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Committee of Unsecured Creditors

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF HAWAII

In re: M WAIKIKI, LLC, Debtor. 67404	Case No. 11-02371 Chapter 11 Interim Hearing Date Date: September 13, 2011 Time: 1:30 p.m. Judge: Hon. Robert J. Faris

COMMITTEE'S OPPOSITION TO DEBTOR'S EMERGENCY MOTION FOR (A) AUTHORIZATION (I) OBTAIN POSTPETITION SECURED INDEBTEDNESS; (II) GRANT SECURITY INTERESTS AND SUPERPRIORITY CLAIMS PURSUANT TO SECTIONS 105(A), 364(C) AND D OF THE BANKRUPTCY CODE; (III) GRANT REPLACEMENT LIENS TO PREPETITION SECURED LENDERS; (IV) USE CASH COLLATERAL PURSUANT TO SECTION 363 OF THE BANKRUPTCY CODE, AND (B) SCHEDULE A FINAL HEARING PURSUANT TO BANKRUPTCY RULE 4001

The Official Committee of Unsecured Creditors (the "Committee") appointed in the above-captioned Chapter 11 case, through its undersigned proposed counsel, submits this preliminary opposition (the "Opposition")[1] to the *Emergency Motion for (A) Authorization to (I) Obtain Postpetition Secured Indebtedness; (II) Grant Security Interests and Superpriority Claims Pursuant to Sections Estate Pursuant to Sections 105(A), 364(C) and (D) of the Bankruptcy Code, (III) Grant Replacement Liens to Prepetition Secured Lenders; (IV) Use Cash Collateral Pursuant to Section 363 of the Bankruptcy Code, and (B) Schedule a Final Hearing Pursuant to Bankruptcy Code 4001* (the "Motion"),[2] filed by the above-referenced debtor and debtor-in-possession, M Waikiki, LLC (the "Debtor") on September 7, 2011.

BACKGROUND

1. On August 31, 2011 (the "Petition Date"), the Debtor commenced this case by filing a voluntary petition for reorganization under Chapter 11 of Title 11 of the United States Code, 11 U.S.C. §§ 101 *et seq*. (the "Bankruptcy Code") in the United States Bankruptcy Court for the District of Hawaii (the "Court").

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[1] The Committee retained counsel two business days before the interim hearing on the Motion and reserves the right to supplement and amend its opposition prior to any final hearing on the Motion. The Committee is in negotiations with the Trust over the terms of the DIP Facility and expect to have proposed modifications at the hearing.

[2] Terms used herein and not otherwise defined shall have the meanings given them in the Motion.

2. The Debtor continues to operate its business and manage its property as debtor and debtor in possession pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code.

3. On September 9, 2011, the Office of the United States Trustee ("UST"), pursuant to Section 1102 of the Bankruptcy Code, appointed the Committee consisting of the following members: (i) Marriott Hotel Services, Inc. ("Marriott"), (ii) Hawaiian Electric Company, Inc. ("HECO"),[3] and (iii) Communications Pacific, Inc. *See Notice of Appointment of Committee of Creditors*, docket # 81.

4. On September 9, 2011, the Committee voted to retain, subject to Court approval, Wagner Choi & Verbrugge as its counsel.

5. On September 12, 2011, the UST added King Food Services, Inc. to the Committee. *See Notice of Amended Notice of Appointment of Committee of Creditors*, docket # 99.

6. The Debtor owns the M Waikiki, formerly known as the Waikiki Edition, a 353-room boutique hotel located on Ala Moana Boulevard (the "Hotel"). Since its opening as a Marriott-managed property in late September, 2010 to late August, 2011, the Hotel has lost an average of approximately $840,000 per month. *See* Declaration of Damian McKinney in Support of First Day Motions, docket # 17 at ¶ 19 ("McKinney Declaration").

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[3] The Committee has elected HECO as its chair.

7. The Debtor commenced a lawsuit against Marriott in the Supreme Court for the State of New York in May, 2011, and then replaced Marriott as hotel manager on or about August 28, 2011. *Id.* ¶ 19.

8. The Debtor admits that the filing of its emergency petition on August 31, 2011, was for the purpose of preventing Marriott from being returned as Hotel manager pursuant to a TRO issued by the New York court. *Id.* at ¶¶ 28, 29.

9. As of the Petition Date, Marriott was owed approximately $5.4 million on account of advances it had made to fund the Debtor's operating shortfalls.

10. Immediately upon filing the case, the Davidson Family Trust, the proposed DIP lender (the "Trust" or "DIP Lender"), advanced $250,000 into the Hotel for operations, without a Court order (the "Initial Advance"). The Trust is an insider that has invested or contributed approximately $108 million into the Debtor. *See* Exhibit "C" to Motion at 10 (proposed Interim Order).

