

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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In re:

Chapter 11

LEVEL 8 APPAREL, LLC,

Case No. 16-13164-JLG

Debtor.

**Hearing Date: November 28, 2016
4:00 p.m.**

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**DEBTOR IN POSSESSION’S EMERGENCY MOTION FOR ENTRY OF ORDER
AUTHORIZING (I), ON AN INTERIM BASIS, DEBTOR TO USE CASH
COLLATERAL PURSUANT TO 11 U.S.C. §363, AND (II) PAYMENT OF PRE-
PETITION PRIORITY WAGES NUNC PRO TUNC TO PETITION DATE
PURSUANT TO 11 U.S.C. §§105, 362, 363(B), AND 549, AND EXTENDING THE
TIME FOR THE DEBTOR TO FILE SCHEDULES AND STATEMENT OF
FINANCIAL AFFAIRS**

Debtor-in-Possession, Level 8 Apparel, LLC (the “Debtor”), by and through its
undersigned proposed counsel, hereby files its Motion for Authority to Use Cash Collateral
Pursuant to 11 U.S.C. §363, and in support thereof, respectfully states as follows:

JURISDICTION

1. This Court has jurisdiction over this Motion pursuant to 28 U.S.C. §§ 157 and
1334. This is a core proceeding pursuant to 28 U.S.C. § 157(b). Venue is proper before this
Court pursuant to 28 U.S.C. §§ 1408 and 1409.

2. The statutory predicate for the relief requested in this Motion is 11 U.S.C. §§
105 and 363 and Rule 4001(d)(1)(D) of the Federal Rules of Bankruptcy Procedure.

BACKGROUND

3. On November 14, 2016, the Debtor filed a voluntary petition for relief under
Chapter 11 of the Bankruptcy Code (“Petition Date”). Pursuant to Bankruptcy Code
§§1107(a) and 1108, the Debtor is operating its business and managing its affairs as a

debtor in possession. As of the date hereof, no trustee or examiner or statutory committee has been appointed in this Chapter 11 case.

4. The Debtor is an outerwear design, import/manufacturing company that produces, among other things, men's and women's outerwear garments. The Debtor currently holds licenses to produce and sell Elie Tahari men's outerwear, Tahari men's outerwear, and On Five men's and women's apparel and outerwear. The Debtor also has a private label division, which produces apparel for large vertical retailers such as Costco, Express, Urban Outfitters, Lane Bryant, and others. *See* Affidavit of Frank Spadaro pursuant to Local Rule 1007-2, ("Spadaro Affid.") submitted herewith as Exhibit A.

5. The filing herein was necessitated by a pre-petition judgment entered against the Debtor by a former supplier, Weihai Textile Group Import & Export Co., Ltd., in the action captioned *Weihai Textile Group Import & Export Co., Ltd.v. Level 8 Apparel, LLC*, et al., (Case No. 11 Civ. 4405 (AC)(FM)) brought in the United States District Court for the Southern District of New York (hereafter the "Weihei Action").

6. Pursuant to an exclusive sales representative agreement ("Capstone Agreement") between the Debtor and Capstone Capital Group LLC ("Capstone") dated September 29, 2015, the Debtor became engaged as the exclusive sales representative of Capstone for the purpose of securing and fulfilling purchase orders issued for outerwear goods under the Eli Tahari trademark (which the Debtor has licensed the rights to), as well as to produce goods under a private label for retailers such as Costco, Express, Urban Outfitters, Lane Bryant and others. A copy of the Capstone Agreement is attached hereto as Exhibit B.

7. Under the Capstone Agreement the Debtor secures purchase orders from retailers on behalf of Capstone. Although not the same as a factoring agreement the Capstone Agreement functions similar to a factoring agreement insofar as, upon the receipt of a purchase order from a customer, Capstone will advance sales commissions owed to the Debtor to enable the Debtor to supervise the production of the goods prior to receiving payment from the customer. However Capstone directly pays to the factory identified by the Debtor the manufacturing costs and shipping and transportation costs associated with the order.

8. Under the Capstone Agreement certain commissions due to the Debtor are restricted and not paid to account for unsold merchandise and credits and chargebacks requested by the customer. Capstone can restrict payment for such restricted commissions for up to 180 days after goods were delivered to the warehouse maintained by Capstone.

