IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re	:	**Chapter 11**
NEWPAGE CORPORATION, *et al.*,	:	**Case No. 11-12804 ( )**
Debtors.[1]	:	**Joint Administration Requested**

MEMORANDUM OF LAW IN SUPPORT OF DEBTORS' MOTION DATED SEPTEMBER 7, 2011 FOR ORDER AUTHORIZING USE OF CASH COLLATERAL PURSUANT TO BANKRUPTCY CODE SECTION 363(C)(2)

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[1] The Debtors in these chapter 11 cases, along with the last four (4) digits of each Debtor's federal tax identification number, as applicable, are: Chillicothe Paper Inc. (6154), Escanaba Paper Company (5598), Luke Paper Company (6265), NewPage Canadian Sales LLC (5384), NewPage Consolidated Papers Inc. (8330), NewPage Corporation (6156), NewPage Energy Services LLC (1838), NewPage Group Inc. (2465), NewPage Holding Corporation (6158), NewPage Port Hawkesbury Holding LLC (8330), NewPage Wisconsin System Inc. (3332), Rumford Paper Company (0427), Upland Resources, Inc. (2996), and Wickliffe Paper Company LLC (8293). The Debtors' corporate headquarters is located at 8540 Gander Creek Drive, Miamisburg, OH 45342.

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This memorandum of law is filed in support of the *Debtors' Motion for Interim and Final Orders Pursuant to 11 U.S.C. §§ 105, 361, 362, 363 and 364: (I) Authorizing Debtors to (A) Obtain Post-Petition Financing, and (B) Grant Senior Liens, Junior Liens and Superpriority Administrative Expense Status; (II) Authorizing Use of Cash Collateral; (III) Granting Adequate Protection to Certain Prepetition Secured Parties; (IV) Scheduling a Final Hearing; and (V) Granting Related Relief* (the "Motion"), which includes, among other things, a request for authorization to use cash collateral.[2]

SUMMARY OF ARGUMENT AND RELIEF REQUESTED PURSUANT TO BANKRUPTCY RULE 4001(B)[3]

New Page Corporation ("NewPage") and certain of its subsidiaries and affiliates as debtors and debtors-in-possession (collectively with NewPage, the "Debtors"), comprise the largest coated paper manufacturer in North America based on production capacity. The business is operationally profitable and currently projects positive EBITDA of hundreds of millions of dollars per year. Indeed, it has been cash flow positive on an operating basis since its formation in 2005. The Debtors are in chapter 11 because their debt burden is far too large now that their expenses have increased with inflation of energy and commodity prices while their revenues have been unable to grow during the great recession.

[2] Unless indicated otherwise, capitalized terms used, but not immediately defined herein, have the meanings assigned to them in the Motion.

[3] Rule 4001(b) of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") permits a court to approve a debtor's request for use of cash collateral. The Motion fully complies with Bankruptcy Rule 4001(b) and highlights all the relevant information pursuant to Local Rule 4001-2 of the Local Rules of Bankruptcy Practice and Procedure of the United States Bankruptcy Court for the District of Delaware (the "Local Rules"). Bankruptcy Rule 4001(b) provides:

> (b) Use of cash collateral.
> (1) Motion; service.
> (A) Motion. A motion for authority to use cash collateral shall be made in accordance with Rule 9014 and shall be accompanied by a proposed form of order.
> (B) Contents. The motion shall consist of or (if the motion is more than five pages in length) begin with a concise statement of the relief requested, not to exceed five pages, that lists or summarizes, and sets out the location within the relevant documents of, all material provisions, including:
> (i) the name of each entity with an interest in the cash collateral;

As of the Commencement Date, the Debtors were the borrowers under a revolving credit facility secured by first liens against the Debtors' current assets (*i.e.*, cash, accounts receivable, and inventory) (the "Prepetition Senior Secured Revolver"). The Debtors' notes in the approximate principal amount of $ 1.77 billion (the "Prepetition First Lien Notes") are secured by first liens against the Debtors' mills and equipment and second liens against the Debtors' current assets. Although there is significant additional debt secured by junior liens against the Debtors' mills and equipment, there are no other liens against the Debtors' current assets that convert into cash collateral.

Pursuant to the Motion, the Debtors request authorization to substitute a new DIP Credit Facility for their prepetition revolver, and to use their cash collateral. The request to use its cash collateral only implicates holders of the Prepetition First Lien Notes (the "Prepetition First Lien Noteholders") because they were secured prepetition by a second lien against the cash collateral and will remain secured by the same second lien. This is because the new DIP Credit Facility and its first lien replaces the Prepetition Senior Secured Revolver and its first lien against the

