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UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW JERSEY

In re:	:	Case No. 14-16484 (CMG) (Jointly Administered)
MEE Apparel LLC and MEE Direct LLC,	:	Chapter 11
	:	The Honorable Christine M. Gravelle
Debtors.	:	
	:	Hearing Date: April 21, 2014 at 10:00 a.m.

OBJECTION OF THE UNITED STATES TRUSTEE TO (A) VERIFIED APPLICATION IN SUPPORT OF DEBTORS' MOTION FOR AN ORDER PURSUANT TO 11 U.S.C. §§ 363 AND 365 AND FED. R. BANKR. P. 2002, 6004 AND 6006: (1) APPROVING "STALKING HORSE" ASSET PURCHASE AGREEMENT FOR THE SALE OF SUBSTANTIALLY ALL OF THE DEBTORS' ASSETS; (2) APPROVING BIDDING PROCEDURES AND FORM, MANNER AND SUFFICIENCY OF NOTICE; (3) SCHEDULING (A) AN AUCTION SALE AND (B) A HEARING TO CONSIDER APPROVING THE HIGHEST AND BEST OFFER; (4) AUTHORIZING THE DEBTORS TO SELL SUBSTANTIALLY ALL THEIR ASSETS FREE AND CLEAR OF LIENS, CLAIMS, ENCUMBRANCES, AND INTERESTS AND TO ASSUME AND ASSIGN CERTAIN RELATED EXECUTORY CONTRACTS AND UNEXPIRED LEASES; AND (5) GRANTING OTHER RELATED RELIEF AND (B) MOTION FOR AN INTERIM AND FINAL ORDER AUTHORIZING THE DEBTORS TO OBTAIN POST-PETITION FINANCING PURSUANT TO 11 U.S.C. SECTIONS 105, 361, 362, 364(c) AND 364(e)

In support of her Objection to the Debtors' Motions (A) for an Order pursuant to 11 U.S.C. §§ 363 and 365 and Fed. R. Bankr. P. 2002, 6004 and 6006: (1) approving "stalking horse" asset purchase agreement for the sale of substantially all the Debtors' assets; (2) approving bidding procedures and form, manner and sufficiency of notice; (3) scheduling (A) an

auction sale and (B) a hearing to consider approving the highest and best offer; (4) authorizing the Debtors to sell substantially all their assets free and clear of liens, claims, encumbrances and interests and to assume and assign certain related executor contracts and unexpired leases; and (5) granting other related relief (the "Bid Procedures and Sale Motion") and (B) for an Interim and Final Order (I) Authorizing the Debtors to Obtain Post-Petition Financing Pursuant to 11 U.S.C. Sections 105, 361, 362, 364(c) and 364(e); (II) Authorizing Use of Cash Collateral; (III) Scheduling a Final Hearing Pursuant to Fed. R. Bankr. P. 4001; and (IV) Granting Other Related Relief (the "DIP Motion"), Roberta A. DeAngelis, United States Trustee for Region 3 ("U.S. Trustee"), by and through her undersigned counsel, states as follows:

1. This Court has jurisdiction to hear and determine this Objection.

2. Pursuant to 28 U.S.C. § 586(a)(3), the U.S. Trustee is charged with administrative oversight of the bankruptcy system in this District. Such oversight is part of the U.S. Trustee's overarching responsibility to enforce the laws as written by Congress and interpreted by the courts. *See United States Trustee v. Columbia Gas Systems, Inc. (In re Columbia Gas Systems, Inc.)*, 33 F.3d 294, 295-96 (3d Cir. 1994) (noting that U.S. Trustee has "public interest standing" under 11 U.S.C. § 307 which goes beyond mere pecuniary interest); *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498, 500 (6th Cir. 1990) (describing the U.S. Trustee as a "watchdog").

