HEARING: Wed., July 21, 2010 (3:00 p.m.)

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	Chapter 11
	:	
JENNIFER CONVERTIBLES, INC.,	:	Case No. 10-13779 (ALG)
	:	
Debtors.	:	(Jointly Administered)
	:	

UNITED STATES TRUSTEE'S OMNIBUS RESPONSE AND OBJECTIONS TO CERTAIN OF THE DEBTORS' FIRST-DAY MOTIONS

TO: THE HONORABLE ALLAN L. GROPPER,
UNITED STATES BANKRUPTCY JUDGE:

Tracy Hope Davis, the Acting United States Trustee for Region 2 (the "United States Trustee"), hereby respectfully files her response and objections to certain of the first-day motions of Jennifer Convertibles, Inc. and related Chapter 11 debtors (collectively, the "Debtors"). In support of her response and objections, the United States Trustee respectfully represents as follows:

INTRODUCTION

In these cases, the Debtors request extraordinary relief at the first-day hearing, with limited notice and before an official committee of unsecured creditors is appointed. This relief, if granted in full, would pre-determine the outcome of this case. The relief the Debtors request include granting their sole critical vendor and top unsecured creditor, a creditor who post-confirmation is expected to obtain 95 per cent equity control of the reorganized companies, a purchase money security interest and post-petition critical vendor payments. The Debtors also request that two of the Debtors' principal insiders, their CEO and CFO, be allowed pre-petition

wage payments that significantly exceed the statutory cap, the very same insiders who under a plan support agreement are expected to retain board positions and be potential beneficiaries of third-party releases and a management incentive plan. Until the appointment of an official committee of unsecured creditors, such extraordinary relief is not appropriate.

BACKGROUND

On July 18, 2010 (the "Filing Date"), the Debtors commenced these cases by filing voluntary petitions under chapter 11 of the Bankruptcy Code. No Official Committee of Unsecured Creditors (the "Committee") has yet been appointed in these cases. The United States Trustee has scheduled an Organizational Meeting for the formation of a Committee for Friday, July 23, 2010, at 11:00 a.m. (the "Organizational Meeting"), and on or about the Filing Date provided notices of the Organizational Meeting by electronic mail and Federal Express overnight delivery.

The United States Trustee hereby incorporates by reference the facts and representations made in the Declaration of Rami Abada Pursuant to Rule 1007-2 of Local Bankruptcy Rules of the Southern District of New York dated July 19, 2010 (the "Abada Declaration"), ECF Doc. No. 3, and in the exhibits and schedules thereto.

The Debtors operate the largest group of sofa-bed specialty retail stores and leather specialty retail stores in the United States, with stores located throughout the Eastern seaboard, Midwest, West Coast and Southwest. *See* Abada Decl., at ¶ 6. The Debtors operate in two business segments: Jennifer and Ashley. Jennifer stores, of which the Debtors operate 130 across the country, focus on the sofa-bed concept. Ashley stores, of which the Debtors operate seven stores, focus on big box full line home furniture retail. *See id.*, at ¶¶ 6-8.

The stock of lead debtor, Jennifer Convertibles, Inc. is publicly held. *See* Abada Decl., at Schedule 4. The Debtors have no secured liabilities. *See id.*, at Schedule 2.

Prior to the Filing Date, the Debtors reached a plan support agreement (the "Plan Support Agreement") with their lead supplier and top unsecured creditor Haining Mengnu Group Co. Ltd. ("Mengnu"). *See* Abada Decl., at ¶ 57; *see also* Abada Decl., Ex. B (the Plan Support Agreement and Plan Term Sheet). Under the Plan Support Agreement, Mengnu would convert its pre-petition debts to 95 percent of the Debtor's newly issued stock, with the remaining five percent to be held by the remaining unsecured creditors, who would also receive a *pro rata* share of $1.4 million of unsecured notes to be issued by a "Reorganized Jennifer," a new entity. The unsecured trade creditors would not receive a distribution in these cases, and all currently outstanding equity interests will be canceled. *See* Abada Decl., at ¶ 57; Plan Term Sheet at 2-4.

OBJECTIONS

Critical Vendor Motion with Mengnu

The Critical Vendor Motion, ECF Doc. No. 4, should not be heard by the Court until a Committee is appointed and obtains counsel to review the Debtors' request for this extraordinary relief.