9. Prior to the Petition Date, the Debtor had a pre-petition secured debt owing to Capstone in the amount of \$2,650,000, which amount is covered by UCC-1s filed against the Debtor on August 12, 2011 and October 21, 2015, securing said obligations of the Debtor by “all assets of the Debtor.”

10. The Internal Revenue Service is also priority secured creditor in a disputed amount of \$408,000. On or about October 22, 2013 the IRS filed a federal tax lien against the Debtor. More recently, on or about November 8 the IRS restrained the Debtor’s bank account which at the time had the sum of \$58,592 on deposit.

11. The Debtor primarily generates income from the commissions it earns from the fulfillment of purchase orders pursuant to the Capstone Agreement. *See Spadaro Affid.*,

¶¶ 24-27. As of the Petition Date the Debtor had approximately \$52,000 in its operating account (subject to an IRS lien). The Debtor anticipates that in the thirty (30) days following the Petition Date the Debtor will earn approximately \$175,000 in commissions, although monthly revenues are expected to increase to \$225,000 in January 2017 and \$200,000 in February 2018. The Debtor further expects, based on booked orders and orders which are expected to be received, the Debtor will fulfill in excess of \$20 million in purchase orders for 2017, for which the Debtor will receive a sales commission ranging from 7% to 10% (all collectively, the “Cash Collateral”).

12. On September 26, 2016, in the Weihei Action, the Honorable Frank Maas, United States Magistrate Judge, entered a decision granting judgment to Weihei on its cause of action for breach of contract against Level 8 (and a co-defendant) in the amount of \$1,345,764, plus \$606,013 in prejudgment interest. Judge Maas also granted Level 8 a judgment on its counterclaim, but only in the amount of \$53,000.

RELIEF REQUESTED

13. By this Motion, the Debtor seeks the entry of an Order (i) authorizing (a) the Debtor to use cash collateral and granting adequate protection pursuant to 11 U.S.C. §363, Federal Rules of Bankruptcy Procedure 4001(b)(2) and Local Rule 4001-2, and (b) payment of pre-petition priority wages, *nunc pro tunc* to Petition Date, pursuant to 11 U.S.C. §§105, 362, 363(b), 549, and 1107, (ii) extending the time for the Debtor to file Bankruptcy Schedules and Statement of Financial Affairs, (iii) setting the time for a final hearing and objection deadline for this Motion, and granting such other and further relief as is just and proper.

14. As set forth in the Affidavit of Frank Spadaro pursuant to Local Rule 1007

(“Spadaro Affid.”), incorporated herein, the Debtor requires the use of cash collateral to fund all necessary operating expenses of the Debtor’s business.

15. The Debtor will suffer immediate and irreparable harm if it is not authorized to use cash collateral to fund the expenses set forth in the Budget. Absent such authorization, the Debtor will not be able to continue to operate its business and protect and preserve property of the estate, including fulfilling purchase orders for 2017 that are expecting to total no less than \$20 million and collecting payment therefor.

16. The Debtor acknowledges that Capstone and the IRS will have a lien on the cash collateral in accordance with 11 U.S.C. §§361 and 363. In connection therewith, the Debtor seeks the use of Cash Collateral in the ordinary course of business.

CASH COLLATERAL AND THE RELIEF SOUGHT BY THE DEBTOR

17. The Debtor’s use of property of the estate is governed by Section §363 of the Bankruptcy Code, which provides that:

If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

11 U.S.C. §363(c)(1). A debtor in possession has all of the rights and powers of a trustee with respect to property of the estate, including the right to use property of the estate in compliance with Section 363 of the Bankruptcy Code. *See* 11 U.S.C. §1107(a).

18. When a Chapter 11 debtor-in-possession is authorized to operate its business, it may use property of estate in ordinary course of business, but is prohibited from using cash collateral absent consent of the secured creditor or court authorization. *In re Kahn*, 86 B.R. 506 (Bankr. W.D. Mich. 1988); *In re Westport-Sandpiper Associates*

Ltd. P'Ship, 116 B.R. 355 (Bankr. D. Conn. 1990)(debtor may not use cash collateral unless entity that has interest in it consents or debtor proves that interest of the entity is adequately protected).

