IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re: AMBRI, INC., Debtor.[1]	Chapter 11 Case No. 24-10952 (LSS) **Re: Docket No. 18**

OBJECTION OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS TO THE DEBTOR'S MOTION FOR ENTRY OF INTERIM AND FINAL ORDERS (I) AUTHORIZING THE DEBTOR TO (A) OBTAIN POSTPETITION FINANCING AND (B) UTILIZE CASH COLLATERAL, (II) GRANTING ADEQUATE PROTECTION TO PREPETITION SECURED PARTIES, (III) MODIFYING THE AUTOMATIC STAY, (IV) SCHEDULING A FINAL HEARING, AND (V) GRANTING RELATED RELIEF

The Official Committee of Unsecured Creditors of Ambri, Inc. (the "Committee") objects (the "Objection") to the *Debtor's Motion for Entry of Interim and Final Orders (I) Authorizing the Debtor to (A) Obtain Postpetition Financing and (B) Utilize Cash Collateral, (II) Granting Adequate Protection to Prepetition Secured Parties, (III) Modifying the Automatic Stay, (IV) Scheduling a Final Hearing, and (V) Granting Related Relief* (the "Motion").[2] In support of this Objection, the Committee respectfully states as follows:

PRELIMINARY STATEMENT

1. The Debtor proposes to enter into a DIP financing facility (the "DIP Facility") provided by its existing Prepetition Secured Parties who are also ***insider equity holders*** (together, the "DIP Lenders"), consisting of $9.5 million of new money and a roll-up of the full outstanding balance of asserted prepetition indebtedness owed to the Prepetition Secured Parties of over $27

[1] The Debtor's mailing address is 53 Brigham Street, Unit 8, Marlborough, MA 01752, and the last four digits of the Debtor's federal tax identification number are 0023.

[2] Docket No. 18. Capitalized terms not otherwise defined herein shall have their meaning as set forth in the Motion.

million (the "Roll-Up"). A portion of the Roll-Up in the amount of $3.75 million – the Interim Roll-Up – has already been approved through the Interim Order. As a result of the Roll-Up, following entry of the Final Order, the DIP Lenders intend to credit bid approximately $36.5 million for the Debtor's assets through a fast-track sales process. Given the insider status of the Prepetition Secured Parties, this Court's analysis of the proposed DIP Facility and Final Order should be subject to a heightened level of scrutiny.

2. The Committee urges the Court to deny the remaining Roll-Up and unwind the Interim Roll-Up, which was subject to the Committee's challenge rights under the Interim Order.[3] ***The Prepetition Secured Notes (as defined below) are not debt; they are equity***. Each contain the following provision:

> **Tax Treatment**. The parties hereto hereby acknowledge and agree that, notwithstanding that this Note is titled as a "Secured Convertible Promissory Note," for United States federal and state income tax purposes this Note is more properly characterized as equity rather than debt. Accordingly, the parties agree, unless otherwise required by applicable law, to treat the Note as equity for all United States federal and state income tax purposes (including, without limitation, on their respective tax returns or other informational statements). The Company hereby agrees that, unless otherwise required by applicable law, it will classify this Note as equity at the time of issuance in the manner required under Section 385 of the Code.[4]

3. Although the foregoing provision relates to the tax treatment of the Prepetition Secured Notes, it is a glaring admission of the true nature of such notes. The holders of the Prepetition Secured Notes are insider investors of the Debtor, who hold majority equity interests in the Debtor and previously extended loans to the Debtor only to then convert them to equity. On

[3] The Committee intends to file a standing motion and proposed challenge complaint against the Prepetition Secured Parties.

[4] Prepetition Secured Notes ¶5(p).

or about October 2, 2023, such noteholders agreed to provide purported "secured loans" to the Debtor, initially an advance of just under $10 million (the "Initial Tranche"). No one bothered to file a UCC-1 financing statement to perfect the asserted liens of the Prepetition Secured Parties under the Initial Tranche for 51 days until the second round of funding in November 2023. Such UCC-1 filing is now avoidable as a preferential transfer as to the Initial Tranche.

4. There are many other factors why the Prepetition Secured Notes should be characterized as equity, rather than debt, as will be reflected in the Committee's standing motion and proposed challenge complaint. For instance, no principal or interest is payable under the Prepetition Secured Notes until maturity and they are automatically convertible into equity upon the occurrence of a qualified equity financing or upon the agreement of the requisite holders of the notes. The noteholders also received warrants to purchase additional shares in the Debtor and effectuated an exchange of preferred shares that increased the liquidation preference by two times (2x) the original issue price. Taken together, the clear intent of the tax treatment provision above and various other factors weigh heavily in favor of recharacterizing the Prepetition Secured Notes as equity. Hence, no further Roll-Up should be approved and the Interim Roll-Up should be disavowed. The DIP Lenders should be permitted to credit bid only the new money that they advance to the Debtor postpetition.

5. The DIP Facility is also objectionable by proposing to encumber all of the previously unencumbered assets of the Debtor's estate (the "Unencumbered Assets"), including commercial tort claims, the proceeds of Avoidance Actions, and over $2.4 million in cash in the Debtor's deposit accounts as of the Petition Date.[5] To the Committee's knowledge, there are no deposit account control agreements with the Debtor or its depository banks in favor of the

[5] Interim Order ¶6, 8.

