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Bankruptcy Issues in the Retail Sector

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AIG bailed out by the Government! September Numbers for Job Losses the Worst in Five Years! WAMU put into Receivership! \$750 Billion Bailout Package Approved! Consumer confidence levels at an all-time low! While the current downturn in the economic market has riveted the public in recent weeks, retailers have been feeling the negative ripple effects of growing consumer pessimism for some time. The contraction in consumer spending and the credit markets has pushed several large retailers, including Linens 'N Things and Sharper Image, to seek bankruptcy protection even as the retail industry gears up for its busiest quarter. The purpose of this paper is to discuss retail bankruptcies, the market factors leading to retail bankruptcies and other issues which the practitioner involved in a retail bankruptcy should be aware.

I. Introduction

Since the end of 2007, predictions have abounded that a new wave of retail bankruptcy cases were on the horizon.¹ The bubble surrounding the residential real estate market had finally burst, and consumers were becoming concerned about the value of the homes they had purchased. As the residential housing market slowed, retailers that relied on the sale of furnishings for homes (such as furniture, appliances, or décor), as well as home improvement stores, began to run into problems (i.e., bankruptcy filings of Bombay Company, Levitz, Sofa Express, Inc. and the slowdown in revenue of Home Depot and Lowes).² The lower value of homes coupled with rising costs in fuel, food, and energy, caused consumers to begin to “buy down” in 2008. As a result, many retailers in the causal dining, fashion, furniture and home goods industries began to feel the negative effects. Department stores such as Dillard’s and J.C. Penney’s experienced double-digit declines in sales as compared to September of 2007.³ Even high end retailers are beginning to feel the pinch.⁴ The downward trend in sales in the retail industry is bound to continue as negative economic news continues to play across headlines. Retailers hoping for a holiday rebound are facing the reality that this could be the worst Christmas season in decades.

With the ongoing disheartening economic news and the corresponding difficulties faced by retailers, the question the bankruptcy practitioner must consider is: What effects will the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) have on the upcoming surge of retail bankruptcy filings?

¹ Matt Miller, *The Coming Catastrophe*, The Deal.Com (March 20, 2008), <http://thedeal.com/pipline/tdd/ViewArticle.dl?id=1000694672>.

² *Id.*

³ Stephanie Rosenbloom, *Retailers' Sales Fall Sharply at Both High End and Low*, N.Y. TIMES, October 8, 2008, available at <http://www.nytimes.com/2008/10/09/business/09retail.html?scp=1&sq=retailers%20sales%20fall%20sharply&st=cse> (stating that same-store sales at Dillard's dropped 12 percent and J.C. Penney's sales dropped 12.4 percent from last year.)

⁴ *Id.* (stating that same-store sales at Neiman Marcus dropped 15.8 percent and Sak's dropped 10.9 percent from last year.)

II. First Day Issues

BAPCPA modified the Bankruptcy Code and Rules relating to first day issues, changes which are sure to impact upcoming retail bankruptcy filings. Among the matters discussed herein will be the changes to Rule 6003, 4001 and section 366.

A. Rule 6003

On December 1, 2007, Rule 6003 of the Federal Rules of Bankruptcy Procedure⁵ became effective.⁶ The plain language of Rule 6003 states that, except in circumstances to avoid immediate and irreparable harm, no relief should be granted within twenty (20) days of the filing of a petition for any application to employ professionals, application to use, sell, lease or otherwise dispose of property, or a motion to assume or assign an executory contract or unexpired lease. According to the Advisory Committee notes to Rule 6003, the purpose of the new rule is to slow down the “flurry of activity during the first days of a bankruptcy case,” which often takes place prior to the formation of any creditors’ committee.⁷

1. *The Implications of Rule 6003*

To date, only one court has issued a written opinion regarding Rule 6003.⁸ In *In re First NLC Financial Services LLC*, the United States Trustee objected to the debtor’s request for interim relief to employ counsel by arguing that the employment of debtor’s counsel was not necessary unless the debtor could show that immediate and irreparable harm would occur absent the entry of an order.⁹ Noting that the first clause of Rule 6003 came from Rule 4001(b)(2) and (c)(2) on the use of cash collateral, and based on the absence of specific language in Rule 6003 barring the entry of an interim order, the bankruptcy court entered an order allowing the employment of bankruptcy counsel on an interim basis. The court’s decision was based on testimony elicited from the Debtor’s chief restructuring officer that, as the chief restructuring

⁵ The Federal Rules of Bankruptcy Procedure will be referred to herein as the “Rules,” or individually as the “Rule.”

⁶ FED. R. BANK. P. 6003 states:

Except to the extent that relief is necessary to avoid immediate and irreparable harm, the court shall not, within 20 days after the filing of the petition, grant relief regarding the following:

(a) an application under Rule 2014;

(b) a motion to use, sell, lease, or otherwise incur an obligation regarding property of the estate, including a motion to pay all or part of a claim that arose before the filing of the petition, but not a motion under Rule 4001; and

(c) a motion to assume or assign an executory contract or unexpired lease in accordance with § 365.

