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UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF WASHINGTON AT YAKIMA

In re: 47 HOPS LLC, Debtor.	No. 17-02440 MOTION TO APPROVE INTERIM USE OF CASH COLLATERAL, GRANT REPLACEMENT LIENS, AND SET FINAL HEARING

The Debtor herein, 47 Hops LLC ("Debtor"), through its attorney Nathan T. Riordan and Wenokur Riordan PLLC, moves for an order approving the interim use of cash collateral, granting replacement liens, and setting the final hearing pursuant to 11 U.S.C. §363 and Fed. R. Bankr. Pro. 4001(b).

A. BACKGROUND

1. On August 11, 2017 (the "Petition Date"), the Debtor filed a voluntary petition in this Court for relief under Chapter 11 of title 11 of the United States Code, 11 U.S.C. §§101-1330, as amended (the "Bankruptcy

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Code"). The Debtor continues to manage and operate its business as a debtor-in-possession pursuant to sections 1107 and 1108 of the Bankruptcy Code.

2. No trustee or examiner has been appointed in Debtor's Chapter 11 case, and no committees have been appointed or designated.

3. The Court has jurisdiction over the matter pursuant to 28 U.S.C. §§ 157 and 1334. Venue is proper pursuant to 28 U.S.C. §§ 1408 and 1409. This is a core proceeding pursuant to 28 U.S.C. § 157 (b) (2).

4. The Debtor is a merchant/wholesaler of hops and hop products whose business and operations are all located in Yakima, Washington. *See Declaration of Douglas MacKinnon*, ("MacKinnon Dec."), para. 4.

5. The Debtor derives its revenue from the processing, sale, storage, and delivery of hops and hop products. The Debtor purchases hops and hop products primarily from growers, processes the hops into pellet form, and then sells the baled hops to beer brewers in the U.S. and abroad. *MacKinnon Dec.*, para. 5.

6. The husband and wife team of Doug and Anastasia MacKinnon formed the 47 Hops LLC ("47 Hops" or the "Debtor") in January of 2013. The MacKinnons own 100% of the Debtor, which primarily purchases hops and hop products from growers, processes the hops into pellet form, and then sells the

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processed hops to beer brewers in the U.S. and abroad. *MacKinnon Dec*., para. 6.

7. The Debtor has contracts with 11 hops growers to purchase their hops and hop products. These grower contracts typically span three to five years of hops planting, harvesting, and delivery to the Debtor's processing and storage facility in Yakima, Washington. The Debtor then processes the hops into pellet form, packages them in air-tight mylar foils and stores them at temperatures at or below freezing. The Debtor then sells the hops to brewers/breweries on both a contract and spot-market[1] sales basis. The Debtor has 150+ contracts with brewers/breweries for the sale of hops. Typically the brewery contracts also span a period of three years for storage at and delivery from the Debtor's facility. *MacKinnon Dec*., para. 7.

8. The growth in the hops industry has been fueled by the popularity of the craft beer industry, which had been enjoying annual double-digit growth for some years. Growth in the craft beer industry peaked at 18% in February 2014. Since then, growth in the craft beer market has decreased to its current level of approximately 6% year on year in 2016, according to a Brewers Association press release on March 28, 2017. *MacKinnon Dec*., para. 8.

[1] "Spot-market" sales are sales that fill an immediate, short-term demand.

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9. Optimism surrounding the double-digit growth of the craft beer industry continued much longer than the actual growth itself. Farmers continue to this day to plant additional acreage with the reasoning that all their hops are contracted, despite information that brewers are not paying in a timely manner on the contracts. Copious articles and statistics published by the Brewers Association and others proclaiming the craft beer industry was on track to reach 20% of domestic U.S. beer production by 2020 dominated the industry news, fueled the frenzy, and further supported the belief that additional hops acreage was necessary. *MacKinnon Dec.*, para. 9.

10. The overly optimistic atmosphere in the hop industry continued unchallenged through 2015 and into the beginning of 2016. Brewers enjoyed annual double-digit growth of their most popular brands for several years. Variety shortages gave the impression of overall shortages to many brewers who, with a false sense of confidence, were comfortable signing long-term contracts for hops at high prices. Growers continued to plant for those contracts. In 2016, when the slow-down in the craft beer market became obvious, many brewers began asking for contract renegotiations. Slowing growth happened first among the largest craft brewers where competition was fierce. In the early stages of the slow-down, growth by small- and medium-sized brewers absorbed

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reductions from the larger brewers' contracts. Merchants absorbed this round of renegotiations by shuffling inventory from the haves to the have-nots. *MacKinnon Dec*., para. 10.

