

Peter S. Partee, Sr.  
Michael P. Richman  
Andrew Kamensky  
Richard P. Norton  
Robert A. Rich  
HUNTON & WILLIAMS LLP  
200 Park Avenue, 53<sup>rd</sup> Floor  
New York, New York 10166-0136  
(212) 309-1000

*Proposed Attorneys for Debtors and Debtors-in-Possession*

UNITED STATES BANKRUPTCY COURT  
SOUTHERN DISTRICT OF NEW YORK

In re:	}	Chapter 11
ATARI, INC., <i>et al.</i> ,	}	Case No. 13-10176_( <u>    </u> )
Debtors. <sup>1</sup>	}	Joint Administration Requested

**MOTION OF THE DEBTORS AND DEBTORS-IN-POSSESSION  
FOR ENTRY OF AN ORDER (I) AUTHORIZING, BUT NOT DIRECTING, THE  
DEBTORS TO PAY PREPETITION WAGES, SALARIES AND BENEFITS, (II)  
AUTHORIZING, BUT NOT DIRECTING, THE DEBTORS TO PAY PREPETITION  
PAYROLL TAXES, WITHHOLDINGS AND REIMBURSABLE EXPENSES;  
(III) AUTHORIZING, BUT NOT DIRECTING, THE DEBTORS TO CONTINUE  
EMPLOYEE BENEFIT PROGRAMS ON A POSTPETITION BASIS; AND  
(IV) AUTHORIZING ALL FINANCIAL INSTITUTIONS TO HONOR  
ALL RELATED CHECKS AND ELECTRONIC PAYMENT REQUESTS**

The debtors and debtors-in-possession in the above-captioned cases (collectively, the “Debtors”), by and through their proposed undersigned counsel, hereby move (the “Motion”) for the entry of an order, the proposed form of which is attached hereto as **Exhibit A** (the “Proposed Order”), pursuant to sections 105(a), 363(b)(1), 507(a)(4), 507(a)(5), 1107(a) and 1108 of Title 11 of the United States Code, 11 U.S.C. §§ 101-1532 (as amended, the “Bankruptcy Code”) and Rules 6003(b) and 6004(h) of the Federal Rules of Bankruptcy Procedure (the “Bankruptcy

<sup>1</sup> The other Debtors are Atari Interactive, Inc., Humongous, Inc., and California U.S. Holdings, Inc.

Rules”): (a) authorizing, but not directing, the Debtors, in the exercise of their business judgment, to pay the pre-petition wages, salaries and benefits of their employees, (b) authorizing, but not directing, the Debtors, in the exercise of their business judgment, to pay employee-related taxes, withholdings and reimbursable expenses; (c) authorizing, but not directing, the Debtors, in the exercise of their business judgment, to continue employee benefit programs on a postpetition basis; (d) authorizing all financial institutions to receive, process, honor and pay all checks presented for payment and electronic payment requests relating to the foregoing; and (e) waiving any applicable stays that would serve to limit the immediate effectiveness of an order granting the foregoing. In support of the Motion, the Debtors submit the *Declaration of Robert A. Mattes (I) In Support of Chapter 11 Petitions and First Day Motions and (II) Pursuant To Local Bankruptcy Rule 1007-2* (the “First Day Declaration”). In further support of the Motion, the Debtors respectfully represent as follows:

### **I. Background**

1. On January 21, 2013 (the “Petition Date”), each of the Debtors filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York (the “Court”). The Debtors continue to operate their businesses and manage their properties as debtors-in-possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code. The Debtors have, pursuant to a separate motion, moved the Court for entry of an order authorizing joint administration of these chapter 11 cases.

2. No request for the appointment of a trustee or an examiner has been made in these cases and no statutory committees have been appointed or designated.

3. A description of the Debtors’ businesses, the reasons for filing these chapter 11 cases and the relief sought from this Court to allow for a smooth transition into operations under

chapter 11 is set forth in the First Day Declaration, which is being filed contemporaneously with this Motion.

**A. Overview of the Debtors' Workforce and Employee Obligations**

4. As of the Petition Date, Debtor Atari, Inc. ("Atari") has forty-eight (48) employees, including 47 full-time employees and 1 part-time employee (collectively, the "Employees"). The other Debtors do not have any employees. The Debtors also work directly with two individuals working as independent contractors as set forth below.

5. Of the Employees, 44 are paid salary and 4 are paid on an hourly basis. No Employee is represented by a union or covered by a collective bargaining agreement. The Employees perform a variety of critical functions, including sales, accounting, administration, finance, management and other tasks. The Employees' highly specialized skills, knowledge and understanding of the Debtors' businesses and operations are essential to achieve an effective reorganization.

6. To maintain morale and stability of the Employees during this critical time, the Debtors, by this Motion, seek authority to pay and honor, in their sole discretion, certain prepetition claims and obligations related thereto for, among other things, wages, salaries, payroll services, federal, state and local withholding taxes, and other amounts withheld (including Employees' share of insurance premiums, taxes, and 401(k) contributions), health insurance, workers' compensation benefits, vacation time and other paid time off, short- and long-term disability, and all other benefits that the Debtors have historically provided to the Employees in the ordinary course of business (collectively, the "Employee Obligations"), to pay all costs incident to the Employee Obligations, and to continue to pay and honor the Employee Obligations in the ordinary course of business on a postpetition basis.

**B. Employee Wages, Reimbursable Expenses,  
and Independent Contractor Compensation**

**i. Unpaid Wages**

7. The Debtors pay their salaried Employees semi-monthly on a current basis. The four hourly employees are paid approximately two weeks in arrears. The average gross semi-monthly payroll for the Employees is \$258,600. The next scheduled payroll date is on January 31, 2013, for the pay period of January 16, 2013 through and including January 31, 2013. The vast majority of Employees are paid by direct deposit through electronic transfer of funds directly to the Employees' accounts, but some Employees may be paid by check.