Prepetition Secured Parties. None of the funds in the Debtor's accounts are identifiable proceeds of other collateral because they primarily constitute the remaining funds originally advanced to the Debtor by the Prepetition Secured Parties themselves. No DIP or adequate protection liens or superpriority claims should extend to the Unencumbered Assets, which should be preserved for the benefit of the estate's unsecured creditors. And the DIP Lenders should not be permitted to credit bid for the Debtors' cash on hand, which is projected to exceed $2.3 million under the Debtor's budget as of the week ending July 14, 2024.[6]

6. Given the highly disputed nature of the Prepetition Secured Notes (as addressed above and in a forthcoming challenge complaint), there should be no section 506(c) surcharge, marshaling, or section 552 "equities of the case" waivers in favor of the Prepetition Secured Parties.[7]

7. Finally, the DIP Facility and proposed Final Order unduly limit the Committee's ability to thoroughly exercise its statutory duties. The Carve-Out in the Interim Order includes discriminatory treatment of the Committee's professionals as compared to the Debtors' professionals, by providing the Committee's professionals with $0 for the Post-Carve-Out Trigger Notice Cap.[8] Although the Challenge Deadline for the Committee is 60 days from formation of the Committee and there is a tolling provision if a timely standing motion and proposed complaint are filed,[9] further extensions should be permitted with consent of the applicable Prepetition Secured Parties or by the Court for cause. The Committee also should be granted more than

[6] Interim Order, Exhibit 1 (Budget).

[7] Interim Order ¶19, 29, 30.

[8] Interim Order ¶11(a).

[9] Interim Order ¶25.

$25,000 to conduct a full investigation of the Prepetition Secured Parties' asserted liens and claims.[10] The Committee requests at least $100,000 for this purpose.

8. In sum, while the Committee has no objection in principle to securing additional funding necessary to fund the Debtor's operational and administrative needs in this case, any attempt by the insider DIP Lenders to improve their position or sanitize otherwise seriously defective prepetition debt at the expense of unsecured creditors should not be sustained. Unless and until the Roll-Up is dropped and other significant revisions made as requested herein, the Motion should be denied.

BACKGROUND

I. General Background

9. On May 5, 2024 (the "Petition Date"), the above-captioned debtor (the "Debtor") filed its voluntary petition for relief under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"). The Debtor is operating its business and managing its property as 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 case.

10. On May 20, 2024, the Office of the United States Trustee appointed the Committee in this case pursuant to 11 U.S.C. § 1102.[11] The Committee members are: (i) CSC Leasing Co.; (ii) J. Calnan & Assoc.; and (iii) Quarry Square Owner, LLC.

II. Prepetition Debt

11. The DIP Lenders are also Prepetition Secured Parties. Two of the proposed DIP Lenders, Gates Frontier, LLC and Paulson Partners, L.P. or their respective affiliates, hold 57.65%

[10] Interim Order ¶26.
[11] Docket No. 68.

of the Debtor's total equity and 85.32% of the Debtor's senior preferred equity as disclosed in the Debtor's voluntary petition.[12] The same equity holders or their affiliates are providing the vast majority ($7.7 million or approximately 81%) of the new money DIP term loan commitments.[13]

12. The Debtor's prepetition capital structure is set forth in paragraphs 17 to 21 of the Motion. The Debtor stipulates in the Interim Order that it owes the Prepetition Secured Parties not less than $27,070,301.51 (including interest and fees),[14] which was incurred under the *Secured Convertible Note and Warrant Purchase Agreement* dated as of October 2, 2023 (the "Prepetition Secured Note Purchase Agreement") and associated *Secured Convertible Promissory Notes* (together, the "Prepetition Secured Notes") funded in three rounds prior to the Petition Date:

Tranche	Funding Date	Loan Amount (principal)
Initial Tranche	Oct. 2, 2023	$9,999,999.99
Second Tranche	Nov. 15, 2023	$8,027,174.09
Third Tranche	Jan. 19, 2024	$7,224,456.69
	Total:	$25,251,630.77

13. Each of the Prepetition Secured Notes contains the following acknowledgment by the parties that, and a requirement that the Debtor treat, the indebtedness under the Prepetition Secured Notes as an equity investment for tax purposes.

> **Tax Treatment**. The parties hereto hereby acknowledge and agree that, notwithstanding that this Note is titled as a "Secured Convertible Promissory Note," for United States federal and state income tax purposes this Note is more properly characterized as equity rather than debt. Accordingly, the parties agree, unless otherwise required by applicable law, to treat the Note as equity for all United States federal and state income tax purposes (including,

[12] Docket No. 1 at p. 12.

[13] Docket No. 18 at p. 202 (DIP Credit Agreement, Schedule 2.1(a)).

[14] Interim Order, Recital D.

> without limitation, on their respective tax returns or other informational statements). The Company hereby agrees that, unless otherwise required by applicable law, it will classify this Note as equity at the time of issuance in the manner required under Section 385 of the Code.[15]

14. On November 22, 2023, fifty-one (51) days after the funding of the Initial Tranche, an "all asset" UCC-1 financing statement was filed in favor of the Prepetition Secured Parties. Such filing constitutes an avoidable preferential transfer made in favor of insiders of the Debtor within one year prior to the Petition Date.

