

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE**

In re:	:	Chapter 11
	:	
NovaSom, Inc.,	:	Case No. 19-11734 (BLS)
	:	
Debtor.	:	
	:	

**MOTION OF THE DEBTOR, NOVASOM, INC., FOR ENTRY OF INTERIM AND
FINAL ORDERS (I) AUTHORIZING THE DEBTOR TO PAY CERTAIN
PREPETITION TAXES AND (II) GRANTING RELATED RELIEF**

NovaSom, Inc., the above-captioned debtor and debtor-in-possession (“NovaSom” or the “Debtor”), by its proposed undersigned counsel, hereby moves this Court (the “Motion”) for entry of interim and final orders (i) authorizing the Debtor, in its discretion, to pay prepetition taxes, including any related penalties and interest (collectively, the “Prepetition Taxes”), to various local, state, and/or federal authorities (collectively, the “Authorities”) as such Prepetition Taxes come due in the ordinary course of business, on an interim basis and on a final basis, and (ii) granting certain related relief.¹ In support of this Motion, the Debtor respectfully represents as follows:

Jurisdiction and Venue

1. This Court has jurisdiction to consider this Motion under 28 U.S.C. §§ 157 and 1334.
2. Venue is proper pursuant to 28 U.S.C. §§ 1408 and 1409.
3. This is a core proceeding under 28 U.S.C. § 157(b).
4. The statutory bases for the relief requested herein are Sections 105, 363, 507, 541,

¹ Contemporaneously with the filing of this Motion, the Debtor has filed its Motion to Pay Certain Pre-Petition Payroll and Various Employee Benefits and Expenses, which seeks, among other things, authority to pay various federal, state, and local withholding, deductions, and payroll-related or similar taxes arising from the prepetition period.

1107, and 1108 of Title 11 of the United States Code (the “Bankruptcy Code”), as well as Rules 6003 and 6004 of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”), and Rule 9013-1(m) of the Local Rules of Bankruptcy Practice and Procedure of the United States Bankruptcy Court for the District of Delaware (the “Local Rules”).

5. The Debtor consents to the entry of final orders or judgments by the Court if it is determined that the Court, absent consent of the parties, cannot enter final orders or judgments consistent with Article III of the United States Constitution.

Background

6. On August 2, 2019 (“Petition Date”), the Debtor filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code. The Debtor is operating its business and managing its properties as a debtor-in-possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code. No request for the appointment of a trustee or examiner has been made in this Chapter 11 case.

7. A detailed description of the Debtor’s business, capital structure, and the reasons for commencing the Chapter 11 Case is set forth in the Declaration of Gregory Stokes in support of the Debtor’s First Day Pleadings (the “Stokes Declaration”).

8. NovaSom is a home sleep testing (“HST”) company having its principal place of business in Glen Burnie, Maryland. Its business model is to send a medical device (FDA approved sleep recorder) to a patient’s home in order for the patient to be tested for obstructive sleep apnea (“OSA”) in his or her own home, rather than in a sleep lab, when a physician prescribes the HST based on symptoms and the patient’s condition. The device records and auto-scores the number of apnea events, then sends the data back to NovaSom’s servers via a cell phone chip in the device. Sleep physicians are then able to overscore the data and give an

opinion to the ordering physician as to the patient's likelihood of having OSA.

9. From 2010 to 2012, NovaSom developed a new device ("AccuSom"), which enabled sleep data to be sent wirelessly, rather than requiring the return of the device to a lab in order to download the data. When that device launched, sales were not as robust as planned, and the management team was replaced in 2013 by a commercially oriented team. Between 2013 and 2017, orders for the AccuSom HSTs grew 500%. However, the average sales price dropped by nearly 30% over that period of time due to market conditions and the general availability of HST providers. Additionally, the cost of growing the sales was significant and included hiring more sales representatives, as well as support and customer service personnel to manage the orders. As a result, NovaSom never reached profitability.