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(ii) the purposes for the use of the cash collateral;
(iii) the material terms, including duration, of the use of the cash collateral; and
(iv) any liens, cash payments, or other adequate protection that will be provided to each entity with an interest in the cash collateral or, if no additional
adequate protection is proposed, an explanation of why each entity's interest is adequately protected.
(C) Service. The motion shall be served on: (1) any entity with an interest in the cash collateral; (2) any committee elected under § 705 or appointed under § 1102 of the Code, or its authorized agent, or, if the case is a chapter 9 municipality case or a chapter 11 reorganization case and no committee of unsecured creditors has been appointed under § 1102, the creditors included on the list filed under Rule 1007(d); and (3) any other entity that the court directs.
(2) Hearing.
The court may commence a final hearing on a motion for authorization to use cash collateral no earlier than 14 days after service of the motion. If the motion so requests, the court may conduct a preliminary hearing before such 15 day period expires, but the court may authorize the use of only that amount of cash collateral as is necessary to avoid immediate and irreparable harm to the estate pending a final hearing.
(3) Notice.
Notice of hearing pursuant to this subdivision shall be given to the parties on whom service of the motion is required by paragraph (1) of this subdivision and to such other entities as the court may direct.

current assets. Additionally, because Bankruptcy Code section 552 prevents the second lien from encumbering postpetition property that is not the proceeds or products of prepetition collateral, the Debtors are providing the Prepetition First Lien Noteholders with replacement liens against their postpetition cash, accounts receivable, and inventory. The replacement liens, together with the Debtors' continued maintenance, preservation, and insurance of all the collateral, adequately protect the Prepetition First Lien Noteholders' security interests.

As shown below, adequate protection is designed to protect against diminutions in the value of a security interest caused by a debtor's use, sale, or lease of the collateral. Adequate protection is not required of any equity cushions, as a matter of law. As a practical matter, the Debtors' positive cash flow will improve the position of the Prepetition First Lien Noteholders because more cash collateral will be regenerated than will be used. Moreover, the alternative to the Debtors' use of cash collateral, namely the cessation of the business, would be catastrophic for the Prepetition First Lien Noteholders because the liquidation value of the collateral is a small fraction of the Debtors' value as a going concern.

PERTINENT FACTS

The Debtors incorporate by reference the facts set forth in the Motion and its supporting declarations (the Epstein Declaration and the O'Dowd Declaration).

ARGUMENT

I. ADEQUATE PROTECTION IS REQUIRED ONLY AGAINST DIMINUTION IN THE VALUE OF THE COLLATERAL FROM THE DEBTORS' USE OF IT

A. Use of Cash Collateral Requires Consent or Court Authorization

1. Sections 363(c)(2)[4] and 363(e)[5] of title 11 of the United States Code (the "Bankruptcy Code") require that any entity with an interest in collateral being used, sold, or leased be adequately protected, and that the debtor must acquire the lender's consent or court authorization before using cash collateral.

2. Bankruptcy Code section 361 governs what adequate protection is supposed to accomplish. It makes clear that adequate protection guards against "a decrease in the value of . . . [the lienholders'] interest in" the collateral:

> When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—
> (1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;
> (2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or

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[4] Bankruptcy Code section 363(c)(2) provides:

> (2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless—
> (A) each entity that has an interest in such cash collateral consents; or
> (B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

[5] Bankruptcy Code section 363(e) provides:

> (e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. This subsection also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under section 362).

> (3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

3. Section 361 of the Bankruptcy Code contains a non-exhaustive list of acceptable forms of adequate protection, including replacement liens. *See Resolution Trust Corp. v. Swedeland Dev. Grp. (In re Swedeland Dev. Grp.)*, 16 F.3d 552, 564 (3d Cir. 1994).

B. Adequate Protection is Awarded Only to Prevent Diminution of the Value of the Secured Lender's Interest in the Collateral

4. The Prepetition Secured Lenders' collateral's value will not decrease due to the Debtors' postpetition operations, and thus no adequate protection is required beyond the replacement liens the Debtors are providing. (Although not at issue here, the Debtors are further protecting the noncash collateral of the Prepetition Secured Lenders by providing the same maintenance and insurance provided prepetition.).

5. Courts have repeatedly held that the purpose of adequate protection is to safeguard the secured claimholder from diminution in the value of its interest from the automatic stay during the Chapter 11 reorganization. *See In re 495 Cent. Park Ave. Corp.*, 136 B.R. 626, 631 (Bankr. S.D.N.Y. 1992); *In re Continental Airlines*, 154 B.R. 176, 180 (Bankr. D. Del. 1993) ("[A] party in interest shall be granted adequate protection *when the continuation of the automatic stay* causes that party to suffer a decrease in the value of its property interest."); *Bluebird Partners, L.P. v. First Fid. Bank, N.A.*, 85 F.3d 970, 972 (2d Cir. 1996) ("Generally, the right to adequate protection allows a secured creditor or its representative to propose a method of protecting its interest against the diminution in value of the security during a bankruptcy proceeding."); *In re Columbia Gas Sys., Inc.,* Nos. 91–803, 91–804, 1992 Bankr. LEXIS 2456, at *3-4 (Bankr. D. Del. Feb. 18, 1992).