15. There is no prepetition deposit account control agreement in favor of the Prepetition Secured Parties. As of the Petition Date, the Debtor's budget reflects a starting cash balance of $2,445,697. Such funds are not proceeds of other collateral of the Prepetition Secured Parties. As noted above, the Debtor's budget projects in excess of $2.3 million of cash remaining as of the week ending July 14, 2024.[16]

16. The Committee has only begun its challenge investigation and the findings set forth herein are preliminary and ongoing.

III. The DIP Facility

17. The proposed DIP Facility consists of superpriority senior secured term loans in an aggregate principal amount of $9.5 million, comprised of: (a) an initial interim draw of $3.75 million made available upon entry of the Interim Order; and (b) $5.75 million to be made available upon entry of the Final Order.

18. As part of the DIP Facility and upon entry of the Final Order, the Debtor is required to roll-up the full amount of principal allegedly due and owing to the Prepetition Secured Parties

[15] Prepetition Secured Notes ¶5(p).

[16] Interim Order, Exhibit 1 (Budget).

in an amount exceeding $27 million.[17] The Interim Roll-Up of $3.75 million was already approved under the Interim Order, subject to the Committee's challenge rights.[18]

19. The Debtor proposes to grant DIP and adequate protection liens and superiority claims on the DIP Collateral, which would include the Unencumbered Assets.[19]

20. The Debtor's ability to use the DIP Facility is limited to the amounts and uses set forth in the Debtor's budget.[20] The investigation budget for the Committee to analyze the Prepetition Secured Parties' liens and claims is capped at $25,000 and the Committee is not granted standing to pursue any estate claims.[21]

21. The Debtor proposes to grant a broad waiver and release of any and all claims, counterclaims, causes of action, defenses or setoff rights against each of the Prepetition Secured Parties, including any rechacterization, subordination, avoidance or other similar claim, subject to the Committee's challenge rights.[22]

22. As a further condition to the DIP Facility, the Debtor must comply with mandatory sale milestones.[23] The DIP Lenders propose to fund a budget just long enough to run a short sales process (for which they intend to be a stalking horse bidder) with bids due on June 20, 2024.

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[17] Interim Order ¶6(f).

[18] Interim Order ¶4.

[19] Interim Order ¶6, 8.

[20] Interim Order, Exhibit 1 (Budget).

[21] Interim Order ¶25, 26.

[22] Interim Order ¶G.

[23] DIP Credit Agreement §5.29.

23. The Motion was filed on the Petition Date and approved on an interim basis on May 8, 2024 (the "Interim Order").[24] The Final Hearing was initially set for May 30, 2024, but has since been continued to June 12, 2024.

IV. The Sale Motion

24. Also on the Petition Date, the Debtor filed its bid procedures and sale motion ("Sale Motion").[25] The Debtor proposes to sell substantially all of its assets to the Prepetition Secured Parties / DIP Lenders / majority equityholders (the "Stalking Horse") for a credit bid, including claims against the Stalking Horse, for a full and complete immunization and release of claims against such parties. The credit bid is equal to the outstanding amount of the DIP Facility, including the Roll-Up, plus the assumption of certain unquantified cure costs and payment of unspecified cash. In order to overbid, a third party bidder would need to offer not less than $36.5 million in cash for the Debtor's assets by the bid deadline of June 20, 2024.

OBJECTION

25. A court should approve a proposed debtor in possession financing only if such financing "is in the best interest of the general creditor body."[26] Moreover, the proposed financing must be "fair, reasonable, and adequate."[27] Postpetition financing also should not be authorized if its primary purpose is to benefit or improve the position of a particular secured lender.[28]

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[24] Docket No. 47.

[25] Docket No. 14.

[26] *In re Roblin Indus., Inc.*, 52 B.R. 241, 244 (Bankr. W.D.N.Y. 1985) (citing *In re Vanguard Diversified, Inc.*, 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983); *see also In re Tenney Village Co., Inc.*, 104 B.R. 562, 569 (Bankr. D. N.H. 1989) ("The debtor's prevailing obligation is to the bankruptcy estate and, derivatively, to the creditors who are its principal beneficiaries").

[27] *In re Crouse Group, Inc.*, 71 B.R. 544, 546 (Bankr. E.D. Pa. 1987).

[28] *See, e.g., In re Aqua Assocs.*, 123 B.R. 192, 195-98 (Bankr. E.D. Pa. 1991) ("[C]redit should not be approved when it is sought for the primary benefit of a party other than the debtor."); *In re Ames Dep't Stores, Inc.*, 115 B.R. 34, 37 (Bankr. S.D.N.Y. 1990) ("[A] proposed financing will not be approved where it is apparent that the purpose of the financing is to benefit a creditor rather than the estate."); *Tenney Village*, 104 B.R. at 568 (debtor in possession

