Docket #0219 Date Filed: 2/18/2013

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	Chapter 11
SCHOOL SPECIALTY, INC., *et al.*,[1]	Case No. 13-10125 (KJC)
Debtors.	(Jointly Administered)
	Hearing Date: February 25, 2013 at 11:00 a.m.
	Objection Deadline: February 18, 2013 at 4:00 p.m. (by agreement with the Debtors)
	Re: Docket Nos. 12, 13, 86, 88, and 159

OBJECTION OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS TO DEBTORS' MOTION TO APPROVE POSTPETITION FINANCING

The Official Committee of Unsecured Creditors (the "Committee") of School Specialty, Inc. and its affiliated debtors and debtors-in-possession in the above-captioned Chapter 11 cases (collectively, the "Debtors"), by and through its proposed counsel, Brown Rudnick LLP and Venable LLP, respectfully submits this objection (the "Objection") to the *Motion of Debtors for Entry of Interim and Final Orders (I) Authorizing Debtors to (A) Obtain Postpetition Financing Pursuant to 11 U.S.C. §§ 105, 361, 362, 364(c)(1), 364(c)(3), 364(d)(1), 364(e) and 507, (B) Utilize Cash Collateral Pursuant to 11 U.S.C. § 363, (C) Grant Priming Liens and Superpriority Claims to the DIP Lenders, (D) Provide Adequate Protection to Prepetition Secured Parties Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364, and (E) Repay in Full Amounts Owed in Connection with the Prepetition Secured Loans or Otherwise Converting the Prepetition Secured Obligations into Postpetition Secured Obligations, (II) Scheduling a Final*

[1] The Debtors in these Chapter 11 Cases, along with the last four digits of each Debtor's federal tax identification number, are: School Specialty, Inc. (1239); Bird-In-Hand Woodworks, Inc. (8811); Califone International, Inc. (3578); Childcraft Education Corp. (9818); ClassroomDirect.com, LLC (2425); Delta Education, LLC (8764); Frey Scientific, Inc. (3771); Premier Agendas, Inc. (1380); Sax Arts & Crafts, Inc. (6436); and Sportime, LLC (6939).

1310125130218000000000005

Hearing Pursuant to Bankruptcy Rules 4001(b) and (c) and (III) Granting Related Relief, dated January 28, 2013 [Docket No. 12] (the "Motion").[2] In support of the Objection, the Committee respectfully states as follows:

PRELIMINARY STATEMENT

The Debtors' request for post-petition financing in these cases is inherently intertwined with the Debtors' request for an expedited sale process. At the February 15, 2013 hearing on the Debtors' motion for approval of certain bidding procedures and the proposed timeline for the sale process, the Court approved such motion on a "preliminary" basis – subject to being revisited if the alternative financing proposal that has been proffered by an "ad hoc" committee of the Debtors' convertible noteholders comes to fruition. The Committee is hopeful that such alternative post-petition financing, which would refinance Bayside's pre-petition Term Loan and the Bayside DIP Facility and provide the Debtors with significantly more "case control" flexibility and lower-cost financing, will soon be firmed up and, moreover, that the Debtors will embrace that offer and revisit the case-defining milestones.

However, even if the Bayside DIP Facility is taken out, the Committee's objections to the case-control sale milestones built into the ABL DIP Facility remain, and are subject to being revisited. Significantly, the April 15, 2013 sale closing deadline (and effective maturity date) under the ABL DIP Facility is not a magic date by which liquidity runs out; the ABL DIP Facility advances to a tight borrowing base and is safely and fully collateralized by inventory and high-credit-quality-backed accounts receivable. Although the ABL DIP Lenders may wish to exit the facility by April 15, it is too tight a timeframe for these cases. Recognizing that not everything can be addressed simultaneously, in the event that the considerable efforts toward

[2] Capitalized terms not otherwise defined herein shall have the meanings ascribed thereto in the Motion or the Interim Order (as defined herein), as applicable.

resolving the Bayside DIP Facility prove successful (which efforts have been among the Committee's primary focal points since its appointment), sufficient time should be allotted to permit a resolution of the similar milestone issues presented by the ABL DIP Facility. Given adequate time, the Debtors, the Committee, the "ad hoc" committee, and the ABL DIP Lenders may be able to reach an accommodation or, alternatively, find a replacement for the ABL DIP Facility in order to allow the Debtors to steer their cases along a more sensible, value-maximizing timeline. The Court should serve as a check-and-balance against any attempt by the ABL DIP Lenders to hold these cases hostage or to run them for their own exclusive benefit. In any event, the ABL DIP Lenders certainly cannot have it both ways – holding these cases to a fast-track timeline and yet charging fees that are unreasonably and astonishingly high in the context of that timeline.

Furthermore, in addition to the case-control provisions, the Committee submits that there are several facets of the proposed DIP Financing that are inappropriate and should be rejected by this Court. Specifically, under the circumstances of these cases, the granting of liens on Avoidance Actions,[3] the waiver of the Bankruptcy Code Section 506(c) surcharge rights, and the waiver of the "equities of the case" exception in Bankruptcy Section 552(b) all improperly serve to usurp value from unsecured creditors and provide an unjustifiable windfall to secured creditors. Moreover, provisions relating to the proposed Carve-Out and the restrictions on the Investigation serve only to hamstring the Committee and frustrate its ability to carry out its fiduciary role, in contravention of settled authority on the vital role played by creditors' committees in the Chapter 11 process. As a final matter, certain provisions in any proposed final

[3] "Avoidance Actions," as used herein and defined in the DIP Documents, means any and all causes of action arising under Bankruptcy Code Sections 542, 544, 545, 547, 548, 549, 550, 551, 553(b), or 724(a), together with any proceeds therefrom.

order with respect to the Motion must be clarified or modified in order to protect the rights of the Committee and its unsecured creditor constituents.