The relief the Debtors request in the Critical Vendor Motion consists of, primarily, (a) granting Mengnu a post-petition purchase money security interest with regard to any inventory shipments it may make post-petition and the proceeds of such inventory and (b) requiring the Debtor to make weekly payments of $400,000 to Mengnu on account of its pre-petition unsecured claim. *See* ECF Doc. No. 4.

The Debtors' Critical Vendor Motion is inextricably interwoven with – and indeed a significant component of – a comprehensive and determinative "Plan Support Agreement" and plan "Term Sheet" executed by the Debtors and Mengnu immediately preceding the filing of these bankruptcy cases. *See* Rule 1007-2 Abada Decl., at Ex. B (and Ex.A thereto). The Critical Vendor Motion, Plan Support Agreement and Term Sheet contain virtually all of the principal terms of a plan of reorganization of the Debtors. *See id*. Therefore, the Critical Vendor Motion cannot and should not be considered in isolation by this Court or any party in interest, particularly at this juncture in these cases, before a Committee has been appointed.

The extent to which unsecured creditors other than Mengnu stand to be affected by the Critical Vendor Motion, the Plan Support Agreement and the Term Sheet cannot be understated. In the unusual absence of pre-petition secured debt, and no noteworthy priority tax debts, these retail cases essentially implicate only two classes of pre-petition trade creditors, both unsecured – *i.e.*, Mengnu on the one hand, and all other unsecured creditors on the other hand.

Without the input of other unsecured creditors, Mengnu has placed the Debtors on a fast track. Under the Plan Support Agreement, the Debtors are required to file a disclosure statement within 30 days of the commencement of the cases, which disclosure statement must be approved within 75 days post-filing. Plan Support Agreement, ¶¶ 4(iii), at 2, and 7(ii)(cc), at 3. The disclosure statement, even if modified under the recommendations of the Court, must be satisfactory to Mengnu. *Id*., at 7(ii)(cc), at 3. Confirmation of a plan of reorganization is required within just 130 days post-filing. *Id*., at ¶ 7(ii)(dd), at 3. *See also*, Term Sheet, at 6 (stating that plan, disclosure statement and confirmation order must be in form and substance satisfactory to Mengnu).

Under the contemplated plan, Mengnu (which asserts a pre-petition claim of $16,673,770) would receive two forms of compensation on its pre- and post-petition claims. *See* Term Sheet, at 2-4. Specifically, as a Class 1 secured creditor on account of post-petition deliveries of inventory under the Critical Vendor Motion, Mengnu will receive 95 percent of the common stock of the "Reorganized Jennifer." *Id*., at 2-3. Furthermore, as a Class 2(A) unsecured critical vendor creditor during the pre-confirmation pendency of the cases, Mengnu will receive $400,000 per week under the Critical Vendor Motion, in payment of its pre-petition unsecured claim. *Id*., at 3-4.

In contrast, all other unsecured creditors, who collectively are owed approximately $29.6 million, *i.e.*, almost twice as much as Mengnu, will not receive any post-petition cash payments on account of their claims, but rather will receive (a) a *pro rata* share of (a) $1.4 million of unsecured notes to be issued by Reorganized Jennifer (the "Unsecured Creditor Notes"), plus (b) a *pro rata* share of five percent of the outstanding common stock of Reorganized Jennifer. *Id*., at 4. This proposed treatment is structurally different, far less favorable, and much riskier than the treatment which Mengnu negotiated for itself with the Debtors prior to the bankruptcy filings. Current preferred and common stock of the Debtors will be cancelled. *Id*.

Due to the integration of the Critical Vendor Motion with the Plan Term Sheet and Plan Support Agreement, and due even further to the relief requested in the Debtors' first-day motion to reject certain leases, *see* ECF Doc. No. 11, and the motion to approve certain sales procedures regarding store closing sales, *see* ECF Doc. No. 22, the overtly *sub rosa* nature of the Critical Vendor Motion cannot be ignored. In the Second Circuit, however, debtors-in-possession are prohibited from using the provisions of section 363 "if it would amount to a *sub rosa* plan of

reorganization." *Iridium Operating LLC v. Official Comm. of Creditors (In re Iridium Operating LLC*, 478 F.3d 452, 466 (2d Cir. 2007). "The reason *sub rosa* plans are prohibited is based on a fear that a debtor-in-possession will enter into transactions that will, in effect, 'short circuit the requirements of [C[]hapter 11 for confirmation of a plan of reorganization.'" *Id*. (quoting *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.*), 700 F.2d 935, 940 (5th Cir. 1983)).

