Terri H. Didion, Assistant United States Trustee
State Bar No. CA 133491
Edward M. McDonald Jr., Trial Attorney
State Bar No. NY 4126009
edward.m.mcdonald@usdoj.gov
UNITED STATES DEPARTMENT OF JUSTICE
Office of the United States Trustee
300 Las Vegas Boulevard, So., Ste. 4300, Las Vegas, NV 89101
Cell: (202) 603-5222
Tel.: (702) 388-6600, Ext. 234
Fax: (702) 388-6658

Attorneys for the U.S. Trustee for Region 17
TRACY HOPE DAVIS

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UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEVADA

In re **FRONT SIGHT MANAGEMENT LLC,** Debtor.	Case No: BK-S-22-11824-ABL Chapter 11 Date: May 27, 2022 Time: 9:30 a.m. Location: Foley Courtroom 1, Telephonic

THE UNITED STATES TRUSTEE'S OMNIBUS OBJECTION AND RESERVATION OF RIGHTS TO DEBTOR'S FIRST DAY MOTIONS

To the Honorable AUGUST B. LANDIS, Chief United States Bankruptcy Judge**:**

Tracy Hope Davis, United States Trustee for Region 17 (the "U.S. Trustee"), by and through her undersigned counsel, hereby presents these objections (the "Omnibus Objection") to the following "first day" motions (collectively, the "First Day Motions") filed by Front Sight Management LLC ("Debtor"):[1]

[1] Unless otherwise noted: "Section" refers to a section of title 11 of the United States Code, 11 U.S.C. §§ 101-1532 (as amended, the "Bankruptcy Code"); "FRBP" refers to the Federal Rules of Bankruptcy Procedure; "FRE" refers to the Federal Rules of Evidence; and "ECF No." refers to the bankruptcy docket for case number 22-11824.

The U.S. Trustee requests that the Court take judicial notice of the pleadings and documents filed in this case, pursuant to FRBP 9017 and FRE 201. To the extent that the objection contains factual assertions predicated upon statements made by Debtor, any of its current or former affiliates, agents, attorneys, professionals, officers, directors or employees, the U.S. Trustee submits that

- *Emergency Motion for Entry of Interim and Final Orders: (1) Authorizing Debtor to Obtain Post-Petition Financing, (II) Granting Priming Liens and Administrative Expense Claims, (III) Authorizing the Debtor's Use of Cash Collateral, (IV) Modifying the Automatic Stay, and (V) Granting Related Relief* [ECF No. 4] (the "DIP Financing Motion");
- *Emergency Motion for Order Authorizing Maintenance Of Certain Prepetition Bank Accounts And Merchant Accounts And Cash Management System* [ECF No. 7] (the "Cash Management Motion");
- *Emergency Motion for Order Extending Time to File Bankruptcy Schedules and Statement of Financial Affairs* [ECF No. 8] (the "Motion to Extend");
- *Emergency Motion for Entry Of An Order: (1) Authorizing, But Not Requiring, Debtor To Pay Or Honor (A) Prepetition Wages, Salaries, And Other Compensation Including Reimbursement Of Expenses And (B) Prepetition Medical, Workers' Compensation, Paid Time Off, And Similar Benefits; And (2) Authorizing And Directing Applicable Banks And Other Financial Institutions To Receive, Process, Honor, And Pay Checks Presented For Payment And To Honor Fund Transfer Requests* [ECF No. 9] (the "Wage Motion");
- *Emergency Application for the Entry of an Order Authorizing the Debtor to Employ and Retain Stretto as Claims, Noticing and Solicitation Agent* [ECF No. 10] (the "Claims Agent Motion"); and,
- *Debtor's Emergency Motion for Order Authorizing Debtor to Pay Critical Vendors and Certain Prepetition Tax Liabilities* [ECF No. 12] (the "Critical Vendors Motion").[2]

INTRODUCTION

1. The Debtor's requests for relief in the First Day Motions should either be (a) denied

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such factual assertions are supported by admissible evidence in the form of admissions of a party opponent under FRBP 9017 and FRE 801(d)(2).

[2] Debtor has also filed an *Emergency Motion for Order (I) Authorizing the Establishment of Certain Noticing Procedures; (II) Establishing Bar Dates and Procedures for Filing Proofs of Claim; and (III) Authorizing the Debtor to Keep Its Member List Confidential* [ECF No. 6], which will be addressed in a separate objection by the U.S. Trustee. [*See* ECF No. 26].

outright or (b) limited to only emergency relief to permit the Debtor to sustain business operations. As to each of the First Day Motions, the Debtor has failed to meet its evidentiary burden for the relief requested. A §341 meeting of creditors has not been held, and the schedules and SOFA have not been filed. As relief sought may also impact parties in interest, including, but not limited to, any official committee of unsecured creditors, the United States Trustee reiterates that any relief granted should be limited to only emergency relief to permit the Debtor to sustain business operations. For these reasons and for the reasons set forth below, the Court should either sustain the United States Trustee's Omnibus Objection or adjourn the hearing on these motions to a later date.

2. The Omnibus Objection is supported by the following memorandum of points and authorities and any argument the Court may permit on the Omnibus Objection.

