IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	)	Case No. 17-10064 (KG)
Chieftain Sand and Proppant, LLC, *et al*.,	)	Chapter 11
Debtors.[1]	)	(Jointly Administered)
	)	**Re: Docket No. 209**

DEBTORS' OBJECTION TO CALDWELL BAKER CO.'S MOTION FOR ALLOWANCE AND IMMEDIATE PAYMENT OF ADMINISTRATIVE EXPENSE CLAIM

The above-referenced debtors and debtors in possession (collectively, the "***Debtors***"), file this objection (the "***Objection***") to the *Motion of Caldwell Baker Co. for Allowance and Immediate Payment of Administrative Expense Claim* (the "***Motion***") [Docket No. 209] and in support thereof, the Debtors respectfully state as follows:

BACKGROUND

A. General Background

1. Chieftain is a privately-owned producer of hydraulic fracturing sand ("***Frac Sand***"), a monocrystalline sand used as a proppant (a solid material, typically sand, designed to keep an induced hydraulic fracture open) to enhance oil and gas product recovery in petroleum-rich unconventional shale deposits.

[1] The Debtors in these chapter 11 cases, and the last four digits of their respective federal tax identification numbers, are Chieftain Sand and Proppant, LLC (1729) and Chieftain Sand and Proppant Barron, LLC (0418). The Debtors' service address is: 331 27th Street, New Auburn, WI 54757.

2. On January 9, 2017 (the "***Petition Date***"), the Debtors each filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code, thereby commencing the above captioned bankruptcy cases.

3. Since the Petition Date, the Debtors have continued to operate and manage their businesses as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code. As of the date hereof, an official committee of unsecured creditors has not been appointed in these cases.

4. On March 27, 2017, the Court entered the Order (A) Authorizing and Approving (1) the Sale of Substantially All of the Debtors' Assets Free and Clear of All Liens, Claims, Encumbrances and Other Interests and (2) the Assumption and Assignment of Certain Executory Contracts and Unexpired Leases in Connection Therewith (the "***Sale Order***") [Docket Item No. 178], which order approves the Debtors' entry into and execution of the related asset purchase agreement (as amended) with Mammoth Energy Services, Inc. or its designee, attached as an exhibit to the Sale Order (the "***Asset Purchase Agreement***"), or the Debtors' entry into and execution of an asset purchase agreement with the Back-up Bidder (the "***Back-Up Bidder Asset Purchase Agreement***"). The Debtors and purchaser, Mammoth Energy Services, Inc., expect to close on the sale transaction prior to a hearing on the Motion.

B. <u>Background Related to Motion</u>

5. Caldwell Baker Co. ("***Caldwell Baker***") and the Debtors were party to that certain railcar lease agreement for 200 railcars that terminated on September 30, 2016.

6. As more fully set forth in the Declaration of Victor Serri in Support of Chapter 11 Petition and First Day Pleadings [Docket No. 4] (the "***First Day Declaration***"), by 2015 the Debtors were confronted with a liquidity crisis due to the petroleum recession that commenced

around 2014. Demand for Frac Sand was diminishing and the Debtors were forced to initiate various cost-cutting initiatives.

7. One of the cost-cutting initiatives that the Debtors undertook was to attempt to restructure their railcar leases. In addition to the 200 railcars leased from Caldwell Baker, the Debtors were party to a railcar lease with CIT Railcar Funding, LLC ("**CIT**") for approximately 467 railcars. Unlike the CIT railcars that were in good condition, the Caldwell Baker railcars were almost 40 years old and nearing the end of their useful life.

8. By May of 2016, the Debtors had made progress with CIT concerning a consensual restructuring of the CIT lease and the parties ultimately reached an agreement that resulted in a reduction of the lease payments due CIT. Caldwell Baker, on the other hand, refused to restructure their lease absent the Debtors making a formal proposal to Caldwell Baker that included an up-front cash payment and long-term note on account of past-due rent.

9. Notwithstanding the fact that the Debtors lacked sufficient cash to make payment on account of past due rent, they voluntarily provided their financial statements and other relevant financial information to Caldwell Baker in a good faith effort to restructure the terms of the lease. Even with access to the Debtors' financial records showing lack of available cash, Caldwell Baker kept insisting that the Debtors had the financial wherewithal to make the payments under the lease and verbally accused the Debtors of engaging in fraudulent conduct.