26. A proposed financing transaction with insiders, such as the one contemplated in this case, is subject to a heightened standard of scrutiny. *See In re Papercraft Corp.*, 211 B.R. 813, 823 (W.D. Pa. 1997) ("[I]nsider transactions are subjected to rigorous scrutiny and when challenged, the burden is on the insider not only to prove the good faith of a transaction but also to show the inherent fairness from the viewpoint of the corporation and those with interests therein.") (citing *Pepper v. Litton*, 308 U.S. 295, 306 (1939), *aff'd*, 160 F.3d 982 (3d Cir. 1998)); *In re Nugelt*, 142 B.R. 661, 667 (Bankr. D. Del. 1992) ("insider transactions subject to greater scrutiny than arms' length transactions."); *In re St. Mary Hosp.*, 86 B.R. 393, 401-02 (Bankr. E.D. Pa. 1988) (denying debtor's proposed postpetition financing arrangement with its parent because the proposed financing gave the parent a superpriority lien on all unencumbered assets of the debtor, which the court found was not fair or reasonable in light of the parties' relationship and the circumstances of the transaction); *Liberty Mut. Ins. Co. v. Leroy Holding Co., Inc.*, 226 B.R. 746, 755 (N.D.N.Y. 1998) ("The conduct of an insider is subject to more rigorous scrutiny."); *Matter of Lifschultz Fast Freight*, 132 F.3d 339, 344 (7th Cir. 1997) ("Insider's dealings with debtor-corporation are ordinarily subject to rigorous or strict scrutiny.").

27. The proposed DIP Facility in the instant case does not survive heightened scrutiny. The Motion attempts to effectuate a strategy by the insider Prepetition Secured Parties to acquire the Debtor's valuable assets on an expedited basis through a credit bid, which is itself defective given that the asserted "secured" claims of the Prepetition Secured Parties should be recharacterized or avoided. At most, the DIP Lenders should be permitted to credit bid no more than the new money (up to $9.5 million) that they actually advance to the Debtor's estate on a

financing terms must not "pervert the reorganizational process from one designed to accommodate all classes of creditors and equity interests to one specially crafted for the benefit of the secured creditor").

postpetition basis. The DIP Facility should not be a means to cleanse the defective Prepetition Secured Parties' prepetition liens and claims and inhibit a competitive sale process.

28. The Committee submits that the DIP Facility should be denied in its present form.

I. The Roll-Up is Inappropriate Where, As Here, the Prepetition Insider Debt is In Dispute

29. Roll-ups are "generally viewed as a more controversial form of adequate protection that courts will approve sparingly."[29] They are generally disfavored because they provide no benefit to the estate while favoring certain prepetition creditors over others.[30] Roll-ups, like the Roll-Up in the DIP Facility at issue, generally harm unsecured creditors in at least two ways. First, they enhance the lenders' collateral package by providing liens over unencumbered assets – assets that would otherwise be available to unsecured creditors and not available for credit bidding. Second, the Bankruptcy Code requires this "rolled-up" debt to be repaid in full and in cash in order for a debtor to successfully emerge from chapter 11, thereby precluding the debtor from treating the prepetition rolled-up debt in accordance with section 1129(b)(2)(A) of the Bankruptcy Code.[31]

30. In this case, the Roll-Up is even more nefarious because it is the basis for a stalking horse credit bid for substantially all of the Debtor's assets. The Roll-Up will have the effect of chilling bidding because the floor purchase price includes over $27 million of rolled-up prepetition

[29] 1 COLLIER LENDING INSTITUTIONS & THE BANKRUPTCY CODE ¶ 5.03[2][b] (citing cases).

[30] *In re Verasun*, No. 08- 12606 (BLS) (Bankr. D. Del. Dec. 3, 2008) [Dkt. No. 316] (J. Shannon noting that Bankruptcy Courts in the District of Delaware, the Southern District of New York, and elsewhere have found that "rollups are not favored. They are strongly discouraged on day one, and the bottom line is that for approval a substantial showing [of need for the financing] has to be made."). *See also In re Saybrook Mfg. Co., Inc.*, 963 F.2d 1490, 1494–96 (11th Cir. 1992) (noting that postpetition cross-collateralization is an "extremely controversial form of Chapter 11 financing" before holding it was not authorized by section 364 of the Bankruptcy Code)*; In re Bruin E&P Partners, LLC*, Tr. of Hr'g at 67:9-10, Case No. 20-33605 (Bankr. S.D. Tex Jul. 17, 2020) (finding that roll-ups are "heavily disfavored under the Bankruptcy Code"); *see also Reynolds v. Servisfirst Bank* (*In re Stanford*), 17 F.4th 116, 128 (11th Cir. 2021) (Jordan, J., concurring).

[31] *See, e.g.,* 3 COLLIER ON BANKRUPTCY ¶ 364.06[2] (16th ed.).

debt, which the Committee submits should be recharacterized as equity or, alternatively, avoided at least in part. As quoted earlier, the Debtor and the holders of the Prepetition Secured Notes expressly agreed for tax purposes that the obligations thereunder should be treated as equity and not debt.[32]

31. The holders of the Prepetition Secured Notes are insider investors of the Debtor, who hold majority equity interests in the Debtor and previously extended loans to the Debtor only to then convert them to equity. On or about October 2, 2023, such noteholders advanced just under $10 million to the Debtor, but no UCC-1 financing statement was filed to perfect the asserted liens of the Prepetition Secured Parties under such Initial Tranche for fifty-one (51) days thereafter. Such UCC-1 filing is now avoidable as a preferential transfer as to the Initial Tranche.