8. As of the Petition Date, the Debtors believe that approximately \$90,000 is unpaid on account of wages and salaries (but excluding PTO (as defined below)) earned prior to the Petition Date (the "Unpaid Wages"). The majority of the Unpaid Wages remain unpaid because they have accrued between the last payroll date (January 15<sup>th</sup>) and the Petition Date (January 21<sup>st</sup>), but do not become due and payable until the next payroll date (January 31<sup>st</sup>). The Debtors believe that certain Unpaid Wages may remain outstanding due to a number of other factors, including (a) discrepancies that exist between amounts paid prepetition and the amounts that should have been paid, and (b) the possibility that some prepetition checks may have not cleared before the Petition Date.

9. The Debtors do not believe that Unpaid Wages as to any individual Employee exceeds the priority cap of \$11,725 under section 507(a)(4) of the Bankruptcy Code and, thus, seek authority to pay any Unpaid Wages in the ordinary course of business and consistent with past practices.

**ii. Reimbursable Expenses**

10. In the ordinary course of business, the Debtors reimburse Employees for certain approved, reasonable expenses incurred in the scope of their employment or service (the “Reimbursable Expenses”). The Reimbursable Expenses include, among other things, business-related travel expenses, meals, hotels, flights, and car rentals. In most cases, Employees pay such expenses directly from their own funds and are reimbursed upon the submission of a claim, with appropriate supporting documentation, itemizing the business expenses. All such expenses are incurred with the understanding that they will be reimbursed by the Debtors in accordance with the Debtors’ reimbursement policy.

11. Although the Debtors request that reimbursement requests be submitted promptly, it is possible that a few Employees were not able to comply with such requests. Accordingly, the Debtors are unable to provide a detailed amount of unpaid prepetition Reimbursable Expenses at this time because it is likely that Employees will submit requests for reimbursement of Reimbursable Expenses incurred prepetition after the Petition Date. Based on historical practices, however, the Debtors estimate that the total obligation as of the Petition Date does not exceed \$15,000 (the “Unpaid Reimbursable Expenses”). The Debtors seek authorization to pay all Unpaid Reimbursable Expenses and to continue to pay Reimbursable Expenses in the ordinary course of business in accordance with their expense reimbursement policy.

**iii. Independent Contractor Compensation**

12. In addition to its Employees, in the ordinary course of business, the Debtors work directly with 2 individuals working as independent contractors (the “Independent Contractors”). The Debtors typically pay monthly invoices for work performed by the Independent Contractors in accordance with the terms of the agreements with such personnel (the “Independent

Contractor Compensation”). The first Independent Contractor provides product development services at a rate of \$37.00 per hour, and works approximately 40 hours per week for the Debtors on site in the Debtors’ Los Angeles office. The second Independent Contractor provides graphic design services at a rate of \$40.00 per hour, and works approximately 20 hours per week for the Debtors remotely. The Debtors estimate that, as of the Petition Date, the Independent Contractors are owed less than \$10,000 in the aggregate.

13. The Debtors are concerned that the Independent Contractors may refuse to work if they are not paid for their services. Accordingly, the Debtors seek to honor and pay the unpaid prepetition amounts on account of Independent Contractor Compensation. In addition, the Debtors seek authority, in their sole discretion, to continue to honor and pay the Independent Contractor Compensation in the ordinary course of business, as routinely done prior to the Petition Date.

**C. Employee Health and Welfare Benefits**

14. The Employees and certain of their dependents and beneficiaries are generally entitled to receive other forms of normal and customary compensation, including medical, dental and vision benefits, short-and long-term disability coverage, and other benefits that the Debtors have historically provided in the ordinary course of business (but not including the 401(k) plan) (collectively, the “Health and Welfare Benefits”), as described below:

Benefit	Gross Monthly Cost	Employee Contribution	Net Monthly Cost to Debtors
Health, Dental & Vision	\$58,000	\$7,000	\$51,000
Executive Ins.	\$4,000	-	\$4,000
Group Term Life Ins., AD&D, Short- and Long-Term Disability	\$3,000	-	\$3,000

Legal Plan		Fully paid by Employees through payroll deductions	
Voluntary Life Ins. and AD&D	-	Fully paid by Employees through payroll deductions	\$0
<b>Total</b>			\$58,000

15. The monthly cost to administer the Health and Welfare Benefits is approximately \$58,000 per month net of Employee contributions. The Debtors estimate that, as of the Petition Date, no prepetition cash obligations remain to be paid with respect to the Health and Welfare Benefits. The Debtors request authority to (a) continue the Health and Welfare Benefits in the ordinary course of business; and (b) pay any prepetition amounts related thereto, including premiums and administration fees, to the extent that the Debtors become aware of amounts that are unpaid as of the Petition Date.

16. The Debtors also pay a third party firm to assist in administering the payments of health care benefits to former employees on COBRA status. The Debtors estimate that any amounts outstanding as of the Petition Date to administer are minimal but request authority to pay such amounts.

17. The Debtors are required to provide disability benefits under the New York Disability Benefits Law (the “DBL”), the state disability insurance program that provides New York employees with income replacement in case of disability caused off-the-job. The carrier for the Debtors’ DBL policy is National Benefit Life Insurance. The policy is paid quarterly and costs the Debtors approximately \$300 per quarter. The Debtors estimate that the outstanding obligations as of the Petition Date under the DBL policy are less than \$500 and seek to remit all such amounts due.

**D. 401(k) Plan**

18. The Debtors maintain a retirement savings plan pursuant to section 401(k) of the Internal Revenue Code (the "401(k) Plan"). Fidelity Investments ("Fidelity") and Preferred Pensions provide services in connection with the 401(k) Plan. Fidelity maintains a schedule of permissible investment options for the plan, record-keeping services, education and enrollment services, contribution processing services, fiduciary advice, and other related services in connection with the 401(k) Plan. The Debtors pay Fidelity an annual fee of approximately \$4,500 which is paid on or around payroll dates by check or deducted from the Debtors' forfeiture account. Preferred Pensions reviews preliminary annual statements prepared by the Debtors, performs testing to ensure compliance with the Internal Revenue Code, and provides other related services in connection with the 401(k) Plan. Preferred Pension is owed \$2,000 as of the Petition Date.

