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11 Creditor Trustee of the Class IV Creditor Trust

12 UNITED STATES BANKRUPTCY COURT
13 SOUTHERN DISTRICT OF CALIFORNIA


14 In re:)
15 STEAKHOUSE PARTNERS, INC., a)
16 Delaware corporation,)
17 Debtor.)
18 _____)

Case No. 08-04147-11
[Chapter 11]

19 In re:)
20 PARAGON STEAKHOUSE)
21 RESTAURANTS, a Delaware)
22 corporation,)
23 Debtor.)
24 _____)

Case No. 08-04152-11
[Chapter 11]

25 In re:)
26 PARAGON OF MICHIGAN, INC., a)
27 Wisconsin corporation,)
28 Debtor.)
_____)

Case No. 08-04153-11 
[Chapter 11]

CREDITOR TRUSTEE'S OMNIBUS
OBJECTION TO DEBTORS' FIRST DAY
MOTIONS; DECLARATION OF T. SCOTT
AVILA IN SUPPORT THEREOF

DATE: May 27, 2008
TIME: 10:30 a.m.
PLACE: Courtroom 218
West F Street
San Diego, CA 92101

Judge: The Honorable James W. Meyers

ORIGINAL

1 TO: THE HONORABLE JAMES W. MEYERS, UNITED STATES BANKRUPTCY
2 JUDGE AND ALL OTHER PARTIES IN INTEREST:
3

4 I.

5 INTRODUCTION

6 T. Scott Avila^{1/} is the Creditor Trustee of the Class IV Creditor Trust (the
7 "Creditor Trustee"). As acknowledged by them, the Debtors owe the Creditor Trustee
8 more than \$ 4 Million which is secured by the Debtors' leasehold interest and
9 intellectual property. The Creditor Trustee is the largest secured claimant in these
10 bankruptcy estates and the funds are specifically earmarked for the Class IV Creditor
11 Trust, the beneficiaries of which are all of the unsecured creditors with claims in
12 excess of \$4,000 of the Debtors' previous bankruptcy proceedings.^{2/} The Class IV
13 Creditor Trust was created in connection with the Debtors' confirmed plan of
14 reorganization in its prior bankruptcy cases.^{3/} The extent and perfection of the
15 secured claim has been approved by the Bankruptcy Court and acknowledged by the
16 Debtors in a court-approved settlement entered on August 10, 2006 and the
17 forbearance agreement they executed in June 2007.

18 As part of the Debtors obligations to the Creditor Trustee, they are required
19 to provide a regular status of their finances and their progress towards selling their
20 stores. While reports have been forthcoming, the Creditor Trustee was not advised of
21

22 ^{1/} Mr. Avila is a managing partner with CRG Partners. He has
23 more than 20 years of management and consulting experience and a seasoned
24 restructuring professional. Mr. Avila helps operationally and financially
25 distressed organizations through out-of-court workouts and Chapter 11
reorganizations. Further information regarding Mr. Avila's qualifications is
located at http://www.crgpartners.com/professionals/avila_s.html.

26 ^{2/} The Class IV Creditor Trust does not include a convenience class
27 that was established under the Plan and the responsibility of the Debtor.

28 ^{3/} RS 02-12648-MG; RS 02-12682-MG; RS 02-12684-MG; RS 02-
12688-MG; and RS 02-12692-MG.

1 the extent of the Debtors' current liquidity crisis until the day of the filing of this
2 bankruptcy petition. The Creditor Trustee is extremely concerned that the Debtors
3 will not have sufficient cash to survive in chapter 11, thus putting at risk the Creditor
4 Trustee's collateral. The Creditor Trustee, with the Debtors' consent, has reviewed
5 the Debtor's books and records and is in the process of creating its own 13 week cash
6 projection. Until the Creditor Trustee can complete his analysis, the Creditor Trustee
7 respectfully requests that this case proceed with extreme caution, especially to the
8 extent the Debtor is spending cash, and that the Court restrict the Debtor's spending
9 to the most narrow definition of necessity so that the Debtors can literally keep the
10 lights on while being as conservative as possible - - at least for a short period of time -
11 - until the Creditor Trustee has sufficient information to make an independent
12 recommendation to this Court.