For all of the foregoing reasons, and as described in more detail below, the Committee respectfully requests that the Court sustain this Objection.

BACKGROUND

I. General Case Background

1. On January 28, 2013 (the "Petition Date"), each of the Debtors filed a voluntary petition for relief under Chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"). Since the Petition Date, the Debtors continue to operate and manage their businesses as debtors-in-possession.

2. On January 30, 2013, the Court conducted a hearing (the "First Day Hearing") on the Debtors' "first-day motions" and entered interim or final relief on certain motions. With respect to the Motion, the Court approved certain of the relief sought therein on an interim basis and entered an interim order on January 31, 2013 [Docket No. 86] (the "Interim Order").

3. On February 5, 2013, the United States Trustee for the District of Delaware appointed the Committee. The following entities comprise the Committee: (i) Intragrated Resources Holding, Inc.; (ii) S.P. Richards Company; (iii) Quad/Graphics, Inc.; (iv) The Bank of New York Mellon Trust Company NA, as Indenture Trustee; (v) Zazove Associates, LLC; (vi) Steel Excel Inc.; and (vii) Davis Appreciation and Income Fund. On that date, the Committee selected its undersigned proposed counsel and The Blackstone Group L.P. as its proposed financial advisor.

4. On February 15, 2013, the Court held a hearing on the Debtors' motion for approval of bidding procedures in connection with the proposed sale of the Debtors' assets to an

affiliate of their pre-petition secured lender, Bayside Finance, LLC ("Bayside") [Docket No. 18] (the "Bidding Procedures Motion"). Over the Committee's objection, the Court approved the Bidding Procedures Motion, the attendant bidding and sale timeframe, and the Sale Control Provisions (as defined herein) on a preliminary basis [Docket No. 213] (the "Preliminary Bidding Procedures Order"), but held that the sale procedures (including the timeline) could be revisited at the Final DIP Hearing (as defined herein) in the event that the proposed alternative post-petition financing closes and replaces the Bayside DIP Facility (as defined herein).[4]

II. Debtors' Pre-Petition Capital Structure

5. The Debtors' pre-petition capital structure consists primarily of the following elements:

- Asset-Based Loan: A $200 million asset-based secured credit facility (the "ABL"), of which $47.62 million was outstanding as of the Petition Date. The ABL is secured by (i) a first-priority security interest on the working capital assets of the Debtors and (ii) a second-priority lien on the remaining assets.

- Term Loan: A $70 million term loan (the "Term Loan") provided by Bayside, of which approximately $67 million was outstanding as of the Petition Date. The Term Loan is secured by (i) a second-priority security interest on the working capital assets of the Debtors and (ii) a first-priority lien on the remaining assets. The Prepetition Term Loan Credit Agreement contains a provision, which, according to Bayside, provides for a $25 million "make whole" payment.

- Unsecured Notes: $157.5 million in original principal amount of 3.75% unsecured convertible subordinated debentures due 2026 (the "Convertible Notes" and each holder thereof, a "Convertible Noteholder"). The Convertible Notes were issued in March and July of 2011 in two separate exchanges of previously issued convertible debt. Interest is paid current at 3.75% and another 3.9755% accretes and is added to the principal. As of the Petition Date, the Convertible Notes have accreted $12.7 million of interest.

[4] To the extent the Court revisits the Preliminary Bidding Procedures Order at the Final DIP Hearing, the Committee fully incorporates herein its objections to the Bidding Procedures Motion, as argued at the hearing on the Bidding Procedures Motion and as set forth in the *Request for Adjournment and Objection of the Official Committee of Unsecured Creditors to Debtors' Motion Establishing Bid Procedures* [Docket No. 177].

- Unsecured Trade Debt: According to the Debtors, approximately $60 million as of the Petition Date.

III. Debtors' Proposed Post-Petition Financing

6. As set forth more fully in the Motion, and as modified during the First Day Hearing (and embodied in the Interim Order), the Debtors propose to enter into certain agreements for the provision of post-petition financing (the "DIP Financing"), consisting of the super-priority new money term loan of $50 million provided by Bayside (the "Bayside DIP Facility") and the super-priority revolving credit facility of $175 million, inclusive of a roll up of all pre-petition obligations owing under the ABL, provided by the ABL DIP Lenders (the "ABL DIP Facility" and, together with the Bayside DIP Facility, the "DIP Facilities"). See Motion at ¶ 12. The DIP Facilities mature on June 30, 2013. See Motion at ¶ 12; Bayside DIP Credit Agreement, § 1.1; ABL DIP Credit Agreement, § 1.1.

7. Because the Debtors must comply with certain case-determinative sale milestones (the "Sale Control Provisions") or risk triggering an Event of Default, June 30 is not a "real" maturity date. Instead, the sale closing deadlines in each of these facilities operate as the effective maturity dates for the DIP Facilities: April 11 (under the Bayside DIP Facility) and April 15 (under the ABL DIP Facility). See Motion at ¶ 12; Bayside DIP Credit Agreement, §§ 5.18, 7.1; ABL DIP Credit Agreement, §§ 5.16, 8. The Sale Control Provisions include, among others, the following case milestones:

	Bayside DIP Facility	**ABL DIP Facility**
Bid Deadline:	March 19, 2013	--
Auction Date:	March 25, 2013	March 29, 2013
Sale Closing:	April 11, 2013	April 15, 2013

See Motion at ¶ 12; Bayside DIP Credit Agreement, § 5.18; ABL DIP Credit Agreement, § 5.16.