3. The U.S. Trustee reserves all rights with respect to the First Day Motions, including, but not limited to her right to take any appropriate action under the Bankruptcy Code, the FRBP, and the Local Rules of the U.S. Bankruptcy Court should the First Day Motions and related pleadings be amended or supplemented. Further, the U.S. Trustee reserves all rights to object to the final relief sought through the First Day Motions.

I. MEMORANDUM OF POINTS AND AUTHORITIES

A. Background Facts and Procedural Posture.

4. On May 24, 2022, Debtor filed a voluntary petition under Chapter 11 of the Bankruptcy Code commencing this case. [*See* ECF No 1]. According to the Piazza Declaration, the Debtor is based in Pahrump, Nevada and provides firearms training courses to the general public, law enforcement and military personnel. [*See* ECF No. 14, p. 3 of 22].

5. BG Law LLP is counsel of record to the Debtor. No applications to retain counsel have been filed as of the date of this Objection. [*See generally* case docket].

6. Debtor has not yet filed schedules A/B, D, E/F, G, H, a statement of financial affairs ("SOFA"), a list of equity security holders, a declaration of electronic filing, a disclosure of attorney compensation, or a creditor matrix. [*See* ECF No. 23; *see generally* case docket].

7. The Section 341 meeting is scheduled for June 23, 2022 at 9:00 a.m. (Pacific Time). [*See* ECF No. 3]. No official committee of unsecured creditors or trustee has been appointed in this case. [*See generally* case docket].

8. The First Day Motions are supported by the declaration of Ignatius Piazza [ECF No. 14] ("Piazza Omnibus Declaration"). The Claims Agent Motion is supported by the declaration of Sheryl Betance [ECF No. 11] ("Betance Declaration").

9. The Court set the hearing on the First Motions on shortened time for May 27, 2022 at 9:30 a.m. [*See* ECF No. 24].

II. ARGUMENT

10. Four principles for Courts to consider with regard to first day motions are:

> First, the requested relief should be limited to that which is minimally necessary to maintain the existence of the debtor, until such time as the debtor can affect appropriate notice to creditors and parties in interest. In particular, a first day order should avoid substantive rulings that irrevocably determine the rights of parties.
>
> Second, first day orders must maintain a level of clarity and simplicity sufficient to allow reasonable confidence that an order will effect no unanticipated or untoward consequences.
>
> Third, first day orders are not a device to change the procedural and substantive rights that the Bankruptcy Code and Rules have established. In particular, first day orders should provide no substitute for the procedural and substantive protections of the plan confirmation process.
>
> Fourth, no first day order should violate or disregard the substantive rights of parties, in ways not expressly authorized by the Bankruptcy Code.

In re The Colad Group, Inc., 324 B.R. 208, 213-14 (Bankr. W.D.N.Y. 2005).

11. Accordingly, the relief sought in the First Day Motions, if granted at all, should only be granted on an interim basis, with a final hearing set so that an Official Committee of Unsecured Creditors, if one can be formed, can review and respond to the final relief sought, preferably after the schedules are filed and the 341 meeting of creditors is held.

A. The Dip Financing Motion Should Be Denied.

12. Before approving debtor in possession financing, a court must consider whether the terms of proposed financing are fair, reasonable and adequate. *See In re Los Angeles Dodgers LLC*, 457 B.R. 308, 312-13 (Bankr. D. Del. 2011).

13. In this respect, courts routinely consider the following factors:

> (1) That the proposed financing is an exercise of sound and reasonable business judgment;
>
> (2) That the financing is in the best interests of the estate and its creditors;
>
> (3) That the credit transaction is necessary to preserve the assets of the estate, and is necessary, essential, and appropriate for the continued operation of the Debtor's businesses;
>
> (4) That the terms of the transaction are fair, reasonable, and adequate, given the circumstances of the debtor-borrower and the proposed lender; and
>
> (5) That the financing agreement was negotiated in good faith and at arm's length between the Debtors, on the one hand, and . . . the Lenders, on the other hand.

See In re Sterling Mining Co., No. 09-20178-TLM, 2009 Bankr. LEXIS 2341, at *8 (Bankr. D. Idaho Aug. 14, 2009), citing *In re Farmland Indus., Inc.*, 294 B.R. 855, 881 (Bankr. W.D. Mo. 2003).

14. The DIP Financing seeks a total of $5 million in DIP Financing, with $1 million approved on an interim basis. [ECF No. 4, p. 3 of 107]. The Loan is from FS DIP, LLC ("Lender") although the DIP Financing Motion provides no information about this entity. [*Id.*].[3] The loan has an interest rate of 9.5% (and a 16% default rate), Lender will be paid two $50,000 loan fees and its counsel's expenses. Lender will receive a first priority priming lien on Debtor's assets (except for a carve-out) including on avoidance actions, and a super-priority claim.

[3] Exhibit C to the Piazza Declaration indicates that it is a Delaware LLC and also a Nevada LLC. [*See* ECF No. 14-3, pp. 2, 15, 22, 24, 26, 45, 53 & 57]. The loan documents included in Exhibit C to the Piazza Declaration have a space for Lender's address, but they are all blank. [*See* ECF No. 14-3, pp. 2, 22, 24, 26, 45, 53 & 57].