13 II.

14 FACTUAL BACKGROUND

15 On February 15, 2002, Steakhouse Partners, and on February 19, 2002
16 Paragon Restaurants and Paragon Michigan filed their voluntary petitions for relief
17 under Chapter 11 of the Bankruptcy Code. The Bankruptcy Court entered an order
18 directing the joint administration on February 22, 2002. Steakhouse Partners,
19 Paragon Restaurants, and Paragon Michigan filed a First Amended Joint Plan of
20 Reorganization of Steakhouse Partners, Inc. et al, dated September 29, 2003 and
21 amended November 4, 2003 (the "Plan"). The Court entered an order confirming the
22 Plan on December 19, 2003.

23 The Plan provided for the creation of the Steakhouse Partners Class IV
24 Creditors Trust (the "Class IV Trust") for the purpose of collecting, maintaining and
25 distributing the Steakhouse Partners Class 4 Creditors Trust Assets. The trust assets
26 consisted of (i) a \$1 million payment within thirty (30) days of the Plan's effective
27 date; (ii) payments under the Class 4 Creditors Note in the principal amount of
28 \$5,030,000, and secured by the Class 4 Creditors Note Security Documents; (iii)

1 500,000 shares of the New Common Stock representing ten percent (10%) of the New
2 Common Stock; and (iv) Litigation Claims. The Class IV Trust was also entitled to a
3 one-time payment of \$17,000 on the Plan's Effective Date relating to reimbursement
4 of some costs. The Plan became effective on December 31, 2003.

5 On or about December 31, 2003, T. Scott Avila accepted the appointment as
6 the Creditor Trustee of the Class IV Trust. Prior to May 2007 (as explained in more
7 detail below), the Debtors only made limited payments to the Creditor Trust under
8 the original Plan and Class IV Note (totaling only \$1,192,000.00). The Creditor
9 Trustee and the Debtors engaged in extensive negotiations to settle the Debtors'
10 failures under the Class IV Note and Security Agreement. The Creditor Trustee and
11 the Debtors ultimately negotiated a settlement agreement which was approved by the
12 bankruptcy court on August 10, 2006.

13 The material terms of the compromise required a lump sum payment of
14 \$4,126,159 (the "Lump Sum Settlement Payment"). The Settlement Payment
15 represented 85% of the outstanding balance of the original note at that time.
16 However, if the Lump Sum Settlement Payment was not made within 20 days from
17 the entry of the court's order, then the Settlement Agreement also provided for an
18 alternative provision. The Alternative Settlement Payment required the Reorganized
19 Debtors to pay \$5,200,000, with \$1,100,000 to be paid immediately upon default (with
20 an additional \$100,000 that was due June 30, 2006 if this alternative was
21 implemented). The remaining \$4,100,000 would be payable over five years, secured
22 by a Note and Security Agreement. The Reorganized Debtors would also be
23 responsible for additional fees and expenses of the Creditor Trustee, including
24 attorneys' fees.

25 The Debtors failed to tender the Lump Sum Settlement Payment. After
26 insuring that the Creditor Trust was properly secured against the new collateral
27 provided for under the settlement, the Creditor Trustee served a Notice of Default on
28 September 19, 2006, which thus triggered the "Alternative Payment". The

1 Alternative Payment required the Debtors to pay the Creditor Trustee a total of
2 \$5,120,419.03 (plus other sums to the Creditor Trustee and for attorney fees, as
3 provided for in the Agreement).

4 As part of the Revised Payment Plan, the Debtors were required to deposit \$1
5 million in a separate, segregated, interest bearing account, on or before January 11,
6 2006 (the "Deposit"). Within two business days after the Creditor Trustee's written
7 notice triggering the Alternative Payment, the Debtors were required to tender i) the
8 Deposit; ii) all accrued interest, and iii) an additional \$200,000 to the Creditor Trust.
9 This provision was not subject to cure and failure to comply was considered an Event
10 of Default. Not only did the Debtors fail to comply, the Creditor Trustee later learned
11 that the Debtors used the Deposit to fund the operating losses of the business when
12 the Debtors' plan to sell and leaseback new restaurants failed. They did so without
13 any notice to the Creditor Trustee and certainly without his permission.