10. NovaSom tried to attract a buyer for the company, and, when that did not work, to find possible private equity groups to provide the resources for continued growth, to find a structured debt provider which was to provide significant growth capital for the company, and then again to find a potential buyer. When this last effort failed, in June, 2019, NovaSom retained Sherwood Partners, a financial advisory firm, at the request of the senior secured lender to help identify potential asset purchasers and determine the best path moving forward to protect its shareholders, creditors and employees. During July, 2019, in consultation with its senior secured lender, NovaSom solicited and received an offer to acquire substantially all of its assets from VirtuOx, Inc. (the "Stalking Horse Purchaser"). That offer was conditioned, among other things, on the immediate filing of a voluntary Chapter 11 petition and an expeditious sale process in which the acquired assets would be sold to the Stalking Horse Purchaser, free and clear of liens, claims, encumbrances and interests pursuant to section 363(b) and (f) of the Bankruptcy Code, with the assumption and assignment of certain executory contracts, subject to higher and

better bids, all as more as fully set forth in the Asset Purchase Agreement, by and between the Stalking Horse Purchaser and the Debtor.

11. NovaSom evaluated the offer of the Stalking Horse Purchaser in conjunction with the Lender and determined that proceeding with this Chapter 11 case (the “Chapter 11 Case”), and a sale to the Stalking Horse Purchaser of substantially all of its assets, subject to a process for obtaining potentially higher, better or competing offers, was in the best interest of NovaSom, its creditors, customers and employees in that, among other reasons, it would stem the Debtor’s operating losses while preserving the continuity of the Debtor’s customer services.

Relief Requested

12. By this Motion, pursuant to Sections 105(a), 363(b), 507(a)(8), 541, 1107(a), and 1108 of the Bankruptcy Code and Bankruptcy Rules 6003 and 6004, the Debtor requests entry of an interim and final order, substantially in the forms attached, respectively, as Exhibit A and Exhibit B, authorizing but not directing the Debtor, in its discretion, to pay the Prepetition Taxes it owes to the Authorities, including all Prepetition Taxes subsequently determined upon audit to be owed for periods prior to the Petition Date.

13. Further, the Debtor requests that this Court authorize all applicable banks and other financial institutions to receive, process, honor, and pay all checks, drafts, electronic fund transfers, or other forms of payment drawn or issued on the Debtor’s bank accounts prior to the Petition Date for Prepetition Taxes (or to reissue checks, drafts, electronic fund transfers, or other forms of payment drawn or issued on the Debtor’s bank accounts, as may be necessary), and authorize the banks and financial institutions to rely on the Debtor’s representations as to which checks, drafts, electronic fund transfers, or other forms of payment drawn or issued on the Debtor’s bank accounts are subject to this Motion; *provided that* sufficient funds are on deposit

in the applicable bank accounts to cover such payments.²

A. Taxes Collected in the Ordinary Course

13. In the ordinary course, the Debtor does not collect any sales tax. The Debtor has a sales tax exempt opinion for medical devices.

B. Other Taxes and Fees Accruing in the Ordinary Course

14. In the ordinary course, the Debtor is subject to certain other miscellaneous taxes or fees.

15. In the ordinary course, the Debtor incurs a use tax paid to Maryland for out of state purchases. These taxes are approximately \$100 a month.

16. In the ordinary course, the Debtor does not pay income tax, but does pay franchise taxes to approximately twenty-five states, mostly on an annual basis. The total amount paid annually by the Debtor is approximately \$25,000.³

17. The Debtor has a Delaware Franchise tax due on September 1, 2019 in the amount of \$4,560.

18. In the ordinary course, the Debtor pays property tax to Anne Arundel County, Maryland. The total amount paid annually by the Debtor is approximately \$60,000, which was already paid in March 2019.

19. By paying the foregoing described Prepetition Taxes as each becomes due, the Debtor ultimately will preserve its estate resources and going-concern value.

20. If the Debtor does not make timely payments, it will have to spend time and

² Contemporaneously with the filing of this Motion, the Debtor filed its Motion for Entry of Interim and Final Orders (I) Authorizing Continued Use of the Debtor's Existing Cash Management System and Bank Accounts; (II) Waiving Certain United States Trustee Requirements, and (III) Granting Related Relief, which seeks, among other things, authority to continue using the Debtor's cash management system, bank accounts and business forms.