19. The Debtors make discretionary matching contributions to the Employee 401(k) accounts of 100% of up to the first 3% contributed by each individual Employee, and 50% of the next 6% contributed by each individual Employee (the "Matching Contribution"). Matching Contributions are paid quarterly, and the Employee must be employed by Atari through the last day of the quarter to be eligible for the Matching Contribution. The Debtors owe approximately \$23,700 in Matching Contributions for the quarter ending December 31, 2012, which is scheduled to be funded substantially from the 401(k) Plan's existing forfeiture account with less than \$1,000 to be paid from the Debtors' cash.<sup>2</sup> The Debtors request authority to continue the

---

<sup>2</sup> Because the Employees' 401(k) benefits vest over time, any unvested funds from a prior employee that has withdrawn his or her vested funds are moved to, and maintained in, a "forfeiture account." The forfeiture account is required by law to remain inside the 401(k) Plan but may be used by the employer to, among other things, make its matching contributions. The current balance in the Debtors' 401(k) Plan's forfeiture account is sufficient to fund the Debtors' Matching Contributions accrued prior to the Petition Date.

401(k) Plan in the ordinary course of business, and to pay Fidelity and Preferred Pensions any related prepetition amounts incidental to the administration of the 401(k) Plan.

**E. Paid Time Off**

20. The Employees are eligible to accrue paid time-off (“PTO”) for vacation, personal, and sick days as described in the following paragraphs. The Debtors request authority to honor, in the ordinary course of business, the PTO liabilities that are owed to their Employees. The Debtors estimate that approximately \$312,000 of earned but unused PTO has accrued as of the Petition Date. In a small number of cases, the amount of combined unused PTO and Unpaid Wages for an individual Employee would exceed the \$11,725 statutory cap.<sup>3</sup> Unused PTO, however, is not a current cash payment obligation, as Employees are only entitled to cash payment for accrued and unused PTO in the event the Employees cease to be employed by the Debtors.

21. The Debtors provide vacation time to all full-time Employees, and all part-time employees working 30 hours or more per week (on a pro-rated basis), as PTO (the “Vacation Time”). The Debtors structure their vacation policy based on the applicable Employee’s length of service to the company. Full-Time Employees start to accrue Vacation Time for each calendar year at the following rates:

Years of Employment	Monthly Accrual Rate (in Days)	Annual Accrual	Maximum Accrual
Less than 3 years	1.25 days per month	15 days	15 days
3+ years of employment	1.67 days per month	20 days	20 days

<sup>3</sup> The Debtors believe that 7 Employees have unused PTO which, combined with their Unpaid Wages, would be in excess of the \$11,725 statutory cap as to each Employee. The aggregate combined unpaid PTO and Unpaid Wages in excess of the cap is approximately \$64,000.

Part-time Employees working 30 hours or more per week accrue monthly vacation at a rate of one-half the time listed on the table above. When an Employee elects to take Vacation Time, that Employee is paid his or her regular salaried or hourly pay. An Employee is only entitled to a cash payment for unused Vacation Time in the event that such Employee is terminated from the Debtors' employment prior to using allotted Vacation Time.

22. The company observes the major holidays celebrated in the United States. At times, the Debtors requests that an Employee work on a company-observed holiday. Employees who work on an observed holiday are eligible for equivalent time off ("Working Holiday Time"). An Employee is only entitled to a cash payment for unused Working Holiday Time in the event that such Employee is terminated from the Debtors' employment prior to using allotted Working Holiday Time.

23. Employees are eligible for sick leave due to illness or injury ("Sick Leave"). Employees accrue Sick Leave benefits at the rate of 5 days per calendar year. Sick Leave benefits are carried over from one calendar year to the next until a maximum of 15 days' worth of sick time has been accrued.

24. The Debtors also allow their full-time Employees, under certain circumstances, to take bereavement leave upon the death of a member of his/her immediate family, and upon request upon the death of a non-immediate family member or close personal friend ("Bereavement Leave"). Full-time Employees generally will be granted five (5) days off with pay for bereavement but may be eligible for up to a maximum of ten (10) days off with pay for bereavement if and when travel is involved. Employees are not entitled to cash payments in the event they choose not to take an authorized Bereavement Leave.

25. Generally, all Employees required to serve jury duty will be paid their regular pay, less any amount of pay the Employee receives as compensation from the government, for an absence of up to 15 days. For an absence in excess of 15 days, the Debtors, at their option, may continue to pay the Employee his or her regular pay less any amount of pay the Employee receives as compensation from the government.

**F. Severance**

26. In the ordinary course of business, the Debtors maintain a severance policy (the “Severance Policy”) that entitles Employees terminated involuntarily to severance depending on the Employees’ position and length of service. Severance is paid in installments each pay period, at the same level of pay received prior to termination, for a set period of time of up to a maximum of one year.

27. Payments made under the Severance Policy are provided to former Employees in exchange for releases entered into with those former Employees, whereby the Employees release claims otherwise held against the Debtors. As of the Petition Date, one former non-insider Employee is entitled to severance payments under the Severance Policy. That former Employee signed a general termination and release agreement on June 6, 2012, and is scheduled to be paid \$10,416.66 per pay period, or \$104,166.60 in the aggregate, under the Severance Policy through June 15, 2013 (the “Unpaid Severance”).

28. As described below, the Debtors seek entry of an order authorizing, but not directing, the Debtors to continue making payments of the Unpaid Severance in the ordinary course, and to continue the Severance Policy on a postpetition basis. The Debtors will not provide insiders (as defined in the Bankruptcy Code) with benefits under the Severance Policy if doing so would violate section 503(c)(2) of the Bankruptcy Code.

**G. Workers' Compensation**

29. The Debtors provide workers' compensation insurance coverage for their Employees at the statutorily-required levels (the "Workers' Compensation Coverage"). The Workers' Compensation Coverage is maintained through an insurance policy with Federal Insurance and has a policy period of November 1, 2012 through November 1, 2013. The next premium installment of \$4,446 is due for payment on February 1, 2013. The Debtors seek authority to continue paying the premiums to maintain the Workers' Compensation Coverage in the postpetition period. As of the Petition Date, the Debtors have paid for Workers' Compensation Coverage for the period through January 31, 2013. Accordingly, no premiums are due as of the Petition Date.