In addition, information fundamental to unsecured creditors other than Mengnu for their decision-making on the Critical Vendor Motion, *i.e.*, the Debtors' demonstration of the wherewithal of Reorganized Jennifer to make payments on the Unsecured Creditor Notes, is not yet available. Without this information, consideration and approval of the Critical Vendor Motion is premature.

The presumptive deadlines set forth in the Plan Support Agreement notwithstanding, a short adjournment of the initial hearing on the Critical Vendor Motion is necessary and would not prejudice either the Debtors or Mengnu, which desires to acquire a 95 percent ownership stake in the Reorganized Jennifer. All other unsecured creditors, however, will be prejudiced generally by the exclusively favorable treatment being given to Mengnu under the Critical Vendor Motion, and Plan Support Agreement and Term Sheet, and prejudiced specifically by any post-petition security interests and liens granted to Mengnu. Even to the extent such security interests and liens arise under an interim critical vendor order, should the Court be inclined to so enter one, such liens and security interests would inevitably subordinate the claims of all other unsecured creditors. These provisions are characteristic of a *sub rosa* plan. In the absence of exigent circumstances, the Court should not approve this outcome prior to the United States

Trustee's appointment of a committee.[1]

Authorization to Pay Pre-petition Wages

The United States Trustee requests that no payments under the motion requesting authorization to pay pre-petition wages and related claims (the "Wage Motion"), *see* ECF Doc. No. 9, to any of the Debtor's insiders be authorized until a Committee is appointed in these cases.

In their Wage Motion, the Debtors have requested that their two most senior insiders – their CEO (Harley Greenfield, who is also Chairman of the current Board) and their CFO (Rami Abada, who is also the President of the Debtors, and their Chief Operating Officer) – receive immediate payments of pre-petition wages in excess of the priority "caps" of 11 U.S.C. § 507(a)(4). Wage Motion, Docket No. 9, ¶ 21-22, at 8. Specifically, Mr. Abada is seeking compensation of $26,689.00, which is more than twice the statutory maximum, and Greenfield is seeking payment of $21,670, which is almost twice the permissible maximum. *Id*. The Debtors claim that such payments are necessary because Messrs. Greenfield and Abada are "integral to the continued operation of the Debtors' businesses and the Debtors are concerned that they will cease working to keep the Debtors' businesses operating unless they are paid the full amount of the prepetition wages owed to them."

Under Rule 6003(b) of the Federal Rules of Bankruptcy Procedure, the Debtors may not obtain relief regarding payment of pre-petition claims within the first 21 days after the Filing

[1] Alternatively, the Court should defer consideration of the Critical Vendor Motion in the entirety, even on an interim basis, until a Committee has had the opportunity to review the Motion, and assess the impact of this relief on unsecured creditor claims. In this sense, only a modest adjournment would be needed as the United States Trustee will be holding the Organizational Meeting this upcoming Friday morning, July 23, 2010 – *i.e.*, just two days after the date scheduled for the initial hearing on the Critical Vendor Motion.

Date except "to the extent that relief is necessary to avoid immediate and irreparable harm." *See* Fed. R. Bankr. P. 6003(b).

The Debtors, consequently, need to explain why Messrs. Abada and Greenfield immediately need to receive such payments, especially in light of the fact that the Plan Support Agreement envisions that Messrs. Abada and Greenfield are guaranteed positions on the board of directors of Reorganized Jennifer, *see* Plan Term Sheet, at 5, and may potentially receive additional pecuniary benefits through a Management Incentive Plan, and additionally become beneficiaries of third-party releases.[2] *See* Plan Term Sheet, at 1-2, 5.

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[2] The arrangements negotiated by Messrs. Greenfield and Abada for their continued employment post-confirmation raise significant concerns about whether the Critical Vendor Motion, the Plan Support Agreement, and the Plan Term Sheet were indeed negotiated at arms-length. As the Court is aware, in the absence of tangible consideration and other contributory features, such releases generally are disfavored in the Second Circuit. *See Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F. 3d 136, 141 (2d Cir. 2005); *In re Karta Corp.*, 342 B.R. 45 (S.D.N.Y. 2006). In this light, whether the interests of the bankruptcy estate were at the forefront of the negotiations underlying the Critical Vendor Motion is, at a minimum, suspect.