8. Pursuant to the Interim Order, this Court authorized the Debtors to borrow $25 million in new money under the Bayside DIP Facility and $175 million under the ABL DIP Facility, inclusive of the ABL Roll Up Obligations. See Interim Order at ¶ 6(b). A hearing on final approval of the DIP Facilities is set for February 25, 2013 at 11:00 a.m. (the "Final DIP Hearing"). Id. at ¶ 32.

IV. Alternative Post-Petition Financing

9. Subsequent to the Petition Date, certain of the Convertible Noteholders regrouped as an "ad hoc" committee (the "Ad Hoc Committee") and are presently working hard to deliver, in advance of the Final DIP Hearing, an alternative proposal that will fully refinance Bayside's Term Loan and the Bayside DIP Facility (reserving the asserted "make whole" portion of the Term Loan pending further proceedings before this Court). This superior post-petition financing proposal contemplated by the Ad Hoc Committee (the "Alternative Proposal") includes much greater "case control" flexibility and a lower cost of post-petition capital. An executed term sheet detailing the financing terms of the Alternative Proposal was delivered to the Debtors and the Court at the February 15, 2013 hearing on the Bidding Procedures Motion. The Committee understands that the Ad Hoc Committee's goal is to deliver a binding commitment to the Debtors by mid-week (of the week of February 18) and to be in a position to close the financing immediately after the Final DIP Hearing.

10. The Committee hopes and expects that the Debtors will embrace the new financing, consent to a modification of the Sale Control Provisions, and move this case forward along a more rational timeline. This refinancing, if provided and adopted by the Debtors, will, of course, render moot the Committee's objections to the Bayside DIP Facility. However, the same troubling Sale Control Provisions will have to be addressed in connection with the ABL DIP

Facility (along with certain other inappropriate provisions therein, which should be modified as described in more detail below).

11. The salient differences between the Bayside DIP Facility and the substantially similar ABL DIP Facility provisions, on the one hand, and the Alternative Proposal, on the other hand, are as follows:

	ABL DIP Facility	**Bayside DIP Facility**	**Alternative Proposal**
Maturity Date:	June 30, 2013	June 30, 2013	September 15, 2013
Interest Rate:			
Non-Default Rate –	At Debtors' election: (i) Base Rate plus Applicable Margin or (ii) LIBOR Rate plus Applicable Margin	LIBOR + 14% per annum	LIBOR + 10% per annum
Default Rate –	+3.00% per annum	+3.00% per annum	+2.00% per annum
Fees:			
Closing Fee –	$2,625,000	$500,000	N/A
Unused Line Fee –	0.50% per annum	1.00% per annum	N/A
Administrative Fee –	N/A	$150,000 per annum	$50,000
Post-Default Carve-Out:	$500,000 (aggregate)	$500,000 (aggregate)	$1,000,000
Case Trajectory:	Immediate sale with Bayside as the credit bidder / stalking horse	Immediate sale with Bayside as the credit bidder / stalking horse	Dual-track process by which assets are marketed for sale and pursuit of a plan of reorganization is undertaken simultaneously in order to maximize recoveries
Milestones:	*Auction Date* – 3/29/13 *Sale Closing* – 4/15/13	*Bid Deadline* – 3/19/13 *Auction Date* – 3/25/13 *Sale Closing* – 4/11/13	*Asset Marketing* – to commence within 25 days of interim approval of the Alternative Proposal *Plan and Disclosure Statement Filing* – within 30 days of interim approval of the Alternative Proposal *Asset Sale Procedures Approved* – within 30 days of interim approval of the Alternative Proposal

			Disclosure Statement and Solicitation – approval within 61 days of interim approval of the Alternative Proposal and solicitation to commence within 65 days *Auction Date* – assuming sufficient interest, within 85 days of interim approval of the Alternative Proposal *Sale and Confirmation Hearings* – within 110 days of interim approval of the Alternative Proposal *Sale Closing and Plan Effectiveness* – within 120 days of interim approval of the Alternative Proposal

ARGUMENT

I. Legal Standards Governing Approval Of The DIP Facilities

12. A court should approve a proposed debtor-in-possession financing only if such financing "is in the best interests of the general creditor body." In re Roblin Indus., Inc., 52 B.R. 241, 244 (Bankr. W.D.N.Y 1985) (internal citations omitted); see also In re Tenney Vill. Co., Inc., 104 B.R. 562, 569 (Bankr. D.N.H. 1989) ("The debtor's pervading obligation is to the bankruptcy estate and, derivatively, to the creditors who are its principal beneficiaries."). In short, the financing's terms must not "pervert the reorganizational process from one designed to accommodate all classes of creditors and equity interests to one specially crafted for the benefit" of a secured creditor. Tenney Vill., 104 B.R at 568.