11. The Debtor would now have the Court approve this prior advance and other relief as set forth in the Motion on an "emergency" basis pursuant to a Motion that was filed more than a week after the Petition Date.

12. The Debtor does not refute the unavoidable fact that the Trust could and can be expected to protect its prepetition investment by making protective advances to the Debtor or by a more reasonable and less expensive DIP financing.

13. The Debtor asserts, however, that the proposed post-petition financing (the "DIP Facility") is in the best interest of creditors when, in fact, the Trust's interests are primarily benefitted. Instead, the Debtor's unsecured creditors will benefit little if at all, and face the daunting prospect of being primed by an ever increasing DIP Facility that will undoubtedly be required to finance this case even for the short term.

14. The Debtor submits in support of the Motion an appraisal dated September 22, 2008 in the amount of $211 million. *See* Exhibit "E" to Motion. If the value of the Hotel does not approach this three-year old valuation (which is no longer relevant), the unsecured creditors face the grim prospect of non-payment in this chapter 11 case.

15. The principal relevant provisions of the DIP Facility are as follows:

a. Loan Commitment: $2,500,000. *See* Motion at ¶ 18 d.

b. Use of Proceeds: Working capital and pay DIP Credit Facility Fees in full. *See* Motion at ¶ 18 e and Budget.

c. Term: The DIP Facility matures, at the latest, 6 months after entry of the Interim Order. *See* Motion at ¶ 18 m.

d. Priority: The DIP Facility (subject only to the carve-out) constitutes a superpriority administrative expense claim, including against proceeds of avoidance actions or other Collateral. *See* Motion at ¶ 18 i.

e. Liens: The DIP Facility grants to the DIP Lender junior liens on the Hotel and all other assets of the Debtor, excluding avoidance actions. *See* Motion at ¶ 18 h.

f. Carve-Out: For the payment of allowed professional fees and U.S. Trustee fees up to $500,000, incurred prior to delivery of a termination notice. *See* Motion at ¶ 18 j.

g. Expenses: All out-of-pocket costs and expenses of the Trust as proposed DIP lender. *See* Motion at ¶ 18 k.

h. Interest Rate: 15%. *See* Motion at ¶ 18 e.

i. Default Interest Rate: 20%. *See* Motion at ¶ 18 f.

j. Conditions Precedent: DIP Lender's review and approval of Budget, no role in management for Marriott (among other conditions). *See* Term Sheet attached as Exhibit "A" to Motion at 4-6 ("Term Sheet").

k. Financial Covenants: Includes minimum weekly revenue, cash receipts and maximum weekly expenses "to be determined." *See* Term Sheet at 4.

l. Waiver of Surcharge Rights: The Debtor waives its right to surcharge prepetition or postpetition collateral pursuant to sections 506(c) or 552(b) of the Bankruptcy Code. *See* proposed Interim Order at 28-29.

m. Committee Challenge: No proceeds of the DIP Facility or other Collateral may be used to investigate or challenge the DIP Facility or the Trust's prepetition liens or claims. *See* Term Sheet at 3-4.

ARGUMENT

A. THE PROPOSED DIP FACILITY SHOULD NOT BE APPROVED UNDER SECTION 364(C).

16. Section 364(c) of the Bankruptcy Code, which governs the ability of a debtor or trustee to obtain credit, provides as follows:

> (c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt –
>
> (1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
>
> (2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
>
> (3) secured by a junior lien on property of the estate that is subject to a lien.

11 U.S.C. § 364(c).

17. "In order to secure approval of post-petition financing pursuant to 11 U.S.C. §§ 364(c) and/or (d), the debtor-in-possession bears the burden of proving the following: 'first, that the proposed financing is an exercise of sound and reasonable business judgment; second, that no alternative financing is available on any other basis; third, that the financing is in the best interests of the estate and its

creditors; and, as a corollary to the first three points, that no better offers, bids, or timely proposals are before the Court.'" *In re Phase-I Molecular Toxicology Inc.*, 285 B.R. 494, 495 (Bankr. N.M. 2002) (citing *In re Western Pacific Airlines, Inc.*, 223 B.R. 567, 572 (Bankr.D.Colo.1997)).

18. The Debtor has the burden of proving "(1) They are unable to obtain unsecured credit per 11 U.S.C. § 364(b), i.e., by allowing a lender only an administrative claim per 11 U.S.C. § 503(b)(1)(A); (2) The credit transaction is necessary to preserve the assets of the estate; and (3) The terms of the transaction are fair, reasonable, and adequate, given the circumstances of the debtor-borrower and the proposed lender." *In re Crouse Group, Inc.*, 71 B.R. 544 (Bankr. E.D. Pa. 1987) (while the court found that debtor failed to satisfy all three prongs, the Court specifically noted that the court "[does] not consider it fair or reasonable that such a substantial debtor and insider should receive one penny at the expense of other creditors").