11. The hop industry, eager to take advantage of a growth opportunity, borrowed hundreds of millions of dollars from banks based on forward contracts with merchants and farmers. Brewers borrowed heavily to expand their production capacity as well. By 2016, the majority of the brewing and hop-related industries were heavily leveraged. This is significant, because it meant cash flow was tight everywhere. It placed banks firmly in control of the hop industry thereby reducing options and necessitating that all activities are geared toward bank repayment. *MacKinnon Dec*., para. 11.

12. The heavy influx of bank money created a vicious cycle. To fund investments in infrastructure, farmers required stability in the form of long-term contracts. Brewers quickly and happily signed long-term contracts of 3-5 years to beat the ever-increasing prices of merchants and farmers. Costs of production increased across the industry due to the influx of bank-controlled money, but sales prices in the hop industry are not tied to costs. They soared even higher than the debt and justified creating what can only be described as "irrational exuberance." The bubble continued to grow. *MacKinnon Dec*., para. 12.

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13. By the end of 2016, brewers and merchants could not match their hop contract volumes to the newly reduced level of demand on the craft beer market. The result was oversupply building up in warehouses across Yakima, as evidenced by the USDA stocks report of March 2017. It became nearly impossible to shuffle inventory between brewers who had surplus hops and those who needed them-- the volume of surplus hops was simply too large. Burdened with debt and clinging to the belief that a contracted position was as good as money in the bank, many farmers and some merchants refused to renegotiate brewer contracts when opportunities arose. In some isolated cases the Debtor was guilty of this, although if reasonable renegotiation of a contract was possible in 2016, the Debtor pursued that route. Realizing the seriousness and scale of the situation, the Debtor became much more flexible with respect to time and renegotiations. Brewers who were unable or unwilling to renegotiate their contracts began to delay deliveries and their corresponding payments, thereby creating a stockpile of contracted hops in merchant inventory, including in the stores of 47 Hops. *MacKinnon Dec*., para. 13.

14. At the time of filing of the Debtor's bankruptcy, the Debtor is aware of large breweries that are only now making payments on their 2015 crop-year inventory to other merchants. Older inventory is also available. The

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Debtor has approximately $75,000 of 2015 inventory held for brewers, which at the time of this writing has not yet been paid. The amount of 2016 inventory held for brewers for which the Debtor still must be paid is nearly $2 million. *MacKinnon Dec*., para. 14.

15. In January 2017, it was clear that the current situation with slowed brewer payments and on-time grower payments would not be sustainable without an ever-increasing line of credit. The Debtor began a series of talks with its largest American hop supplier to explore the possibility of renegotiating contracted positions and lowering the volumes considerably. At that time, the Debtor was open to the idea of reducing volumes and extending the number of years of the contracts in place, a practice common in the industry. The Debtor also offered a nominal sum per pound to be paid. Unfortunately, the supplier was not enthusiastic about renegotiating its contracted position and offered a buy-out price that equaled approximately 50% of the face value of the contract per year. This was not a viable option in an increasingly oversupplied market. Without the cooperation of the Debtor's largest single supplier, introducing the topic of renegotiation with other suppliers was futile. *MacKinnon Dec*., para. 15.

16. As planting commenced in the spring of 2017, it was clear that the majority of farmers were still of the opinion that the market was growing.

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American farmers planted an additional 4,500 acres. However, at the same time, one of the Debtor's largest brewery customers delayed payment of nearly $2 million. As a result, 47 Hops was unable to make the timely March/April payment to several growers. Instead, the Debtor offered a payment plan solution that included three equal monthly payments on the 15th of April, May, and June 2017. The Debtor's largest supplier immediately threatened to file a processor lien if 47 Hops did not make full payment within 20 days of the original due date. On the final day of that deadline, the Debtor and the grower signed an amendment to the agreement effectively giving the Debtor 30 more days to pay the entire amount in full. Other suppliers accepted the original payment plan and quickly agreed to the new terms, and 47 Hops made all those payments per the revised plans. The Debtor's largest supplier remained inflexible to renegotiation unless it was well compensated for such a change. Again, without their cooperation, it was futile for 47 Hops to try negotiating more favorable terms and conditions with other suppliers. *MacKinnon Dec.*, para. 16.