32. And there are other factors why the Prepetition Secured Notes should be characterized as equity, rather than debt. For instance, no principal or interest is payable under the Prepetition Secured Notes until maturity and such notes are automatically convertible into equity upon the occurrence of a qualified equity financing or upon the agreement of the requisite holders. The noteholders also received warrants to purchase additional shares in the Debtor and effectuated an exchange of preferred shares that increased the liquidation preference by two times (2x) the original issue price.

33. In sum, the clear intent of the parties weighs heavily in favor of recharacterizing the Prepetition Secured Notes as equity. Hence, no further Roll-Up should be approved and the Interim Roll-Up should be disavowed. The DIP Lenders should be permitted to credit bid only the new money that they advance to the Debtor postpetition.

[32] Prepetition Secured Notes ¶5(p).

34. Even where roll-ups are approved, it is usually because substantial new money is being provided to the estates that is roughly equivalent to the amount of prepetition debt to be rolled-up.[33] The Roll-Up in this case dwarfs the amount of new money being provided by the DIP Lenders ***by a ratio of close to 3 to 1***.

35. Certainly Delaware courts have approved roll-ups that exceed the amount of new money to be provided under a DIP facility. But this is a case where ***no roll-up should be approved*** given the insider nature of the prepetition debt and the challenges thereto that already have been identified by the Committee.

36. Courts often refuse to grant a roll-up of prepetition debt that is potentially unsecured because it has the effect of elevating an unsecured claim to a secured claim (or in this case, more egregiously, an equity interest to a secured claim).[34] Indeed, where the prepetition debt is undersecured, "the roll-up has the same effect as *Texlon* cross-collateralization," which criticized in particular "a financing scheme so contrary to the spirit of the Bankruptcy Code" granted at a hearing "where the bankruptcy court relies solely on representations by a debtor in possession."[35] The court described the problems intrinsic to this process:

> The debtor in possession is hardly neutral. Its interest is in its own survival, even at the expense of equal treatment of creditors, and close relations with a lending institution tend to prevent the

[33] *See In re Constar Int'l Holdings LLC*, Hr'g Tr. 87:20-25, 88:1-4, Case No. 13-3281 (CSS) (Bankr. D. Del. Jan. 16, 2014) (discussing the benefits of a lower roll-up percentage—*i.e.*, percentage of the full facility that represented rolled-up debt—and noting it was the "driving factor" behind the Court's approval of a 20% DIP roll-up over an alternative 40% DIP roll-up); *In re Vanguard Natural Resources, Inc.,* Docket No. 241 at 2-3, Case No. 19-31786 (Bankr. S.D. Tex. April 30, 2019) (approving roll-up of $65 million with a $65 million new money DIP); *In re Sheridan Holding Company II, LLC*, Docket No. 146 at 2, Case No. 19-35189 (Bankr. S.D. Tex. Oct. 15, 2019) (approving roll-up of $50 million with a $50 million new money DIP).

[34] *See, e.g., In re Saybrook Mfg Co*., 963 F.2d 1490, 1495 (11th Cir. 1992) (holding postpetition financing arrangement *per se* impermissible where undersecured prepetition lender provided postpetition financing in exchange for a security interest in debtor's postpetition property to secure its prepetition debt); *In re FCX, Inc*., 54 B.R. 833, 840 (Bankr. E.D.N.C. 1985) ("[I]f an undersecured creditor can obtain unencumbered assets as security for all of its prepetition claims, that creditor is being preferred to the detriment of other unsecured claimants.").

[35] *In re Texlon Corp.*, 596 F.2d 1092, 1098 (2d Cir. 1979).

> exploration of other available courses in which a more objective receiver or trustee would engage. A hearing might determine that other sources of financing are available; that other creditors would like to share in the financing if similarly favorable terms are accorded them; or that the creditors do not want the business continued at the price of preferring a particular lender.[36]

37. For these reasons, the whole premise of the Roll-Up, putting aside the excessive ratio of roll-up debt versus new money, is simply inappropriate where the extent, scope, and validity of the insider Prepetition Secured Parties' liens and claims are facially invalid and open to challenge.

II. There Should Be No Pledge of Unencumbered Assets

38. The Debtor proposes to encumber all Unencumbered Assets (or the proceeds thereof) that would otherwise be available to unsecured creditors in favor of the DIP Lenders and, to the extent of any diminution in value, the Prepetition Secured Parties.[37] The assets that the Committee believes were unencumbered as of the Petition Date that must be preserved for the benefit of unsecured creditors include, among others, commercial tort claims, the proceeds of Avoidance Actions, and over $2.4 million in cash in the Debtor's deposit accounts as of the Petition Date. There are no deposit account control agreements in favor of the Prepetition Secured Parties. None of the funds in the Debtor's accounts are identifiable proceeds of other collateral because they primarily constitute the remaining funds originally advanced to the Debtor by the Prepetition Secured Parties themselves. The DIP Lenders / Prepetition Secured Parties now seek to prematurely scoop up the Unencumbered Assets through the DIP Facility, Roll-Up, and Final Order.

[36] *Id.* at 1098-99.

[37] Interim Order ¶6, 8.

39. The only way to preserve and protect the interests of unsecured creditors under such circumstances is to treat the Unencumbered Assets as sacrosanct and free and clear of any liens or superpriority claims. As proposed, the DIP Facility would encumber all such previously Unencumbered Assets in favor of the DIP Lenders / Prepetition Secured Parties, without any prospect of a recovery by the unsecured creditors in this case, including cash held on the Petition Date, which was not properly perfected.

