Docket #1077 Date Filed: 5/16/2013

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re SCHOOL SPECIALTY, INC., *et al.*, Debtors.	Chapter 11 Case No. 13-10125 (KJC) (Jointly Administered) **Hearing Date: May 20, 2013 at 1:30 p.m.** **Objections Due: May 16, 2013 at 4 p.m.** **Extended to May 16, 2013 at 6 p.m.** **for the U.S. Trustee**

UNITED STATES TRUSTEE'S OBJECTION TO CONFIRMATION OF THE DEBTORS' AMENDED JOINT PLAN OF REORGANIZATION UNDER CHAPTER 11 OF THE BANKRUPTCY CODE

Roberta A. DeAngelis, the United States Trustee for Region 3 ("U.S. Trustee"), by and through her undersigned attorneys, hereby objects to confirmation of the Debtors' Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code (Docket No. 931-1) (the "Plan"), and in support of that objection states as follows:

PRELIMINARY STATEMENT

1. The Debtors' Plan is not confirmable because it contains releases to be given by the Debtors in favor of numerous non-debtor parties who have not made a "substantial contribution" to the Plan, and which otherwise fail to comply with the elements required for such releases under applicable law. For this reason, as set forth in greater detail below, confirmation of the Debtors' Plan should be denied, unless the Debtors limit the scope of their releases to what is permissible under applicable law.

JURISDICTION

2. Under (i) 28 U.S.C. § 1334, (ii) applicable order(s) of the United States District Court for the District of Delaware issued pursuant to 28 U.S.C. § 157(a), and (iii) 28 U.S.C. § 157(b)(2), this Court has jurisdiction to hear and determine this objection.

3. Pursuant to 28 U.S.C. § 586(a)(3), the U. S. Trustee is charged with administrative oversight of the bankruptcy system in this District. Such oversight is part of the U. S. Trustee's overarching responsibility to enforce the laws as written by Congress and interpreted by the courts. *See United States Trustee v. Columbia Gas Systems, Inc. (In re Columbia Gas Systems, Inc.)*, 33 F.3d 294, 295-96 (3d Cir. 1994) (noting that the U. S. Trustee has "public interest standing" under 11 U.S.C. § 307 which goes beyond mere pecuniary interest); *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498, 500 (6th Cir. 1990) (describing the U. S. Trustee as a "watchdog").

4. Under 11 U.S.C. § 307, the U.S. Trustee has standing to be heard on the issues raised in this objection.

FACTUAL BACKGROUND

5. On January 28, 2013 (the "Petition Date"), the Debtors filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code. The Debtors have been in possession of their respective properties and operate their business as debtors-in-possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code.

6. The U.S. Trustee appointed an official committee of unsecured creditors on February 5, 2013 (the "Committee").

7. The initial DIP financing lenders in these cases were the Debtors' Prepetition Lenders, namely (a) the Prepetition Term Loan Lenders, agented by Bayside Finance LLC (hereinafter "Bayside"), and (b) the Prepetition ABL Lenders (hereinafter "ABL

Lenders").[1] At the final hearing on DIP financing provided by Bayside and the ABL Lenders, an ad hoc group of the Debtors' unsecured Noteholders (the "Ad Hoc DIP Lenders") provided DIP financing sufficient to fully pay Bayside's DIP loan, as well as Bayside's pre-petition claim. Upon information and belief, Bayside has been fully paid all amounts it claims in connection with its DIP financing loan and its pre-petition loans, except for a certain "make-whole" payment that is being held in escrow pending the outcome of litigation.

8. On April 24, 2013, this Court entered an order conditionally approving the Disclosure Statement for Debtors' Amended Joint Plan of Reorganization under Chapter 11 of the Bankruptcy Code. *See* Dkt. Nos. 902 (Order), and 931 (solicitation version of Disclosure Statement with attached Plan).

9. The Plan contains releases (the "Debtor Releases") to be given by the Debtors in favor of numerous non-debtor parties (the "Released Parties").[2]

10. The provision in the Plan addressing the Debtors Releases, which is set forth in the Plan at § IX.I, provides:[3]

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[1] Capitalized terms not defined herein shall have the definition set forth in the Plan.