Id.

⁷ FED. R. BANK. P. 6003, Advisory Committee Note—2007 Amendment.

⁸ *In re First NLC Financial Services LLC*, 382 B.R. 547 (Bankr. S.D. Fla. 2008).

⁹ *Id.* at 549.

officer in literally hundreds of business bankruptcy reorganization cases, “he [had] never seen a debtor-in-possession without counsel in the first 20 days of the case . . . [and] unless counsel was immediately available, the effects on these estates could be devastating.”¹⁰

Just days after the *First NLC Financial Services* court allowed the employment of debtor’s counsel on an interim basis, a New York bankruptcy court, in *In re Quebecor*, entered an order orally denying the request of debtor’s counsel for interim employment, finding that the immediate and irreparable harm standard had not been met in that case.¹¹ However, the *Quebecor* court also denied the U.S. Trustee’s contention that the bankruptcy court lacked the ability to grant interim approval of a professional’s employment under Rule 6003.

2. *The Practical Effects of Rule 6003 – The Lehman Brothers Bankruptcy*

As the initial confusion and concern regarding how Rule 6003 would alter first day motions has subsided, courts seem to have downplayed or simply ignored Rule 6003 in large, complex bankruptcy cases. For instance, though not a retail bankruptcy case, the sale of substantially all of the assets of Lehman Brothers Holdings, Inc. (“LBH”), the largest bankruptcy filing in U.S. history, was noticed and conducted within five days of its bankruptcy filing. At the sale hearing, LBH elicited testimony from its Chief Operating Officer regarding the necessity to complete the sale on an expedited basis. Throughout the course of the sale hearing, no specific mention was made of the requirements of Rule 6003. Nor was Rule 6003 mentioned in the order authorizing the sale of substantially all of the assets of LBH (the “Order”). However, in the Order, the Court appears to have complied with the prerequisites necessary by making findings in accordance with Rule 6003 that the “Debtors’ estates will suffer immediate and irreparable harm if the relief requested in the Motion is not granted on a expedited basis consistent with the provisions set forth herein and the Purchase Agreement, particularly given the wasting nature of the Purchased Assets.”¹²

¹⁰ *Id.*

¹¹ Arthur J. Spector, *Making Sense of New Rule 6003: Interim Approval of the Retention of DIP Professionals*, BANKRUPTCY COURT DECISIONS, February 19, 2008, available at <http://www.bankruptcylitigationblog.com/Bcd4911.pdf> (discussing *In re Quebecor World (USA), Inc.*, Case No. 08-10152-JMP (Bankr. S.D.N.Y. January 23, 2008)).

¹² Order Under 11 U.S.C. §§105(a), 363, and 365 and Federal Rules of Bankruptcy Procedure 2002, 6004 and 6006 Authorizing and Approving (a) the Sale of Purchased Assets Free and Clear of Liens and Other Interests and (B) Assumption and Assignment of Executory Contracts and Unexpired Leases at 3, *In re Lehman Brothers Holdings Inc., et. al.*, Case No. 08-1355-JMP (Bankr. S.D.N.Y. September 20, 2008) (Docket No. 258).

B. Rule 4001

In addition to Rule 6003, Rule 4001, which governs motions and stipulations for use of cash collateral and DIP financing, was also amended.¹³ Instead of forcing parties to review mountains of cash collateral and DIP financing documents in order to find key provisions of each document, amended Rule 4001 requires parties to disclose key provisions of such agreements in the body of any motion for approval of such agreement and to provide cross-references to the location of the key provisions within the agreements themselves.¹⁴ As amended, Rule 4001 simply standardizes many of the guidelines already in place in the local rules and financing guidelines in several districts, including the District of Delaware and the Southern District of New York. For those familiar with the “Checklist” in the Northern District of Texas, the amendments to Rule 4001 do not pose a tremendous change in practice.

¹³ FED. R. BANKR. P. 4001(b) outlines the procedure for the request for use of cash collateral:

(1) Motion; service.

(A) Motion. A motion for authority to use cash collateral shall be made in accordance with Rule 9014 and shall be accompanied by a proposed form of order.

(B) Contents. The motion shall consist of or (if the motion is more than five pages in length) begin with a concise statement of the relief requested, not to exceed five pages, that lists or summarizes, and sets out the location within the relevant documents of, all material provisions, including:

(i) the name of each entity with an interest in the cash collateral;

(ii) the purposes for the use of the cash collateral;

(iii) the material terms, including duration, of the use of the cash collateral; and

(iv) any liens, cash payments, or other adequate protection that will be provided to each entity with an interest in the cash collateral or, if no additional adequate protection is proposed, an explanation of why each entity’s interest is adequately protected.