40. Avoidance actions (and the proceeds thereof), in particular, are uniquely for the benefit of general creditors of the estate, not secured creditors, and should not be encumbered in favor of secured lenders.[38] Avoidance actions are statutory rights designed to ensure equitable distributions of a debtor's estate. Indeed, avoidance powers are intended to allow a debtor in possession or other party with standing to gain recoveries for the benefit of all unsecured creditors. Accordingly, bankruptcy courts often restrict a debtor's ability to pledge avoidance actions and their proceeds as collateral.

41. Here, there is no basis for the DIP Lenders / Prepetition Secured Parties to take liens and superpriority claims on the Unencumbered Assets when the Debtor has offered nothing to unsecured creditors. Any further interim or final orders therefore should make clear that no DIP or adequate protection liens shall attach to any unencumbered assets and any associated superpriority claims shall not be payable from the proceeds thereof. Absent such protections,

[38] *See Official Comm. of Unsecured Creditors v. Goold Electronics Corp. (In re Goold Electronics Corp.)*, No. 93-4196, 1993 U.S. Dist. LEXIS 14318, at *12 (N.D. Ill., Sept. 20, 1993) (vacating bankruptcy court order approving post-petition financing "to the extent that the order assigns to the bank a security interest in the debtor's preference actions."). This is because avoidance actions are not property of a debtor's estate, but rather a construct of bankruptcy law for the benefit of unsecured creditors. *See* 5 COLLIER ON BANKRUPTCY ¶ 541.14 at n.1 ("The avoiding powers of a debtor in possession granted in chapter 5 of the [Bankruptcy] Code are not property of the estate but statutorily created powers to recover property."); *see also Frank v. Mich. State Unemployment Agency (In re Thompson Boat Co.)*, 252 F.3d 852, 854 (6th Cir. 2001) (affirming lower courts' determination that "the bankruptcy Code allows only a trustee, not debtors, to initiate a preference action to avoid certain transfers, so proceeds recovered are property of the bankruptcy estate, not the debtor.").

general unsecured creditors likely will be wholly disenfranchised and left with no recovery in these cases

III. The Full Range of Adequate Protection Proposed for the Prepetition Secured Parties is Excessive Under the Circumstances

42. The Bankruptcy Code only requires debtors to provide a secured creditor with adequate protection to the extent that the automatic stay, the debtors' use of property, or a priming lien "results in a decrease in the value of such entity's interest in such property." 11 U.S.C. § 361(1). The purpose is to protect a secured creditor from diminution in the value of its collateral during the use period.[39] "[T]he initial burden of showing the need for adequate protection [is] upon the creditor having an interest in the property being used by the debtor. In order to meet this burden, the secured creditor must demonstrate that such relief is required by showing a likelihood that the collateral will decrease in value or establishing some other basis for the relief. The burden then shifts to the debtor to show that adequate protection is not needed or can be provided in a different manner."[40] Here, there has been no showing that adequate protection in favor of the Prepetition Secured Parties is needed to the extent proposed in the Motion.

43. Absent diminution, no adequate protection is needed. So, where the lenders' collateral is not diminishing as a result of its use, nothing further is required for adequate

[39] *See United Sav. Ass'n v. Timbers of Inwood Forest Assoc*., 484 U.S. 365, 368 (1988); *In re 495 Central Park Ave. Corp*., 136 B.R. 626, 631 (Bankr. S.D.N.Y. 1992) (goal is to "safeguard the secured creditor from diminution in the value of its interest"); *Lincoln Nat'l Life Ins. v. Craddock-Terry Shoe Corp. (In re Craddock-Terry Shoe Corp.)*, 98 B.R. 250, 255 (Bankr. W.D. Va. 1988) (finding that what needs to be adequately protected is the decrease in value attributable to the stay arising on the petition date).

[40] *Zink v. Vanmiddlesworth*, 300 B.R. 394, 402-03 (N.D.N.Y. 2003) (citations omitted). *See also In re Gunnison Ctr. Apartments*, 320 B.R. 391, 396 (Bankr. D. Colo. 2005) ("The secured creditor 'must, therefore, prove this decline in value—or the threat of a decline—in order to establish a *prima facie* case.'") (quoting *In re Elmira Litho, Inc*., 174 B.R. 892, 902 (Bankr. S.D.N.Y. 1994)); *In re Continental Airlines, Inc*., 146 B.R. 536, 539 (Bankr. D. Del. 1992) ("Post-Timbers courts have uniformly required a movant seeking adequate protection to show a decline in value of its collateral.").

protection.[41] And, diminution is not equivalent to cash collateral use. A prepetition lender is "not entitled to an adequate protection claim on a dollar-for-dollar basis for cash collateral used during the case."[42]

44. The Debtor proposes to grant the insider Prepetition Secured Parties excessive adequate protection in the form of:

- The Roll-Up of over $27 million of prepetition obligations;
- Adequate protection liens, to the extent of any diminution, on the DIP Collateral, including the Unencumbered Assets;
- Superpriority claims to the extent of any diminution payable from the DIP Collateral, including the Unencumbered Assets;
- Validation of the liens and claims of the Prepetition Secured Parties and broad-ranging releases, subject to a shortened challenge period and a small investigation budget for the Committee of only $25,000;
- Payment of interest (at the contract ***default rate*** as to interest accrued prepetition) on the prepetition obligations, plus reimbursement of professional fees.
- Section 506(c) surcharge, marshaling, and equities-of-the-case waivers in favor of the Prepetition Secured Parties for the duration of these cases; and
- Imposition of various sale milestones.