**H. Gross Pay Deductions, Governmental Withholdings and Payroll Taxes**

30. The Debtors routinely deduct certain amounts from the Employees' paychecks during each pay period, including pre-tax deductions associated with Health and Welfare Benefits, the 401-K Plan, and flexible spending accounts<sup>4</sup> (collectively, the "Other Employee Deductions"), and forward those amounts to various third party recipients. On average, the Debtors historically have deducted approximately \$23,000 per pay period from Employees' paychecks on account of the Other Employee Deductions. Prior to the Petition Date, in certain instances, these funds may have been deducted from Employees' prepetition earnings but may not yet have been forwarded to the appropriate third party recipients (the "Unremitted Other Employee Deductions").

---

<sup>4</sup> Flexible spending accounts for the Employees are administered by Paychex. Paychex debits the Debtors' payroll account for its monthly fee of \$185.00. The Debtors believe that no amounts are owed to Paychex as of the Petition Date, and request authority to continue its arrangement with Paychex in the ordinary course of business.

31. In addition to the Other Employee Deductions, the Debtors are required by law to withhold amounts relating to federal, state and local income taxes, Social Security, Medicare and similar taxes (collectively, the “Payroll Taxes”) for remittance to the appropriate federal, state or local taxing authority. The Payroll Taxes, including portions paid by both Employees and the Debtors, total approximately \$125,000 per payroll period. Although the Debtors and ADP (as defined herein), the Debtors’ third-party payroll service provider, withheld the appropriate amounts from the Employees’ earnings for the Payroll Taxes prior to the Petition Date, such funds may not have been due as of the Petition Date and, accordingly, may not have been forwarded to the appropriate taxing authorities (the “Unpaid Payroll Taxes”).

32. The Debtors believe that both the Unremitted Other Employee Deductions and the Unpaid Payroll Taxes are held in trust by the Debtors and/or ADP, and are not property of the Debtors’ estates. Nevertheless, in an abundance of caution, the Debtors seek Court authorization for the Debtors and ADP to remit the Unremitted Other Employee Deductions and Unpaid Payroll Taxes to the appropriate third party recipients.

**I. The Payroll Processor**

33. The Debtors utilize the services of Automated Data Processing, Inc. (“ADP”) to facilitate the administration of employee wages and benefits. The Debtors use the payroll administration services from ADP, but not the banking services. ADP’s responsibilities include processing payroll and transferring funds collected for Payroll Taxes to the applicable third-party recipients. For these services, the Debtors pay ADP approximately \$1,300 per month. Payment for ADP’s services is made approximately five days after each payroll through debit to the Debtors’ payroll account. The Debtors do not believe that there are any outstanding fees owed to ADP as the next fee payable would relate to the first payroll to be made postpetition. However, because the services provided by ADP are crucial to the smooth functioning of the Debtors’

payroll system, the Debtors request permission to pay any unpaid ADP fee out of an abundance of caution.

**J. Direction to Financial Institutions**

34. The Debtors further request that the Court authorize financial institutions to receive, process, honor and pay all checks presented for payment and electronic payment requests relating to the foregoing Employee Obligations, whether such checks were presented or electronic requests were submitted before or after the Petition Date, and that all such financial institutions be authorized to rely on the Debtors' designation of any particular check or electronic payment request as appropriate to be received, processed, honored and paid.

**II. Jurisdiction, Venue and Predicates for Relief Requested**

35. The Court has jurisdiction over this Motion pursuant to 28 U.S.C. § 1334 and the *Amended Standing Order of Reference M-431*, dated January 31, 2012 (Preska, C.J.). Venue in this Court is proper pursuant to 28 U.S.C. §§ 1408 and 1409. This matter is a core proceeding within the meaning of 28 U.S.C. § 157(b)(2).

36. The predicates for the relief requested herein are sections 105(a), 363(b)(1), 507(a)(4), 507(a)(5), 1107(a) and 1108 of the Bankruptcy Code and Bankruptcy Rules 6003(b) and 6004(h).

**III. Relief Requested**

37. In an effort to minimize the personal hardships to Employees and to maintain morale and stability in the Debtors' reorganization efforts during this critical juncture, the Debtors request the immediate entry of the Proposed Order: (i) authorizing the Debtors to continue to pay and honor, in their sole discretion except where payments are required by applicable law, amounts arising under or in connection with the Employee Obligations, including all amounts related to Unpaid Wages, Reimbursable Expenses, Independent Contractor

Compensation, Health and Welfare Benefits, PTO, the 401(k) Plan, the Severance Policy (including the Unpaid Severance), Workers' Compensation Coverage, Unremitted Other Employee Deductions, and Unpaid Payroll Taxes; (ii) authorizing financial institutions with whom the Debtors do business to receive, process, honor, and pay all checks presented for payment and electronic payment requests relating to the foregoing Employee Obligations that the Debtors determine are appropriate to pay; and (iii) waiving the applicability of any stay that would limit the effectiveness of the Proposed Order, including any stay under Bankruptcy Rules 6003 and 6004.

#### **IV. Basis for Relief Requested**

##### **A. The Court Should Authorize the Debtors to Honor The Employee Obligations**

38. Courts generally acknowledge that it is appropriate to authorize the payment or other special treatment of prepetition obligations in appropriate circumstances, such as when necessary to preserve the going concern value of a debtor's business, thus facilitating its reorganization. *See In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989) ("The ability of a Bankruptcy Court to authorize the payment of prepetition debt when such payment is needed to facilitate the rehabilitation of the debtor is not a novel concept"); *see also Armstrong World Indus., Inc. v. James A. Phillips, Inc. (In re James A. Phillips, Inc.)*, 29 B.R. 391, 398 (S.D.N.Y. 1983) (granting authority to pay prepetition claims of suppliers who were potential lien claimants).