15. The loan has numerous default events including failing to confirm a plan with an effective date that is within 180 days of the initial draw, the appointment of a trustee, the granting of a relief from stay, any action by a creditors committee that impairs or amends the interim or final order, the lapse of exclusivity, or the failure to meet the milestones[4] set by Lender, and the automatic stay is modified to allow the Lender to take action upon a default. [*See* ECF No. 4, pp. 3-6 of 107].

16. The Lender is also indemnified and will receive releases and exculpations in the plan. [*See* ECF No. 4, pp. 3-6 of 107].

17. The DIP Financing motion also seeks to pre-approve the Lender as a stalking horse bidder, with the attendant stalking horse protections, in a possible sale. [*See* ECF No. 4, p. 16 of 107]. No committee has been appointed and it is interesting to note that the proposed order for the DIP Financing Motion appears to have been prepared by the Lender's counsel, without input from parties, notably an official committee of unsecured creditors. [*See* ECF No. 4, p. 27 of 107].

18. The Motion and the Piazza Declaration contain inadequate information regarding the need for financing during the interim period. For example, the budget annexed to the Piazza Declaration includes weekly disbursements of $71,428 for professionals who, absent a *Knudsen* order, cannot be paid until 120 days into this case.[5] *See* 11 U.S.C. § 331. The professional fee payments should not be included in the DIP financing approved on an interim basis. In addition, it is unclear whether the pre-petition payments sought through the Wage and Critical Vendor Motions will be paid through the DIP Loan. [*See* ECF No. 14-2, p. 2 of 2].

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[4] Debtor must file a plan and disclosure statement within 30 days of the initial draw and confirm a plan with an effective date that is within 180 days from the first draw. [ECF No. 4, p. 3 of 107].

[5] [*See* ECF No. 14-2, p. 2 of 2]. The budget revenue amounts indicate a steep drop off in: (a) customer cash receipts, from $19,488 in Week 1 to $4,000 in week 13; and (b) daily fees from, from $102,700 in Week 1 to $21,080 in week 13. [*See id.*]. In addition, the Budget indicates that $170,000 is received approximately every month in credit card transaction funds. [*Id.*] The Piazza Declaration does not provide an explanation for the steep drop off in revenue from customer and daily fee transactions, nor does it explain why credit card revenue cannot be accessed more frequently than on a monthly basis. [*See* ECF No. 14, p. 11 of 22; ¶42].

19. The Motion and the Piazza Declaration contain inadequate information regarding the Debtor's efforts to secure DIP financing. Rather, the Debtor represents without further detail that no better terms could be obtained. [*See* ECF No. 4, p. 13 of 107; ¶35; ECF No. 14, p. 9 of 22; ¶37]. Debtor has also failed to provide sufficient evidence of what money is needed during the interim period, provide any information about the proposed Lender other than its name and state residence and explain the relationship if any among the Lender, the Debtor and/or insiders. Debtor should provide this information before the Lender is granted status as a good faith lender. [*See e.g.,* ECF Nos. 4; 14-2, p. 2; 14-3, pp. 2, 15, 22, 24, 26, 45, 53 & 57].

20. Courts recognize that debtors in possession "generally enjoy little negotiating power with a proposed lender…. As a result, lenders often exact favorable terms that harm the estate and creditors." *See In re Defender Drug Stores, Inc.*, 145 B.R. 312, 317 (B.A.P. 9th Cir. 1992). "[B]ankruptcy courts do not allow terms in financing arrangements that convert the bankruptcy process from one designed to benefit all creditors to one designed for the unwarranted benefit of the postpetition lender…. Thus, courts look to whether the proposed terms would prejudice the powers and rights that the Code confers for the benefit of all creditors and leverage the Chapter 11 process by granting the lender excessive control over the debtor or its assets as to unduly prejudice the rights of other parties in interest." *Id*. (internal citations omitted). Bankruptcy courts have not approved financing arrangements that convert the bankruptcy process from one designed to benefit all creditors to one designed for the sole (or primary) benefit of a post-petition lender *See, e.g., Ames Dep't Stores, Inc.*, 115 B.R. 34, 38-39 (Bankr. S.D.N.Y. 1990) (citing *In re Tenney Village Co.*, 104 B.R. 562, 568 (Bankr. D.N.H. 1989) (holding that the terms of a post-petition financing facility must not "pervert the reorganizational process from one designed to accommodate all classes of creditors . . . to one specially crafted for the benefit" of one creditor)) *See also In re Berry Good, LLC*, 400 B.R. 741, 747 (Bankr. Arizona 2008).

21. Events of default under the DIP financing terms include the appointment of a Chapter 11 trustee or an examiner with expanded powers, conversion to Chapter 7, any action

brought against the Lender that would impact the Debtor's obligation under the DIP financing terms, or the Debtor's failure to meet benchmarks set by the Lender. [*See* ECF No. 4, p. 5 of 107].

22. These provisions may improperly skew the bankruptcy process for the benefit of Lender and Debtor's existing management. *See, e.g., Ames Dep't Stores, Inc.*, 115 B.R. at 38 ("It is similarly the practice of this Court not to approve financing arrangements containing clauses triggering default on the appointment of a trustee or examiner under section 1104. Such entrenchment of management may not be in the best interests of the estate and only precludes parties-in-interest from seeking to redress fraud or gross mismanagement through such an appointment.").