19. "Cash collateral" is defined by the Bankruptcy Code as, "cash, negotiable instruments, documents of title securities, deposit accounts or other cash equivalents whenever acquired in the which the estate an entity other than the estate have an interest..." 11 U.S.C. § 363(a). Any cash collateral generated by the Debtor may constitute the cash collateral of Capstone.

20. The Debtor proposes to use the Cash Collateral to cover the following critical and essential post-petition operating expenses: payroll, withholding and related taxes, health insurance costs, rent and utilities, and critical vendors who supervise and manage the production of the Debtor's outerwear garments, all as more fully set forth in the attached Budget. The largest line item in the Debtor's Budget is a payment of \$40,000 to H.B. Co. Ltd. ("HB Ltd."), critical trade vendor based in Seoul, Korea. HB Ltd. is responsible for overseeing the managing the production of goods on behalf of the Debtor. Without the services of HB Ltd. the Debtor could not fulfill its purchase orders. Attached hereto as Exhibit C is a copy of the agreement between the Debtor and HB Ltd. Under the HB Ltd. agreement the Debtor pays HB Ltd. 3% of the value of the purchase orders that the Debtor engages HB Ltd. to manage and supervise. Based on their historical business practices the Debtor and HB. Ltd have entered into a course of dealing whereby the Debtor pays HB Ltd. a monthly amount that is believed to approximate the total value of purchase orders, subject to an year end reconciliation conducted in January. The course of dealing between the Debtor and HB Ltd. provides for the Debtor to pay HB

Ltd. \$40,000 per month.

21. As more fully set forth in ¶¶33-37 below, the Debtor also seeks approval, *nunc pro tunc* to the Petition Date, of the payment of pre-petition priority wage and benefits claims, exclusive of federal, state and city withholding taxes and healthcare costs, totaling \$64,416.22.

22. Since the initial hearing in connection with Debtor's request for authority to use cash collateral was held on November 22, 2016, counsel for the Debtor has spoken with IRS Bankruptcy Specialist Michael Scotto DiClemente, who is temporarily assigned to this case. Mr. DiClemente subsequently notified the Office of the United States Attorney for the Southern District of New York and transmitted the Debtor's initial Cash Collateral Motion filed on November 17, 2016, which then assigned the matter to Assistant United States Attorney Lawrence H. Fogelman. Counsel for the Debtor conferred with AUSA Fogelman today and preliminary discussions were had concerning the IRS' stipulation to the use of cash collateral upon the Debtor's provision of adequate protection.

APPLICABLE AUTHORITY FOR RELIEF REQUESTED

A. The Court Should Enter an Order Authorizing the Continued Use of Cash Collateral Because the Debtor is Providing the Secured Creditors with Adequate Protection.

23. The Bankruptcy Code does not define "adequate protection" but does provide a non-exclusive list of the means by which a debtor may provide adequate protection, including "other relief" resulting in the "indubitable equivalent" of the secured creditors interest in such property. *See* 11 U.S.C. § 361.

24. Adequate protection is to be determined on a case by case factual analysis. See *In re Realty Southwest Associates*, 140 B.R. 360 (Bankr. S.D.N.Y. 1992); *Martin v. United States (In re Martin)*, 761 F.2d 472, 474 (8th Cir.1985); *In re Mosello*, 195 B.R. 227 (Bankr. S.D.N.Y. 1996).

25. For example, in *Mbank Dallas N.A. v O'Connor*, 808 F.2d 1393, 1396 (10th Cir. 1987) the court held that “[i]n order to encourage the Debtors’ efforts in the formative period prior to the proposal of a reorganization, the court must be flexible in applying the adequate protection standard.” See also *In re Q-C Circuits Corp.*, 231 B.R. 506 (Bankr. E.D.N.Y. 1999) (holding that the granting or a replacement lien provided adequate protection).