3. Under 11 U.S.C. § 307, the U.S. Trustee has standing to be heard on the issues raised by this Objection.

PRELIMINAY STATEMENT

4. Through the Bid Procedures and Sale Motion, the Debtors seek to sell substantially all of their assets to an insider, Suchman, LLC ("Suchman"). Both the Debtors and

Suchman are owned by Seth Gerszberg ("Gerszberg"). Suchman is the Debtors' pre-petition lender, indirect equity owner, DIP lender and guarantor of certain obligations. As the sale is to an insider, the bidding procedures and sale should be closely scrutinized, and the Debtors bear a heightened burden of proving the elements necessary for authorization of the bidding procedures and the sale. Such heightened scrutiny is necessary because the case may have been filed to allow Gerszberg to acquire the assets of the Debtors without the burdens and liabilities of the Debtors.

5. In an attempt to meet the heightened scrutiny standard, the Debtors hired Jeffrey L. Gregg ("Gregg") as the Debtors' Chief Restructuring Officer ("CRO") a month and a half prior to the Petition Date. In support of the heightened standard, the Debtors set forth that the terms of the Asset Purchase Agreement for the sale of substantially all of the Debtors' assets to Suchman "were primarily negotiated by [ ] Gregg, the Debtors' newly hired, independent Chief Restructuring Officer, the Debtors' professionals and Suchman's professionals." *See* Docket Entry 26-1 at ¶ 38. However, although the Debtors set forth that Gregg is independent, he is required to report and attend meetings with Gerzsberg and he operates the Debtors under the direction of Gerzsberg. *See* Docket Entry 15-2 at ¶ 1(c) and 1(d). In addition, Gregg is only responsible for implementing a sale transaction, restructuring proposal or alternative that is approved by Gerzsberg and "only to the extent and in the manner authorized and directed by [Gerzsberg]." *See id.* at ¶ 3. It is clear Gregg is not independent as alleged by the Debtors.

6. Despite the insider relationship, Suchman seeks certain bid protections including the pre-approval of an expense reimbursement of $200,000.00, an initial overbid of $100,000.00 and minimum bid increments of $100,000.00. *See* Docket Entry 26-2 at Section 7.1. In addition, Suchman received or may be entitled to receive an expense reimbursement for its pre-petition

fees and expenses in connection with this sale. *See id.* The bid protections should be denied as a result of the relationship between the Debtors and Suchman.

7. The Bid Procedures and Sale Motion was filed on shortened time and the DIP Facility requires an auction to be conducted by May 17, 2014. As Gerszberg is on every side of the transaction, the Court should instead slow the process down, not speed it up. In fact, the Committee seeks additional time to understand the pre-petition transactions, the proposed restructuring transactions, and the Debtors' exit strategy to determine if these cases will benefit anyone other than Gerszberg. *See* Docket Entry 121 at ¶ 1. Such request should be granted.

8. In addition, the Debtors' exit strategy is of concern to the U.S. Trustee. At this time, there is no assurance that the Debtors will confirm a chapter 11 plan. Through the proposed sale and the Interim DIP Order, the Debtors seek to sell substantially all of their assets and grant broad releases to Gerszberg, Suchman and related entities with respect to many causes of action after the expiration of the Committee's challenge period. *See* Docket Entry 68 at ¶ 20(b). The result appears to be a sub rosa plan.

9. Further, the Debtors seek to transfer personally identifiable information of its customers to Suchman. *See* Docket Entry 26-1 at ¶ 28. However, since the Debtors advise their customers that "their personal information will not be disclosed to third-party vendors outside of the Debtors," a consumer privacy ombudsman must be appointed to protect the information. *See id.* at ¶ 27.

BACKGROUND AND RELEVANT FACTS

10. On April 2, 2014 (the "Petition Date"), the Debtors filed voluntary Chapter 11 petitions. *See* Docket Entry 1. The U. S. Trustee has just recently appointed an Official Committee of Unsecured Creditors (the "Committee") on April 10, 2014. *See* Docket Entry 92.

11. The Debtors are leading providers of youth apparel and streetwear under the "Ecko Unltd." and "Unltd." brands. *See* Bid Procedures and Sale Motion at ¶ 6. Prior to the Petition Date, the Debtors developed, manufactured and sourced clothing apparel and accessories for wholesale customers and their own retain locations. *See id.*

12. Prior to the Petition Date, the Debtors retained Innovation Capital, LLC as investment banker to market the Debtors' assets for sale. *See id.* at ¶ 7. The Debtors also discussed with Suchman, one the Debtors' pre-petition lenders, indirect equity owner and DIP lender, the possibility of a credit bid to serve as the "stalking horse" for the sale of the Debtors' assets. *See id.* at ¶ 8.

