chapter 11 cases and any superseding Chapter 7 case including, without limitation, those specified in Bankruptcy Code sections 105, 326, 328, 330, 331, 503(b), 506(c), . . . , subject and junior only to the Carve-Out.” *See* Interim DIP Order at ¶ 4; ¶ 9(B) (granting DIP Lender a postpetition superpriority administrative expense claim against each of the Debtors with recourse to all property and all proceeds). Granting Atalaya a superpriority claim, without carving out

Avoidance Actions and § 506(c) claims is tantamount to granting it a lien over Avoidance Actions as well as a waiver of §506(c) surcharge rights. For the same reasons as set forth in Sections A and B above, the UST objects to granting Atalaya any such superpriority claim without carving out Avoidance Actions and section 506(c) claims.

D. The Final DIP Order Should Not Be Binding on a Successor Trustee

The Interim DIP Order proposes that upon it becoming final, its terms and provisions be binding on a later appointed trustee – including a Chapter 7 Trustee. *See supra* at ¶4.c. The DIP Motion sets forth the various sections of the DIP Order that are to bind any successor to the Debtors and justifies the inclusion of those provisions because “the DIP Secured Parties will not enter into the DIP Facility without these provisions.” Notice and Motion Pursuant to Federal Rule of Bankruptcy Procedure 4001(d), p. 8.

Given the context in which the DIP Motion arises and the fact that the main purpose of the financing is to fund the operations of the Debtors in an amount sufficient to carry them through a quick sale whereby Atalaya will receive substantially all the Debtors’ assets in exchange for the credit bid for its first lien debt that it purchased a mere two days prior the Petition Date, the terms of the DIP Order should not be binding on any successor Chapter 7 Trustee. Such provision is deemed overreaching, especially in a case such as this, where conversion to a Chapter 7 is a likely possibility given that it remains questionable at this time how the Debtors could meet the requirements of 11 U.S.C. § 1129 to confirm a plan.

E. The Budget Should Be Revised

The UST has not seen a draft of a budget to be submitted with the proposed Final DIP Order – to the extent one is circulating or being negotiated. Accordingly, the UST reserves his rights to raise any other issues with respect to the payments proposed therein. At a minimum,

the UST requests that any final budget include, to the extent that the Court orders the UST to appoint a consumer privacy ombudsman in connection with the sale of substantially all of the Debtors' assets, that any fees and expenses related to the ombudsman and any retained professional be also included as part of the budget and carve-out.

CONCLUSION

The UST objects to the provisions discussed above and requests that to the extent that a Final DIP Order is entered, that the provisions be eliminated to ensure that the Debtors' estates are not burdened with unreasonable and unnecessary charges and expenses, and that assets that were not part of Atalaya's collateral prior to bankruptcy will remain unencumbered and available for the benefit of the general unsecured creditors.

WHEREFORE, the UST respectfully requests that the DIP Motion be denied unless all of the overreaching provisions are eliminated, and the interests of the Debtors' estates are properly protected.

JOHN P. FITZGERALD, III
ACTING UNITED STATES TRUSTEE
REGION FOUR

By: /s/ Elisabetta G. Gasparini
Elisabetta G. Gasparini, Id. 11548
Trial Attorney
1835 Assembly Street, Ste. 953
Columbia, SC 29201
(803) 765-5227
(803) 765-5260 (facsimile)
Elisabetta.g.gasparini@usdoj.gov

Date: 12/10/2018

CERTIFICATE OF SERVICE

I, Elisabetta G. Gasparini, do hereby certify that on December 10, 2018, I served the below-named documents upon the parties listed below by electronic mail.

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Haynes and Boone, LLP
Ian T. Peck
J. Frasher Murphy
2323 Victory Avenue, Suite 700
Dallas, TX 75219

McNair Law Firm, P.A.
Robin Stanton
Michael Weaver
104 South Main Street, Suite 700
Greenville SC 29601

Holland & Knight LLP
Brent McIlwain
200 Crescent Court, Suite 1600
Dallas, TX 75201

Fox Rothschild, LLP
Kevin McCarrell
2 W. Washington St., Suite 1100
Greenville, SC 29601

Bradford J. Sandler
Pachulski Stang Ziehl & Jones LLP
919 North Market Street, 17th Floor
Wilmington, DE 19801

Keith Poston
Nelson Mullins
1320 Main Street
Columbia, SC 29201

By: /s/ Elisabetta G. Gasparini
Elisabetta G. Gasparini, Id. 11548
Trial Attorney
1835 Assembly Street, Ste. 953
Columbia, SC 29201
(803) 765-5227
(803) 765-5260 (facsimile)
Elisabetta.g.gasparini@usdoj.gov

Date: 12/10/2018