10. In addition to accruing rental charges under the lease that the Debtors could not afford to make, due to a lack of available rail at the Debtors' plant, the Debtors were incurring storage charges due Iowa Northern Railway Company ("***Iowa Northern***") pursuant to an agreement between Iowa Northern and the Debtors concerning storage of excess railcars.

11. Due to limited demand for Frac Sand and with Caldwell Baker's lease set to expire in September 2016, on May 25, 2016, the Debtors initiated a series of email correspondence to Caldwell Baker requesting that Caldwell Baker provide the Debtors with a return location for unused or returned railcars. Despite Caldwell Baker being concerned about the Debtors' ability to comply with the terms of its lease, Caldwell Baker responded that it hoped to provide return instructions to the Debtors before the lease terminated at the end of September 2016.

12. Obtaining timely return instructions from Caldwell Baker was critical to the Debtors' efforts to conserve their remaining cash. This is due to the fact that freight charges related to the return of such railcars were already paid when the sand was first shipped to third-party end user terminals. To the extent instructions could be provided to the Debtors in advance of the unloading of the Frac Sand from the railcars, the Debtors could divert the railcars back to Caldwell Baker' preferred return location, thereby avoiding the extra time and expense of having such railcars sent to Iowa Northern for storage. Despite repeated assurances from Caldwell Baker that they would timely provide the Debtors with return information, with the exception of approximately 58 railcars that were returned to Caldwell Baker prior to the bankruptcy, all remaining railcars had to be diverted to Iowa Northern for storage since Caldwell Baker failed to timely advise the Debtors concerning return instructions.

13. By the summer of 2016, demand for the Debtors' Frac Sand was non-existent, resulting in the Debtors writing-down their Frac Sand inventory to zero on their books for accounting purposes. In addition, although railcars were located throughout the country during this time, the Frac Sand in such railcars had already been sold to third parties and the sales had already been accounted for on the Debtors' books and records.

14. In September 2016, with the Debtors projected to run out of cash prior to year-end, the Debtors were forced to shut down their business, layoff most of their employees and warm-idle their plant.

15. On November 3, 2016, Iowa Northern terminated its storage agreement with the Debtors due to non-payment of rent.

16. As of the Petition Date, 140 empty railcars belonging to Caldwell Baker were being stored at Iowa Northern and two were at terminals still waiting to be offloaded due to a lack of demand for the Frac Sand (with such Frac Sand no longer belonging to the Debtors). All other railcars were in the possession of Caldwell Baker. Despite the unsubstantiated statements in the Motion, the Debtors have never entered into agreements to sublet the railcars in violation of the lease.

17. On January 11, 2017, the Debtors filed a motion to reject certain contracts and unexpired leases nunc pro tunc to the Petition Date [Docket No. 43], including its railcar lease with CIT. The Court entered an Order [Docket No. 113] approving such rejection motion on February 3, 2017. The Caldwell Baker lease was not included since it had terminated pre-petition. At the time of rejection, certain of CIT's railcars were located at Iowa Northern. Upon information and belief, CIT was able to secure the return of such railcars from Iowa Northern notwithstanding the fact that Iowa Northern had previously terminated its storage agreement with the Debtors.

18. Notwithstanding the fact that (i) the Debtors engaged in good faith negotiations to restructure the lease with Caldwell Baker and repeatedly requested return instructions from Caldwell Baker with respect to the railcars well in advance of the lease termination date, (ii) the lease terminated approximately three months prior to the Petition Date, (iii) the Debtors ceased

operating their businesses in September 2016, (iv) the approved DIP Budget (which was served on Caldwell Baker) contained no line item for payment of post-petition rent on account of their lease, (v) Caldwell Baker failed to timely provide the Debtors' with return locations for the majority of their the railcars and (vi) the Debtors obtained no post-petition benefit from the lease or railcars, Caldwell Baker waited more than three months after the filing of these cases to make its demand for payment of over half a million dollars' worth of alleged rent due under the lease.