23. In addition, the default provision regarding actions against the Lender may improperly undercut the adversarial system contemplated by the bankruptcy process. *See In re Tenney Village Co., Inc.*, 104 B.R. at 569 ("It is said that a Chapter 11 lender should not be required to finance the prosecution of claims against it. That is true. If the lender believes that this will occur, it can elect not to make the loan. It cannot expect, however, to change the rules of a Chapter 11 case.") (discussing limitations on the ability of an unsecured creditors committee to challenge a DIP loan).

24. The releases of the Lender that are to be inserted in the Chapter 11 plan should be denied to the extent that they constitute non-consensual third party non-debtor releases that violate Ninth Circuit law. [*See* ECF No. 14-3, p. 5 of 60]. *See Resorts Int'l v. Lowenschuss (In Re Lowenschuss)*, 67 F.3d 1394 (9th Cir. 1995); *American Hardwoods, Inc. v. Deutsche Credit Corp. (In re American Hardwoods Inc.)*, 885 F.2d 621 (9th Cir. 1989).

25. The relief requested in the Motion includes an alteration of the automatic stay so that the proposed Lender can take action against the Debtor upon the occurrence of a default, with what appears to be a 10-day cure period. [*See* ECF No. 4, p. 5 of 107; ECF No. 14-3, pp. 20-21 of 60].

26. The Debtor has not demonstrated the necessity for sidestepping the usual process for obtaining relief from stay. *See In re Tenney Village Co., Inc.*, 104 B.R. 562, 568 (Bankr.

D.N.H. 1989) (denying final approval of DIP financing agreement that would have, among other things, granted lender relief from the automatic stay unless the debtor obtained an order prohibiting foreclosure within a 7-day notice period).

27. The proposed DIP financing terms provide for liens covering the proceeds of any avoidance actions. However, avoidance actions should be maintained for the benefit of unsecured creditors. *Cf. Buncher Co. v. Official Comm. of Unsecured Creditors of GenFarm Ltd. P'ship IV*, 229 F.3d 245, 250 (3d Cir. 2000) ("When recovery is sought under section 544(b) of the Bankruptcy Code, any recovery is for the benefit of all unsecured creditors …."); *see also McFarland v. Leyh (in Re Tex. Gen. Petroleum Corp.)*, 52 F.3d 1330, 1336 (5th Cir. 1995) ("[T]he general policy behind the assertion of avoidance actions. The proceeds recovered in avoidance actions should not benefit the reorganized debtor; rather, the proceeds should benefit the unsecured creditors. 5 Collier on Bankruptcy P 1123.02, at 1123-23 (Lawrence P. King ed., 15th ed. 1994).").

28. The proposed interim order provides for a Section 364(e) finding at the interim stage. [*See* ECF No. 4, p. 33 of 107; ¶J].

29. Such a finding would all but immunize the DIP financing from appellate review. *See* 11 U.S.C. § 364(e); *In re Adams Apple, Inc.*, 829 F.2d 1484, 1488-89, 1491 & n.6 (9th Cir. 1987) (dismissing appeal of approval of cross-collateralization clause as moot pursuant to Section 364(e), even though the cross-collateralization clause may have been illegal per se).

30. This sweeping relief should not be granted on such extremely short notice. Through the DIP Loan terms, including the numerous default provisions, the proposed financing appears to transfer control portions of the case to the DIP Lender. Accordingly, the DIP Financing Motion should be denied.

B. <u>The Cash Management Motion Should Be Denied.</u>

31. Through the Cash Management Motion, Debtor seeks entry of an order authorizing the continued use of Debtor's bank accounts (the "Accounts"), which are located at Bank of America, Wells Fargo, American First National Bank, City National Bank and Bank of Texas. [*See* ECF No. 7, p. 8 of 24].[6]

32. Debtor requests a waiver of Section 345 and the U.S. Trustee Guidelines so that it does not have to close pre-petition accounts. [*See* ECF No. 7, pp. 12-13 of 24].

33. Through the Cash Management Motion, Debtor requests authority to "treat the Cash Accounts, CD Account and Merchant Account for all purposes as debtor-in-possession accounts." [*See* ECF No. 7, p. 10 of 24; lines 9-10].

34. Section 345(a) of the Bankruptcy Code requires the trustee or a debtor in possession to deposit or invest money of the estate so that it will result in the "maximum reasonable net return. . . [while] taking into account the safety of such deposit or investment." *See* 11 U.S.C. § 345 (emphasis added).[7] Section 345(b) requires that estate funds be deposited or invested so as to ensure that the funds are protected for the benefit of creditors. *See* 11 U.S.C. § 345(b). The Debtor is enjoying the protections afforded it under the Code. Section 345 of the Code and the Guidelines are both designed to ensure that creditors' interests are also protected.