6. Here, because the Debtors' operations have been and are cash flow positive, the only diminution of the value of the Prepetition First Lien Noteholders' cash collateral stems from section 552 of the Bankruptcy Code,[6] which deprives the Prepetition First Lien Noteholders of liens against postpetition cash that is not the proceeds of prepetition collateral. Therefore, the Debtors are providing the Prepetition First Lien Noteholders with a replacement lien having the same second priority as their prepetition lien held against the Debtors' postpetition current assets. Because the Debtors use cash to manufacture more coated paper and to regenerate cash, there is no diminution. In fact, the Debtors project a positive EBITDA of hundreds of millions of dollars per year, and have not had negative cash flow since their inception.

7. Without a decrease in the value of the collateral, there is no need for adequate protection. *See In re Mullen,* 172 B.R. 473, 476 (Bankr. D. Mass. 1994) ("[T]he value of the creditor's interest in property must be declining if the creditor is to be lacking adequate protection, and the courts have so held."); *In re Oaks Partners, Ltd.*, 135 B.R. 440, 449 (Bankr.

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[6] Section 552 of the Bankruptcy Code provides:

> (a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.
>
> (b) (1) Except as provided in sections 363, 506 (c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.
>
> (2) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

N.D. Ga. 1991); *In re Walters*, 136 B.R. 256, 258 (Bankr. C.D. Cal. 1992); *see also In re 354 E. 66th St. Realty Corp.*, 177 B.R. 776, 782 (Bankr. E.D.N.Y. 1995) ("The purpose or intent of granting adequate protection payments are to maintain the status quo for that creditor and to protect the creditor from diminution or loss of the value of its collateral during the ongoing Chapter 11 case. If that creditor is oversecured or if there is no reason to believe that the collateral will diminish, then adequate protection payments may not be granted." (emphasis added)).

8. When a debtor's postpetition financing primes prepetition liens, which is not the case here, adequate protection ensures that a creditor's collateral is afforded the same level of protection it would have had if there had not been postpetition superpriority financing. Here, the Prepetition Secured Lenders have the same position postpetition as they had prepetition. In *In re Swedeland Dev. Grp.*, the court stated:

> Whether protection is adequate "depends directly on how effectively it compensates the secured creditor for loss of value" caused by the superpriority given to the post-petition loan . . . In other words, the proposal should provide the pre-petition secured creditor with the same level of protection it would have had if there had not been post-petition superpriority financing.

16 F.3d. at 564.

9. Although this is not a hearing regarding adequate protection of the Prepetition First Lien Noteholders' noncash collateral, the Debtors' commitment to continue to maintain, preserve, and insure their noncash collateral as they have always done provides complete protection to the Prepetition First Lien Noteholders. Actions such as maintenance, repair, and insurance can preserve and prevent diminution in the value of the collateral, and thus render any additional adequate protection unnecessary. *See In re Ralar Distribs.*, 166 B.R. 3, 6 (Bankr. D. Mass. 1994) (observes that "[a]ctivities of a debtor can enhance collateral value and thereby

provide adequate protection"); *Confederation Life Ins. Co. v. Beau Rivage, Ltd.*, 126 B.R. 632, 639 (N.D. Ga. 1991) ("Since the rents were used for structural and cosmetic repairs, thereby increasing the occupancy and income of the apartments and making the property more valuable, Confederation Life's security was not depleted."); *In re Holly's, Inc.*, 140 B.R. 643, 696 (Bankr. W.D. Mich. 1992) (insurance policy held by the debtor was considered adequate protection).

10. The collateral of the Prepetition Revolver Lenders and the Prepetition First Lien Noteholders (the "Prepetition Priority Parties") is secured by the Debtors' current assets: (i) present and future cash, (ii) account receivables, (iii) inventory, (iv) intercompany debt, and (v) deposit accounts (the "ABL Collateral"). The Prepetition First Lien Noteholders and the Prepetition Second Lien Noteholders (the "Prepetition Secured Parties") also hold liens against the Debtors' plants, property, and equipment (the "Fixed Collateral," and, together with the ABL Collateral, the "Prepetition Collateral").

11. By any yardstick, the Prepetition Secured Lenders are adequately protected. The Debtors' ongoing cash flow positive operations and their access to the capital provided by the DIP Credit Facility and the use of Cash Collateral will not only preserve the Debtors' liquidity and assets, but will also preserve and enhance the value of the Debtors' businesses.

12. There is no foreseeable risk of diminution of the Prepetition Secured Lenders' collateral. The Debtors are continuously maintaining their plants and keep them in excellent working condition. The Debtors' technicians manage the day-to-day operations and maintain the Debtors' machinery. In some instances, the Debtors engage outside maintenance and repair service providers to fix or maintain their machinery.

13. The Debtors have a repair and maintenance plan for each of their mills. According to the repair and maintenance plan, each mill undergoes extensive maintenance at

least once a year. Because the machinery used in the plants is heavy and sophisticated, during such repairs the plant is shut down and specialized contractors perform extensive maintenance that keeps the machines in excellent condition. Additionally, the Debtors contract to have maintenance vendors on-site to provide immediate and critical repairs to the machines. The Debtors are continuing to implement all repair and maintenance plans and such activity will not be interrupted by these chapter 11 cases. This continuous upkeep protects the underlying encumbered assets from any diminution of value.