[2] The Plan also includes third party releases. *See* Plan § IX.K. Such releases are being given by those entities that vote to accept the Plan and who do not check a box on the ballot that allows them to opt-out of the releases, and by those entities that are deemed to vote in favor of the Plan because they are unimpaired. *See id*.

[3] For ease of reading, the text of § IX.I of the Plan has been altered in the quote that follows in the text above in the following non-substantive ways: (a) to change the text from being in all capitals and in boldface to being in regular typeface, (b) to add spacing between certain provisions, and (c) to add definitions of certain terms, in brackets. In addition, because the text in the Plan is in all capitals, it is not clear which terms are intended to be defined terms (as such terms otherwise would appear in initial capitals only). Counsel has made best efforts to identify all defined terms and place them in initial caps in the quote that follows.

On the Effective Date, the Debtors and the Reorganized Debtors, on behalf of themselves and their estates, shall be deemed to release unconditionally

(a) all of their respective officers, directors, employees, partners, advisors, attorneys, financial advisors, accountants, and other professionals, who served in such capacities on or after the petition date,

(b) (i) the DIP Agents [defined as the ABL DIP Agent and the Ad Hoc DIP Agent] and the Bayside DIP Agent,

(ii) the DIP Collateral Agents [defined as the collateral agents for the ABL DIP Facility, the Ad Hoc DIP facility and, to the extent not already repaid in full, the Bayside DIP Facility],

(iii) the Notes Indenture Trustee [defined as the trustee under the certain indenture dated March 1, 2011, as amended, between SSI and the Bank of New York Mellon Trust Company], and

(iv) the Prepetition Agents [defined as the Prepetition ABL Agents and Bayside Finance LLC],

(c) officers, directors, principals, members, employees, partners, subsidiaries, affiliates, advisors, attorneys, financial advisors, accountants, and other professionals of each of the DIP Agents, the Bayside DIP Agent, DIP Collateral Agents, the Notes Indenture Trustee and the prepetition agents,

(d) the DIP Lenders [defined as the Ad Hoc DIP Lenders, Bayside DIP Lenders and ABL DIP Lenders] and the Prepetition Lenders [defined as the ABL Lenders and Bayside],

(e) officers, directors, principals, members, employees, partners, subsidiaries, affiliates, advisors, attorneys, financial advisors, accountants, and other professionals of the DIP Lenders, and the Prepetition Lenders,

(f) the members of the Creditors Committee and the Noteholders [defined as holders of School Specialty Inc. 3.75% convertible Subordinated Notes], and

(g) officers, directors, principals, members, employees, partners, subsidiaries, affiliates, advisors, attorneys, financial advisors,

accountants, and other professionals of the Creditors Committee and the Noteholders

(collectively, the "Released Parties" and each a "Released Party") from any and all claims, obligations, suits, judgments, damages, rights, causes of action and liabilities whatsoever, whether known or unknown, foreseen or unforeseen, existing or hereafter arising, in law, equity or otherwise, based in whole or in part upon actions taken solely in their respective capacities described above for any omission, transaction, event or other occurrence taking place on or prior to the effective date in any way relating to the debtors, the Chapter 11 Cases, the Disclosure Statement or the Plan, except that

(i) no individual shall be released from any act or omission that constitutes gross negligence, willful misconduct, fraud or criminal acts as determined by a final order,

(ii) the Reorganized Debtors shall not relinquish or waive the right to assert any of the foregoing as a legal or equitable defense or right of set off or recoupment against any claims of any such persons asserted against the Debtors,

(iii) the foregoing release shall not apply to any obligations that remain outstanding in respect of loans or advances made to individuals by the debtors, and

(iv) the foregoing release applies to the released parties solely in their respective capacities described above.

For the avoidance of doubt, the Debtors shall release the Noteholders, only to the extent permitted by law and to the extent that such Noteholders vote in favor of the Plan and do not mark their ballots to indicate their refusal to grant the releases of the Released Parties provided for in the Plan.

Notwithstanding the foregoing, no claims of the estates asserted by the Creditors Committee against the Prepetition Term Loan Lenders, including without limitation, such claims in respect of the Prepetition Escrowed Amounts, shall be released by this provision.

Plan § IX.I.