17. At the end of 2016 and the beginning of 2017, large brewers began to aggressively try to sell off their excess inventory. As a result, low spot-market prices between brewers and merchants, and also between brewers, were commonplace. It was obvious that, under current market conditions, a buy-out

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payment at anything near 50% of contract face value would be impossible. It was also obvious that with the market quickly moving into a heavily oversupplied surplus condition due to continued planting by farmers, the situation would become more extreme as time progressed. As of July 2017, word on the street is that there is already an additional 1,800 acres of hops planned for 2018. The momentum and enthusiasm among farmers to continue planting contracted hops will ensure that prices on the spot hop market will continue to be significantly lower than contracted prices. *MacKinnon Dec*., para. 17.

18. Doug and Anastasia MacKinnon own 100% of the Debtor, and their combined knowledge of and experience in the hops industry is vast. Doug MacKinnon is president of the Debtor and has worked in the hops industry since 1999. Doug has served as Director of Hop Growers of America and as Chairman of the Economic Committee of the International Hop Growers Convention, and he has written and maintained a blog on the hops and hops-related industries on the Debtor's website for many years. Anastasia MacKinnon has been involved in the hops industry for over a decade. Anastasia is Vice President of Sales and International Business Development, and she

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transacts Debtor domestic and international business in four languages. *MacKinnon Dec*., para. 18.

19. The Debtor plans to reject almost all of the Debtor's grower contracts in order to free itself from the obligation to purchase hops at above-market prices. The Debtor will then purchase hops on the spot market at market prices from brewers and farmers willing to sell to it. Once free to float in the market and source hops at current market prices, the Debtor can then sell hops to brewers at competitive prices. Currently, the Debtor's contracts with brewers suffer from two problems. First, many of the contracts are priced above today's market, thereby incentivizing brewers to breach their contracts. The Debtor has found suing for breach and attempting to collect on judgments to be very expensive, frustrating, and an overall bad business practice. Second, because demand has softened, many of the brewers have surplus hops and do not need the amounts for which they originally contracted with the Debtor. Therefore, rejecting the contracts for purchase will allow the Debtor to aid the customer by realigning their contracted volumes with their actual needs at competitive market prices. *MacKinnon Dec*., para. 19.

20. The Debtor's contacts within the hops market will enable the Debtor to find hops to purchase despite the Debtor's mass rejection of grower

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contracts. The surplus of hops everywhere in the market means that many parties will be eager to sell hops even at sharply reduced prices, rather than lose the hops to spoilage. *MacKinnon Dec*., para. 20.

21. The Debtor maintains a competitive advantage due to the Debtor's knowledge of both the domestic and international hops markets on both the buy and sell side, including a broad familiarity with varieties of hops specific to different regions all over the globe. The Debtor is confident that, once freed from unprofitable contracts, it can take advantage of the Debtor's knowledge of the needs and preferences of the players in the hops industry world-wide to continue to make profitable sales of hops in sufficient quantities to be a viable ongoing business. *MacKinnon Dec*., para. 21.

22. The Debtor owes Columbia Bank (the "Bank") approximately $4.5 million for a line of credit, and has guaranteed an additional $2.3 million owed to Columbia Bank by an affiliate. Columbia Bank's line of credit is secured by a security interest in all of the Debtor's inventory and accounts receivable. *MacKinnon Dec*., para. 22.

UCC: inventory (as of 8/11/17): $3,415,000

A/R (as of 8/11/17): $320,000

Bank accounts: $128,000

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23. The Debtor's regular payment to Columbia Bank is approximately $18,750 per month. Debtor proposes to continue to pay Columbia Bank's regular debt service as adequate protection, as described below. *MacKinnon Dec.*, para. 23.