13. In February 2014, Suchman agreed to make a credit bid for the Debtors' assets. *See id.*

14. In these cases, the Debtors filed the Bid Procedures and Sale Motion requesting, among other things, approval of certain bid procedures including, but not limited to, the pre-approval and reimbursement for all reasonable and actual costs and expenses up to an amount equal to $200,000.00 incurred by Suchman in connection with its bid (the "Expenses Reimbursement") and an initial minimum overbid over and above the Purchase Price and the Expense Reimbursement, and minimum bid increments thereafter of $100,000.00 (the "Overbid Protection"). *See* Asset Purchase Agreement, Section 7.1.

15. The U.S. Trustee objects to the Motion on the following basis: (a) the pre-approval of the Expense Reimbursement is not appropriate under these circumstances and under relevant Third Circuit law; (b) the Overbid Protections are not necessary in light of the fact that Suchman, as the Debtors' pre-petition lender, indirect equity owner, DIP lender and guarantor of certain obligations, has the ability to credit bid its entire claim of $54.66 million; (c) heightened

scrutiny is required for a sale to an insider; (d) the sale of substantially all of the Debtors' assets may constitute a *sub rosa* plan; and (e) the transfer of personally identifiable information requires the appointment of a consumer ombudsman.

APPLICABLE LAW AND ANALYSIS

16. The U.S. Trustee agrees with the objection filed by the Committee (the "Committee Objection") that the Bid Procedures and Sale Motion should not be approved because, among other issues, it does not provide sufficient time for the Committee or any other party-in-interest to conduct an investigation and address certain issues in these cases, most of all the insider transactions.

A. The Expense Reimbursement is not appropriate under relevant Third Circuit law.

17. First, the U.S. Trustee objects to the pre-approval of the Expense Reimbursement offered to Suchman without further consideration by this Court or further court order. To award an expense reimbursement to Suchman, the court must determine that the fee was an actual and necessary cost and expense of preserving the estate. *See Calpine Corp. v. O'Brien Environmental Energy, Inc. (In re O'Brien Environmental Energy, Inc.)*, 181 F.3d 527 (3d Cir. 1999).

18. In *O'Brien*, the Third Circuit Court of Appeals stated that ". . . the allowability of break-up fees, like that of other administrative expenses, depends upon the requesting party's ability to show that the fees were actually necessary to preserve the value of the estate." *O'Brien*, 181 F.3d at 535. The burden is on the Debtors to prove the necessity of, and benefit to the estate from, the proposed breakup fee or expense reimbursement. Moreover, although "the considerations that underlie the debtor's judgment may be relevant to the bankruptcy court's

determination on a request for break-up fees and expenses," "the business judgment rule should not be applied as such in the bankruptcy context." *O'Brien*, 181 F.3d at 535.

19. The Expense Reimbursement is not appropriate in this context where a stalking horse bidder is an insider of the Debtor. There is no basis to allow this relief and to make the determination that the Expense Reimbursement is valid and beneficial to the estate.

20. For instance, although breakup fees and reimbursement of expenses are sometimes approved to compensate an initial bidder for the time and expense of negotiating an agreement and for conducting due diligence in connection therewith, the Expense Reimbursement in these cases is premature because it is unknown what if any expense reimbursement may be required.

21. For example, the justification that Suchman has spent considerable time in connection with identifying and quantifying the assets and negotiating the purchase agreement does not seem to ring true when the stalking horse is Suchman. In fact, Suchman, as the Debtors' pre-petition lender, indirect equity owner, DIP lender and guarantor of certain obligations, should already be intimately familiar with the Debtors and their assets. It is hard to believe that there are real significant due diligence costs here based on the relationship between the Debtors and Suchman.

22. Another consideration in determining the allowability of a break-up fee or expense reimbursement is that the protection is needed to induce a bid. Here, as of the Petition Date, Suchman was owed $27.28 million from a loan dated October 30, 2009 (the "Initial Suchman Loan") and $20.38 million from a loan dated May 17, 2013 (the "WF Credit Facility"). *See* Docket Entry 18 at ¶¶ 19-21. In addition, Suchman will be providing Debtor-In-Possession financing to the Debtors in the amount of $7 million. *See* Docket Entry 68.