39. Payment of the Employee Obligations is critical to the ongoing operation of the Debtors' businesses. If the Employee Obligations are not paid, the Debtors will risk the tangible and intangible loss of the value of their businesses, including, among other things, losses relating to the cost of replacing Employees who seek alternative employment and losses related to the

disruption of, and lower productivity in, the Debtors' business operations resulting from low employee morale and high turnover.

**i. Certain of the Employee Obligations are Entitled to Priority Treatment**

40. Sections 507(a)(4) and 507(a)(5) of the Bankruptcy Code require that certain claims for pre-petition wages, salaries, commissions, paid time off, and employee benefit contributions be accorded priority in payment in an amount not to exceed \$11,725 for each employee. Under section 507(a)(4) of the Bankruptcy Code, employees are granted a priority claim for:

allowed unsecured claims, but only to the extent of \$11,725 for each individual or corporation, as the case may be, earned within 180 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first, for

—  
(A) wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual . . . .

11 U.S.C. § 507(a)(4). Likewise, under section 507(a)(5) of the Bankruptcy Code, employees are granted a priority claim for:

allowed unsecured claims for contributions to an employee benefit plan —

(A) arising from services rendered within 180 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first;

(B) but only for each such plan, to the extent of —

(i) the number of employees covered by each such plan multiplied by \$11,725; less

(ii) the aggregate amount paid to such employees under paragraph (4) of this subsection, plus the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan.

11 U.S.C. § 507(a)(5).

41. The majority of prepetition Employee Obligations are below the statutory priority limit for each individual Employee. As priority claims, the Debtors are required to pay these claims in full to confirm a chapter 11 plan. *See* 11 U.S.C. § 1129(a)(9)(B) (requiring payment of certain allowed unsecured claims for (a) salaries, and commissions, including vacation, severance, and sick leave pay earned by an individual, and (b) contributions to an employee benefit plan). Accordingly, granting the relief sought herein would only affect the timing, but not the amount, of payment of the Employee Obligations to the extent they constitute priority claims, and payment of the priority claims does not have any material negative impact on recoveries for general unsecured creditors. Indeed, the Debtors submit that payments of up to \$11,725 per Employee at this time will enhance the value of the Debtors' estates for the benefit of all interested parties because it will help ensure that the Employees, who are highly skilled and have specialized knowledge regarding the Debtors' assets and operations, continue to provide vital services to the Debtors at this critical juncture.

**ii. Payment of Certain of the Employee Obligations is Required by Law**

42. The Debtors also seek authority to honor and pay the Unremitted Other Employee Deductions and the Unpaid Payroll Taxes to the appropriate third party entities to whom such obligations are owed. These amounts principally represent Employees' earnings that governments, Employees, and judicial authorities have designated for withholding from Employees' salaries. Indeed, the Unpaid Payroll Taxes and Unremitted Other Employee Deductions (including contributions to the Employee Benefit Programs) are not property of the Debtors' estates because they have been deducted from Employees' salaries on another party's behalf. *See* 11 U.S.C. § 541(d) (property of the estate excludes "property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest"); *see*

*also Begier v. IRS*, 496 U.S. 53, 59 (1990) (property held by the debtor in trust for another is not “property of the estate” because the debtor does not own an equitable interest in such property); *City of Farrell v. Sharon Steel Corp. (In re Sharon Steel Corp.)*, 41 F.3d 92, 98-101 (3d Cir. 1994) (holding that funds withheld from employees’ paychecks may be subject to a trust, and thus are not property of the debtor’s estate, even where such funds are commingled with the debtor’s other property). Accordingly, continued payment of the Unremitted Other Employee Deductions and Unpaid Payroll Taxes will not harm or prejudice the Debtors’ creditors, including unsecured creditors.

43. Additionally, certain federal and state laws require the Debtors and their officers to make certain tax payments that have been withheld from the Employees’ paychecks. *See* 26 U.S.C. §§ 6672 and 7501(a); *see also City of Farrell v. Sharon Steel Corp.*, 41 F.3d at 98-99 (holding that state law requiring a debtor to withhold city income tax from its employees’ wages created trust relationship between the debtor and the city for payment of taxes withheld). Many taxing authorities impose personal liability on the officers and directors of entities responsible for collecting taxes from employees to the extent any such taxes are collected but not remitted. *See DuCharmes & Co. v. Michigan (In re DuCharmes & Co.)*, 852 F.2d 194, 195-96 (6th Cir. 1988) (noting that individual officers of a company may be held personally liable for failure to pay trust fund taxes). Accordingly, if these amounts remain unpaid, there is a risk that the Debtors’ officers and directors may be subject to lawsuits on account of any such nonpayment during the pendency of these chapter 11 cases. Lawsuits of this type obviously would constitute a significant distraction for the Debtors’ officers and directors at a time when they should be focused on the Debtors’ efforts to administer these cases and preserve and maximize the value of their estates.

iii. **Continuing to Honor the Severance Policy is Appropriate**

44. It is well-established in the Second Circuit that

severance payments are a form of compensation for the termination of the employment relation, for reasons other than the displaced employees' misconduct, primarily to alleviate the consequent need for economic readjustment but also to recompense [them] for certain losses attributable to the dismissal.

*Supplee v. Bethlehem Steel Corp. (In re Bethlehem Steel Corp.)*, 479 F.3d 167, 173 (2d Cir. 2007) (citing *Strauss-Duparquet, Inc. v. Local Union No. 3, Int'l Brotherhood of Elec. Workers*, 386 F.2d 649, 651 (2d Cir. 1967)). As such, the Second Circuit has consistently held that severance payments triggered by termination represent "a new benefit payable because of termination rather than one that would be 'payable under any circumstances.'" *Id.* When such a new benefit is incurred "as an incident of the administration of the bankrupt's estate, it [is] an administrative expense and entitled to priority as such an expense." *Id.*

45. To the extent the Debtors determine any post-petition payments under the Severance Policy are actual and necessary costs of administering any of the estates, the Debtors request authority to make such payments as administrative expenses in the ordinary course of business. In any restructuring of a business such as this one, employees are an important stakeholder in the company and in the reorganization process. Indeed, the Employees will help determine the ultimate success or failure of the reorganization effort. By continuing the Severance Policy during this difficult time, the Debtors effectively will minimize the disruption of workflow and protect their assets. If the Debtors are unable to continue the Severance Policy in the ordinary course of business, current Employees may question the Debtors' commitment to the Severance Policy (and Employees generally), which is intended to ease their financial burden in the event they are terminated. Employee morale and loyalty will be jeopardized at a time when Employee support is most critical. Moreover, the Debtors will lose the benefit of releases

that are signed by Employees prior to termination and the protections afforded the Debtors therein. The Debtors will not provide insiders (as defined in the Bankruptcy Code) with benefits under the Severance Policy if doing so would violate section 503(c)(2) of the Bankruptcy Code.