ARGUMENT

A. The Debtors Releases Are Impermissibly Broad Under Applicable Law

11. The Plan provides releases by the Debtors and their estates of many non-debtor parties. Pursuant to this Court's decision in *In re Tribune Company,* 464 B.R. 126 (Bankr. D. Del. 2011)(Carey, J.), and *In re Washington Mutual, Inc.,* 442 B.R. 314 (Bankr. D. Del. 2011)(Walrath, J.), among others, the five factors set forth in In re *Zenith Elecs. Corp.,* 241 B.R. 92, 110 (Bankr. D. Del 1999) and *In re Master Mortgage Inv. Fund, Inc.*, 168 B.R. 930, 937-38 (Bankr. W. D. Mo. 1994) should be considered to determine whether, notwithstanding § 524(e) of the Code, a plan may provide for releases by debtors of non-debtor entities. *See Tribune* 464 B.R. at 186; *Washington Mutual*, 442 B.R. at 346; *In re Spansion, Inc.*, 426 B.R. 114, 142-43, n. 47 (Bankr. D. Del 2010)(Carey, J.); *In re Coram Healthcare Corp.*, 315 B.R. 321, 335 (Bankr. D. Del. 2004)(Walrath, J). Those factors are as follows:

1. identity of interests between debtor and non-debtor releasee, so that a suit against the non-debtor will deplete the estate's resources (e.g., due to a debtor's indemnification of a non-debtor);

2. substantial contribution to the plan by non-debtor;

3. necessity of release to the reorganization;

4. overwhelming acceptance of plan and release by creditors; and

5. payment of all or substantially all of the claims of the creditors and interest holders under the plan.

Tribune 464 B.R. at 186 (citing *Washington Mutual*, 442 B.R. at 346 (citing *Zenith,* 241 B.R. at 110)). "The factors are neither exclusive nor conjunctive requirements, but simply provide

guidance in the Court's determination of fairness." *Tribune* 464 B.R. at 186 (citing *Washington Mutual*, 442 B.R. at 346).

12. In the present cases, neither the Plan nor the Disclosure Statement address whether any of the *Zenith* factors are met for any of the Released Parties. As discussed more fully below, none of the *Zenith* factors appear to be present with respect to any of the Released Parties, except that the first factor, identify of interest, may apply to the Debtors' officers and directors, and the second factor, substantial contribution, may apply to the Ad Hoc DIP Lenders.

13. For ease of analysis, the Released Parties can be broken down into the following categories:

a. The **Ad Hoc DIP Lenders**, their Agent and Collateral Agent;

b. The **Bayside DIP Lenders**, their Agent and Collateral Agent;

c. The **ABL DIP Lenders**, their Agent and Collateral Agent;

d. The **Pre-Petition Lenders**, namely the ABL Lenders and the Bayside Term Loan Lenders, and their Prepetition Agents;

e. **Unsecured Noteholders**, to the extent that they did not opt-out of providing their third-party release to various non-debtor parties, and the **Notes Indenture Trustee**;

f. The **officers, directors,** principals, members, employees, partners, subsidiaries, **affiliates**, advisors, attorneys, financial advisors, accountants, and other **professionals** of the entities listed in paragraphs a through e above;

g. **Estate fiduciaries** that are covered by the exculpation clause in the Plan, namely (i) the Debtors' officers, directors, members, partners,

advisors, attorneys, financial advisors, accountants, and other professionals; (ii) the Committee, its officers, directors, principals, members, partners, advisors, attorneys, financial advisors, accountants, and other professionals;

h. **Other persons and entities related to the Debtors and the Committee** that are not entitled to exculpation because they are not estate fiduciaries: the employees of the Debtors, the employees of the members of the Committee, and all subsidiaries and affiliates of the members of the Committee; and

i. The **Reorganized Debtors'** officers, directors, employees, partners, advisors, attorneys, financial advisors, accountants, and other professionals.

14. As demonstrated above, nearly all parties having any involvement in this case, as well as each such party's officers, directors, employees, affiliates and professionals, are receiving releases from the Debtors. The only parties not receiving releases from the Debtors are trade creditors and other general unsecured creditors (other than unsecured Noteholders), and the Debtors' shareholders.