23. As set forth in the Bid Procedures and Sale Motion, "Suchman can bid any portion, or the full face value, of its secured pre-petition loan and DIP loan claims under and to the fullest extent permitted by Section 363(k) of the Bankruptcy Code." *See* Docket Entry 26 at ¶ 35. In essence, it appears that Suchman may be able to credit bid up to $54.66 million in order to obtain the Debtors' assets.[1] Suchman had $54.66 million reasons to enter into a stalking horse agreement with the Debtors.

24. In addition, it appears that Suchman may not only be entitled to the Expense Reimbursement post-petition but that it may be entitled to a separate expense reimbursement for any and all fees incurred pre-petition in connection with the transaction contemplated by the Asset Purchase Agreement: "prior to the Petition Date, [the Debtors] shall pay all reasonable fees, costs and expenses incurred by [Suchman] in connection with the transactions contemplated by this Agreement through the Petition Date." *See* Docket Entry 26-2 at Section 12.1. *See also id.* at Section 7.1. No further information is provided as to whether the Debtors paid a pre-petition expense reimbursement or whether it is part of the Expense Reimbursement. The Debtors should be required to disclose any amounts that were paid to Suchman in connection with the stalking horse transaction pre-petition. In addition, the Debtors should be required to disclose any payments that are going to be paid to Suchman in connection with the stalking horse transaction pre-petition.

25. Any payments that Suchman received pre-petition as an expense reimbursement should be disgorged. Any payments contemplated to be made to Suchman as a pre-petition expense reimbursement should be denied. Further, as the Asset Purchase Agreement is dated

[1] As of the Petition Date, the Debtors have assets of approximately $30 million. *See* Docket Entry 18 at ¶ 14. It appears that Suchman can credit bid almost double the amount the Debtors' assets are worth.

April 2, 2014, which is the Petition Date, it is difficult to understand what fees Suchman is seeking as an Expense Reimbursement post-petition.

26. For the foregoing reasons, the Court should deny any expense reimbursements to Suchman either pre-petition or post-petition.

B. The Overbid Protections are Not Necessary.

27. The Debtors seek to require another bidder to bid at least $300,000.00 above and beyond the stalking horse bid of $11.3 million plus the assumption of certain liabilities. *See* Docket Entry 26-2 at Section 7.1. The $300,000.00 is comprised of a $200,000.00 Expense Reimbursement and a $100,000.00 over bid. *See id.*

28. As set forth above, the Court should deny the Expense Reimbursement. If the Expense Reimbursement is denied, other bidders will be required to make an initial bid of $100,000.00 more than the offer made by Suchman. As Suchman is able to credit bid its entire claim, there does not appear to be any need to institute such an initial overbid other than to forestall bidding. In addition, the $100,000.00 minimum bid increments is also unnecessary due to Suchman's ability to credit bid. The minimum bid increments should be reduced so as to not forestall any bidding.

C. Heightened Scrutiny Involving Insider Transactions.

29. The Debtors bear the burden of proving that they have satisfied the requirements of Section 363(f), the good faith finding under Section 363(m), and the heightened scrutiny required by non-bankruptcy law for insider transactions. *See In re Univ. Heights Ass'n,* 2007 Bankr. LEXIS 1200, at *14 (Bankr. N.D.N.Y. January 22, 2007) (recognizing the insider nature of a transaction requires heightened scrutiny); *In re Medical Software Solutions*, 286 B.R. 431, 445 (Bankr. D. Utah 2002) ("[W]hen a pre-confirmation [Section 363(b)] sale is of all, or

substantially all, of the Debtor's property, and is proposed during the beginning stages of the case, the sale transaction should be 'closely scrutinized, and the proponent bears a heightened burden of proving the elements necessary for authorization.'").