14 On Friday, February 2, 2007, the Creditor Trustee (and his professionals) met
15 with Stone Douglass (and his professionals) to review the status of the proposed
16 financing of Steakhouse restaurants and the subsequent funding to the Class IV
17 Creditors Trust. The Creditor Trustee was informed that the funding had not closed
18 and that a closing could no longer be expected.

19 As a result, the Creditor Trustee began to actively enforce his rights under
20 the Security Agreement. The Creditor Trustee was appointed to the Debtors' board of
21 directors; the Debtors agreed to employ an Investment Banker to explore a sale of
22 assets; and the Creditor Trustee retained a restaurant expert to review a few of the
23 locations (Carvers and Hungry Hunter), with the purpose to provide an opinion on the
24 best possible process to monetize these assets. Steakhouse also agreed to reimburse
25 the Trust of professional fees incurred going forward, but the Debtors have not paid
26 those expenses to date.

27 Shortly after his appointment to the board of directors, the Creditor Trustee
28 resigned because he was justifiably concerned that his new duties to the board may

1 conflict with his duties to the Creditor Trust. However, the Debtors had provided
2 marketing information to the Creditor Trustee (or his representative) every week.

3 On or about May 18, 2007, the Creditor Trustee properly sent a notice to the
4 Debtors that they were in default under the Alternative Payment as well. Because
5 the Debtors were not entitled to cure the payment of the Deposit, the Debtors were in
6 material default as of September 21, 2006.

7 After consulting with the "Largest Creditors" of the Creditor Trust, the
8 Creditor Trustee provided the Debtors with two alternatives: either the Debtors must
9 execute a forbearance agreement with the Creditor Trustee by June 15, 2007 or the
10 Creditor Trustee will file a motion seeking to convert the chapter 11 case to chapter 7
11 due to a material default under the plan. The Debtors in fact executed the
12 forbearance agreement with minor modifications. Under the forbearance agreement,
13 the Debtors were required to either make cash payments by certain trigger dates, or
14 have entered into asset purchase agreements for the equivalent amount by the same
15 trigger dates. The Debtors complied with the forbearance agreement to the extent
16 that they entered into the assets purchase agreements, and monetized approximately
17 \$928,000 to the Creditor Trustee.

18 On or about December 19, 2007 the Creditor Trustee distributed
19 approximately \$925,000 to his beneficiaries. Approximately \$4.1 Million remains
20 outstanding, plus attorneys fees, interest and expenses.

21 III.

22 THE CREDITOR TRUSTEE'S LIMITED OBJECTION TO MOTION NUMBER 3
23 FOR ORDER AUTHORIZING PAYMENT OF NON-INSIDER PRE-PETITION
24 ACCRUED WAGES, SALARIES, COMMISSIONS ETC.

25 As correctly noted by the Debtors, whether the Court should permit the
26 payment of pre-petition compensation is governed by the necessity doctrine. As
27 discussed in *In re NVR L.P.*, 147 B.R. 126, 127 -128 (Bkrtcy.E.D.Va.,1992):
28

1 unsecured claim without any evidence that the Debtors can afford such an enormous
2 expenditure. See Motion 3, p. 17: 13-18. Wulkowicz Decl. ¶¶ 30, 37.

3 There is also no evidence that these employees are still employed with the
4 Debtors. The Creditor Trustee is informed that the Debtor has closed at least two (2)
5 locations on Tuesday, May 20, 2008 and that they are considering whether other
6 stores should be closed immediately. To the extent that any employee is no longer
7 employed by any of the Debtors, then there is no necessity to pay that employee at
8 this time. Rather, that employee should not receive any pre-petition payment prior to
9 plan confirmation. The Creditor Trustee requests that the order specifically exclude
10 any and all employees that are not currently employed by one of the Debtors.

11 Moreover, the Debtors should not be permitted to pay any compensation tied
12 to performance. When added together, the pre-petition performance based request
13 accounts for \$186,871. The Debtors explain that they have not paid any performance
14 based "wages for the periods 12/2007 and periods 1, 2, 3 and 4/2008, each of which is
15 currently due and/or payable." Motion 3, p. 11: 7-23; Wulkowicz Decl. ¶ 39. There is
16 no specific explanation why these long overdue payments must be made now in order
17 to maintain employee confidences and loyalties. At the very least, approval of the
18 performance based compensation should wait until the Creditor Trustee concludes his
19 investigation of the Debtor's cash position and 13 week cash projections.