B. USE OF CASH COLLATERAL

24. The Debtor requires use of cash collateral in order to fund its current operations.

25. Under Bankruptcy Code §363(c)(1), the Debtor may use property of the estate in the ordinary course of business without notice or a hearing. However, pursuant to §363(c)(2), the Debtor may not use cash collateral in the ordinary course of business, except if the court authorizes use of cash collateral or each entity with an interest in cash collateral consents. Upon request of the secured creditor, the court shall prohibit or condition the use of cash collateral as in necessary to provide the creditor with adequate protection. 11 U.S.C. §363(e). Moreover, the court may authorize the use of cash collateral at a preliminary hearing if there is a reasonable likelihood that the debtor will prevail at the final hearing. 11 U.S.C. §363(c)(3).

26. Although the term "adequate protection" is not defined in the Code, Section 361 sets forth three methods by which the debtor can sustain its burden

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of proof: (1) periodic cash payments equivalent to the decrease in value, (2) an additional or replacement lien on other property, or (3) other relief that provides the indubitable equivalent. *In re Mellor*, 734 F.2d 1396, 1400 (9th Cir. 1984); 11 U.S.C. §361.

27. Here, the Bank is the only party with a lien on cash collateral. The Debtor has prepared a budget for its proposed use of cash collateral. A copy of the 30-day interim budget is attached to the Declaration of Douglas MacKinnon as Exhibit A. The Debtor seeks authority to use cash collateral on an interim basis pursuant to the budget on Exhibit A. The Debtor may vary from the budget by not more than 10% without Court approval. A copy of the 6-month budget is attached to the Declaration of Douglas MacKinnon as Exhibit B. The Debtor seeks authority at a final hearing to use cash collateral on a final basis pursuant to the budget on Exhibit B. Any and all payments for administrative claims indicated on Exhibit B will be set aside in trust and remain subject to bankruptcy court approval.

28. In order to provide "adequate protection" (within the meaning of Sections 361 and 363 of the Bankruptcy Code), for the use of the Bank's cash collateral (to the extent of any diminution in the value of the Bank's Collateral after the filing of the respective Debtor's Bankruptcy petition), the Debtor

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proposes to grant the Bank a security interest and a continuing replacement lien on accounts, assets and cash acquired by Debtor post-petition to the extent of the value and amount of cash collateral of the Bank that is actually used by the Debtor, and the same position, quality, extent, and nature as the liens the Bank had in property belonging to the Debtor pre-petition.

29. As further adequate protection, the Debtor shall

i. provide to the Bank, concurrently with filing with the Bankruptcy Court, copies of Debtor's monthly financial reports as required by the court and the United States Trustee;

ii. continue to maintain insurance on its place of business;

iii. not incur any indebtedness with priority over the liens of the Bank;

iv. not sell any of its assets, other than inventory and goods in the ordinary course of business, without Court approval;

v. make no payments on pre-petition debts, except for pre-petition wages, and salaries in an amount not to exceed the unsecured priority amounts set forth in 11 U.S.C. §507(a)(4), unless expressly consented to in writing by the Bank, or approved by the Bankruptcy Court after notice and hearing;

30. The Debtor estimates its total forced liquidation value is approximately $1,200,000, which estimate includes the forced 30-day

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liquidation value of the Bank's collateral, which is $962,630 for inventory, $160,000 (50%) for accounts receivable.[2] The estimate also includes $41,000 for equipment (50%), which is not the Bank's collateral. Whether using the cost value or the liquidation value of the inventory, the Bank is undersecured and not entitled to adequate protection in the form of interest payments. It is important to note that using the cost value of the inventory likely overstates the fair market value of the inventory due to the current market surplus. In addition, because the Debtor's accounts receivable and cash balance will increase steadily over the next six months, depreciation is not a factor, and the Bank is therefore not entitled to an adequate protection payment to prevent diminution of the value of the Bank's collateral. *MacKinnon Dec.*, para. 24.

31. During the term of any Order allowing the use of cash collateral, the Debtor shall cooperate with the Bank in providing full and reasonable access to information respecting the Bank's collateral and cash collateral, and the Debtor's financial conditions, assets, and liabilities, including without limitation permitting the Bank to inspect upon reasonable notice the Bank's collateral and replacement collateral and the Debtor's books and records.

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[2] The Debtor's schedules reflect the value of the inventory on a cost basis at $3,415,777 and the accounts receivable at $320,000.

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32. Nothing contained herein shall constitute a waiver or modification of the Bank's rights and priority in its existing collateral of the Debtor.

DATED August 11, 2017.

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