13. In order to obtain approval of post-petition financing, the debtor bears the burden of proving that: (a) the proposed financing is an exercise of sound and reasonable business judgment; (b) the financing is in the best interests of the estate and its creditors; (c) the transaction is necessary to preserve the assets of the estate, and is necessary, essential, and appropriate for the continued operation of the debtor's business; (d) the terms of the transaction are fair, reasonable, and adequate given the circumstances of the debtor-borrower and proposed lender; and (e) the financing was negotiated in good faith and at arm's length by the debtor, on the one hand, and the lender, on the other hand. See In re Farmland Indus., Inc., 294 B.R. 855, 879-80 (Bankr. W.D. Mo. 2003).[5]

II. The DIP Facilities Inappropriately Usurp Value From Unsecured Creditors And Weaken The Mandate Of The Committee

A. The DIP Facilities Improperly Usurp Value From Unsecured Creditors By Granting Liens On Avoidance Actions

14. Through inclusion of Avoidance Actions and their proceeds in DIP Collateral (see Interim Order at ¶ 12(a)) and granting the DIP Lenders recourse against Avoidance Actions and their proceeds on account of the Superpriority Claims (see Interim Order at ¶ 8), the Debtors propose to shift unencumbered value to the DIP Lenders in a manner that is inconsistent with both the intent behind the Avoidance Actions and the scope of a debtor-in-possession's avoidance powers. See Interim Order at ¶¶ 8, 12(a), 18(a). It is well-established that the avoidance powers can only be exercised for the benefit of the estate. See, e.g., Bear, Stearns Sec.

[5] See also In re Mid-State Raceway, Inc., 323 B.R. 40, 60 (Bankr. N.D.N.Y. 2005) (looking at several factors in considering whether to approve post-petition secured financing, including whether financing is necessary to preserve the assets of the estate); In re Aqua Assocs., 123 B.R. 192, 195-96 (Bankr. E.D. Pa. 1991) (citing In re The Crouse Group, Inc., 71 B.R. 544, 549 (Bankr. E.D. Pa. 1987) (holding that proposed financing should be beneficial and reasonable)); In re Ames Dep't Stores, Inc., 115 B.R. 34, 37 (Bankr. S.D.N.Y. 1990) (focusing on reasonableness of terms of proposed financing).

Corp. v. Gredd, 275 B.R. 190, 194 (S.D.N.Y. 2002) ("[T]he purpose of § 547 is to ensure fair distribution between creditors, while the purpose of § 548 is to protect the estate itself for the benefit of all creditors."). The intent behind the avoidance powers is to allow the debtor-in-possession to recover certain payments on behalf of all creditors. See Mellon Bank (E.), N.A. v. Glick (In re Integrated Testing Prods. Corp.), 69 B.R. 901, 904 (D.N.J. 1987) (finding that only the trustee, acting on behalf of all the creditors, has a right to recover payments made as preferences); see also Buncher Co. v. Official Comm. Of Unsecured Creditors of GenFarm Ltd. P'ship IV, 229 F.3d 245, 250 (3d Cir. 2000) ("When recovery is sought under section 544(b) of the Bankruptcy Code, any recovery is for the benefit of all unsecured creditors, including those who individually had no right to avoid the transfer."); Citicorp Acceptance Co. v. Robison (In re Sweetwater), 884 F.2d 1323, 1328 (10th Cir. 1989) ("[P]ost-petition avoidance actions should be pursued in a manner that will satisfy the basic bankruptcy purpose of treating all similarly situated creditors alike . . . ."). To restrict recoveries on account of Avoidance Actions to a few privileged creditors distorts the very purpose of providing the debtor-in-possession with avoidance powers in the first place.

15. Moreover, the Avoidance Actions are not the Debtors' property, but rather rights that may be exercised for the benefit of the Debtors' creditors. See Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery (In re Cybergenics Corp.), 226 F.3d 237, 243-47 (3d Cir. 2000) (holding that state law fraudulent transfer claim is not an asset of the debtor). As such, the Debtors do not possess the authority to grant a security interest in the Avoidance Actions for the benefit of only a few of the Debtors' creditors.

16. Furthermore, it is particularly inappropriate to secure the ABL Roll Up Obligations and the Adequate Protection Obligations with liens on Avoidance Actions. It is

well-settled that any Avoidance Action comes into being only after the filing of a bankruptcy petition, and Section 552(a) of the Bankruptcy Code specifically prohibits property acquired after the commencement of the bankruptcy case from being subjected to a lien securing pre-petition debt. See Barber v. McCord Auto Supply, Inc. (In re Pearson Indus. Inc.), 178 B.R. 753, 764-65 (Bankr. C.D. Ill. 1995); McGoldrick v. Juice Farms, Inc. (In re Ludford Fruit Prods. Inc.), 99 B.R. 18, 24-25 (Bankr. C.D. Cal. 1989). Therefore, any attempt to secure the pre-petition debt embodied in the ABL Roll Up Obligations or the Adequate Protection Obligations with a lien on after-acquired property contravenes Section 552(a) of the Bankruptcy Code and should be rejected.

B. The Budgeted Fees And Carve-Out For Committee Professionals Are Inadequate

17. The thirteen-week cash flow and post-petition financing forecast attached to the Interim Order (the "Budget") and the Carve-Out serve to handcuff the Committee and inhibit the fulfillment of its statutory duties. Under the Bankruptcy Code, the Committee plays a crucial and active role in ensuring the integrity of the bankruptcy process by "monitor[ing] the conduct of the debtor to ensure its compliance with the Bankruptcy Code and advis[ing] the creditors of their rights." First Merchs. Acceptance Corp. v. J.C. Bradford & Co., 198 F.3d 394, 403 (3d Cir. 1999). The Committee serves a broad constituency, as it "owes its responsibility and duty to the class it represents viz., the general unsecured creditors of Debtor." In re TSIC, Inc., 393 B.R. 71, 78 (Bankr. D. Del. 2008).