46. The Debtors further request authority to, at their discretion, continue making regular payments of the Unpaid Severance to the one former Employee scheduled to receive such payments through June 15, 2013. By paying the Unpaid Severance, the Debtors will preserve the benefit of the release signed by that former Employee. Payment of the Unpaid Severance is entitled to priority treatment up to the \$11,725 cap as described in the paragraphs above. The Debtors further submit that unpaid prepetition severance above the \$11,725 cap has been authorized by courts in this district in other chapter 11 cases. *See, e.g., In re Hawker Beechcraft, Inc.*, Case No. 12-11873 (SMB) (Bankr. S.D.N.Y. May 30, 2012) (authorizing unpaid prepetition severance of \$21,000 to one former employee); *In re Pinnacle Airlines*, Case No. 12-11343 (REG) (Bankr. S.D.N.Y. May 11, 2012) (authorizing \$2.4 million in unpaid prepetition severance; employees were given anywhere from four to fifty-two weeks' severance pay); *In re Bally Total Fitness of Greater New York, Inc.*, Case No. 07-12395 (BRL) (authorizing payment of \$204,000 in aggregate severance payments incurred prepetition to 15 former employees; remaining severance payments owed to each individual ranged between \$1,300 and \$69,000); *In re Lear Corp.*, Case No. 09-14326 (ALG) (Bankr. S.D.N.Y. Jul. 31, 2009) (authorizing payments of up to eight weeks' severance owed as of the petition date).

iv. **The Doctrine of Necessity Provides a Basis for Granting the Requested Relief**

47. In authorizing payments of certain prepetition obligations, courts have relied on several legal theories that are rooted in sections 105(a), 363(b), 1107(a), and 1108 of the Bankruptcy Code.

48. Pursuant to sections 1107(a) and 1108 of the Bankruptcy Code, debtors-in-possession are fiduciaries “holding the bankruptcy estate[s] and operating the business[es] for the benefit of [their] creditors and (if the value justifies) equity owners.” *In re CoServ, L.L.C.*, 273 B.R. 487, 497 (Bankr. N.D. Tex. 2002). Implicit in the fiduciary duties of any debtor-in-possession is the obligation to “protect and preserve the estate, including an operating business’s going-concern value.” *Id.* Some courts have noted that there are instances in which a debtor can fulfill this fiduciary duty “only . . . by the preplan satisfaction of a prepetition claim.” *Id.* The *CoServ* court specifically noted that the preplan satisfaction of prepetition claims would be a valid exercise of the debtor’s fiduciary duty when the payment “is the only means to effect a substantial enhancement of the estate . . .” *Id.*

49. Consistent with a debtor’s fiduciary duties, courts also have authorized payment of prepetition obligations under section 363(b) of the Bankruptcy Code where a sound business justification exists for doing so. *See In re Ionosphere Clubs, Inc.*, 98 B.R. at 175 (finding a sound business justification to pay prepetition wages); *see also Armstrong World Indus., Inc. v. James A. Phillips, Inc. (In re James A. Phillips, Inc.)*, 29 B.R. at 398 (relying on section 363(b) of the Bankruptcy Code to allow contractor to pay prepetition claims of suppliers who were potential lien claimants because the payments were necessary for general contractors to release funds owed to the debtors). Specifically, the business judgment standard requires that a debtor “articulate some business justification, other than the mere appeasement of major creditors.” *In re Ionosphere Clubs, Inc.*, 98 B.R. at 175.

50. In addition, the Court may authorize payment of prepetition claims in appropriate circumstances based on section 105(a) of the Bankruptcy Code. Section 105(a) of the Bankruptcy Code empowers the court to “issue any order, process, or judgment that is necessary

or appropriate to carry out the provisions of this title.” 11 U.S.C. § 105(a). Under section 105(a) of the Bankruptcy Code, courts may permit pre-plan payments of prepetition obligations when essential to the continued operation of the debtor’s business. Specifically, courts may use their power under section 105(a) of the Bankruptcy Code to authorize the “pre-plan payment of a prepetition obligation when essential to the continued operation of the debtor” pursuant to the doctrine of necessity. *In re NVR L.P.*, 147 B.R. 126, 127 (Bankr. E.D. Va. 1992) (payments justified if in the best interests of both the debtor and the creditors); *see also In re Just for Feet, Inc.*, 242 B.R. 821, 825 (D. Del. 1999) (rejecting argument “that this court does not have the authority under section 105(a) of the Bankruptcy Code to authorize payment of the pre-petition claims”); *In re Structurlite Plastics Corp.*, 86 B.R. 922, 931 (Bankr. S.D. Ohio 1988) (holding that “a bankruptcy court may exercise its equity powers under § 105(a) [of the Bankruptcy Code] to authorize payment of pre-petition claims”).

51. The traditional source of authority for preplan payments of prepetition debts is the “doctrine of necessity” or “necessity of payment” rule first recognized by the United States Supreme Court over 125 years ago in *Miltenberger v. Logansport R. Co.*, 106 U.S. 286 (1882). In *Miltenberger*, the Supreme Court acknowledged the basic duty of an equity receiver “to protect and preserve the trust funds in its hands.” *Id.* at 310 (quoting *Wallace v. Loomis*, 97 U.S. 146, 162-63 (1878)). More importantly, the Supreme Court held that, consistent with this duty, “[m]any circumstances may exist which may make it necessary and indispensable to the business . . . and preservation of the property, for the receiver to pay pre-existing debts . . . out of earnings of the [debtor] . . . under the order of the court . . .” *Id.* at 311-12.