30. "In applying heightened scrutiny**,** courts are concerned with the integrity and entire fairness of the transaction at issue, typically examining whether the process and price of a proposed transaction not only appear fair but are fair and whether fiduciary duties were properly taken into consideration." *See In re Innkeepers USA Trust*, 442 B.R. 227, 231 (Bankr. S.D.N.Y. 2010).

31. Here, on or about February 16, 2014, which is a month and a half prior to the Petition Date, the Debtors hired Gregg as their CRO. *See* Docket Entry 15-2 at Exhibit A. Pursuant to the February 16, 2014 Engagement Letter (the "Engagement Letter"), Gregg was given certain powers and duties that mainly include bankruptcy related powers and duties: (i) refinance the Debtors' indebtedness in bankruptcy; (ii) direct the preparation of all financial information to be used during the bankruptcy, (iii) direct the negotiations of debtor-in-possession financing; retain or terminate professionals employed or retained by the debtors for purposes of the bankruptcy; (iv) direct the preparation of information including monthly operating reports; (v) participate in all meetings with lenders concerning business operations and the conduct of the bankruptcy cases; and (vi) direct and participate in the formulation and implementation of any financing facilities before or during the bankruptcy case. *See id.* In addition to the above powers and duties, Gregg may also perform certain services requested or directed by the Manager. *See id.*

32. Pursuant to the Engagement Letter, Gregg is required to report and attend meetings with the Managers of the Debtors. *See id.* Gregg also operates under the direction of

the Manager. *See id.* The Manager that signed the Engagement Letter on behalf of both Debtors was Seth Gerzsberg, the owner of the Debtors and Suchman. *See id.*

33. As a result, it appears that Mr. Gerzsberg was involved on both sides of this transaction.

34. The Debtors have the burden of establishing that the bidding procedures and the Asset Purchase Agreement satisfy the heightened standard for insider transactions. Such a showing has not been made. In addition, the timeline set by Suchman does not afford a fair opportunity for interested parties to participate in the Auction. For example, the Debtors retained Innovation Capital, LLC ("Innovation") shortly before the Petition Date in order to commence contacting potentially interested parties to solicit interest in the Debtors' assets. As there does not appear to have been any pre-petition marketing of the assets by Innovation, interested third parties should be afforded more than a little more than a month to conduct due diligence, procure financing and formulate bids. The U.S. Trustee agrees with the Committee Objection that the proposed timeline should be extended at least four weeks. *See* Docket Entry 121 at ¶ 16.

D. The Releases in the Interim DIP Order and the Sale of Substantially All of the Debtors' Assets May Constitute a Sub Rosa Plan.

35. A transaction is an impermissible sub rosa plan if it disposes of all or substantially all of a debtor's assets without following the Bankruptcy Code's procedural protections in connection with the development and approval of a plan of reorganization, such that the sale itself is a de facto plan. The procedural protections provided in the Bankruptcy Code include, among other things, the right to receive a detailed disclosure statement from a debtor and the right to vote on the proposed plan.

36. Because of the importance of these protections to ensure that creditors are treated fairly, courts have rejected proposed post-petition agreements between debtors and select

creditors that have the effect of dictating material terms of a plan of reorganization without complying with the Bankruptcy Code's procedural requirements for plan confirmation. *See In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983) ("The debtor and the bankruptcy court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan sub rosa in connection with a sale of assets"); *see also In re Decora Industries,* Case No. 00-4459-JJF, 2002 WL 32332749 at *8 (D. Del. May 20, 2002) ("the focus of 'sub rosa' plan analysis is oriented toward those situations in which a debtor proposes to sell 'all' or 'substantially all' of its assets without the benefit of a confirmed plan or a court-approved disclosure statement."); *In re Swallen's, Inc.*, 269 B.R. 634, 638 (BAP 6th Cir. 2001) ("At least when a party in interest objects, a bankruptcy court cannot issue orders that bypass the requirements of Chapter 11, such as disclosure statements, voting, and a confirmed plan, and proceed to a direct reorganization on the terms the court thinks best, no matter how expedient that might be.")

37. Here, the purported sale of substantially all of the Debtors' assets may constitute a sub rosa plan because it constitutes a complete disposition of all of the Debtors' valuable assets and thereby impermissibly dictates the terms of a future plan of reorganization. In addition, through the Interim DIP Order, the Debtors also seek to dictate terms of a future plan by seeking a broad release for the Debtors' insiders outside the plan process.