³ The Debtor paid franchise taxes with the filing of the tax extensions in March 2019. The Debtor doesn't have accrued unpaid taxes for tax year 2018. The Debtor also just paid a filing fee for the Maryland Annual report that was due and owing, in the amount of \$300.

money resolving a multitude of issues related to these obligations, including whether (i) the obligations are priority, secured, or unsecured; (ii) the obligations are pro-ratable or fully prepetition or post-petition; and (iii) penalties, interest, attorneys' fees, and costs accrued on a post-petition basis, and if so, whether the penalties, interest, attorneys' fees, and costs are priority, secured, or unsecured.

21. The Debtor justifiably wants to avoid these unnecessary potential disputes and expenses and, therefore, seeks permission to pay the Prepetition Taxes in the ordinary course.

Legal Basis for the Relief Requested

A. Funds Related to Certain Prepetition Taxes May Be Held In Trust and Are Not Property of the Estate

33. Certain Prepetition Taxes the Debtor seeks authority to pay are collected or withheld by the Debtor and may be held in trust for the benefit of the applicable Authority.

34. As a result, any such taxes and regulatory/statutory surcharges are not property of the Debtor's estate under section 541 of the Bankruptcy Code, and such funds are therefore not available for the satisfaction of creditors' claims. See, e.g., Begier v. IRS, 496 U.S. 53 (1990) (withholding taxes are property held by debtor in trust for another and, as such, not property of the Debtors' estates); City of Farrell v. Sharon Steel Corp., 41 F.3d 92, 95 (3d Cir. 1994) (withheld taxes were subject to a trust); Al Copeland Enters., Inc. v. Tex. (In re Al Copeland Enters.), 991 F.2d 233, 235 (5th Cir. 1993) (Debtors' prepetition collection of sales taxes and interest thereon were held subject to trust and not property of estate); see generally Official Comm. of Unsecured Creditors of the Columbia Gas Transmission Corp. v. Columbia Gas Sys., Inc. (In re Columbia Gas Sys. Inc.), 997 F.2d 1039, 1060 (3d Cir. 1993) (indicating that even if a statute does not establish an express trust, a constructive trust may be found).

35. Instead, the Debtor may be obligated to remit such funds to the applicable

Authority.

36. Many federal, state, and local statutes also impose personal liability on officers and directors of companies for certain Prepetition Taxes.

37. To the extent that the relevant Prepetition Taxes remain unpaid by the Debtor, the Debtor's members, managing members, officers, directors, and/or other executives may be subject to lawsuits or criminal prosecution during this Chapter 11 Case. Any such lawsuit or criminal prosecution (and the ensuing potential liability) would distract the Debtor and its members, managing members, officers, directors, and/or other executives from devoting their full attention to the Debtor's business and the orderly administration of this Chapter 11 Case. The Debtor believes that these distractions would materially and adversely affect its ability to operate in the ordinary course of business and to administer this Chapter 11 Case, with resulting detriment to all parties in interest.

38. Accordingly, the Debtor should be granted authority to pay the Prepetition Taxes in the ordinary course.

B. Payment of the Prepetition Taxes is Appropriate Pursuant to Sections 363(b) and 105(a) of the Bankruptcy Code and the Doctrine of Necessity

39. To the extent that use of the property of the Debtor's estate is implicated here, the relief requested is appropriate under Sections 363(b) and 105(a) of the Bankruptcy Code and the related "doctrine of necessity."

40. As a general matter, bankruptcy courts and other federal courts acknowledge that it is appropriate to authorize the payment (or other special treatment) of pre-petition obligations in appropriate circumstances. See, e.g., In re The Philadelphia Orchestra Assn., No. 11-13098 (ELF) (Bankr. E.D. Pa. April 21, 2011).

41. More specifically, under section 363(b)(1) of the Bankruptcy Code, a debtor may,

in the exercise of its sound business judgment and after notice and a hearing, “use, sell or lease, other than in the ordinary course of business, property of the estate.” 11 U.S.C. § 363(b)(1); see also Official Comm. of Unsecured Creditors of LTV Aerospace & Defense Co. v. LTV Corp. (In re Chateaugay Corp.), 973 F.2d 141, 143 (2d Cir. 1992) (holding that a court may approve an application under Section 363(b) upon a showing of a good business reason for the disposition).