15. With respect to the first *Zenith* factor, which is identity of interests between the Debtors and non-debtor releasees, the only Released Parties as to whom such factor could arguably apply are the officers and directors of the Debtors. However, even if such factor is present, it alone is not sufficient to justify providing the Debtors' officers and directors with Debtor Releases. *See Washington Mutual*, 442 B.R. at 349-350 (finding insufficient basis for the debtors' release of their directors, officers and professionals, even though one of the *Zenith* factors, identity of interest, was present) (citing *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203, 216 (3d Cir. 2000)). As to the

other categories of Released Parties, there has been no assertion, let alone proof, of any identity of interests between those parties and the Debtors.

16. As to the second *Zenith* factor, the Debtors have not yet identified any "substantial contribution" made to the Plan by any of the Released Parties. An example of a substantial contribution would be if a Released Party made a lump sum payment to the Plan, thereby allowing the Debtors to make a distribution to unsecured creditors. *See, e.g.*, *Coram*, 315 B.R. at 335. In *Coram*, after examination of the *Zenith* factors, this Court allowed the debtors to release noteholders who had contributed $56 million in funding to the plan, which funds allowed the debtors to repay in full all creditors other than the noteholders, as well as make a significant distribution to the debtors' shareholders. *Id.*

17. None of the Released Parties in the present cases has made any cash contribution, or any other substantial contribution, to the Plan, except that the Ad Hoc DIP Lenders have agreed to accept stock in satisfaction of nearly half of their superpriority DIP financing claim of $155 million. None of the other DIP Lenders or Pre-Petition Lenders has compromised their claims in any fashion. The Bayside DIP claim and its pre-petition claim have already been paid in full in cash. The ABL DIP will be paid in full in cash by the Effective Date, and its pre-petition claim will be satisfied in full under the Plan.

18. The Debtors may argue that the Bayside DIP Lenders and the ABL DIP Lenders provided contribution to these cases by making DIP loans to the Debtors. However, such loans are not contributions *to the Plan*. Moreover, the Bayside and ABL DIP Lenders were well compensated for making such DIP loans, and received expansive releases under the DIP financing orders. Any further release is unnecessary and excessive. In addition, the DIP loans provided by the Bayside DIP Lenders and the ABL DIP Lenders had onerous milestones

that did not provide the Debtors with sufficient time to solicit their Plan. In fact, at the hearing on the Disclosure Statement on April 22, 2013, the Court adjourned the confirmation hearing to a date beyond the milestone date for plan confirmation, indicating that such milestones were being used to "bully" not only certain parties in interest, but also the Court. Thus, not only have the Bayside DIP Lenders and the ABL DIP Lenders not made substantial contributions to the Plan, they have taken positions that have actually hindered the plan process.

19. None of the other categories of Released Parties have made a substantial contribution. The Debtors' officers, employees and professionals may have assisted in negotiating or drafting the Plan, but that alone does not qualify as the kind of contribution to the Plan that would justify a release. *See Washington Mutual*, 442 B.R. at 349-50, 354. In that case, this Court held that there was no basis for allowing debtor releases or third party releases of the debtors' directors, officers, or professionals when their only contribution was the negotiation of the global settlement and plan, which was part of their jobs, for which they received compensation. *Id.* Moreover, as in the present cases, the debtors' directors, officers and professionals in *Washington Mutual* were to receive exculpation for their post-petition activities, and therefore the Court found that releases were "unnecessary, duplicative and exceed the limits of what they are entitled to receive." 442 B.R. at 350. The same is true here.

20. The same analysis is applicable as to any contribution made by the Committee, its members and professionals that relate to the Plan, as they shall receive exculpations for such work. *See* Plan, § IX.K. Yet the Debtor Releases goes beyond the scope of the exculpation provided in the Plan. For example, the exculpation clause will cover only the period of time Committee members and other estate fiduciaries served during the chapter 11 proceedings, as required under applicable law. *See Tribune*, 464 B.R. at 189 (citing

W*ashington Mutual*, 442 B.R. at 350-51) ("exculpation clauses should be limited to *fiduciaries who have served during the chapter 11 proceedings*: estate professionals, the committees and their members, and the debtors' directors and officers")(emphasis added).[4] In contrast, the Debtors Release of the members of the Committee, as well as their officers, directors and professionals, covers pre-petition periods and actions that are unrelated to their duties as Committee members. In such manner, the Plan provides benefits to the unsecured creditors who are members of the Committee that are not provided to other unsecured creditors in their class. Such unequal treatment among members of the same class is not permissible. *See* 11 U.S.C. § 1123 (a)(4)(a plan must provide the same treatment for each claim or interest of a particular class, unless the holder of a claim agrees to less favorable treatment).