18. Competently and effectively performing these statutory duties in Chapter 11 cases requires creditors' committees to engage the assistance of various professionals, including legal counsel and financial advisory services. See First Merchs. Acceptance Corp., 198 F.3d at 403 ("Responsible fulfillment of these duties may entail a substantial amount of work by committee

members which is of value to the committee as a whole and may require services by a creditor's counsel."). Consequently, courts have held that the lack of a meaningful carve-out for professionals' fees in post-petition financing is unacceptable and contrary to the goals of the Bankruptcy Code. See, e.g., Ames Dep't Stores, 115 B.R. at 38 ("[I]t has been the uniform practice in this Court . . . to insist on a carve out from a super-priority status and post-petition lien in a reasonable amount designed to provide for payment of the fees of debtor's and the committees' counsel and possible trustee's counsel in order to preserve the adversary system. Absent such protection, the collective rights and expectations of all parties-in-interest are sorely prejudiced.").[6]

19. The DIP Financing provides for (i) a limited $800,000 "budget" for all of the Committee's professionals (i.e., Brown Rudnick LLP, Venable LLP, and The Blackstone Group L.P.) for the initial thirteen-week cash flow period (~$61,500 a week for all Committee professionals in the aggregate) (see Budget), which is intended to cover the *entirety* of the case through sale closing, leaving just a liquidation plan to follow (this "budget" is part of the pre-default Carve-Out for all case professionals); and (ii) a $500,000 post-default Carve-Out for unpaid professional fees and expenses incurred and accruing after the occurrence and during the continuance of an Event of Default (see Interim Order at ¶ 9). Where, as here, the Debtors'

[6] See also In re Twenty Six Realty Assocs., No. 95 CV 1262, 1995 WL 170124, at *11 (E.D.N.Y. Apr. 4, 1995) ("[C]arve-out provisions are commonly relied upon to ensure the debtor's ability to be represented in the adversarial proceedings during the pendency of its bankruptcy."); In re Cottrell Int'l, LLC, No. 00-13592, 2000 Bankr. LEXIS 1093, at *9 (Bankr. D. Colo. July 26, 2000) (bankruptcy courts should not unduly restrict the availability of funds to pay professionals in the case, including counsel for the creditors' committee); In re Evanston Beauty Supply, Inc., 136 B.R. 171, 177 (Bankr. N.D. Ill. 1992) ("Negotiated 'carveouts' . . . are viewed as being necessary in order to preserve the balance of the adversary system in reorganization . . . . 'Carveouts' are used in order to avoid skewing the necessary balance of debtor and creditor protection needed to foster the reorganization process.").

bankruptcy filing is being used by the secured lenders to accomplish a process akin to a state law foreclosure action, it becomes all the more important to ensure the preservation of the adversary system through an appropriate Budget and Carve-Out. The Budget and the Carve-Out should be appropriately modified to (i) align the Committee-professionals line-item with the Debtors-professionals line-item, and (ii) provide for an increased post-default Carve-Out. In the context of the procedural history of these cases (in which there have already been two contested evidentiary hearings in just the first three weeks), an expected competing post-petition financing proposal, and a very short sale process all taking shape and requiring extensive efforts by professionals and Committee members in the very early stages of these cases, these proposed modifications are essential to ensure that the Committee is able to satisfy its fiduciary duties.

C. The Terms Of The Investigation Are Inappropriate Under The Circumstances

20. The DIP Financing imposes overly restrictive terms on the Investigation and potential pursuit of Lender Claims by the Committee. See Interim Order at ¶¶ 22-23. First, the Committee may expend only $25,000 of DIP Collateral in the Investigation. Id. at ¶ 22. Second, the Committee is not granted standing to commence and prosecute any Lender Claims but rather must gain standing before filing an adversary proceeding. Id. at ¶¶ 22, 23(a), (c). And the Committee is allotted only sixty days from its appointment to (i) investigate, (ii) prosecute and secure standing, and (iii) commence an adversary proceeding asserting a Lender Claim (otherwise, the Debtors' stipulations as to the amounts and perfection of the Prepetition Debt and release of all claims or causes of action against the Prepetition Secured Parties become binding). Id. at ¶ 23(a).

21. The $25,000 Investigation budget is wholly inadequate in light of the size of the Debtors' business, the amount of the funded debt, and the efforts required for such an Investigation. To date, the Committee has made several information requests of the Debtors,

consisting of approximately thirty categories of necessary diligence and has thus far received only partial responses. What documents have been received by the Committee consist of thousands of pages requiring review. While the Committee will keep working cooperatively with the Debtors in this respect, it is already clear that the current Investigation budget is insufficient. Aside from assets generally perfected through UCC-1 filings, the Debtors have significant assets, including real estate, leases, deposit accounts, and cash, that are perfected by means other than the filing of a financing statement. Further, the Debtors own a substantial amount of intellectual property which may be of significant value (and with respect to which perfection must be examined).

22. Moreover, this customary perfection analysis is only the tip of the iceberg. The Committee also must investigate whether there exist any claims against Bayside in connection with, among other things, the original negotiation, documentation, and closing of the May 2012 Term Loan, Bayside's declaration of default and acceleration and assertion of the "make whole" in December and January, and Bayside's actions in forcing the Debtors into the hurried sale process. Further, a contested hearing with regard to Bayside's asserted "make whole" claim (which contested matter falls within the definition of "Lender Claim") has already been set for March 12, 2013 *at the request of Bayside* and, thus, any amounts expended by the Committee in connection with this dispute should not be charged against the Investigation budget.