While subject to further examination by the Committee and parties in interest, it appears that one of the events contributing to the pre-petition financial decline of the Debtors implicates a "Related Company" in which relatives of the CEO, Mr. Greenfield, have financial and ownership interests. The Debtors' pre-petition transactions with the Related Company earlier this year, in which the Debtors generally took back the operations at stores previously licensed to the Related Company, purchased the inventory located at such stores, and assumed certain debts, are described in the Abada Declaration. *See* Abada Decl., at ¶¶ 50-52, at 18-19.

However, Mr. Greenfield's personal connections to the Related Company are conspicuously absent from the Abada Declaration. *See id*. Those familial ties are instead explained in the publicly-available Form 10-Q filed by the lead debtor, Jennifer Convertibles, Inc. (the "Lead Debtor") with the Securities and Exchange Commission on April 13, 2010. *See* http://www.otcmarkets.com/edgar/GetFilingHtml?FilingID=7184357.

This recent Form 10-Q explains that the Related Stores operated under licenses from the Debtors without the concomitant obligation to pay royalties. *Id*., Note 5, at 6. The Related Company is owned by the estate of a deceased stockholder of the Lead Debtor who was also Mr.

Extension of Time to File Schedules

In their Motion for Extension of Time to File Schedules (the "Extension Motion"), ECF Doc. No. 10, the Debtors request an additional twenty days beyond the deadline provided by Rule 1007(c) of the Federal Rules of Bankruptcy Procedure to file their Schedules and Statements of Financial Affairs (collectively, the "Schedules"). *See* Extension Mot., at ¶ 13. The Plan Support Agreement, however, provides that the Schedules should be filed no later than twenty days after the Filing Date. *See* Plan Support Agreement, at ¶ 4(ii).

Consequently, the Debtors need to explain why "cause" exists to grant this extension. *See* Fed. R. Bankr. P. 1007(c). Also, in light of the expedited inventory sales process the Debtors envision in the Plan Support Agreement, and in the Motion to Shorten Time to Schedules a Sales Procedures Hearing, *see* ECF Doc. No. 20, Schedules should be filed in time for a Committee to evaluate any proposed sales procedures. And certainly, in no event should the Court enter an order authorizing any sale of inventory before the Schedules are filed.

Motion to Continue Customer Programs
Motion to Satisfy Pre-Petition Claims of Common Carriers
Motion to Pay Pre-Petition Taxes
Motion to Continue Insurance Policies

In regard to the Debtors' motions to Continue Customer Programs, ECF Doc. No. 15, Satisfy Pre-Petition Claims of Common Carriers, ECF Doc. No. 16, Motion to Pay Pre-Petition Taxes, ECF Doc. No. 7, and Motion to Continue Insurance Policies (the "Insurance Motion"), ECF Doc. No. 8 (collectively, the "Payment Motions"), the United States Trustee respectfully requests that the Debtors be authorized to make only those payments on pre-petition claims that

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Greenfield's brother-in-law. *Id*. The sister of Mr. Greenfield was the President of the Related Company. *Id*.

are due and payable within the first 21 days of the Debtors' cases, and that the relief requested in the Payment Motions be only granted on an interim basis.

Under Rule 6003(b) of the Federal Rules of Bankruptcy Procedure, Debtors may not obtain relief regarding payment of pre-petition claims within the first 21 days after the Filing Date except "to the extent that relief is necessary to avoid immediate and irreparable harm." *See* Fed. R. Bankr. P. 6003(b). Because a Committee has not yet been appointed and has not had an opportunity to review the propriety of the claims requested in the Payment Motions, the United States Trustee asks this Court to limit any payments authorized to those that are due and payable within the period established by Rule 6003(b), namely, the first 21 days after the Filing Date.

Motion to Shorten Notice

In their Motion to Short Notice, ECF Doc. No. 20, the Debtors request that the Court schedule a hearing on Friday, July 23, 2010, at 3:00 p.m. with regard to the hearing on the Motion to Approve Sales Procedures, ECF Doc. No. 23, with objections due by 10:00 a.m. that same day. As set forth above, however, the Organizational Meeting will be held at 11:00 a.m. that day – *i.e.*, one hour after the objections are to be due.

The United States Trustee respectfully requests that the hearing on the Motion to Approve Sales Procedures be scheduled for a date subsequent to the date of the Organizational Meeting, so that a Committee would have time to retain counsel and/or financial advisor(s) who could review the propriety of the relief requested and have an opportunity to comprehensively respond to the relief requested.