OBJECTION

19. Caldwell Baker has failed to demonstrate that it conferred an actual benefit to the Debtors' estates, as required pursuant to 11 U.S.C. § 503(b) in order to have a valid administrative claim. Section 503(b) of the Bankruptcy Code provides that, "[a]fter notice and a hearing, there shall be allowed, administrative expenses ... including– (1)(A) the actual, necessary costs and expenses of preserving the estate ...." Pursuant to section 507(a)(1) of the Bankruptcy Code, administrative expenses are entitled to the highest priority in the distribution of assets of the debtor's estate. 11 U.S.C. § 507(a)(1).

20. Courts narrowly construe administrative expenses because "the affording of priority status to one creditor has an impact upon other creditors of the debtor's estate and conflicts with the goal of bankruptcy to provide creditors with an equal distribution of a debtor's resources ...." *In re Lease-A-Fleet, Inc.*, 140 B.R. 840, 844 (Bankr. E.D. Pa. 1992); *see also In re Unidigital, Inc.*, 262 B.R. 283, 288 (Bankr. D. Del. 2001) (noting that administrative expenses "affect two important bankruptcy concerns: minimizing administrative costs during Chapter 11 to preserve the debtor's scarce resources and thus encourage rehabilitation ... and obtaining maximum and equitable distribution of estate assets to creditors").

21. Thus, the Third Circuit has established strict criteria for determining whether a claim is entitled to administrative expense status. To qualify, a claimant must demonstrate that the expense (i) arose from a postpetition transaction with the debtor in possession and (ii) provided an actual benefit that was necessary to preserve the value of the estate. *See Calpine Corp. v. O'Brien Envtl. Energy, Inc. (In re O'Brien Envtl. Energy Inc.)*, 181 F.3d 527, 532–33 (3d Cir. 1999) (citing *Cramer v. Mammoth Mart, Inc. (In re Mammoth Mart, Inc*.), 536 F.2d 950, 954 (1st Cir. 1976)) ("the debt must arise from a transaction with a debtor in possession *and the consideration supporting the claimant's right to payment must be beneficial to the debtor in possession in the operation of the business*.") (emphasis supplied); *see also Unidigital*, 262 B.R. at 288–89 (applying test from *Mammoth Mart* and finding that "absent a benefit to the estate, no priority claim is allowable"); *In re Cont'l Airlines, Inc.*, 146 B.R. 520, 526 (Bankr. D. Del. 1992) ("Of course, only those expenses that genuinely inure to the benefit of the estate deserve payment ahead of other claimants ... If the estate has not benefited, the administrative claim results in unnecessary depletion of assets to the detriment of all creditors.").

22. Further, only expenses providing an actual and concrete benefit to the estate deserve administrative status ahead of other creditors. One of the underlying purposes of granting such benefits administrative priority is because the estate, as the recipient of an actual benefit, would otherwise be unjustly enriched. *See In re Cont'l Airlines, Inc*., 146 B.R. 520 (Bankr. D. Del. 1992). But "only those expenses that genuinely inure to the benefit of the estate deserve payment ahead of other claimants." *Id.* at 526 (emphasis supplied). "If the estate has not benefited, the administrative claim results in unnecessary depletion of assets to the detriment of all creditors." *Id.*

23. Accordingly, if a creditor confers only a potential benefit upon the estate rather than an actual benefit, the creditor should not be awarded an administrative claim. *See In re ICS Cybernetics, Inc.* 111 B.R. 32, 36 (Bankr. N.D.N.Y. 1989). The *Cybernetics* court, in rejecting a broad interpretation of the term "actual," stated that:

> This more narrow interpretation requires actual use of the creditor's property by the debtor, thereby conferring a concrete benefit on the estate before a claim is allowable as an administrative expense. Accordingly, the mere potential of benefit to the estate is insufficient for the claim to acquire status as an administrative expense. The court's administrative expense inquiry centers upon whether the estate has received an actual benefit, as opposed to the loss a creditor might experience by virtue of the debtor's possession of its property.