42. For a court to approve the use, sale, or lease of estate property under Section 363(b) of the Bankruptcy Code, the debtor must “articulate some business justification, other than mere appeasement of major creditors[.]” In re Ionosphere Clubs, Inc., 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989) (holding that the debtor’s payment of prepetition claims was necessary to protect its business and to ensure successful reorganization).

43. Likewise, section 105(a) of the Bankruptcy Code empowers the Court to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].”

44. The Court’s power under section 105(a) includes entering orders authorizing the payment of pre-petition debt “when such payment is needed to facilitate the rehabilitation of the debtor[.]” Ionosphere Clubs, 98 B.R. at 175; see also In re NYR L.P., 147 B.R. 126, 127 (Bankr. E.D. Va. 1992) (holding that Section 105(a) permits a court to authorize the “pre-plan payment of a pre-petition obligation when essential to the continued operation of the debtor.” (citing Ionosphere Clubs, 98 B.R. at 177)).

45. Here, the Debtor submits that payment of the Prepetition Taxes is necessary and appropriate and, therefore, authorization to pay the same is within the Court’s power under sections 363(b) and 105(a) of the Bankruptcy Code.

46. The Court may also use its power under section 105(a) to authorize payment of

the Prepetition Taxes pursuant to the “doctrine of necessity.”

47. In a chapter 11 case, the doctrine of necessity is a mechanism by which the Court can exercise its equitable power to allow payment of prepetition claims when necessary for the survival and rehabilitation of the debtor. See In re Lehigh & New England Ry. Co., 657 F.2d 570, 581 (3d Cir. 1981) (holding that a court may authorize payment of prepetition claims when payment is essential to continued operation of the debtor); In re Just for Feet, Inc., 242 B.R. 821, 824 (D. Del. 1999) (noting that section 105 and the doctrine of necessity provide courts with authority to permit payment of prepetition claims necessary to facilitate a successful reorganization).

49. The rationale for the doctrine of necessity is consistent with the paramount goal of chapter 11—“facilitating the continued operation and rehabilitation of the debtor.” In re Ionosphere Clubs, Inc., 98 B.R. at 176.

50. The relief requested by way of this Motion represents a sound exercise of the Debtor’s business judgment and is necessary for the preservation of the resources and going-concern value of its estate.

51. Indeed, if the Debtor does not pay its Prepetition Taxes, the respective Authorities may prevent the Debtor from conducting business, subject the Debtor to audits, seek to lift the automatic stay, and perhaps impose liens, all of which would disrupt the Debtor’s operations and harm all parties in interest.

52. Moreover, interest and penalties may accrue post-petition to the extent that the Prepetition Taxes are secured by liens on the Debtor’s property. See 11 U.S.C. § 506(b); United States v. Ron Pair Enters., Inc., 489 U.S. 235, 238-49 (1989) (holding that section 506(b) of the Bankruptcy Code entitles a creditor to receive post-petition interest on a nonconsensual over-

secured claim allowed in a bankruptcy case).

53. By paying the Prepetition Taxes, the Debtor might actually reduce the amounts ultimately paid to the Authorities because prompt payment will avoid the imposition of liens and accrual of interest and penalties on account of the Prepetition Taxes.

54. Payment of the Prepetition Taxes is also appropriate given that a significant portion of them, as discussed below, are afforded priority status. Likewise, the amounts paid will be offset by the amount of post-petition resources that the Debtor will not have to expend in disputes with the Authorities—complications that, in the context of this case, would needlessly waste the resources of the Debtor and this Court.

C. Certain Prepetition Taxes Constitute Priority Claims Under Section 507(a)(8) of the Bankruptcy Code

55. The Debtor believes that certain Prepetition Taxes are entitled to priority status under section 507(a)(8) of the Bankruptcy Code and must be satisfied before any general unsecured claims against the Debtor's estate. See 11 U.S.C. §§ 507(a)(8).⁴

56. To the extent that the Prepetition Taxes are entitled to priority treatment under section 507(a)(8), the Authorities may also attempt to assess additional accrued fees, interest, and penalties. See § 507(a)(8)(G) (granting priority status to a “penalty related to a claim of a kind specified in this paragraph and in compensation for actual pecuniary loss”).