35. Generally, unless the funds are insured, guaranteed, or backed by the full faith and credit of the United States Government or its agencies, the institution holding the estate funds must post a bond in favor of the United States or, in the alternative, deposit securities pursuant to 31 U.S.C. § 9303 as security. To ensure that trustees and debtors in possession meet their responsibilities to safeguard funds in accordance with Section 345, the United States Trustee monitors fiduciaries and depositories. *See* United States Trustee Program Policy and Practices Manual, Volume 7, "Banking and Bonding," ("Manual"), § 7-1.1, pp. 1-2, at https://www.justice.gov/ust/file/volume_7_banking_and_bonding.pdf/download.[8]

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[6] Bank of America, City National Bank, Bank of Texas, and Wells Fargo are all authorized depositories in the District of Nevada. *See* https://www.justice.gov/ust-regions-r17/region-17-general-information at "Authorized Depositories," "District of Nevada Authorized Depositories." However, American First National Bank is not an authorized depository in Nevada.

[7] Section 345 covers both deposits and investments.

[8] The U.S. Trustee is mindful that some courts have concluded that guidelines established by the U.S. Trustee do not have the force and effect of law. *See, e.g., In re Young*, 205 B.R. 894, 897 (Bankr. W.D. Tenn. 1997); *In re Lani Bird, Inc.*, 113 B.R. 672, 673 (Bankr. D. Hawaii 1990); *In re Gold Standard Baking, Inc.*, 179 B.R. 98, 105-06 (Bankr. N.D. Ill. 1995); *In re Johnson*, 106 B.R. 623, 624-25 (Bankr. D. Neb. 1989). As a result, "if the court is to require debtors to comply with

36. The Uniform Depository Agreement ("UDA") between the depository and the United States Trustee requires all depository to maintain collateral, unless an order of the bankruptcy court provides otherwise, in an amount of no less than 115 percent of the aggregate bankruptcy funds on deposit in each bankruptcy estate that exceeds the FDIC insurance limit. *See* Manual, §§7-1.2.1, p. 2 and 7-1.3, pp. 5-6.

37. Pursuant to the UDA, each authorized depository is required to provide quarterly reports for all bankruptcy estate accounts on deposit at all branches of the depository within the district. *See* Manual, § 7-1.3.2, p. 6.

38. Compliance with the U.S. Trustee Guidelines will ensure that banks can identify bank accounts for debtors-in-possession, ensure compliance with the requirements of 11 U.S.C. § 345(b), and that all post-petition monies received by the Debtor will be readily identifiable and easily accounted for during the pendency of this case.

39. The U.S. Trustee objects to the Cash Management Motion because it does not appear to require the banks where the Accounts are located to re-designate those Accounts as DIP accounts. The Cash Management Motion simply provides that "the Debtor will request the respective banks convert these accounts into debtor-in-possession accounts. . . ." [*See* ECF No. 7, p. 10 of 24; lines 10-11].

40. The U.S. Trustee objects to maintaining the American First National Bank account. American First National Bank is not an authorized depository in the District of Nevada and, therefore, estate funds held by this bank do not have the protections and reporting requirements afforded by Section 345 and the Guidelines.

41. To be in compliance with the Guidelines, the Debtor should be required to have the Accounts that are at Authorized Depositories designated as "Debtor-in-Possession" accounts as

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particular provisions of the U.S. T.'s Guidelines, it must be for a reason independent of the Guidelines themselves." *Johnson*, 106 B.R. at 624.

Compliance with the U.S. Trustee guidelines will ensure that banks can identify bank accounts for debtors-in-possession, ensure that they are in compliance with the requirements of 11 U.S.C. § 345(b), and that all post-petition monies received by the debtor will be readily identifiable and easily accounted for during the pendency of this case.

soon as possible, and no later than two weeks from the date the order is entered granting final relief on the Cash Management Motion.

42. In addition, any new accounts opened should be DIP accounts at authorized depositories. Id.

43. For the reasons stated above, the emergency relief requested by the Debtor in the Cash Management Motion should be denied.

C. <u>The Motion to Extend Should Be Denied.</u>

44. This case was filed on May 24, 2022, without Schedules A/B through H, or a statement of financial affairs ("SOFA"). [*See* ECF No. 1; *see generally* case docket].

45. Debtor is seeking debtor in possession financing of $5 million, with $1 million on an interim basis, with attendant liens and super-priority status for the proposed DIP lender and which will require confirmation within 180 days through one of the First Day Motions. [*See* ECF No. 4].

46. The deadline for creditors to file proofs of claim is September 21, 2022 (for non-governmental creditors) and November 21, 2022 (for governmental creditors). [*See* ECF No. 3, p. 2 of 2].

47. Debtor is seeking to reduce the bar date for non-governmental creditors by 68 days to July 15, 2022, through one of the First Day Motions. [*See* ECF No. 6, p. 9 of 44].

48. Pursuant to FRBP 1007(c), a debtors must file, *inter alia*, its schedules and SOFA with 14 days of the petition, unless an extension is granted by the Court. *See* Fed. R. Bankr. P. 1007(c). Accordingly, without an extension, Debtor would have to file its schedules and statements by Tuesday, June 7, 2022.

49. The Section 341 meeting of creditors is scheduled for June 23, 2022 at 9:00 a.m. [*See* ECF No. 3].

50. The Motion to Extend seeks to extend the date for the Debtors to file their schedules and statements by an additional 14 days to June 21, 2022, without prejudice to the Debtor seeking further extensions. [*See* ECF No. 8, pp. 7 & 12 of 14].