14. Further, the Debtors are paying the required premiums on their different insurance policies and thus providing additional assurance that the collateral will not be diminished in any way.[7]

15. The Debtors' everyday business operations as well as capital expenditures and other value-increasing improvements work as a substitution of one sort of Prepetition Collateral for another, and no additional adequate protection is required. *See In re 495 Cent. Park Ave. Corp.*, 136 B.R. 626, 631 (Bankr. S.D.N.Y. 1992) ("[T]here is no question that the property would be improved by the proposed renovations and that an increase in value will result. In effect, a substitution occurs in that the money spent for improvements will be transferred into value. This value will serve as adequate protection for Hancock's secured claim.")

16. Replacement liens can independently provide adequate protection. *See Resolution Trust Corp. v. Swedeland Dev. Group (In re Swedeland Dev. Group)*, 16 F.3d 552, 566 (3d Cir. 1994) (the principle of adequate protection is "demonstrated plainly by the recognition in section 361 that a secured lender may be adequately protected by a replacement lien"); *Save Power Ltd.*

[7] Contemporaneously with the Motion the Debtors filed the *Debtors' Motion for Order Pursuant to Sections 503(b), 363(b), and 105(a) of the Bankruptcy Code (I) Authorizing Continuation of Insurance Programs and Payment of Prepetition Insurance Obligations, and (II) Directing Banks and Financial Institutions to Honor and Process Related Checks and Transfers*, thus making sure that all the Debtors' insurance policies are effective.

v. Pursuit Athletic Footwear (In re Pursuit Athletic Footwear), 193 B.R. 713, 722 (Bankr. D. Del. 1996) (finding a creditor is adequately protected by a replacement lien, and denying a request for additional protection); *Bank of N.Y. Trust Co. NA v. Pac. Lumber Co. (In re Scopac)*, 624 F.3d 274, 278 (5th Cir. 2010) ("Adequate protection . . . in short, it is a payment, replacement lien, or other relief sufficient to protect the creditor against diminution in the value of his collateral during the bankruptcy"). *Collier* also supports the proposition that adequate protection can be satisfied with replacement liens:

> If the trustee proposes to grant, under section 364, a senior lien on property on which the entity has a lien, to secure a loan from a new lender, the trustee must provide adequate protection of the entity's interest in the property. Although usually this protection will take the form of additional or replacement liens . . .

3 COLLIER ON BANKRUPTCY ¶ 361.03 [2] (16th ed. 2011).

17. Because the Debtors' businesses and operations are continuing in the same manner as before the filing of these chapter 11 cases, and all sale proceeds continue to be deposited into the same bank accounts, the Prepetition First Lien Noteholders will still hold a lien (and a replacement lien) on the current assets after the Commencement Date.

18. Further, the Debtors have a positive operating cash flow, which means that the Debtors are earning more than they are spending on an operational level. The use of cash collateral has generated more cash and actually enhanced the value of the cash collateral.[8] Accordingly, the regenerated cash maintains the Prepetition First Lien Noteholders' liens and there has been no diminution of the ABL Collateral.

19. As explained above, there is no diminution in the value of the Prepetition Secured Parties' Prepetition Collateral. Accordingly, in these cases adequate protection requires nothing

[8] According to the Debtors' last 10-Q (filed on August 15, 2011), the adjusted EBITDA was $32 million.

more than the replacement liens, implementing the maintenance and repair plans, purchasing and maintaining insurance policies, and having a positive cash flow. The Debtors' financial and business operations are stable, and thus there is no need to further protect the Prepetition Secured Parties. As stated in *Collier*,

> Even if there is not substantial excess value in the collateral, if the collateral is of relatively stable value there should be no need to protect the creditor against a periodic decline in the value of the collateral.

3 COLLIER ON BANKRUPTCY ¶ 361.03 [5][a] (16th ed. 2011).

C. Adequate Protection is Not Required for an Equity Cushion Giving Rise to Postpetition Interest or Fees

20. Adequate protection protects the value of a secured creditors' collateral as of the day it is requested and is not intended to preserve an 'ever-green' equity cushion for the creditor. Thus, an oversecured claimholder is not entitled to receive periodic protection[9] to preserve the value of its equity cushion. *See Orix Credit Alliance v. Delta Resources (In re Delta Resources)*, 54 F.3d 722, 730 (11th Cir. 1995) ("[A]n oversecured creditor's interest in property which must be adequately protected encompasses the decline in the value of the collateral only, rather than perpetuating the ratio of the collateral to the debt.").