Authorization to Continue Existing Cash Management System

In their motion to Continue their Existing Cash Management System and to Maintain

Existing Bank Accounts and Business Forms, ECF Doc. No. 12 (the "Cash Management Motion"), the Debtors request that the Debtors be allowed to maintain their existing bank accounts and their existing cash management system without any need to open any new bank accounts. *See* ECF Doc. No. 12. The Debtors also request that they be allowed to maintain their existing business forms without any requirement for the Debtors to be designated in those forms as "debtors in possession" until the stock of existing checks and business forms is depleted. *Id.*

Section 345 of the Bankruptcy Code directs that the trustee must deposit or invest money of the estates to achieve the "maximum reasonable net return" while considering the safety of the deposit or investment. 11 U.S.C. § 345(a). Unless the deposits or investments are backed by the full faith and credit of the United States, or insured or guaranteed by the United States (or a federal agency), the party with whom money of the estate has been deposited must either post a bond in favor of the United States or, in the alternative, deposit securities of the type specified in section 9303 of title 31 of the United States Code as security for the invested funds, unless the Court, for cause, orders otherwise. 11 U.S.C. § 345(b).

The United States Trustee requests that those of the Debtors' deposit bank accounts that are maintained at banks that are not authorized depositories in the Southern District of New York (namely, Citizens Bank and Provident Bank) be transferred to banks that are authorized depositories in the Southern District of New York by July 31, 2010. Additionally, the Debtors' funds in the Debtors' certificate of deposit account at American Express Bank FSB should be transferred to an authorized depository institution at the maturity of the account. The United States Trustee also requests that any new accounts the Debtors may open post-petition be at institutions that are authorized depositories in the Southern District of New York, so as to ensure

her Office's continual monitoring of these depositories.

Finally, because the Debtors have failed to show that indicating "debtor in possession" status will be unduly burdensome upon them, the United States Trustee respectfully requests that the Debtors be required to indicate their "debtor in possession" status on all their checks and business forms within one week of the Filing Date.

Motions to Retain and Compensate Professionals
Monthly Compensation Motion

The Debtors are seeking Court approval of their retention of proposed counsel and financial advisor, respectively the law firm of Olshan Grundman Frome Rosenzweig & Wolosky LLP ("Olshan"), ECF Doc. No. 5, and TM Capital Corp. ("TM Capital"), ECF Doc. No. 18. Bankruptcy Rule 6003(a) provides that "except 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 relief regarding . . . an [employment] application under Rule 2014." Fed. R. Bankr. P. 6003(a).

The Abadi Declaration and the declarations filed in support of these employment applications, *see* Doc. Nos. 5 and 18, do not contain any representations, however, to support a finding that the Debtors will be immediately and irreparably harmed unless the applications are granted. Unless the Olshan firm and TM Capital represent at the first-day hearing that they will immediately terminate their representations of the Debtors unless their retention applications are immediately approved, it is difficult to conjecture what immediate and irreparable harm may arise. While the immediate entry of a retention order may serve as a source of comfort to Olshan and TM Capital, comfort does not rise to the level of cognizable immediate and irreparable harm

required for the entry of relief pursuant to Rule 6003(a).

Furthermore, the Court should refrain from entering even interim retention orders. Interim retentions also fall within the purview of Rule 6003(a), which is entitled "Interim and Final Relief Immediately Following the Commencement of the Case – Applications for Employment . . ." See *Florida Dept. of Revenue v. Piccadilly Cafeterias*, 554 U.S. 33, 128 S.Ct. 2326, 2336 (holding that "statutory titles and section headings are tools available for the resolution of a doubt about the meaning of a statute.").

Finally, the Debtors seek the entry of an order establishing monthly compensation procedures for the retained professionals. *See* ECF Doc. No. 13. The procedures proposed by the Debtors, however, do not conform to the Court's governing administrative order, i.e., General Order M-388 (dated November 25, 2009). Moreover, due to its close ties to the Debtors' employment applications, the Court should consider the Debtors' monthly compensation motion at such time as it considers the employment applications.

CONCLUSION

WHEREFORE, the United States Trustee respectfully requests that the Court sustain these Objections, and enter such other and further relief as it deems just and proper.

Dated: New York, New York
July 20, 2010

Respectfully submitted,
TRACY HOPE DAVIS
ACTING UNITED STATES TRUSTEE

By: ***/s/ Andrew D. Velez-Rivera***

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