51. In this case, Debtor is seeking extensive first day relief, including to extend the deadline to file schedules to the eve of the Section 341 meeting, while at the same time to reducing the non-governmental claims bar date by more than 2 months, and subject the Debtor to a timeline dictated by the DIP financing terms.

52. On the first day, the Debtor filed first day motions and declarations comprising approximately 840 pages, however, the Debtor has not provided evidence to support a finding that "cause" exists to grant the emergency relief requested by the Motion to Extend. The Motion to Extend on its face impinges upon the rights of creditors and parties to be heard as they will be unable to gain an understanding the Debtor's full financial profile before emergency relief is granted. [*See* ECF Nos. 4 & 6-14].

53. Accordingly, the Extension Motion should only be granted, if at all, through Wednesday, June 15, 2022. This will also afford creditors and parties in interest a week to review these schedules before the Section 341 meetings of creditors.

D. <u>The Wage Motion Should Be Denied.</u>

54. The Debtor seeks to pay various pre-petition debts, including wages ($281,396.91), payroll taxes ($73,757.73), long term disability and term life insurance payments (unknown), worker's compensation premiums ($7,362), and employees' reimbursable expenses (unknown) to the Debtor's employees, other than Mr. Piazza. [*See* ECF No. 9, pp. 4 & 11-14 of 26; *see also* ECF NO. 14, p. 11 of 22].

55. The Piazza Declaration simply states with regard to the Wage Motion that payment is necessary to "minimize the hardship that the Employees will suffer if prepetition obligations are not paid when due, and to avoid disruption of the Debtor's workforce." [*See* ECF No. 14, p. 11 of 22; ¶43].

56. The Wage Motion is predicated on 11 U.S.C. §§ 105, 363, 507, 1107 and 1108. [*See* ECF No. 9, p. 3 of 26]. As the Debtor's request for relief in the Wage Motion is predicated on such authorities, it should be denied.

57. The "general rule is that a distribution on prepetition debt in a Chapter 11 case should not take place except pursuant to a confirmed plan of reorganization, absent extraordinary circumstance." *See In re Airbeds, Inc*., 92 B.R. 419, 422 (B.A.P. 9th Cir. 1988).

58. The Wage Motion provides that no employee has a claim higher than $15,390 and that therefore no employee will be paid above the cap set by Section 507(a)(4). [*See* ECF No. 9, p. 12 of 26]. However, the Section 507(a)(4) cap is presently $15,150 (raised from $13,650 on April 1, 2022). *See* 11 U.S.C. §507(a)(4). The Debtors should confirm that no one covered by the Wage Motion will be paid over the cap set forth in Section 507(a)(4).

59. Neither the Wage Motion nor the Piazza Declaration articulate extraordinary circumstances nor provide sufficient evidence to support the emergency relief the Wage Motion seeks. *See* FRBP 6003(b); *see also In re Humboldt Creamery, LLC,* 2009 WL 2820552, at *1 (Bankr. N.D. Cal. Apr. 23, 2009) ("The request is governed by Rule 6003(b) of the Federal Rules of Bankruptcy Procedure. This rule does not permit the payment of a claim which arose prepetition for the first 20 days of a bankruptcy unless it is necessary to avoid immediate and irreparable harm.").

60. The Debtor does not contend nor provide evidence that any of its employees have threatened to resign or whether such employees can be replaced. [*See* ECF Nos. 9 & 14].

61. Accordingly, the Debtor has not provided sufficient evidence of "immediate and irreparable harm" to warrant relief under FRBP 6003.

62. The Wage Motion seeks Court authority to "to continue with its payroll schedule in the ordinary course of its business." [*See* ECF No. 9, p. 12 of 26; ¶31]. Such blanket authority should be denied because ordinary course payments do not require Court authorization under Section 363(b)(1). See 11 U.S.C. § 363(b)(1).

63. Although the Wage Motion provides that Mr. Piazza is the only insider employee, but will not be paid through the Wage Motion, the Debtor should confirm that no payments to be made through the Wage Motion implicate Section 503(c). *See In re Journal Register Co.*, 407 B.R. 520, 535 (Bankr. S.D.N.Y. 2009).

64. For the reasons stated above, the relief requested by the Debtor in its Wage Motion should be denied.

E. The Indemnity and Limitation of Liability Provisions in the Claims Agent Motion Should Be Denied.

65. The Claims Agent Motion requests permission to use Bankruptcy Management Solution, Inc. ("Stretto") as claims and noticing agent pursuant to its Services Agreement, which is attached to the Betance Declaration. [*See* ECF Nos. 10-11].