38. Before a sale is allowed, the Debtors should be required to provide information concerning any assets remaining after the sale for the benefit of the estate and explain the Debtors' exit strategy.

E. Under Sections 363(b)(1) and 332 of the Bankruptcy Code, A Consumer Privacy Ombudsman May Be Required.

39. The U.S. Trustee notes that through the sale of the Debtors' assets, the Debtors propose to transfer their customer's personally identifiable information to Suchman. *See* Docket Entry 26-1 at ¶ 28.

40. As set forth in the Bidding Procedures Motion, "[i]n the ordinary course of business, the Debtors advise their customers purchasing goods in their retail stores and on-line that their personal information will not be disclosed to third party vendors outside the Debtors." *See id.* at ¶ 27.

41. As a result, a consumer privacy ombudsman must be appointed to protect the information. 11 U.S.C. § 363(b)(1) provides:

> (b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate, except that if the debtor in connection with offering a product or a service discloses to an individual a policy prohibiting the transfer of personally identifiable information about individuals to persons that are not affiliated with the debtor and if such policy is in effect on the date of the commencement of the case, then the trustee may not sell or lease personally identifiable information to any person unless –
>
> > (A) such sale or lease is consistent with such policy; or
> > (B) after appointment of a consumer privacy ombudsman in accordance with section 332, and after notice and a hearing, the court approves such sale or such lease –
> > (i) giving due consideration to the facts, circumstances, and conditions of such sale or such lease; and
> > (ii) finding that no showing was made that such sale or such lease would violate applicable nonbankruptcy law.

The Debtors privacy policy is posted on its website and a copy of that privacy policy is annexed hereto and made a part hereof as Exhibit "A". (See also, the Debtor's website at http://www.ecko.com/default/customer-service/privacy/).

42. But, in the relevant part, the privacy policy states that:

> [The Debtors] also reserve the right to transfer personal information about you in the event it sells or transfers all or a portion of the business or assets. Should such a sale or transfer occur, [the Debtors] will use reasonable efforts to direct the assignee or successor-in-interest to use personal information you have provided in a manner that is consistent with this Privacy Policy.

43. Nevertheless, it remains unclear if the transfer of personally identifiable information to third parties as potential purchasers is permissible under the privacy policy. The Debtors have also failed to adequately address the issue in the Bid Procedures and Sale Motion to assure that the proposed sale is consistent with the privacy policy or all of the personally identifiable information collected by the Debtors is protected.

44. In sum, if the Debtors intend to sell or transfer the personally identifiable information of its customers (or assets containing personally identifiable information), a consumer privacy ombudsman should be appointed under 11 U.S.C. §§ 363(b)(1)(B) and 332(a), given that the marketing and sale of such information is not wholly consistent with the Debtors' privacy policy.

45. In addition to the objections set forth above, for the reasons set forth in the Committee Objection, the U.S. Trustee objects to certain provisions sought in the DIP Motion including but not limited to the releases, the liens on proceeds of avoidance actions and Section 506(c) waiver. *See* Docket Entry 121 at ¶ 32.

46. The U.S. Trustee reserves any and all rights, remedies and obligations to, *inter alia*, complement, supplement, augment, alter and/or modify this Objection and to conduct any and all discovery as may be deemed necessary or as may be required and to assert such other grounds as may become apparent upon further factual discovery, assert further and additional objections at any hearing on the Bid Procedures and Sale Motion and DIP Motion, and to take whatever other actions are deemed necessary, justifiable and appropriate.

CONCLUSION

WHEREFORE, in light of the foregoing, the United States Trustee respectfully requests that the Bid Procedures and Sale Motion and the DIP Motion not be approved, and that the Court grant such further relief as is just and equitable.

Respectfully submitted,

ROBERTA A. DeANGELIS
UNITED STATES TRUSTEE
REGION 3

By: */s/ Jeffrey M. Sponder*
Jeffrey M. Sponder
Trial Attorney

Dated: April 18, 2014

PRIVACY POLICY

SITE OPERATOR Privacy Policy

PRIVACY POLICY

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