57. Accordingly, payment of the Prepetition Taxes merely expedites the treatment that these claims are entitled to and is consistent with the priority scheme of the Bankruptcy Code. Further, it will spare the Debtor the cost of paying any additional accrued amounts to

⁴ Section 507(a)(8) of the Bankruptcy Code affords priority to, among other things, unsecured claims of governmental units for (i) taxes on or measured by income or gross receipts for a taxable year ending on or before the Petition Date (§ 507(a)(8)(A)); (ii) taxes required to be collected or withheld and for which the debtor is liable in whatever capacity, (§ 507(a)(8)(C)); and (iii) under certain circumstances, employment taxes on wages, salaries, or commissions (§ 507(a)(8)(D)).

which the Authorities may be entitled.

D. Payment of the Prepetition Taxes is Appropriate Under Sections 1107 and 1108 of the Bankruptcy Code

58. The Debtor is operating its business as a debtor-in-possession under sections 1107(a) and 1108 of the Bankruptcy Code, and it is therefore a fiduciary “holding the bankruptcy estate and operating the business for the benefit of creditors and (if the value justifies) equity owners.” In re CoServ, L.L.C., 273 B.R. 487, 497 (Bankr. N.D. Tex. 2002).

59. A chapter 11 debtor-in-possession has the implicit duty “to protect and preserve the estate, including an operating business’s going-concern value.” *Id.*

60. Courts have noted that a debtor-in-possession can, in certain instances, fulfill its fiduciary duty “only . . . by the preplan satisfaction of a prepetition claim.” *Id.* The bankruptcy court in CoServ specifically noted that preplan satisfaction of prepetition claims would be a valid exercise of a debtor’s fiduciary duty when the payment “is the only means to effect a substantial enhancement of the estate.” *Id.* The bankruptcy court provided a three-prong test for determining whether a preplan payment on account of a prepetition claim was a valid exercise of a debtor’s fiduciary duty:

First, it must be critical that the debtor deal with the claimant. Second, unless it deals with the claimant, the debtor risks the probability of harm, or, alternatively, loss of economic advantage to the estate or the debtor’s going concern value, which is disproportionate to the amount of the claimant’s prepetition claim. Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim.

Id. at 498.

61. In this case, payment of the Prepetition Taxes meets each CoServ element. First, it is critical that the Debtor deals with the Authorities because, as described above, the Authorities likely maintain secured or priority claims against the Debtor for the Prepetition

Taxes. If the Debtor does not pay the Prepetition Taxes, the Debtor anticipates that the Authorities may bring claims and other litigation against the bankruptcy estate.

62. Second, failure to timely pay the Prepetition Taxes will economically disadvantage the Debtor because (i) the time and expense that the Debtor would need to devote to any audit or litigation instituted by an Authority over unpaid Prepetition Taxes would likely far outweigh any savings from the temporary non-payment of such Prepetition Taxes and (ii) interest and penalties will accrue on the Prepetition Taxes.

63. Therefore, the potential harm that would stem from the failure to pay the Prepetition Taxes is disproportionate to the amount of any prepetition claim that may be paid, particularly given that the Debtor will have sufficient cash to pay the Prepetition Taxes in the ordinary course of business and via DIP financing.

64. Finally, the Debtor has examined other options short of paying the Prepetition Taxes and has determined that, to avoid expense and disruption to the Debtor's business operations, there exists no practical or legal alternative to paying the Prepetition Taxes.

65. Courts in the District of Delaware have routinely granted similar relief.⁵

66. Accordingly, for these reasons, and pursuant to sections 105(a) and 363(b) of the Bankruptcy Code, the Debtor submits that the relief requested is essential, appropriate, and in the best interests of its estate and should therefore be granted.