21. In *Timbers*, the United States Supreme Court held that adequate protection does not include postpetition interest on the secured portion of a claim. *See United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 372-73 (U.S. 1988). While an oversecured creditor is entitled to postpetition interest pursuant to section 506(b) of the Bankruptcy Code, these payments are not required to be made until after confirmation - not periodically throughout

[9] According to section 361(1) of the Bankruptcy Code "periodic cash payments" are only one form of adequate protection. Nevertheless, the determination of adequate protection can come in many forms and is dependent on the facts of each case. *See In re Swedeland Develop. Grp., Inc.*, 16 F.3d at 564.

the chapter 11 cases.[10] *See Fin. Sec. Assur. Inc. v. T-H New Orleans Ltd. P'shp. (In re T-H New Orleans Ltd. P'shp.)*, 116 F.3d 790, 799 (5th Cir. 1997) ("However, as *Timbers* dictates, accrued interest under § 506(b) is not paid to an oversecured creditor until the plan's confirmation or its effective date, whichever is later."); *Delta Resources*, 54 F.3d at 729 ("[A]n oversecured creditor . . . is entitled to receive postpetition interest as part of its claim at the time of confirmation of a plan or reorganization, that is, at or near the conclusion of the bankruptcy case."); *Key Bank N.A. v. Milham (In re Milham)*, 141 F.3d 420, 423 (2d Cir. 1998) (noting that "[a]n oversecured creditor . . . is entitled to receive postpetition interest as part of its claim at the time of confirmation of a plan) (quoting *Delta Resources,* 54 F.3d. at 729); *In re Harko*, 211 B.R. 116, 119 (B.A.P. 2d Cir. 1997) (same); *Wills v. Heritage Bank (In re Wills)*, 226 B.R. 369, 378 n.14 (Bankr. E.D. Va. 1998).

22. Put differently, an oversecured claimholder's entitlement to postpetition interest under section 506(b) of the Bankruptcy Code does not create an entitlement to receive postpetition interest payments as adequate protection. *See In re M4 Enters. Inc.*, 183 B.R. 981, 985 (Bankr. N.D. Ga. 1995) ("[T]he Court concludes that a [n] [oversecured] creditor is not entitled to periodic payments of postpetition interest as adequate protection under 11 U.S.C. § 363(e) for the Trustee's use of cash collateral."). Further, the court in *Delta Resources* specifically held that an oversecured claimholder is not entitled to receive postpetition interest on its collateral during the automatic stay to assure adequate protection:

> we conclude that 11 U.S.C. § 506(b), providing for postpetition interest on oversecured claims, read in *pari materia* with 11 U.S.C. § 362(d)(1), concerning conditioning the automatic stay on adequate protection, and 11 U.S.C. § 502, regarding the allowance of claims, requires that the payment of accrued postpetition interest

[10] Payment of postpetition interest pursuant to section 506(b) will be made at the end of a chapter 11 case because the determination of a creditor's secured status occurs at or near a bankruptcy's conclusion.

> to an oversecured creditor await the completion of reorganization or confirmation of the bankruptcy case. The *ratio decidendi* enunciated by the Supreme Court in *Timbers* that an undersecured creditor is not entitled to receive postpetition interest on its collateral during the stay to assure adequate protection under 11 U.S.C. § 362(d)(1) applies equally well to an oversecured creditor.

54 F.3d at 730 (emphasis added).

23. *Timbers* and *In re Delta Resources* show that payment of postpetition interest to an oversecured creditor is not required to maintain adequate protection and is corroborated by *Collier*, which states that the right to receive postpetition interest does not trigger a right to receive interest payments as adequate protection:

> It seems settled that under *Timbers of Inwood Forest*, interest accrues only up to the value of the creditor's "interest" in the collateral under section 506(a); interest itself should not trigger a right to adequate protection payments even if the interest accrual consumes the entire equity in the property.

3 COLLIER ON BANKRUPTCY ¶ 361.03 [1] (16th ed. 2010) (emphasis added).

24. Put differently, adequate protection is not intended to protect the creditors' right to continue to accrue interest, and creditors have no right to adequate protection of an equity cushion. *See Id.* at ¶ 361.03 [2][a].

II. THE DEBTORS SEEK AUTHORITY TO MAKE RECHARACTERIZABLE PAYMENTS OF AMOUNTS EQUAL TO POSTPETITION INTEREST AND PROFESSIONAL FEES TO PREPETITION FIRST LIEN NOTEHOLDERS

A. The Debtors Seek Authority in Their Discretion to Make Payments in the Amounts of Interest and Fee Payments to the Prepetition First Lien Noteholders

25. As described above, there is no diminution in the value of the Prepetition Priority Parties' collateral, and the Debtors are not required to make any adequate protection payments.

As further shown above, the Debtors are not required to make postpetition interest payments prior to the effective date of a chapter 11 plan.