23. Considering (i) the Committee's duty to investigate Lender Claims (and the considerable efforts that will be required in that regard), (ii) the fact that the valuation evidence already adduced in these cases demonstrates substantial value for unsecured creditors (such that

the Prepetition Secured Parties are oversecured),[7] and (iii) the fact that the fees and expenses of the Committee's professionals remain subject to a reasonableness review in any event, the proposed limit on the budget for the Investigation is unreasonable, unworkable, and serves only to impede the Committee in carrying out its obligations (while inappropriately shielding, and advancing the interests of, the Prepetition Secured Parties).

24. Furthermore, the Committee should be granted standing now to pursue the Lender Claims. In light of the sixty-day window in which to commence an adversary proceeding with respect to a Lender Claim, and the current accelerated timeline for a sale of the Debtors' assets, it is inefficient not to grant the Committee standing and authorization, as part of any final order on the Motion, to pursue any claims it determines should be asserted. A grant of standing now alleviates the attendant risks and costs of a later dispute over standing (and the commencement of a Lender Claim) that would be magnified as a potential closing of a sale of the Debtors' assets approaches.

25. In sum, the needlessly restrictive budget, time, and other constraints placed on the Investigation strip the Committee of its rights and undermine the adversary system. See Ames Dep't Stores, 115 B.R. at 38 (requiring post-petition financing order to provide creditors' committee with a reasonable carve-out in order to preserve the adversary system). The terms of the Investigation should be modified as described above in order to permit the Committee to satisfy its duties in these cases.

---

[7] See Declaration of Nicholas P. Leone at ¶ 25 (annexed to the *Request for Adjournment and Objection of the Official Committee of Unsecured Creditors to Debtors' Motion Establishing Bid Procedures*) [Docket No. 177].

D. Waiver Of Bankruptcy Code Section 506(c) Surcharge Rights Is Inappropriate

26. Under the DIP Financing, the Debtors waive the ability to surcharge the DIP Collateral, Prepetition Priority Collateral, and the Cash Collateral, as permitted by Bankruptcy Code Section 506(c). See Interim Order at ¶ 15. The effect of the Section 506(c) waiver is to eliminate a further avenue of recovery for the Debtors' estates and to guarantee that the costs of the Debtors' restructuring will be borne by the unsecured creditors alone. Because waivers of surcharge rights contravene the intent behind Bankruptcy Code Section 506(c),[8] courts routinely reject such waivers.[9]

---

[8] See, e.g., Precision Steel Shearing v. Fremont Fin. Corp. (In re Visual Indus., Inc.), 57 F.3d 321, 325 (3d Cir. 1995) ("[Section] 506(c) is designed to prevent a windfall to the secured creditor . . . . The rule understandably shifts to the secured party . . . the costs of preserving or disposing of the secured party's collateral, which costs might otherwise be paid from the unencumbered assets of the bankruptcy estate . . . .") (internal citation omitted); Kivitz v. CIT Group/Sales Fin., Inc., 272 B.R. 332, 334 (D. Md. 2000) ("[U]nsecured creditors should not be required to bear the cost of protecting property that is not theirs [and] the secured party [must] bear the cost of preserving or disposing of its own collateral."); In re AFCO Enters., Inc., 35 B.R. 512, 515 (Bankr. D. Utah 1983) ("When the secured creditor is the only entity which is benefited by the trustee's work, it should be the one to bear the expense. It would be unfair to require the estate to pay such costs where there is no corresponding benefit to unsecured creditors."); In re Codesco, Inc., 18 B.R. 225, 230 (Bankr. S.D.N.Y. 1982) ("The underlying rationale for charging a lienholder with the costs and expenses of preserving or disposing of the secured collateral is that the general estate and unsecured creditors should not be required to bear the cost of protecting what is not theirs.").

[9] See, e.g., McAlpine v. Comerica Bank-Detroit (In re Brown Bros., Inc.), 136 B.R. 470, 474 (W.D. Mich. 1991) (finding a waiver to be unenforceable as interfering with the congressional mandate that the trustee have the authority to use a portion of a creditor's collateral to preserve or dispose of that collateral); Hartford Fire Ins. Co. v. Norwest Bank Minn., N.A. (In re Lockwood Corp.), 223 B.R. 170, 176 (B.A.P. 8th Cir. 1998) (holding that provision in financing order purporting to immunize the post-petition lender from § 506(c) surcharges was unenforceable); In re The Colad Group, Inc., 324 B.R. 208, 224 (Bankr. W.D.N.Y. 2005) (refusing to approve post-petition financing agreement to the extent that the agreement purported to modify statutory rights and obligations created by the Bankruptcy Code by prohibiting any surcharge of collateral under § 506(c)); In re Willingham Invs., Inc., 203 B.R. 75, 80 (Bankr. M.D. Tenn. 1996) (holding that secured creditor could not immunize its pre-petition claims from a surcharge under § 506(c) in cash collateral order by receiving super-priority claim under § 507(b)); see also In re

27. Here, a waiver of Section 506(c) surcharge rights is particularly prejudicial to unsecured creditors. With the short sale process and credit bid contemplated, this case is really akin to a state law foreclosure action. However, because the Debtors, Bayside, and the ABL DIP Lenders have chosen this Court and Chapter 11 as the forum for effectuating the sale, it is manifest that the protections of the Bankruptcy Code should govern. Moreover, in light of the fact the DIP Lenders are not providing an adequate Carve-Out (as a way to "fund" themselves into a Section 506(c) waiver), it is apparent that the waiver of Section 506(c) surcharge rights will result in unsecured creditors bearing all of the restructuring costs. Thus, the Section 506(c) waiver is inappropriate and should be struck from the terms of the DIP Financing and any final order entered with respect to the Motion.