Id. (emphasis supplied). Applying this principle, the court denied administrative expense status to a creditor for equipment that a debtor held in storage but was not using. *Id.* at 38. The court held that although keeping equipment for purpose of assuring availability to end-users at a later date was a prudent business practice, it conferred only a potential benefit upon the estate, not an actual benefit, because the estate never ended up using the equipment. *Id.; see also In re Enron Corp.*, 279 B.R. 695, 706 (Bankr. S.D.N.Y. 2002) (and cases cited therein) ("[t]he mere possession of the claimant's property by the debtor does not warrant administrative claim status [and] the 'option' to use the property that is inherent in possession is considered not sufficient to establish benefit to the estate if the debtor does not actually use the property.") (internal citations omitted); *General Am. Trans. Corp. v. Martin (In re Mid Region Petroleum Inc.),* 1 F.3d 1130, 1133 (10th Cir. 1993) (holding that mere possession of leased rail cars "is not the type of benefit which is provided administrative expense protection because a benefit to the estate only results from use of the leased property"); *In re Patient Educ. Media, Inc.*, 221 B.R.

97, 102 (Bankr. S.D.N.Y. 1998) (stating that, if the debtor "does not use the property, the nondebtor is relegated to an unsecured claim. Even where the debtor in possession possesses a nondebtor's property, or has the option to use, no administrative expense liability will attach unless he actually uses it").

24. The Delaware Bankruptcy Court in *Continental* adopted a similar narrow interpretation of "actual benefit." *In re Cont'l Airlines, Inc.*, 146 B.R. at 527-28 (refusing to award administrative expense status to damages arising from a debtor's postpetition breach of an airplane lease). The *Continental* Court noted the importance of proving an actual benefit to the estate arising from the breach -- the fact that a debtor's breach presumably makes available to the estate the money that the debtor would have used to perform is not an "actual benefit." All breaches have that effect and therefore the analysis "omits the 'actual, necessary' requirement of section 503(b)(1)(A)." *Id.* at 527-28. Instead, what must be shown is whether the estate is unjustly enriched -- in other words, whether the consideration that the creditor provided the estate in return for the money it seeks to recover as an administrative expense conferred an actual and concrete benefit upon the estate.

25. **If a claimant "cannot establish a benefit to the estate, the breach of an executory agreement or lease does not give rise to a claim for administrative expense, but only an unsecured breach of contract claim under section 502(g)."** *Continental Airlines*, 146 B.R. at 526 (internal quotation omitted) (emphasis added).

26. In the instant case, Caldwell Baker cannot satisfy its burden that the Debtors' estates benefitted post-petition in connection with its lease. As set forth in the First Day Declaration and repeated on multiple occasions throughout these cases, the Debtors ceased business operations in September 2016. The Debtors' approved DIP Budget, which was served on Caldwell Baker,

contained no line item for payment of post-petition rent related to railcars since the Debtors were not operating during the bankruptcy. In fact, the Debtors immediately moved to reject its lease with CIT (the other railcar lessor) when they filed for bankruptcy protection since they no longer had any need for railcars. Although certain CIT railcars contained Frac Sand in them and others were located at Iowa Northern, CIT consented to the rejection effective as of the Petition Date and did not seek administrative rent from the Debtors.

27. As set forth by the court in *Cybernetics*, the mere possession and storage of the property is not enough to entitle Caldwell Baker to an administrative expense claim. Caldwell Baker must show that the Debtors used the property post-petition in the ordinary course of the Debtors' business. *See Id.* at 527 (holding that the requirement for an administrative expense claim is that the property was used by the debtor post-petition in the ordinary course of business).

28. According to the Debtors' records, as of the Petition Date, 140 railcars belonging to Caldwell Baker were being stored at Iowa Northern, 58 were previously returned to the lessor and 2 remained at third-party terminals loaded with Frac Sand, with the Debtors having no remaining financial interest in such Frac Sand. Although the Debtors made every attempt to return the railcars to Caldwell Baker's preferred locations, the Debtors were forced to divert most of the railcars to Iowa Northern as a result of Caldwell Baker's failure to timely provide return instructions.

29. Further, with respect to Caldwell Baker's unsubstantiated allegation that it is prohibited from inspecting railcars that are located at Iowa Northern, many of CIT's railcars were also located at Iowa Northern as of the Petition Date and CIT never informed the Debtors that they had any difficulty inspecting and/or removing their railcars from Iowa Northern.