19. The Debtor has not filed any declarations or other evidence in support of its Motion. The McKinney Declaration does not speak to any of the requirements of § 364(c) and/or (d). No evidence has been submitted to indicate that the Debtor even considered other sources of funding, let alone the interest rate.

20. The Debtor has failed in its burden of showing that it sought alternative financing from other lenders on less burdensome terms and that the terms of the transaction are fair to the estate and all creditors

B. THE TERMS OF THE DIP FACILITY SHOULD BE SCRUTINIZED AS AN INSIDER TRANSACTION.

21. The Committee is informed that the Trust is an insider. "[A]n insider's dealings with a bankrupt corporation must be 'subjected to rigorous scrutiny.'" *Brewer v. Erwin & Erwin, P.C. (In re Marquam Inv. Corp.)*, 942 F.2d 1462, 1465 (9th Cir. 1991) (quoting *Pepper v. Litton*, 308 U.S. 295, 306 (1939)).

22. "Courts must scrutinize transactions between insiders and the debtor-in-possession to ensure that the transactions are fair to the estate and creditors." *In re Regenteiner Printing Co.*, 122 B.R. 323, 326 (N.D. Ill. 1990).

23. An initial review of the proposed DIP Facility reveals a host of unfair and inequitable provisions including:

- **The Proposed Interest Rate is Excessive and Unjustified.**

24. The proposed interest rate on the outstanding balance of the DIP Facility at 15% per annum is excessive given the relationship between the borrower and the DIP Lender. In other cases before this Court in considering DIP financing by insiders, the Court has approved interest rates at the 7% and/or 8% level. *See*, *In re Grove Farm Fish & Poi, LLC*; Case No. 10-03340; *In re Pomare, Ltd.*; Case No. 08-01448; *In re Sunra Coffee, LLC*; Case No. 09-01909. The Court should only approve interest in the range of 7% or 8% per annum in this case. A DIP lender ought to be reasonably compensated for the use of its capital, however

a compensation rate of 15% interest is more appropriate for a third-party lender than for an insider lender.

25. According to the Debtor, the Hotel is worth more than $200 million and the proposed DIP Facility is junior only to a $114 million first mortgage, making the DIP Facility fully secured. A 15% interest rate is clearly unwarranted under the circumstances.

26. Further, the proposed DIP Loan provides for default interest at the rate of 20% per annum. This default interest should be reduced dramatically or eliminated. It would appear that the Debtor is substantially in the control of the Trust, putting the Trust as DIP Lender in a position to engineer a default should it chose to do so. Other provisions to the proposed loan agreement require the Debtor to comply with numerous other covenants and reporting requirements, the failure of any one of which would result in a default. It would be far too easy to create a default triggering the default interest rate. The incentive on the part of the Debtor to benefit one of its controlling interests should be eliminated.

- **The $250,000 Initial Advance Should Not be Approved.**

27. The Debtor proposes to roll into the DIP Facility the initial $250,000 paid into the Debtor by the Trust shortly after the filing of the Petition herein and without first seeking an order from this Court authorizing the loan. If the Debtor required an immediate fusion of cash, the Debtor could have filed an emergency motion with the Court which the Court would have considered immediately. The

DIP Lender decided to make the loan without first petitioning the Court for protection. There is no basis for treating this unsecured, unauthorized loan to the Debtor as part of the secured loan now being requested by the DIP Lender.

- **The Term of the Facility is Indefinite and Illusory**

28. The term of the loan is defined in the Loan Term Sheet attached as Exhibit "A" to the Debtor's Motion. The Term Sheet sets forth a number of occurrences which will constitute a "DIP Credit Facility Termination Event." Among the various Termination Events is item (ix) "such other events as may be designated by the Administrative Agent." *See* Motion at ¶ 18 m. This Term presumably gives the Administrative Agent authority to terminate the loan in its sole discretion, whether or not the Debtor is otherwise in compliance.