E. Waiver Of The "Equities Of The Case" Exception Is Inappropriate

28. Under the DIP Financing, the Debtors also waive the "equities of the case" exception under Bankruptcy Code Section 552(b) for the benefit of the Prepetition Secured Parties. See Interim Order at ¶ 15. The purpose of Section 552(b) and its "equity exception" is to prevent a windfall to the secured creditor at the expense of unsecured creditors from the appreciation in the value of its collateral. See Stanziale v. Finova Capital Corp. (In re Tower Air, Inc.), 397 F.3d 191, 205 (3d Cir. 2005) ("Section 552(b) is normally relevant in Chapter 11, 'to prevent a secured creditor from reaping benefits from collateral that has appreciated in value as a result of the trustee's/debtor-in-possession's use of other assets of the estate.'") (citation

---

Motor Coach Indus. Int'l, Inc., Case No. 08-12136 (Bankr. D. Del. Oct. 22, 2008) (Final Order Authorizing Debtors to Obtain Postpetition Financing) (Docket No. 244) (removing a § 506(c) waiver from the final post-petition financing order after the creditors' committee objected to its inclusion); In re Fedders North America, Inc., Case No. 07-11176 (Bankr. D. Del. Oct. 5, 2007) (Final Order Authorizing Debtors to Obtain Postpetition Financing) (Docket No. 272) (a § 506(c) waiver in the interim post-petition financing order was removed from the final post-petition financing order after the creditors' committee objected to its inclusion).

omitted); In re Muma Servs., Inc., 322 B.R. 541, 558 (Bankr. D. Del. 2005). A waiver of the "equity exception" should be authorized, if ever, only when it would be critical to the financing – such a need has not been demonstrated here. Further, as noted above, the oversecured status of the Prepetition Secured Parties, together with the apparent reality of unsecured creditors bearing the restructuring costs in this case designed to hand the company to Bayside, belies the need for a waiver of the statutory rights provided in Section 552(b).

F. Several Provisions In The DIP Financing Require Clarification

29. The Committee respectfully submits that the following provisions in the Interim Order and/or the ABL DIP Facility should be clarified in any final order entered with respect to the Motion:

- ***Financial Reporting*.** Paragraphs 10 and 18(f) of the Interim Order provide for certain financial reporting by the Debtors to the Prepetition Secured Lenders and the DIP Lenders. The Committee submits that the Debtors should also provide any such financial reporting to the Committee. As this financial reporting is already being required of the Debtors, there is no justification for not providing the same to the Committee.

- ***Exercise of Rights or Remedies*.** Paragraph 14(c) of the Interim Order states, without justification, that in "any hearing regarding any exercise of rights or remedies [upon an Event of Default], the only issue that may be raised by any party in opposition thereto shall be whether, in fact, an Event of Default . . . has occurred and is continuing . . . ." The Committee has not waived its rights to challenge the exercise of rights or remedies after an Event of Default. Paragraph 14(c) of the Interim Order should be modified accordingly to preserve the Committee's rights to challenge the exercise of rights or remedies *and* whether, in fact, an Event of Default has occurred and is continuing.

- ***Avoidance of Pre-Petition ABL Debt (i.e., the ABL Roll Up Obligations)*.** Section 2.4(e)(vii) of the ABL DIP Credit Agreement requires that, if any portion of the ABL Roll Up Obligations is avoided or disgorged (through an Avoidance Action, Lender Claim, or otherwise), any amounts recovered shall be used in their entirety to prepay outstanding amounts due under the ABL DIP Facility. This provision entirely frustrates the Committee's ability to pursue and recover on a Lender Claim or Avoidance Action for the benefit of unsecured creditors. Even if such an action were successful, the proceeds would still flow to the ABL DIP Lenders. This provision is inappropriate and should be rejected.

III. The Alternative Proposal, Together With Certain Modifications To The ABL DIP Facility, Will Allow The Case To Proceed Along A More Reasonable Timeline

30. The Alternative Proposal, if embraced and pursued by the Debtors, would replace Bayside's Term Loan and the Bayside DIP Facility (leaving only the asserted "make whole" portion of the Term Loan to be funded into escrow and resolved in further proceedings before this Court). The Alternative Proposal would unquestionably provide the Debtors with post-petition financing on superior terms. First, the Alternative Proposal would take out the Term Loan *and* the Bayside DIP Facility with funds provided at a lower interest rate, along with a marked decrease in fees. Specifically, the Alternative Proposal provides an interest rate 4% lower than the Bayside DIP Facility and 1% lower than the Term Loan. Furthermore, the Alternative Proposal features a more favorable fee structure, as it excludes a Closing Fee and an Unused Line Fee and includes a substantially smaller Administrative Fee. And, perhaps most importantly, the Alternative Proposal provides the Debtors with the runway to pursue the restructuring ultimately found to be in the best interests of the estate and all creditors – not just a hurried sale for the sole benefit of secured creditors. The dual-track sale and plan process, whereby the Debtors will actively market their assets and simultaneously file and prosecute a plan and disclosure statement before the Court, allows both processes to play out to see which one will be most value-maximizing for the Debtors' estates.