E. The Court Should Authorize Banks to Honor and Pay Checks Issued and Electronic Funds Transferred to Pay the Prepetition Taxes

67. The Debtor further requests that the Court authorize its banking institutions and

⁵ See, e.g., In re Magnum Hunter Res. Corp., Case No. 15-12533 (KG) (Bankr. D. Del. Dec. 16, 2015) (D.I. 72); In re Colt Holding Co. LLC, Case No. 15-11296 (LSS) (Bankr. D. Del. June 16, 2015) (D.I. 75); In re Quicksilver Resources, Inc., et al., Case No. 15-10585 (LSS) (Bankr. D. Del. Apr. 14, 2015) (D.I. 192); In re Cal Dive Int'l, Inc., Case No. 15-10458 (CSS) (Bankr. D. Del. Mar. 6, 2015) (D.I. 64).

all other applicable banks and other financial institutions to receive, process, honor, and pay any and all checks drawn or electronic funds relating to the Prepetition Taxes, whether such checks were presented before or after the Petition Date; *provided that* sufficient funds are on deposit in the applicable bank accounts to cover such payments.

68. The Debtor has sufficient liquidity to pay such amounts as they become due in the ordinary course of business. The Debtor believes that checks or wire transfer requests, other than those relating to authorized payments, will not be honored inadvertently.

69. The Debtor also seeks authority to issue new post-petition checks or effect new electronic fund transfers, on account of the Prepetition Taxes, to replace any prepetition checks or electronic fund transfer requests that may be dishonored or rejected as a result of the commencement of the Debtor's Chapter 11 Case.

F. Interim Relief is Necessary to Avoid Immediate and Irreparable Harm

70. Under Bankruptcy Rule 6003, the Court may grant a motion to “use . . . property of the estate, including a motion to pay all or part of a claim that arose before the filing of the petition” within twenty-one days after the Chapter 11 case's commencement to the extent “relief is necessary to avoid immediate and irreparable harm.” Fed. R. Bankr. P. 6003.

71. As set forth in the First Day Declaration and herein, payment of the Prepetition Taxes is necessary to avoid immediate and irreparable harm to the Debtor and its estate, and relief on an interim basis is therefore appropriate under Bankruptcy Rule 6003, if applicable.

72. The urgency of the relief requested justifies immediate relief.

Request for Waiver of Stay

73. The Debtor further seeks waiver of any stay of the effectiveness of the order approving this Motion. Pursuant to Bankruptcy Rule 6004(h), “[a]n order authorizing the use,

sale or lease of property other than cash collateral is stayed until the expiration of 14 days after entry of the order, unless the court orders otherwise.”

74. As set forth above, payment of the Prepetition Taxes is essential to prevent irreparable damage to the Debtor’s operations, reputation, and value as a going concern.

75. Accordingly, the Debtor submits that ample cause exists to justify a waiver of the fourteen-day stay imposed by Bankruptcy Rule 6004(h), to the extent that it applies.

Reservation of Rights

76. Nothing contained in this Motion is an admission of the validity of any claim against the Debtor, a waiver of the Debtor’s or any other party’s rights to dispute any claim, or an approval or assumption of any agreement, contract, or lease under Section 365 of the Bankruptcy Code. If the Court grants the relief requested in this Motion, any Court-authorized payment is not an admission of the validity of any claim or a waiver of the Debtor’s or any other party’s right to subsequently dispute such claim. In addition, authorization to pay the claims described in this Motion will not be deemed a direction to the Debtor to pay such claims; rather, the Debtor will make such payments in its discretion.

Notice

77. The Debtor has provided notice of this Motion to (a) the Office of the United States Trustee for the District of Delaware; (b) East West Bank and the subordinated noteholders; (c) the United States Attorney for the District of Delaware; (d) the entities listed on the List of Creditors Holding the 20 Largest Unsecured Claims filed pursuant to Bankruptcy Rule 1007(d); (e) the Internal Revenue Service, (f) David Weitman, K&L Gates LLP, 1717 Main Street, Suite 2800, Dallas, Texas 75201, (g) all parties entitled to notice pursuant to Local Rule 9013-1(m), and (h) the banks honoring and paying the Debtor’s checks and electronic fund

transfers via electronic or overnight mail, as appropriate.

78. Due to the urgency of the relief requested, the Debtor submits that no other or further notice is necessary.

No Prior Request for Relief

79. The Debtor has not made any prior motion for the relief sought in this Motion to this Court or any other Court.

WHEREFORE, the Debtor respectfully requests entry of interim and final orders in the form proposed.

Dated: August 2, 2019

/s/ Peter C. Hughes

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