52. This doctrine “recognizes the existence of the judicial power to authorize a debtor in a chapter 11 case to pay pre-petition claims where such payment is essential to the continued

operation of the debtor.” *In re Ionosphere Clubs, Inc.*, 98 B.R. at 176; *see also In re Lehigh & N.E. R. Co.*, 657 F.2d 570, 581 (3d Cir. 1981) (payment of creditors’ claims authorized under “necessity of payment” doctrine); *In re UNR Indus., Inc.*, 143 B.R. 506, 519-20 (Bankr. N.D. Ill. 1992) (“key to determining whether pre-petition . . . claim may be paid post-petition under the Necessity Doctrine is . . . whether payment of the claim will be in the best interests of the estate and/or the other creditors”), *reversed and remanded on other grounds, UNR Indus. v. Bloomington Factory Workers*, 173 B.R. 149 (N.D. Ill. 1994). This doctrine is consistent with the paramount goal of chapter 11 -- “facilitating the continued operation and rehabilitation of the debtor.” *In re Ionosphere Clubs, Inc.*, 98 B.R. at 176; *see also Dudley v. Mealey*, 147 F.2d 268, 271 (2d Cir. 1945) (“Let it [(a hotel)] once shut down, and it will lose much of its value . . . . Some priority to [the hotel’s prepetition suppliers] may be essential to the preservation of the business”).

53. Moreover, courts have specifically recognized the applicability of the “necessity of payment” doctrine with respect to the payment of prepetition employee compensation and benefits. *See, e.g., In re Gulf Air, Inc.*, 112 B.R. 152, 153 (Bankr. W.D. La. 1989) (authorizing payment of prepetition amounts due, *inter alia*, for wages, benefits, health insurance premiums and per diem expenses under the “necessity of payment doctrine”); *Mich. Bureau of Workers’ Disability Comp. v. Chateaugay (In re Chateaugay Corp.)*, 80 B.R. 279, 285-89 (S.D.N.Y. 1987) (affirming a bankruptcy court order authorizing the debtor to pay pre-bankruptcy wages, salaries, employee benefits and reimbursements, and workers’ compensation claims and premiums); *In re Ionosphere Clubs, Inc.*, 98 B.R. at 175-76 (discussing prior order authorizing payment of prepetition wages, salaries, medical benefits and business expense claims).

54. Courts have articulated various tests for determining whether prepetition claims may be honored. Some courts have held that the holders of the claims must be “indispensable” or “necessary” to the debtor’s rehabilitation efforts. *In re Just for Feet, Inc.*, 242 B.R. at 824-25; *see also In re Payless Cashways, Inc.*, 268 B.R. 543, 547 (Bankr. W.D. Mo. 2001). Other courts have held prepetition claims may be paid if the debtor establishes that (i) continued dealing with the creditor is “virtually indispensable to profitable operations,” (ii) failure to deal with the creditor will eliminate “an economic advantage [which is] disproportionate to the amount of the [claimant’s prepetition] claim,” and (iii) there is “no practical or legal alternative” to payment of the claim. *In re CoServ, L.L.C.*, 273 B.R. at 498; *see also In re Mirant Corp.*, 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003).

55. The relief requested in this Motion satisfies each of these standards. The majority of the Employees rely exclusively on their compensation, benefits, and reimbursement of expenses to satisfy their daily living expenses. Consequently, these Employees will be exposed to significant financial difficulties if the Debtors are not permitted to continue to honor the Employee Obligations in the ordinary course. Accordingly, the Debtors’ failure to pay and continue to honor the Employee Obligations will jeopardize Employee morale and loyalty at a time when the Employees’ support is critical to the Debtors’ reorganization efforts.

56. While the Employees are few in number, each of the Employees is highly skilled in his/her respective areas of expertise and has direct knowledge of the Debtors’ business and operations. The continued service and dedication of the Employees is critical to the Debtors and their prospect for a successful reorganization in cases under chapter 11 of the Bankruptcy Code. To retain the Employees during the pendency of these chapter 11 cases, and to avoid jeopardizing the Debtors’ efforts at maximizing value for all of their constituents, the Debtors

believe that they must have authority to pay, honor or otherwise satisfy all Employee Obligations as summarized above. Additionally, any Employee attrition would cause the Debtors to incur additional expenses to find appropriate and experienced replacements, which could severely disrupt the Debtors at an important juncture.

57. For all of the foregoing reasons, the Debtors respectfully submit that the payment of the Employee Obligations is essential to the success of these chapter 11 cases, represents a sound exercise of the Debtors' business judgment, and is in the best interests of the Debtors' estates and creditors.

58. Relief similar to the relief requested herein has been granted by courts in this District in other chapter 11 cases. *See, e.g., In re Hawker Beechcraft, Inc.*, Case No. 12-11873 (SMB) (Bankr. S.D.N.Y. May 31, 2012) (authorizing the debtors to pay various employee obligations, including prepetition employee obligations); *In re Pinnacle Airlines Corp.*, Case No. 12-11343 (REG) (Bankr. S.D.N.Y. May 11, 2012) (same); *In re Lear Corporation*, Case No. 09-14326 (ALG) (Bankr. S.D.N.Y. Jul. 31, 2009) (same); *In re General Motors Corp.*, Case No. 09-50026 (REG) (Bankr. S.D.N.Y. June 1, 2009) (same); *In re Chrysler LLC*, Case No. 09-50002 (AJG) (Bankr. S.D.N.Y. May 4, 2009) (same); *In re Chemtura Corp.*, Case No. 09-11233 (REG) (Bankr. S.D.N.Y. April 13, 2009) (same); *In re Steve and Barry's Manhattan, LLC*, Case No. 08-12579 (ALG) (Bankr. S.D.N.Y. July 10, 2008) (same); *In re Ciena Capital LLC*, Case No. 08-13783 (ALG) (Bankr. S.D.N.Y. Oct. 3, 2008) (same); *In re Interep Nat'l Radio Sales, Inc.*, Case No. 08-11079 (RDD) (Bankr. S.D.N.Y. April 1, 2008) (same).