26. Adequate protection is meant to ensure that the secured creditors receive the value for which it originally bargained pre-bankruptcy. *Swedeland Dev. Group., Inc.*, 16 F.3d 552, 564 (3rd Cir. 1994) (citing *In re O'Connor*, 808 F.2d 393, 1396-97 (10th Cir. 1987)). Courts have noted that the essence of adequate protection is the assurance of the maintenance and continued responsibility of the lien value during the interim between the filing and the confirmation. *In re Arrienes*, 25 B.R. 79, 81 (Bankr. D. Or. 1982); *In re Pine Lake Village Apartment Co.*, 19 B.R. 819 (Bank. S.D.N.Y.1982). The purpose of adequate protection requirement is to protect secured creditors from diminution of value during the use period. See *In re Kain*, 86 B.R.506, 513 (Bankr. W.D. Mich. 1988); *In re Becker Indus. Corp.*, 58 B.R. 725, 736 (Bankr. S.D.N.Y. 1986); *In re Ledgmere Land Corp.*, 116 B.R. 338, 343 (Bankr. D. Mass. 1990).

27. In the instant case, adequate protection provided to Capstone and the IRS includes a replacement lien on the Debtor’s commissions and receivables and the

Debtor's projected positive cash flow, and in the case of the IRS, on a preliminary basis, a monthly payment in the range of \$5,833 to \$7,434 ("Interim IRS Adequate Protection Payment").

28. Section 361(2) of the Bankruptcy Code expressly provides that the granting of a replacement lien constitutes a means of providing adequate protection. 11 U.S.C. § 361(2). In the instant case, granting Capstone and the IRS a replacement lien on post-petition collateral to the extent its prepetition collateral is diminished by the Debtor's use of cash collateral provides Capstone with adequate protection. *See e.g., O'Connor*, 808 F.2d 1393; *In re Coody*, 59 B.R. 164, 167 (Bankr. M.D. Ga. 1986); *In re Dixie-Shamrock Oil & Gas, Inc.*, 39 B.R. 115, 118 (Bankr. M.D. Tenn. 1984).

B. The Use of Cash Collateral Will Preserve The Debtor's Going Concern Value Which Will Inure to the Benefit of Capstone and other Creditors

29. The continued operation of the Debtor's business will preserve its going concern value, enable the Debtor to capitalize on that value through a reorganization strategy, and ultimately facilitate the Debtor's ability to confirm a Chapter 11 plan. Preservation of the Debtor's business as going concern in and of itself serves to provide adequate protection for Bankruptcy Code purposes. *See* 495 Cent. Park Ave Copr. 136 B.R. 626, 631 (Bankr. S.D.N.Y. 1992). If the Debtor is not allowed to use cash collateral, it will be unable to operate (including fulfilling purchase orders that are currently in production) and forced to shut down.

30. It is well established that a bankruptcy court, where possible, should resolve issues in favor of preserving the business of the debtor has a going concern. A debtor, attempting to reorganize a business under Chapter 11, clearly has a compelling need to use cash collateral in its effort to rebuild. Without the availability of cash to meet

daily operating expenses such as rent, payroll, utilities etc., the congressional policy favoring rehabilitation over economic failure would be frustrated. *In re George Ruggiere Chrysler-Plymouth, Inc.*, 727 F.2d 1017, 1019 (11th Cir. 1984); *In re 499 W. Warren Street Associates, Ltd. Partnership*, 142 B.R. 53 (Bankr. S.D.N.Y. 1992).

31. The Debtor believes that use of Cash Collateral pursuant to the terms and conditions set forth above is fair and reasonable and adequately protects the secured creditor in this case. The combination of: (i) the Debtor's ability to preserve the going concern value of the business with the use of cash collateral; and (ii) providing Capstone with the other protections set forth herein, adequately protect its secured position under §361(2) and (3). For all of the reasons stated above, this Court's approval of the Debtor's use of cash collateral is proper herein.

32. The Debtor believes that the approval of this Motion is in the best interest of the Debtor, its creditors and its estate because it will enable the Debtor to (i) continue the orderly operation of its business and avoid an immediate total shutdown of operations; (ii) meet its obligations for necessary ordinary course expenditures, and other operating expenses; and (iii) make payments authorized under other orders entered by this Court, thereby avoiding immediate and irreparable harm to the Debtor's estate.

C. The Court Should Approve, Nunc Pro Tunc to the Petition Date, Post-Petition Payments of Pre-Petition Priority Wage Claims

33. On November 15, 2016 the Debtor caused to be paid the priority wage claims of its employees, totaling \$64,416.22 ("Prepetition Wage Payment").