66. The Services Agreement contains a number of clauses and provisions, including ones for indemnification, limitation of liability, arbitration and attorney fees, specifically:

> 9. Indemnification
> (a) To the fullest extent permitted by applicable law, the Company shall indemnify and hold harmless Stretto and its members, directors, officers, employees, representatives, affiliates, consultants, subcontractors, and agents (collectively, the "Indemnified Parties") from and against any and all losses, claims, damages, judgments, liabilities, and expenses, whether direct or indirect (including, without limitation, **counsel fees and expenses**) (collectively, "Losses") resulting from, arising out of, or related to Stretto's performance hereunder. Without limiting the generality of the foregoing, Losses include any liabilities resulting from claims by any third parties against any Indemnified Party.
> (b) Stretto and the Company shall notify each other in writing promptly upon the assertion, threat or commencement of any claim, action, investigation, or proceeding that either party becomes aware of with respect to the Services provided hereunder.
> (c) The Company's indemnification of Stretto hereunder shall exclude Losses resulting from Stretto's gross negligence or willful misconduct.
> (d) The Company's indemnification obligations hereunder shall survive the termination of this Agreement.
>
> 10. Limitations of Liability
> Except as expressly provided herein, Stretto's liability to the Company for any Losses, unless due to Stretto's gross negligence or willful misconduct, shall be limited to the total amount paid by the Company to Stretto for the portion of the particular work that gave rise to the alleged Loss. In no event shall Stretto be liable for any indirect, special, or consequential damages (such as loss of anticipated profits or other economic loss) in connection with or arising out of the Services provided hereunder.

> ….
>
> 16. Arbitration
> Any dispute arising out of or relating to this Agreement or the breach thereof shall be finally resolved by arbitration administered by the American Arbitration Association under its Commercial Arbitration Rules, and judgment upon the award rendered by the arbitrators may be entered in any court having jurisdiction. There shall be three arbitrators named in accordance with such rules. The arbitration shall be conducted in the English language in Irvine, California in accordance with the United States Arbitration Act. Notwithstanding the foregoing, upon commencement of any chapter 11 case(s) by the Company, any disputes related to this Agreement shall be decided by the bankruptcy court assigned to such chapter 11 case(s).

[*See* ECF No. 11, pp. 13-15 of 16 (emphasis added)].

67. Unless Stretto can show that it cannot obtain insurance to protect it against liability, or that insurance is prohibitively expensive, the indemnification provision should be denied. *See In re Metricom,* 275 B.R. 364, 372-73 (Bankr. N.D. Cal. 2002) (denying an indemnification provision for a financial advisor as unreasonable pursuant to Section 328(a)).

68. The Indemnification Clause and the Limitation of Liability provision only contain carve-outs for gross negligence or willful misconduct. Stretto has not shown why it should be indemnified for its own negligence.

69. The Indemnification Clause requires the payments of counsel fees and expenses. "It is a "bedrock principle" of American law that "[e]ach litigant pays his own attorney's fees, win or lose, unless a statute or contract provides otherwise." *Zurich Am. Ins. Co. et al. v. Team Tankers A.S. et al.*, 811 F.3d 584, 590 (2d Cir. 2016) (quoting *Baker Botts L.L.P. v. ASARCO LLC*, 135 S. Ct. 2158, 2164, 192 L. Ed. 2d 208 (2015))." *Broker Genius, Inc. v. Seat Scouts LLC*, 2018 U.S. Dist. LEXIS 81185 at pp. *20-*21 (S.D. N.Y. May 14, 2018).

70. Stretto has not shown that these provisions are reasonable and should be approved.

71. The arbitration provision in the Services Agreement may also be unreasonable, at least to the extent it interferes with the Court's consideration of disputes under the Bankruptcy Code. *See In re Home Express, Inc.,* 226 B.R. 657, 658-59 (Bankr. N.D. Cal. 1998) (While

arbitration enjoys a "favored status," disputes relating to 11 U.S.C. §§ 327 through 331 "fall within the extremely narrow category of disputes which Congress probably never envisioned being delegated to nonjudicial entities for resolution.").

72. The Services Agreement also includes a late fee of 1.5% per month after a bill becomes 30 days late. [*See* ECF No. 11, pp. 10-11 of 16].

73. Stretto and Debtor have also failed to carry their burden in showing any late fees set forth in the Services Agreement are reasonable. While a late fee may be reasonable for companies that are not in bankruptcy, the Debtors and Stretto have failed to show that this provision is reasonable given that this Debtor is in bankruptcy.

74. Accordingly, Claims Agent Motion should be denied.

F. <u>The Critical Vendors Motion Should Be Denied.</u>

75. The Piazza Declaration asserts that the critical vendors "will likely terminate or disrupt the services they provide to the Debtor" if they are not paid for pre-petition claims at the outset of the case. The Piazza Declaration does not provide any information as to whether the products or services provided by these vendors could be replaced. [*See* ECF No. 14, pp. 19-20 of 22; ¶¶ 88-91]. Thus there is no evidence that these vendors will refuse to provide the services and/or products.

76. The Debtor predicates the Motion on Sections 105(a), 363(b), 507(a)(8), 541(d), 1107(a) and 1108. None of these statutory provisions support the Debtor's requested relief with respect to critical vendors. [*See* ECF No. 12, p. 1 of 19].

77. Section 105 does not authorize the relief requested in the Motion. *See In re Berry Good, LLC*, 400 B.R. 741, 746 (Bankr. D. Ariz. Dec. 4, 2008) ("[M]ost circuit courts, including the Ninth, have held that the bankruptcy court does not have general equitable power under § 105(a) to overrule the Code's priority scheme by favoring one class of unsecured creditors over another.").