21. The Debtors Release also covers all employees, subsidiaries and affiliates of each Committee member, which persons and entities would not be entitled to be exculpated, because they are not estate fiduciaries. *See Tribune*, 464 B.R. at 189; W*ashington Mutual*, 442 B.R. at 350-51. Because such parties are not entitled to be exculpated, they should not be able to receive a release that is much broader than an exculpation, when none of the *Zenith* factors apply to them.

22. The Debtors have not identified any contribution the unsecured Noteholders who are not also Ad Hoc DIP Lenders, or their officers, directors, affiliates and professionals, have made to the Plan.

[4] The exculpation provision that appeared in the solicitation version of the Plan was not limited to fiduciaries, or to the period of time between the Petition Date and the Effective Date. However, the Debtors have agreed to modify that provision to limit it in such fashion. The U.S. Trustee reserves all rights to object to the exculpation provision if such modifications are not made.

23. As to the third *Zenith* factor, the U.S. Trustee leaves the Debtors to their proof as to whether the release of any of the Released Parties is necessary to the reorganization.

24. The fourth *Zenith* factor is overwhelming acceptance of the plan and release provisions by creditors. This information is not yet available.

25. The fifth *Zenith* factor, which is the payment of all or substantially all of the claims of the Debtors' creditors and interest holders, cannot be met under any circumstance. The Debtors' Plan provides for a 20% pay-out to unsecured creditors in classes 5 and 8; 20% to 45% for trade creditors in class 6; 6% to the over $170 million in Noteholder claims in class 7; and no distribution to interest holders.

26. Finally, the Reorganized Debtors' officers, directors, employees, partners, advisors, attorneys, financial advisors, accountants, and other professionals are to be released by the Debtors. To the extent this provision is intended to act as a release of future actions, or to release persons or entities employed in the future by the Reorganized Debtors, it should not be allowed. *See Washington Mutual*, 442 B.R. at 348 (rejecting the release of the liquidating trustee, because, *inter alia*, the trustee has not yet taken any action for which he needed a release).

27. The Debtors have the burden to establish whether the *Zenith* factors have been met as to each of the non-debtors who are the beneficiaries of the Debtor Releases. Because an evidentiary predicate is necessary to approve the Debtor Releases, the U.S. Trustee reserves argument on this issue until the record at the confirmation hearing is closed.

B. **Reservation Of Rights Regarding Substantive Consolidation.**

28. The Plan provides for the "deemed" substantive consolidation of the Debtors for purposes of the Plan and distributions thereunder. *See* Plan, § V.A. The U.S. Trustee leaves the Debtors to their burden to establish that the grounds have been met for such deemed substantive consolidation under applicable law, including *In re Owens Corning*, 419 F.3d 195 (3rd Cir. 2005), and reserves all rights related thereto.

CONCLUSION

29. As detailed above, the Plan is not confirmable because the scope of the Debtor Releases is significantly broader than what is permitted under applicable law.

30. The U.S. Trustee leaves the Debtors to their burden and reserves any and all rights, remedies and obligations to, *inter alia*, complement, supplement, augment, alter and/or modify this objection, file an appropriate Motion and/or conduct any and all discovery as may be deemed necessary or as may be required and to assert such other grounds as may become apparent upon further factual discovery.

WHEREFORE, the U.S. Trustee respectfully requests that this Court issue an order denying confirmation of the Plan, and/or granting such other relief as this Court deems appropriate, fair and just.

Dated: May 16, 2013
Wilmington, Delaware

Respectfully submitted,

ROBERTA A. DeANGELIS
UNITED STATES TRUSTEE

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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re SCHOOL SPECIALTY, INC., *et al.*, Debtors.	Chapter 11 Case No. 13-10125 (KJC) (Jointly Administered)

CERTIFICATE OF SERVICE

I , Juliet Sarkessian, hereby certify that on May 16, 2013, I caused copies of the United States Trustee's Objection To Confirmation Of The Debtors' Amended Joint Plan Of Reorganization Under Chapter 11 Of The Bankruptcy Code to be served upon the parties and counsel listed on the attached sheet, by email.

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