45. For all the reasons noted above, the insider Prepetition Secured Parties should not receive the benefit of any Roll-Up or any liens and superpriority claims payable from the Unencumbered Assets. All such insider prepetition liens and claims should be recharacterized as equity or otherwise avoided.

[41] *Save Power Ltd. v. Pursuit Athletic Footwear (In re Pursuit Athletic Footwear)*, 193 B.R. 713, 716 (Bankr. D. Del. 1996).

[42] *Official Comm. v. UMB Bank, NA (In re Residential Cap.)*, 501 B.R. 549, 596-97 (Bankr. S.D.N.Y. 2013).

IV. Section 506(c), Marshaling, and Section 552(b) Waivers Are Inappropriate Given the Issues with the Insider Prepetition Secured Notes

46. The Debtor intends to grant broad waivers of Bankruptcy Code section 506(c) surcharge, marshaling, and "equities of the case" rights as to the DIP Lenders and the Prepetition Secured Parties.[43] The Committee objects to each of these provisions given the highly disputed nature of the Prepetition Secured Notes.

47. Specifically, the waiver of rights under section 506(c) of the Bankruptcy Code is inappropriate and must be denied. Section 506(c) of the Bankruptcy Code allows a debtor to charge the costs of preserving or disposing of a secured lender's collateral to the collateral itself.[44] This provision ensures that the cost of liquidating a secured lender's collateral is not paid from unsecured creditor recoveries.[45] Courts have widely recognized that section 506(c) waivers are not to be granted lightly.[46] Indeed, courts have explicitly provided that the waiver is not permitted without the consent of the committee[47] or unless modified to provide for timely payment of administrative claims.[48]

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[43] *See* Interim Order ¶¶ 19, 29, 30.

[44] *See* 11 U.S.C. § 506(c).

[45] *See*, *e.g.*, *Precision Steel Shearing v. Fremont Fin. Corp. (In re Visual Indus., Inc.)*, 57 F. 3d 321, 325 (3d Cir. 1995) ("section 506(c) is designed to prevent a windfall to the secured creditor"); *Kivitz v. CIT Group/Sales Fin., Inc*., 272 B.R. 332, 334 (D. Md. 2000) ("the reason for [section 506(c)] is that unsecured creditors should not be required to bear the cost of protecting property that is not theirs").

[46] *See*, *e.g.*, *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A*., 530 U.S. 1, 12 (2000) (finding that section 506(c) is a rule of fundamental fairness for all parties in interest and authorizing the surcharge of a secured lender's collateral where reasonable and appropriate).

[47] *See In re Mortgage Lenders Network, USA, Inc*., Case No. 07-10146 (PJW), Hr'g Tr. (Docket No. 346) at 21 (Bankr. D. Del. March 20, 2007) (noting that without the committee's prior approval, the section 506(c) waiver may not be approved).

[48] *See In re NEC Holdings Corp.*, No. 10-11890 (Bankr. D. Del. July, 13, 2010), ECF No. 233, and Hearing Tr. at 108:1-5, ECF No. 224 ("I need some evidence that there's a probability that admin claims are going to be paid in full, including 503(b)(9) claims or I won't approve the financing."); *Hartford Fire Ins. v. Northwest Bank Minn. (In re Lockwood Corp.)*, 223 B.R. 170, 176 (BAP 8th Cir. 1998) (holding that provision in financing order purporting to immunize the postpetition lender from section 506(c) surcharge was unenforceable); *In re Colad Grp.*, 324 B.R. 208, 224 (Bankr. W.D.N.Y. 2005) (refusing to approve postpetition financing agreement to the extent that the agreement

48. Through the proposed section 506(c) waiver, the Debtor would irrevocably waive the estate's rights to charge certain costs or expenses incurred in the administration of this case. This provision should be stricken from any Final Order with regard to the insider Prepetition Secured Parties because all such rights should be expressly preserved.

49. The DIP Lenders / Prepetition Secured Parties also seek to restrict this Court's ability to implement equitable marshaling. The waiver of any marshaling requirements is prejudicial because the DIP Lenders and the Prepetition Secured Parties, to the extent that either is granted any interest in the Unencumbered Assets, should be required to exhaust remedies from other DIP Collateral before turning to the Unencumbered Assets, especially in this case where there may be no value for unsecured creditors from any other sources aside from the Unencumbered Assets. Marshaling may be a key remedy in ensuring that unsecured creditors do not bear the brunt of the expense of this case while having no prospect of any other distributions.[49]

50. Finally, the Debtor proposes that the "equities of the case" exception under Bankruptcy Code section 552(b) not apply to the DIP Lenders / Prepetition Secured Parties. The "equities of the case" exception in section 552(b) allows a debtor, committee, or other party in interest to exclude postpetition proceeds from prepetition collateral on equitable grounds, including to avoid using unencumbered assets to fund the cost of a secured lender's foreclosure.[50] "'The purpose of the equity exception is to prevent a secured creditor from reaping benefits from collateral that has appreciated in value as a result of the trustee's/debtor-in-possession's use of

purported to modify statutory rights and obligations created by the Bankruptcy Code by prohibiting any surcharge of collateral under section 506(c)).