30. To the extent that Caldwell Baker alleges that the Debtors entered into agreements with other entities concerning the use of the railcars as a basis for their administrative expense claim, the Debtors vehemently deny entering into any such agreements. The only income that the Debtors derived during these cases (as reflected in their Monthly Operating Reports) resulted from collection of accounts receivable and wet sand sales that took place on-site and did not involve use of railcars. In fact, the Debtors could not move any railcars during these cases since the locomotives that are required to move the railcars were removed prior to the filing.

31. Finally, to the extent Caldwell Baker takes the position that the Debtors' failure to comply with return conditions mandates payment of the requested administrative expense claim, this position also fails as a matter of law.

32. In *Continental Airlines*, the lessor and financing parties were party to a leveraged aircraft lease with the debtor, which lease provided that if the airframe or any engine was not in compliance with the stated return conditions, then the lessee must compensate the lessor for the "then current cost of overhaul ... by a reputable maintenance facility." *Id.* at 528. The debtor returned the aircraft in a state that did not comply with the lease return conditions, and the lessor parties sought allowance of administrative expenses for, among other things, the estimated cost to bring the aircraft into compliance with the return conditions. The court began by noting that cash savings realized as a result of the debtor's decision not to expend estate assets to satisfy lease obligations are, on their own, insufficient to support a finding that the estate received a benefit for the purposes of section 503(b)(1) of the Bankruptcy Court. *Id.* 527–28. Thus, the court concluded that the lessor parties "must show that the failure to return the aircraft in compliance with the lease return conditions resulted in a benefit to the estate." *Id.* at 528. Despite testimony that the airframe and one of the engines were not in compliance with the return

condition obligations under the lease, the court found that the movants had not met their burden of proof because there was no showing that the debtor's failure to bring the engine and airframe into compliance with the lease return conditions provided benefit to the estate. *Id.*

33. In the instant case, the Debtors made every attempt to return the railcars to Caldwell Baker's preferred locations. Commencing in May 2016, the Debtors repeatedly requested that Caldwell Baker provide them with locations to return the railcars. In most instances, Caldwell Baker failed to comply with the Debtors' requests, resulting in 140 railcars being stored at Iowa Northern at the time of the bankruptcy filing.

34. With respect to any allegation that the nearly forty year old railcars were in need of repair, per *Continental Airlines*, cash saving alone do not constitute a benefit to the estate for purposes of section 503(b)(1) of the Bankruptcy Code. Finally, the Debtors vehemently deny the unsubstantiated allegations contained in the Motion that the Debtors entered into agreements with other entities concerning use of the railcars in violation of the lease. The Debtors engaged in no wrongdoing of any kind.

35. In sum, the Debtors made every effort to comply with their return obligations and Caldwell Baker's failure to act should not serve as a basis to award it a significant administrative expense claim.

36. Finally, with respect to Caldwell Baker's request for immediate payment of its alleged administrative expense claim, there is simply no basis to award payment (much less immediate payment) based on the facts of these cases. As set forth above, there are no funds in the approved DIP Budget to make post-petition payments to Caldwell Baker prior to the confirmation of a plan. Upon closing of the sale, the majority of the sale proceeds will be used to satisfy the Debtors' pre-petition secured debt and the Debtors will only be left with cash in

amount required to wind down their estates pursuant to a wind-down budget that is approved by the Debtors' pre-petition lender. To the extent there are any remaining funds in the wind-down account, such funds will revert back to the pre-petition lender. By sitting on its hands for the past three months and failing to meet its burden under Section 503(b) of the Bankruptcy Code, Caldwell Baker has forfeited its right to request immediate payment of any alleged administrative expense claim.

CONCLUSION

WHEREFORE, the Debtors respectfully request that the Court deny the Motion.

Dated: May 16, 2017
Wilmington, Delaware

GIBBONS P.C.

By: */s/ Howard A. Cohen*
Howard A. Cohen (DE 4082)
Natasha M. Songonuga (DE 5391)
300 Delaware Avenue, Suite 1015
Wilmington DE 19801-1761
Telephone: (302) 518-6330
Facsimile: (302) 429-6294
Email: hcohen@gibbonslaw.com
nsongonuga@gibbonslaw.com

ATTORNEYS FOR THE DEBTORS