20 Similarly, although the amount is fairly nominal (\$10,000), there is no
21 necessity - - right now - - to permit reimbursement of expenses. According to the
22 Wulkowicz declaration, there is a built in lag period for the reimbursement of such
23 expenses. Wulkowicz Dec. 12, ¶ 3.⁴ Like the performance based compensation, the

24
25 ⁴ "Employees are reimbursed upon the submission of expense
26 reports and supporting documentation. Such reports are *normally* submitted
27 within two weeks after the employee incurs the expense and, after review
28 and approval of the expense report, the Debtors reimburse the employee by
check drawn on the Union Bank Concentration Account." (emphasis added)

(continued...)

1 Debtors' request to reimburse expenses should be revisited after the Creditor Trustee
2 concludes his investigation.

3 IV.

4 THE CREDITOR TRUSTEE'S LIMITED OBJECTION TO MOTION NUMBER 5
5 FOR ORDER AUTHORIZING PAYMENT OF PRE-PETITION ACCRUED UTILITY
6 SERVICES ETC.

7 As indicated with respect to pre-petition wages, the Debtor should only be
8 permitted to pay prepetition accrued utility services for locations that are operating.
9 To the extent that the Debtors have closed any stores, or intend to close stores within
10 the next few days, they should not be permitted to pay pre-petition utilities.

11 V.

12 THE CREDITOR TRUSTEE DOES NOT OBJECT TO SOME OF
13 THE DEBTOR'S FIRST DAY MOTIONS.

14 The Creditor Trustee does not object to the following first day motions:

- 15 1. First Day Motion No. 1: Motion for Order Directing Joint
16 Administration of Related Cases Pursuant to Federal Rule of Bankruptcy Procedure
17 1015(b) and Local Bankruptcy Rule 1015-1.
- 18 2. First Day Motion No. 2: Motion for Order Limiting Scope of Notice (this
19 Motion was previously approved by the Court with the Creditor Trustee's consent).
- 20 3. First Day Motion No. 4: Motion for Order (1) Authorizing Continued
21 Use of Existing Business Forms and Records and (2) Authorizing Maintenance of
22 Existing Corporate Bank Accounts and Cash Management System.
- 23 4. First Day Motion No. 6: Motion for Order Authorizing Payment of
24 Installment Under Prepetition Insurance Premium Agreement.

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27 _____
28 ^{4/} (...continued)
Wulkowicz Dec. 12, ¶ 3.

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VI.

CONCLUSION

The Creditor Trustee naturally understands the need to maintain operations for operational stores. However, to the extent the Debtors seek to make payments now of pre-petition obligations, it must show the necessity of such expenditures. The Debtors have not provided some basic information to determine if the payments are really necessary and in the best interest of the estate. The Court therefore should sparely permit the Debtor in this early stage of the case to spend cash only on pre-petition claims that are truly necessarily to the Debtor's future survival.

DATED: May 23, 2008

WEINSTEIN, WEISS & ORDUBEGIAN LLP

By Shawn Z Wein
Attorneys for T. Scott Avila
Creditor Trustee of the Class IV
Creditor Trust

DECLARATION OF T. SCOTT AVILA

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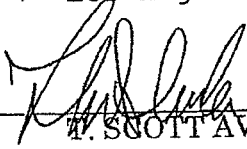
I, T. Scott Avila, declare:

1. I am the duly appointed Creditor Trustee for the Class IV Creditor Trust. If called as a witness, I could testify to all matters set forth herein based on my personal knowledge except as indicated otherwise.

2. I have reviewed the *Creditor Trustee's Omnibus Objection to Debtors' First Day Motions* (the "Objection"). All of the factual recital stated in the Objection are made of my own personal knowledge and believe.

I declare under penalty of perjury under the laws of the United States of American that the foregoing is true and correct.

Executed this 23 day of May 2008, at Los Angeles, California.



T. SCOTT AVILA

SERVICE LIST

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