78. The Supreme Court has construed Section 105(a) to enable a bankruptcy court to implement, rather than override, the Bankruptcy Code. *Norwest Bank Worthington v. Ahlers*, 485

U.S. 197, 206 (1988); *In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004). "The general rule is that a distribution on prepetition debt in a Chapter 11 case should not take place except pursuant to a confirmed plan of reorganization, absent extraordinary circumstances." *Rosenberg Real Estate Equity Fund III v. Air Beds, Inc. (In re Air Beds, Inc.)*, 92 B.R. 419, 422 (B.A.P. 9th Cir. Oct. 17, 1988).

79. Based upon these authorities, as well as the lack of evidentiary support marshalled in support of the Critical Vendors Motion, Section 105(a) does not provide a sufficient basis for granting the relief requested in the Critical Vendors Motion.

80. Ninth Circuit case law casts considerable doubt on whether the necessity of payment doctrine applies outside of the context of railroad reorganizations and otherwise survived the enactment of the Bankruptcy Code. *B & W Enterprises, Inc. v. Goodman Oil Co. (In re B & W Enterprises, Inc.)*, 713 F.2d 534, 537 (9th Cir. 1983) ("*The Necessity of Payment Rule was created for and has been applied only to railroad cases.* Absent compelling reasons, we deem it unwise to tamper with the statutory priority scheme devised by Congress in the 1978 Act.") (citation omitted) (emphasis added). With respect to the argument that a bankruptcy court's general equitable powers authorize such relief, the Ninth Circuit observed, "[t]here is no indication Congress intended the courts to fashion their own rules of super-priorities within any given priority class." *Id.*[9]

81. However, the Ninth Circuit has noted, in *dicta*, that "[c]ases have permitted unequal treatment of pre-petition debts when necessary for rehabilitation, in such contexts as . . . debts to providers of unique and irreplaceable supplies. . . ." *Burchinal v. Central Washington Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484, 1490 (9th Cir. 1987) (emphasis added).

82. "Even those courts that would allow such payments, under § 105(a), or under other code sections, such as a § 363 use of estate funds outside the ordinary course, demand a stringent evidentiary test showing that the payment of the pre-petition claims is "critical to the debtor's reorganization." *In re Berry Good, LLC*, 400 B.R. at 746-47.

[9] The Seventh Circuit Court of Appeals observed that a doctrine of necessity was just a "fancy name for a power to depart from the Code." *In re Kmart Corp.*, 359 F.3d at 871.

83. As the Seventh Circuit Court of Appeals has noted

> The foundation of a critical-vendors order is the belief that vendors not paid for prior deliveries will refuse to make new ones. [. . . .] If paying the critical vendors would enable a successful reorganization and make even the disfavored creditors better off, then all creditors favor payment whether or not they are designated as "critical." This suggests a use of § 363(b)(1) similar to the theory underlying a plan crammed down the throats of an impaired class of creditors: if the impaired class does at least as well as it would have under a Chapter 7 liquidation, then it has no legitimate objection and cannot block the reorganization. [. . . .] For the premise to hold true, however, it is necessary to show not only that the disfavored creditors will be as well off with reorganization as with liquidation [. . .] but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued.

In re Kmart Corp., 359 F.3d at 872-873 (internal citations omitted) (emphasis added).

84. Debtor has not satisfied the requirements for invoking Section 363(b) for the relief requested in the Motion. In *Kmart*, the court observed that Section 363(b) could possibly serve as a basis for requested critical vendor payments but only upon a showing that (1) any prepetition creditor would have ceased doing business with the debtor if the prepetition creditor was not paid its prepetition claim, (2) debtor could have posted a letter of credit to assure vendors of payment, (3) discrimination among unsecured creditors was the only way to facilitate a reorganization and (4) the disfavored creditors fared as well or better than they would have fared had the critical vendor order not been entered. 359 F.3d at 873-874.

85. Here, as in *Kmart*, the Debtor has not offered sufficient evidence to establish these factors. For example and with reference to the first *Kmart* factor, the Debtor has not established that the critical vendors will cease doing business with the Debtor if the Debtor fails to pay such vendor its prepetition claim. *See* 359 F.3d at 873. Such a showing is necessary for the Critical Vendors Motion to have merit.

86. Because the Debtor has not offered sufficient evidence to establish each of the *Kmart* factors, the Debtor has not met its burden under 11 U.S.C. § 363(b). For this reason, the Court should deny the relief requested in the Critical Vendors Motion with respect to the payment of pre-petition claims of vendors.

87. For the reasons set forth above, the Critical Vendors Motion should be denied.

III. CONCLUSION

88. In view of the shortened notice provided to creditors, to the extent they are granted at all, the First Day Motions relief should be limited to only what the Debtor requires to sustain operations. Alternatively, the First Day Motions should be adjourned until a later date. The adjournment would permit parties that were not provided sufficient notice and any official committee the opportunity to be heard on the Motions.

89. The United States Trustee also expressly reserves her rights to object to any amendments made to the First Day Motions, or any other additional relief requested in any subsequently filed motion.

WHEREFORE, the U.S. Trustee requests to Court to sustain her Omnibus Objection; and grant such other relief as is just under the circumstances.

Dated: May 26, 2022

Respectfully Submitted,

TRACY HOPE DAVIS
UNITED STATES TRUSTEE
By: /s/ *Edward M. McDonald Jr.*
Edward M. McDonald Jr., Trial Attorney