- **The Superpriority Claim on Avoidance Actions Must be Stricken.**

29. The proposed DIP Facility collateral does not extend to the Debtor's avoidance actions under the Bankruptcy Code. However, the DIP Lender is also offered a superpriority administrative claim under Section 364(c)(1) of the Bankruptcy Code, including superpriority over the Debtor's avoidance actions which are otherwise excluded from the DIP Lender's "Collateral." Recoveries under avoidance actions ought to be excluded from the coverage of the DIP Lender's superpriority administrative claim. Debtors-in-possession always point to the existence of a DIP loan to induce unsecured vendors to extend credit. The Debtor's unsecured creditors who continue to provide goods and services post-

petition are in effect making unsecured loans to the Debtor that are no different than the loans being made to the Debtor by the DIP Lender. If the Debtor's reorganization were to fail, these unsecured post-petition vendors will be left holding the proverbial bag with absolutely no recourse. In the failed *Aloha Airlines* cases, there are in excess of $4 million of unpaid chapter 11 administrative expenses who do not have any recourse to the avoidance actions because the superpriority claims of the DIP lenders in that case extended to the debtors' avoidance claims.

30. At a minimum, any interest that the DIP Lender ought to have in the Debtor's avoidance action recoveries should be no greater than *pari passu* with the claims of other administrative creditors who are in effect making similar loans to the Debtor post-petition.

- **The Carve-Out Needs to be Clarified.**

31. The proposed DIP loan provides for a carve-out not to exceed $500,000 in the aggregate for (a) allowed professional fees and expenses incurred in the Chapter 11 case; (b) certain chapter 7 trustee fees; and (c) the payment of fees pursuant to 11 U.S.C. § 1930. The proposed carve-out prohibits the use of any of the carve-out (and the Committee assumes any of the DIP Lender's funding) for the purpose of investigating and/or prosecuting claims against the DIP Lender or the Administrative Agent in their capacity as it relates to the DIP loan and more importantly, as it relates to their other relationships with the Debtor including as

the maker of what has been defined as the subordinated secured debt. Nothing in the DIP loan or the carve-out provision should inhibit the Committee from investigating the validity, nature, and extent of the DIP Lender's pre-petition loans or contributions to the Debtor.

32. Furthermore, it appears that the carve-out ceases being available upon the occurrence of a notice of default. The work of the Committee's (nor the Debtor's) professionals will not stop just because the DIP Lender calls the DIP Facility into default.

33. The funding of a workable professional fee carve-out is a required "price of admission" for secured creditors that hope to use the benefits of chapter 11 to maximize the value of their collateral. The Trusts seek the benefits the chapter 11 process affords them while seeking to avoid the necessary costs. To be blunt, the various limitations on the carve-out would deny the Committee the right to do its statutorily mandated job.

- **§§ 506(c) and § 552(b) Surcharge Rights Should Not be Waived.**

34. The DIP Motion also proposes the waiver of the Debtor's and estate's ability to surcharge the Lenders/DIP Lender's collateral under 11 U.S.C. §105(a), §506(c) and §552(b). Courts routinely reject the waiver of surcharge rights under sections 506(c) and 552(b). See e.g., *Hartford Fire Ins. Co. v. Nw. Bank Minn. (In re Lockwood Corp.)*, 223 B.R. 170, 176 (8th Cir. B.A.P. 1998) (holding that provision in financing order purporting to immunize the postpetition lender from

section 506(c) surcharges was unenforceable); *In re Colad Group, Inc.*, 324 B.R. 208, 224 (Bankr. W.D.N.Y. 2005) (refusing to approve postpetition financing agreement to the extent that the agreement purported to modify statutory rights and obligations created by the Bankruptcy Code by prohibiting any surcharge of collateral under section 506(c)).

35. The waiver of sections 506(c) and 552(b) rights is particularly improper given the circumstances here. As described above, the Debtor's general unsecured creditors are faced at least now with a very uncertain prospect of a successful reorganization. Preservation of the Trust's investment benefits the Trust as a pre-petition lender and owner. It cannot plausibly be argued that general unsecured creditors are receiving any benefit equitably sufficient to justify denying the estate the right to assert section 506(c) surcharge claims against the Trust or asserting section 552(b) equities of the case exceptions to the general rule of section 552(b). As such, the waivers should be stricken from the proposed DIP Facility.

C. ANY INTERIM APPROVAL OF THE DIP FACILITY SHOULD BE ON LIMITED TERMS.

36. Until the Committee has an opportunity to understand the Debtor's current financial condition and the proposed Budget (which is outdated), any interim relief that the Court may grant should be for a very limited period and only on a junior secured basis. The entry of a 45 page interim order replete with

extensive findings of fact at this stage of the case is simply unwarranted. At a minimum, any order entered should be for interim relief only and should clearly state that any and all findings are subject to restatement and review upon further hearing prior to the entry of a Final Order.

CONCLUSION

WHEREFORE, the Committee respectfully requests that the Court deny the Motion or grant it on the limited terms proposed by the Committee, and grant such further relief as the Court deems just.

DATED: Honolulu, Hawaii, September 13, 2011

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