31. However, notwithstanding the potential refinancing of the Bayside DIP Facility, the ABL DIP Facility would (if approved) remain in place and provide for the substantially identical (and equally inappropriate) Sale Control Provisions.[10] These Sale Control Provisions, if

[10] The Committee's views as to the Debtors' proposed sale of assets, related procedures, and the Sale Control Provisions are set forth more fully in the *Request for Adjournment and Objection of the Official Committee of Unsecured Creditors to Debtors' Motion Establishing Bid Procedures* [Docket No. 177].

not modified, would continue to squeeze the Debtors' cases and impose the same truncated sale timeframe as was compelled by the Bayside DIP Facility. Under these circumstances, approval of the Sale Control Provisions in the ABL DIP Facility would run afoul of the legal standards governing approval of post-petition financing. Under applicable law, the ABL DIP Lenders are not permitted to specially benefit from the provision of post-petition financing or hold the bankruptcy cases hostage to the detriment of the Debtors' unsecured creditors. See Farmland Indus., 294 B.R. at 879-80; Tenney Vill., 104 B.R at 568. The Committee respectfully submits that the Court should endorse the milestones under the Alternative Proposal, as they stand to maximize value for the benefit of the Debtors' estates and all parties-in-interest.[11]

32. In any event, the Committee notes that arranging financing (such as the Alternative Proposal) takes time. To the extent that the efforts toward resolving the Bayside DIP Facility have been fruitful, additional time should be allotted to permit a concomitant resolution of the milestone issues presented by the ABL DIP Facility. If such time is afforded, it may be the case that the Debtors, the Committee, the Ad Hoc Committee, and the ABL DIP Lenders will be able to find a middle ground or an adequate replacement for the ABL DIP Facility. In either

[11] Even if the Court were to find that entry into the ABL DIP Facility, including the Sale Control Provisions is fair, reasonable, and in the best interests of the estate, a certain degree of flexibility should be introduced to alleviate any unintended or unforeseen severe consequences in these cases. For example, a breach of a Sale Control Provision is an immediate Event of Default without allowance for a cure, and the ABL DIP Lenders may exercise rights and remedies without notice. See ABL DIP Credit Agreement, §§ 5.16, 8.2(a), 9.1. It is inappropriate to now mandate a default under and acceleration of the ABL DIP Facility – which would precipitate a value-destructive tailspin – at a time when the facts and circumstances may require the Debtors to depart from the strictures of the Sale Control Provisions in the best interests of the estate. Accordingly, the Sale Control Provisions should be limited by a "fiduciary out" and/or cure period. This would allow the Debtors to fulfill their fiduciary duties and for parties in interest (including, without limitation, the Debtors, the Committee, the ABL DIP Lenders) to negotiate and/or bring matters before this Court in the event that a superior restructuring alternative is proposed, without jeopardizing value throughout the capital structure.

event, the Debtors would be provided with the opportunity to proceed down the value-maximizing, dual-track path. Thus, this Court should either adopt the milestones set forth in the Alternative Proposal or give the key parties a modicum of additional time to reach a resolution with the ABL DIP Lenders or to find replacement financing for the ABL DIP Facility.

33. Lastly, the ABL DIP Lenders cannot have it both ways – namely, (i) squeezing unsecured creditors with a truncated sale timeframe and (ii) benefiting from exorbitant fees, a roll up of pre-petition obligations, and their oversecured status. In particular, the ABL DIP Lenders are requesting payment of a $2.625 million Closing Fee and an Unused Line Fee of 0.50% per annum (multiplied by the unused portion of the ABL DIP Facility). See Interim Order at ¶ 12. To gauge the true nature of these fees, it is important to note that, as of the week ending April 13, 2013 (the date closest to the April 15 sale closing deadline in the ABL DIP Facility), the Debtors' Budget forecasts a Funded ABL Debt Balance of $66.4 million (which amount is also the highest usage of the ABL DIP Facility prior to the April 15 sale closing deadline). This consists of a funded amount of $18.78 million over and above the $47.62 million pre-petition ABL balance (which has been rolled up). The $2.625 million Closing Fee amounts to approximately ***14%*** of the net additional post-petition funding advanced by the ABL DIP Lenders. In light of the real and practical extent of the term and dollar amount of their commitment (notwithstanding a stated maturity date of June 30, 2013 and a headline commitment of $175 million), the proposed fees under the ABL DIP Facility are unreasonable and should not be approved.

34. The Committee respectfully submits that modifications to the Sale Control Provisions and the provisions calling for exorbitant fees in the ABL DIP Facility are necessary for the protection of all parties-in-interest and are not unduly burdensome to the ABL DIP

Lenders. Absent these changes, the ABL DIP Facility, as proposed, is not fair, reasonable, or in the best interests of the Debtors' estates under Farmland Industries, Tenney Village, and their progeny.

RESERVATION OF RIGHTS

35. The Committee and its members reserve all of their respective rights, claims, defenses, and remedies, including, without limitation, the right to amend, modify, or supplement this Objection, to seek discovery, to raise additional objections during the Final DIP Hearing, and to negotiate and document alternative post-petition financing terms and proposals.

[*Remainder of page intentionally left blank.*]

CONCLUSION

WHEREFORE, for the foregoing reasons, the Committee respectfully requests that the Court (i) sustain this Objection; (ii) deny the Motion; and (iii) grant such other and further relief as is just and proper.

Dated: February 18, 2013
Wilmington, Delaware

/s/ Jamie L. Edmonson
VENABLE LLP
Jamie L. Edmonson, Esq. (No. 4247)
1200 North Broom Street
Wilmington, DE 19806
(302) 656-3929
(410) 244-7742 (fax)

and

BROWN RUDNICK LLP
Robert J. Stark, Esq.
Seven Times Square
New York, NY 10036
(212) 209-4800
(212) 209-4801 (fax)

-and-

Steven D. Pohl, Esq.
Thomas H. Montgomery, Esq.
One Financial Center
Boston, MA 02111
(617) 856-8200
(617) 856-8201 (fax)

Proposed Counsel to the Official Committee of Unsecured Creditors