34. With respect to a bankruptcy court's authority, pursuant to 11 U.S.C. §§105, in conjunction with other provisions of the Code, e.g. §§363(b), 362, 1107(a), one court has stated:

Thus, there has evolved a rule for the payment of prepetition wages and benefits which is based on both common sense and the express provisions of the Bankruptcy Code. If employees are not paid, they will leave. If they leave the Debtor's business, the bankruptcy case fails shortly after the filing. No one will benefit from the process. The Code gives employees a statutory priority that elevates the claims above the general unsecured claims, and, in fact, most claims in the bankruptcy case. To the extent that the existing holders of claims of higher priority than the wage claims consent or do not timely object, such priority claims may be made during the pendency of the bankruptcy case. The treatment and payment of such claims before confirmation does no violence to the Code or existing case law in this circuit. In fact, such orders are usually "necessary" and "appropriate" to implement a debtor's reorganization under Chapter 11.

See In re CEI Roofing, Inc., 315 B.R. 50 (Bankr. N.D. Tex. 2004); see also,

In re The Colad Group, Inc., 324 B.R. 208 (Bankr. W.D.N.Y. 2005)(authorizing post-petition payment of pre-petition wages and benefits, and use and sales tax);

In re CoServ, 273 B.R. 487 (Bankr. N.D. Tex. 2002).

35. Fundamental to the Debtor's ability to rehabilitate and re-organize, and remain a going concern that generates millions of dollars in revenues and employs, directly and indirectly, dozens of people, is its ability to continue to pay its employees, who are accorded priority status under 11 U.S.C. §507. Such employees enhance and preserve the value of the estate for the benefit of all creditors. *See CoServ*, 273 B.R. at 497; *In re Just for Feet*, 242 B.R. 821, 824 (Bankr. D. Del. 1999)("Certain pre-petition claims by employees, and trade creditors, however may need to be paid in facilitate a successful reorganization"); *In re Wehrenberg, Inc.*, 260 B.R. 468, 469 (Bankr. E.D. Mo 2001)(allowing the payment of pre-petition debt under section 105 "when such payment are necessary to the continued operation of the Debtor).

36. Courts have also relied upon the doctrine of necessity to approve pre-petition wage and benefit claims. *See, e.g., In re Equalnet Communications Corp.*, 258

B.R. 369 (Bankr. S.D. Tex. 2000); *In Re Ionosphere Clubs, Inc.*, 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989)(section 105 empowers bankruptcy courts to authorize payment of prepetition debt “when such payment is needed to facilitate the rehabilitation of the debtor.”)

37. Insofar as employee wages and benefits are priority payments, as are payments of withholding and related employment payroll taxes, the authorization of same, *nunc pro tunc* to the Petition Date, “does no violence to the Code or existing case law.” As such the Court should approve the Prepetition Wage Payment *nunc pro tunc* to the Petition Date.

D. The Automatic Stay Should Be Modified on a Limited Basis

38. The requested relief contemplates a modification to the automatic stay to permit the Debtor to grant the security interest and liens to Capstone and the IRS described above, and to perform such acts as may be requested to assure the perfection and priority of such security interest and liens. Stay modifications of this kind are ordinary and standard for the use of cash collateral and in the Debtor’s business judgment, are reasonable and fair under the present circumstances.

E. The Debtor Requires An Extension of Time to Complete Schedules and Statement of Financial Affairs.

39. Due to the urgent need for the Debtor to secure use of cash collateral, and the concerted efforts required to arrive at an stipulated order for use of cash collateral with Capstone and the IRS, and to likewise secure no objection from the Office of the United States Trustee, compounded by the impending Thanksgiving holiday, the Debtor requires additional time to complete its schedules and statement of financial affairs.

Moreover, since the Petition Date Counsel for the Debtor has also had to become engaged in matters concerning the Debtor's status as defendant in a state court proceeding pending in Nassau County.

40. Both Bankruptcy Rule 1007 and 11 USC §1116(3) contemplate that a Debtor, for cause shown, may obtain an extension of time not to exceed 30 days after the date of the order for relief. For the foregoing reasons the Debtor respectfully requests entry of an order extending the time for the Debtor to file its schedules and statement of financial affairs through and including December 14, 2016.

41. Proposed orders granting the relief requested is attached hereto as Exhibits C and D, respectively.

Dated: November 23, 2016
New York, New York

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