26. Nevertheless, the Debtors may seek, at their sole discretion, to continue making payments in the amounts of postpetition interest and fee payments (i) in exchange for releases of claims to default interest, and (ii) to avoid compound interest claims. Such payments, if any, will be made in the Debtors' sole discretion and in accordance with the Debtors' business judgment and will depend, among other things, on the Debtors' liquidity. In *In re U.S. Concrete, Inc.*, the court ordered:

> [T]he Debtors were authorized to repay the Prepetition Obligations, which such repayment reflects the Debtors' exercise of prudent business judgment because the Prepetition Lenders are oversecured claimants, and, were the Prepetition Obligations to remain outstanding for the duration of these Cases, the Prepetition Lenders would be entitled to postpetition interest pursuant to section 506(b) of the Bankruptcy Code, potentially, at the default rate set forth in the Prepetition Credit Agreement. Repaying and discharging the Prepetition Obligations at the outset of these Cases, therefore, maximizes the value of the Debtors' estates.

Case No. 10-11407 (PJW), 2010 Bankr. LEXIS 6016, at*9 (Bankr. D. Del. May 21, 2010).

27. Similarly "there is significant case law to support the use of the business judgment standard in approving a consensual Cash Collateral Order." *See Aurelius Capital Master, Ltd. v. Tousa Inc.*, Case No. 08-61317-CIV-GOLD, 2009 U.S. Dist. LEXIS 12735, at *59 (S.D. Fla. Feb. 5, 2009). Courts generally approve postpetition financing and the use of cash collateral when the terms are in the best interests of the debtors, their creditors and their estate; appear fair and reasonable; reflective of the debtors' exercise of business judgment; and are supported by reasonably equivalent value and fair consideration. *See, e.g., In re Bear Island Paper Co., L.L.C.*, Case No. 10-31202 (DOT), 2011 Bankr. LEXIS 1884, at *21 (Bankr. E.D.

Va. Mar. 30, 2011); *In re CB Holding Corp.*, 447 B.R. 222, 227 (Bankr. D. Del. 2010); *In re NEC Holdings Corp.*, Case No. 10-11890 (PJW), 2010 Bankr. LEXIS 6025, at *21 (Bankr. D. Del. July 16, 2010); *In re Mastercraft Interiors, Ltd.*, Case No. 06-12769 PM, 2006 Bankr. LEXIS 4387, at *12 (Bankr. D. Md., May 19, 2006).

B. The Debtors are Reserving the Right to Characterize the Payments They Remit

28. Pursuant to section 506(b) of the Bankruptcy Code, a creditor is entitled to receive postpetition interest and fees only if it is oversecured. *See* 11 U.S.C. §506(b); *see also Timbers*, 484 U.S. at 372-73. Therefore, the Debtors reserve the right to recharacterize any payments they may make before confirmation as interest, fees, or principal, once the valuation of the Prepetition First Lien Noteholders' collateral is made in connection with confirmation. The Debtors reserve the right to treat any interim payments to creditors as principal if the Court does not ultimately determine those creditors made substantial contributions.

29. Such recharacterization and application of the payments toward the principal debt are in line with the Bankruptcy Code's policies. *See Baybank-Middlesex v. Ralar Distribs. (In re Ralar Distribs.)*, 182 B.R. 81, 86 (D. Mass. 1995) ("As a policy matter, providing the undersecured creditor with postpetition interest would leave it in a better position than it found itself in at the time of the filing of the automatic stay.").

30. Indeed, courts apply postpetition interest paid to undersecured creditors towards the reduction of principal debt. *See In re Wabash Valley Power Ass'n*, 72 F.3d 1305, 1322 (7th Cir. 1995) ("Post-petition debt payments to an undersecured creditor which are taken from after-acquired property will thus ordinarily be used to reduce the principal amount of the secured debt"); *In re Erie Playce LLC*, 441 B.R. 905, 909 (Bankr. N.D. Ill. 2010) ("Because Harris is undersecured, it is not entitled to apply the monthly payments under § 362(d)(3)(B)(ii) to

postpetition interest. The payments must be applied to the principal obligation."); *Gonzalez Class Action Plaintiffs v. Freedom Communs. Holdings, Inc. (In re Freedom Communs. Holdings, Inc.)*, Civ. No. 09-825-SLR, 2009 U.S. Dist. LEXIS 113725 (D. Del. Dec. 4, 2009) (denying appeal and holding that an adequate protection package that provided for payment of interest and fees to undersecured creditors was legal because it included a recharacterization provision); *In re Jenkins*, 99 B.R. 949, 952 (Bankr. W.D. Mo. 1988). In *In re Kalian*, 169 B.R. 503 (Bankr. D.R.I. 1994), the creditor was undersecured and there was no diminution of the collateral's value. Thus, the court held that any postpetition interest paid as adequate protection should be applied to the principal debt:

> Northeast is precluded from collecting post-petition interest payments, both under 11 U.S.C § 506(b) and the holding in *Timbers* . . . any postpetition payments of rental income to Northeast should be applied to the principal balance of its secured claim, as long as Northeast remains undersecured.

Id. at 507 (emphasis added).