[49] *See Official Comm. v. Hudson United Bank (In re America's Hobby Center)*, 223 B.R. 275, 287 (Bankr. S.D.N.Y. 1998); *Ramette v. United States (In re Bame)*, 279 B.R. 833 (BAP 8th Cir. 2002) (marshaling doctrine invoked against taxing authorities to benefit estate's unsecured creditors).

[50] *See* 11 U.S.C. § 552(b).

other assets of the estate (which normally would go to general creditors) to cause the appreciated value.'"[51] Given the objectionable nature of the Prepetition Secured Parties' liens and claims in this case, there should be no waiver of any equitable rights of the Debtor's estate.

51. In sum, the waiver of section 506(c), marshaling, and "equities of the case" rights are inappropriate for the reasons set forth herein and should be excised from the Final Order.

V. The Proposed Carve-Out and Challenge Provisions Are Objectionable

52. Through the DIP Facility, the Debtor proposes to circumscribe the Committee's ability to properly exercise its statutory duties.

53. The Carve-Out in the Interim Order includes discriminatory treatment of the Committee's professionals as compared to the Debtors' professionals (who stand to receive up to $100,000, plus allowed success or transaction fees), by providing the Committee's professionals with $0 for the Post-Carve-Out Trigger Notice Cap.[52]

54. The Challenge Deadline for the Committee should be subject to further extension with consent of the applicable Prepetition Secured Parties or by the Court for cause. The Committee also should be granted more than $25,000 to conduct a full investigation of the Prepetition Secured Parties' asserted liens and claims.[53] At a minimum, the Committee's investigation budget should be increased to $100,000.

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[51] *In re Muma Servs*., 322 B.R. 541, 558-559 (Bankr. D. Del. 2005) (quoting *Delbridge*, 104 B.R. at 826). There is no reason to waive such rights here. *See*, *e.g*., *In re Metaldyne Corp*., 2009 Bankr LEXIS 1533, at *19 (Bankr. S.D.N.Y. June 23, 2009) ("[T]he Court, in its discretion, declines to waive prospectively an argument that other parties in interest may make. If, in the event, the Committee or any other party [in] interest argues that the equities of the case exception should apply to curtail a particular lender's rights, the Court will consider it."); *Sprint Nextel Corp. v. U.S. Bank Nat'l Ass'n (In re TerreStar Networks)*, 457 B.R. 254, 272-73 (Bankr. S.D.N.Y. 2011) (request for section 552(b) waiver was premature because factual record not fully developed).

[52] Interim Order ¶11(a).

[53] Interim Order ¶26.

VI. Other Committee Issues with the DIP Facility and Final Order

55. The Committee has various additional objections to any proposed further interim or final order:

- Any provision requiring the immediate payment of the Prepetition Secured Notes from sale proceeds or other assets should be stricken and no credit bidding of such debt should be allowed, subject to the outcome of the Committee's challenges. For instance, the definition of "Acceptable 363 Sale" in the DIP Credit Agreement requires payment of the Prepetition Secured Indebtedness.
- The Challenge provision in the Interim Order contains this parenthetical, which should be clarified or stricken: "(subject in all respects to any party in interest's right to raise an argument that any agreement or applicable law may limit or affect such party's right or ability to do so)".[54] The Committee should be able to raise whatever rights the Debtor's estate could otherwise raise and this Court acknowledged this point at the first day hearing.[55]
- The wind-down budget of $100,000, plus amounts necessary to satisfy accrued and budgeted professional fees and U.S. Trustee fees, including allowed success or transaction fees for professionals, is insufficient.[56] This amount does not cover

[54] Interim Order ¶25.

[55] Transcript of Hearing on May 7, 2024, p. 28, ln. 4-10:

> THE COURT: Okay. I will say that I agree with Judge Goldblatt's recent decision which says that state law does not determine who can bring a challenge. It can be -- if it's going to be in my order, it can be subject to the ability to raise the issue, but I am not going to provide here that something may limit a parties standing to come in and pursue a claim on behalf of the estate.

[56] Interim Order ¶18.

accrued budgeted administrative expenses (aside from professional fees) or leave anything for the funding of a chapter 11 plan or distributions to unsecured creditors.

- The Budget for Committee professionals is only $290,000 through mid-July, and should be increased in proper relation to the Debtors' and lenders' projected professional fees.
- The Committee should receive advance notice of all amendments, waivers, or other modifications to the DIP Loan Documents and budget. And no changes to the Committee's professional fee budget (after agreement on the budget) should be made without the express consent of the Committee.
- The Committee should have the same rights with respect to information, access, and reporting as the DIP Lenders and the Prepetition Secured Parties pursuant to the DIP Order and DIP Credit Agreement.

RESERVATION OF RIGHTS

56. The Committee hereby reserves its rights to supplement this Objection and/or to further object to the Motion.

WHEREFORE, for all the foregoing reasons, the Committee respectfully requests that this Court: (i) sustain thos Objection and (ii) grant the Committee such other and further relief as this Court deems just and proper.

Dated: June 5, 2024

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