**V. Immediate Relief is Necessary to Avoid Immediate and Irreparable Harm**

59. Pursuant to Bankruptcy Rule 6003(b), the Debtors (a) seek immediate entry of an order granting the relief requested herein and (b) waiver of any stay of effectiveness of such an order. Bankruptcy Rule 6003 provides, in relevant part, that

“[e]xcept to the extent that relief is necessary to avoid immediate and irreparable harm, the court shall not, within 21 days after the filing of the petition, grant . . . (b) a motion to use, sell, lease, or otherwise incur an obligation regarding property of the estate, including a motion to pay all or part of a claim that arose prior to the filing of the petition . . . .”

Fed. R. Bankr. P. 6003(b). Bankruptcy Rule 6004(h) provides that “[a]n order authorizing the use, sale or lease of property other than cash collateral is stayed until the expiration of 14 days after the entry of the order, unless the court orders otherwise.” Fed. R. Bankr. P. 6004(h).

60. Bankruptcy courts have recognized that the bankruptcy estate would suffer irreparable harm if there are distractions to employees that would undermine the debtor’s liquidation efforts under chapter 11 of the Bankruptcy Code. *See Nevada Power Co. v. Calpine Corp. (In re Calpine Corp.)*, 365 B.R. 401, 410 (S.D.N.Y. 2007) (holding that potential distractions to employees constitute “imminent irreparable harm” if they would have a negative impact on the restructuring process); *see also In re Lomas Fin. Corp.*, 117 B.R. 64, 67 (S.D.N.Y. 1990) (imminent and irreparable harm found where “key personnel would be distracted from participating in the reorganization process”). Failure to pay and continue the Employee Obligations would distract the Employees by imposing significant financial hardships on the Employees and their families, reducing the Employees’ morale, and has the potential to derail the Debtors’ efforts to maximize value.

61. Further, any lapse in benefit coverage and financial hardships imposed on the Employees could also constitute immediate and irreparable harm. *See Commc’ns Workers of Am. District One, AFL-CIO v. NYNEX Corp.*, 898 F.2d 887, 891 (2d Cir. 1990) (termination of

insurance coverage constitutes irreparable harm); *see also Whelan v. Colgan*, 602 F.2d 1060, 1062 (2d Cir. 1979) (same).

62. The Debtors believe that, without the requested relief being granted by this Court, some of the Employees would seek alternative employment opportunities. Such a development would deplete the Debtors' workforce, hindering the Debtors' ability to successfully reorganize and maximize value for all of their stakeholders. The loss of valuable Employees and the resulting recruiting of new employees that would be necessary to find replacements would be distracting and costly at this critical time when the Debtors are seeking to maximize the value of their estates. Further, if the Debtors lose Employees, they will incur recruiting expenses in locating replacement employees if, under the Debtors' circumstances, replacement employees could be recruited at all.

63. In light of the potentially negative effects on a debtor's ability to maximize the value of their bankruptcy estates, courts have recognized that the lapse in benefit coverage and financial hardships on employees would constitute "immediate and irreparable harm." *See, e.g., In re General Motors Corp.*, Case No. 09-50026 (REG) (Bankr. S.D.N.Y. June 1, 2009) (approving employee obligation motion); *In re Quebecor World, Inc. (USA)*, Case No. 08-10152 (JMP) (Bankr. S.D.N.Y. Jan. 23, 2008) (same); *In re Answer Fin., Inc.*, Case No. 08-10140 (MFW) (Bankr. D. Del. Jan 23, 2008) (same).

64. Accordingly, the Debtors submit that ample cause exists to justify (a) a finding that the requirements of Bankruptcy Rule 6003(b) have been satisfied and that the immediate entry of an order granting the relief sought herein is appropriate and (b) a waiver of the fourteen-day stay imposed by Bankruptcy Rule 6004(h).

**VI. No Waiver or Admission**

65. Nothing herein is intended or should be construed as: (a) an admission as to the amount, validity or priority of any claim against the Debtors; (b) a waiver of the Debtors' rights with respect to any claim; (c) a promise to pay any claim against the Debtors; (d) an implication or admission that any claim constitutes an Employee Obligation, including Unpaid Wages, Reimbursable Expenses, Other Employee Deductions, Unremitted Other Employee Deductions, Payroll Taxes, Unpaid Payroll Taxes, or a claim arising in connection with an Employee Obligation; or (e) a request to assume any executory contract or unexpired lease, pursuant to section 365 of the Bankruptcy Code.

**VII. Notice**

66. Notice of this Motion has been provided to: (a) the Office of the United States Trustee for the Southern District of New York; (b) counsel to the proposed DIP lender; (c) the creditors holding the thirty (30) largest unsecured claims against the Debtors' estates on a consolidated basis, as identified in the Debtors' chapter 11 petitions; and (d) all parties that have filed a notice of appearance or have requested service in these chapter 11 cases. In light of the nature of the relief requested herein and the potential harm to the Debtors' estates if the relief requested herein is not granted, the Debtors respectfully submit that no other or further notice need be provided.

**VIII. No Prior Request**

67. No prior motion for the relief requested herein has been made to this or any other court.

WHEREFORE, the Debtors respectfully request that the Court (a) enter an order, substantially in the form of the Proposed Order, granting the relief requested herein, and (b) grant to the Debtors such other and further relief as the Court may deem just or proper.

Dated: New York, New York  
January 21, 2013

Respectfully submitted,

*/s/ Peter S. Partee, Sr.*

---

Peter S. Partee, Sr.  
Michael P. Richman  
Andrew Kamensky  
Richard P. Norton  
Robert A. Rich  
HUNTON & WILLIAMS LLP  
200 Park Avenue, 53<sup>rd</sup> Floor  
New York, New York 10166-0136  
(212) 309-1000

*Proposed Attorneys for Debtors and  
Debtors-in-Possession*