31. Similarly, courts acknowledge that adequate protection payments paid to a creditor who is not entitled to such payments will be applied towards the principal rather than interest. *See Confederation Life Ins. Co. v. Beau Rivage, Ltd.*, 126 B.R. 632, 639 (N.D. Ga. 1991) ("If the collateral does not depreciate and the payments are therefore not necessary to compensate the creditor, they may be applied toward the deferred payments in a Chapter 11 plan."); *Nantucket Investors II v. Cal. Fed. Bank (In re Indian Palms Assocs.)*, 61 F.3d 197 (3d Cir. 1995); *Contrarian Funds LLC v. Aretex LLC (In re WestPoint Stevens, Inc.)*, 600 F.3d 231, 260-61 (2d Cir. 2010). In *In re 354 E. 66th St. Realty Corp.*, the court stated:

> When adequate protection payments are granted, in the event that the value of the collateral decreases, and the secured creditor cannot realize the full value of the collateral to support its claim as of the date of the filing of the petition, it may keep the adequate

> protection payments since it was intended that these payments protect the secured creditor from loss. However, unless there is a diminution in the value of the creditor's interest, i.e. its collateral, the adequate protection payments should be applied to reduce the debt.

177 B.R. at 782 (emphasis added).

III. THE DEBTORS SEEK AUTHORITY TO MAKE PAYMENTS FOR PREPETITION SECOND LIEN NOTEHOLDERS' PROFESSIONAL FEES

A. The Debtors Seek Authority in their Discretion to Make Professional Fee Payments to the Prepetition Second Lien Noteholders

32. The Prepetition Second Lien Noteholders are secured only by a second lien on the Fixed Assets and have no security interest in cash collateral. The Debtors' DIP Credit Facility does not affect the rights of the Prepetition Second Lien Noteholders, and no additional adequate protection is required pursuant to section 364(d) of the Bankruptcy Code. Pursuant to the DIP Credit Facility, the DIP Lenders will be granted a first priority lien on only the Debtors' unencumbered assets and ABL Collateral, and junior liens on the Debtors' Fixed Collateral. The DIP Lenders will effectively step into the shoes of the Prepetition Revolver Lenders, and will not diminish the Prepetition First Lien Noteholders' or Prepetition Second Lien Noteholders' relative rights in the Prepetition Collateral.

33. Further, the Prepetition Second Lien Noteholders are likely undersecured or unsecured and are not entitled to (i) any postpetition interest or fee payments pursuant to section 506(b) of the Bankruptcy Code, or (ii) any adequate protection for the reason stated in Section I of this memorandum. If Prepetition Second Lien Noteholders are completely unsecured, they will have no entitlement to adequate protection. *See In re 620 Church Street Bldg. Corp.*, 299 U.S. 24 (1936) (second lien holders were not entitled to adequate protection when there was no value left in the underlying encumbered asset after the first lien debt); *In re Lopez Soto*, 764 F.2d

23, 26 (1st Cir. 1985) ("[T]he first two mortgages exhaust the property's value. It is well established that in such circumstances a bankruptcy court will often treat a lienholder essentially like an unsecured creditor.").

34. Nevertheless, the Debtors seek, in their sole discretion, to make certain payments in an amount equal to professional fees rendered by the Prepetition Second Lien Noteholders' advisors, subject to the Court's ultimate determination as to whether the Second Lien Lenders make a substantial contribution resulting in an allowable claim pursuant to section 503(b) of the Bankruptcy Code. The reason for this request is that this reorganization may well depend on the Prepetition Second Lien Noteholders' ability to refinance all or a portion of the first lien debt. It is in the interest of the reorganization for them to work on this refinancing with the necessary professionals.

35. The Debtors believe that such authority to make professional fee payments to the Prepetition Second Lien Noteholders, will incentivize and expedite the administration of these cases and will prevent unwarranted litigation and benefit the estates and the reorganization.

36. Further, the Debtors and the Prepetition Second Lien Noteholders have been negotiating and exchanging opinions with respect to these chapter 11 cases even before the Commencement Date. Accordingly, prior to the Commencement Date, the Debtors and the Prepetition Second Lien Noteholders entered into an agreement pursuant to which the Debtors paid the Prepetition Second Lien Noteholders' advisors' fees.

B. Reimbursement for Professional Fees will be Made Only If the Second Lien Lenders Meet the Substantial Contribution Standard

37. Section 503(b)(3)(D) of the Bankruptcy Code permits a court to allow, as administrative expenses, the actual and necessary expenses incurred by a creditor who makes a substantial contribution to a chapter 11 case. *See* 11 U.S.C. § 503(b)(3)(D). Section 503(b)(4)

allows for reimbursement of reasonable compensation for services rendered and for reimbursement of actual and necessary expenses incurred by an attorney of any such entity. *See* 11 U.S.C. § 503(b)(4); *Lebron v. Mechem Fin., Inc.*, 27 F.3d 937, 943 (3d Cir. 1994).

38. Section 503(b) "reconciles two conflicting objectives of encouraging participation in the reorganization process and preserving the value of the estate for creditors." *See In re Essential Therapeutics, Inc.*, 308 B.R. 170, 174 (Bankr. D. Del. 2004). While it is a "well-settled rule that [Section 503(b) is] to be narrowly construed," the courts have "wide discretion to determine the amount of expenses awarded under § 503." *In re Glickman, Berkowitz, Levinson, & Weiner, P.C.*, 196 B.R. 291, 294 (Bankr. E.D. Pa. 1996) (citing *In re Lister*, 846 F.2d 55, 56 (10th Cir. 1988)).

39. The phrase "substantial contribution" is not defined in the Bankruptcy Code. Courts, however, generally apply a two-step analysis in considering applications for reimbursement of fees under a theory of substantial contribution. *See In re Summit Metals, Inc.*, 379 B.R. 40, 50-55 (Bankr. D. Del. 2007). First, the court evaluates whether the applicant's efforts pass the substantial contribution test. *Id.* at 50-51. Second, the court reviews whether the fees and expenses of the applicant were actual and necessary. *Id.* at 54.

40. In evaluating whether the substantial contribution test is satisfied, a court must determine whether "the efforts of the applicant resulted in an actual and demonstrable benefit to the debtor's estate and the creditors." *Lebron*, 27 F.3d at 944 (quoting *In re Lister*, 846 F.2d at 57); *accord In re FF Holdings Corp.*, 343 B.R. 84, 87 (D. Del. 2006); *In re Essential Therapeutics, Inc.*, 308 B.R. 170, 176 (Bankr. D. Del. 2004) (finding that services such as drafting plan provisions, participating in hearings and providing assistance during the reorganization process provided a substantial contribution to the estate). Stated otherwise,

compensable services are those "which foster and enhance . . . the progress of reorganization." *See Lebron*, 27 F.3d at 944 (quoting *In re Consol. Bancshres, Inc.*, 785 F.2d 1249, 1253 (5th Cir. 1986)); *see also In re Syntax-Brillian Corp.*, Case No. 08–11407 (BLS), 2009 WL 1606474 (Bankr. D. Del. June 5, 2009) (factors courts consider include whether the services (a) conferred a direct benefit upon the estate, (b) were provided to benefit the estate itself or all the parties in the bankruptcy case, and (c) were duplicative of services performed by others).

41. In most situations where section 503(b)(4) compensation has been awarded, the creditor "took an active role in facilitating the negotiation and successful confirmation of the plan." *In re Granite Partners LP*, 213 B.R. 440, 446 (Bankr. S.D.N.Y. 1997); *see also In re Mirant Corporation*, 354 B.R. 113, 1933-34 (Bankr. N.D. Texas 2006).

42. The benefit must "be more than an incidental one arising from activities the applicant has pursued in protecting his or her own interests." *Lebron*, 27 F.3d at 944. Reimbursement is not permitted for activities of creditors "which are designed primarily to serve their own interests and which, accordingly, would have been undertaken absent an expectation of reimbursement from the estate." *Id.*

43. Nonetheless, the "existence of self-interest cannot in and of itself preclude reimbursement." *Id.* A creditor "who has engaged legal counsel, and as such provided legal services which have directly and materially contributed to a reorganization, and which were not rendered solely on behalf of that creditor's own interest, should be reimbursed for the cost of the legal services and related expenses incurred." *See Glickman*, 196 B.R. at 296 (citing *In re U.S. Lines, Inc.*, 103 B.R. 427, 430 (Bankr. S.D.N.Y. 1989)).

C. If the Prepetition Second Lien Noteholders Do Not Meet the Substantial Contribution Standard the Debtors Reserve the Right to Recharacterize those Payments to their Advisors As Principal or to Seek Disgorgement

44. The Debtors, at their sole discretion, request authority to pay the Prepetition Second Lien Noteholders' advisors. Since it is unlikely that the Prepetition Second Lien Noteholders will turn out to be oversecured, the allowability of payments made to their advisors during the case will depend on the Court's determination on whether they made substantial contributions to these chapter 11 cases.

45. Accordingly, the Prepetition Second Lien Noteholders' "activities must facilitate progress in the case, rather than . . . retard or interrupt." *See In re Summit Metals, Inc.*, 379 B.R. at 50 (quoting *In re Gurley*, 235 B.R. 626, 636 (Bankr. W.D. Tenn. 1999)). Thus, if payment of professional fees to the Prepetition Second Lien Noteholders' advisors were paid, and no substantial contribution was made, the Debtors reserve the right to recharacterize the professional fees as payments paid as principal or to seek disgorgement.

IV. CONCLUSION

46. The adequate protection the Debtors are providing the Prepetition First Lien Noteholders in the form of replacement liens, maintenance, and insurance are more than sufficient to warrant authorization for the Debtors to use cash collateral. By authorizing the Debtors to pay amounts equal to interest and fees to the Prepetition First Lien Noteholders and amounts equal to professional fees to the Prepetition Second Lien Noteholders, the estates will benefit by avoiding default interest and compound interest, and by reaching a speedier, consensual reorganization. Moreover, the estates will remain protected by retaining the power to

characterize all payments as principal at the time of confirmation or to seek disgorgement if required.

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