(C) Service. The motion shall be served on: (1) any entity with an interest in the cash collateral; (2) any committee elected under § 705 or appointed under § 1102 of the Code, or its authorized agent, or, if the case is a chapter 9 municipality case or a chapter 11 reorganization case and no committee of unsecured creditors has been appointed under § 1102, the creditors included on the list filed under Rule 1007(d); and (3) any other entity that the court directs.

Id.

¹⁴ BOB EISENBACK, DON'T MISS THE IMPORTANT BUSINESS BANKRUPTCY RULE AMENDMENTS THAT JUST TOOK EFFECT (Cooley Godward Kronish LLP), December 2, 2007, <http://bankruptcy.cooley.com/2007/12/articles/business-bankruptcy-issues/dont-miss-the-important-business-bankruptcy-rule-amendments-that-just-took-effect/print.html>.

C. 11 U.S.C. § 366 – Utilities

The addition of 11 U.S.C. § 366(c), which defines what constitutes adequate protection for utility providers, caused considerable anxiety among bankruptcy practitioners, especially in large retail bankruptcy cases where a debtor may have dozens, or even hundreds, of utility providers. Prior to BAPCPA, many courts accepted a debtor's assertion that the ability of a utility to assert an administrative claim constituted adequate protection to a utility as required by 11 U.S.C. § 366(a)-(b). Section 366(c) changed this practice when it specifically excluded an administrative claim from the definition of what constituted adequate protection.

The specter of fights with utilities over what constitutes sufficient adequate protection, especially in retail bankruptcy cases where many utilities may be involved, has yet to materialize. Since the enactment of section 366(c), only a handful of cases have emerged. The first published opinion discussing section 366(c) was *In re Lucre Inc.*¹⁵ In *Lucre*, the debtor asked the court to continue the injunction afforded by section 366(a) notwithstanding subsection (c) because of the failure of utility providers to respond to the debtor's proposed offer of adequate protection.¹⁶ The *Lucre* court denied the request stating that section 366(c) did not give the court the discretion to continue the injunction absent a consent of a utility to a debtor's offer of adequate protection or the debtor's consent to a utility providers' demand for adequate assurance.¹⁷ While some courts have followed the *Lucre* court interpretation of section 366(c),¹⁸ others have not. In *In re Syroco Inc.*,¹⁹ the court ruled that a utility provider's failure to respond to a debtor-in-possession's offer of adequate protection should be, and is interpreted as, acquiescence to the offered adequate protection.²⁰ Based on this interpretation, the *Syroco* court continued the injunction allowed by section 366.²¹ This position is often advanced by courts in large retail bankruptcies.²² There is continuing disagreement among courts regarding whether a bankruptcy court has the ability to continue the injunction against a utility provider when that provider has chosen not to respond to a debtor's offer of adequate protection in the form allowed under section 366(c)(2). Though not resolving the *Lucre-Syroco* disagreement, a bankruptcy court in the Southern District of Texas has ruled that a debtor's proposal that it not be required to

¹⁵ *In re Lucre, Inc.*, 333 B.R. 151 (Bankr. W.D. Mich. 2005).

¹⁶ *Id.* at 154.

¹⁷ *Id.*

¹⁸ See, e.g., *In re Beach House Property, LLC*, No. 05-11761-BCK-RMA, 2008 W.L. 961498 (Bankr. S. D. Fla. April 8, 2008); *In re Astle*, 338 B.R. 855, 859 (Bankr. D. Idaho 2006).

¹⁹ *In re Syroco Inc.*, 374 B.R. 60 (Bankr. D. Puerto Rico 2007).

²⁰ *Id.* at 62.

²¹ *Id.*

²² See e.g., Final Order Determining Adequate Assurance of Payment for Future Utility Services, *In re Linens Holding Co., et al.*, Case No. 08-10832 (CSS) (Bankr. D. Del. May 28, 2008) (Docket No. 455); Final Order Pursuant to Sections 105(a) and 366 of the Bankruptcy Code (I) Prohibiting Utilities From Altering, Refusing, or Discontinuing Service; (II) Deeming Utilities Adequately Assured of Future Performance; and (III) Establishing Procedures for Determining Adequate Assurance of Payment, *In re Sharper Image Corporation*, Case No. 08-10322 (KG) (Bankr. D. Del. March 12, 2008) (Docket No. 245); Final Order Approving Adequate Assurance Procedures and Determining Adequate Assurance of Payments for Future Utility Services, *In re Storehouse, Inc.*, Case No. 06-11144-SSM, (Bankr. E. D. Va. Oct. 19, 2006) (Docket No. 232);

furnish any adequate assurance unless a utility specifically requests will not be granted as it is contrary to the statutory provisions of section 366.²³

III. Limited Exclusivity

In addition to changes to procedures discussed above, BAPCPA also severely curtailed the debtor's ability to maintain exclusive control over the formation of a plan of reorganization. This change will impact the amount of time a retailer has in bankruptcy to evaluate, formulate or revise its exit strategy.

A. History

With each prior amendment to the Bankruptcy Code, Congress has attempted to place stricter limitations on the period of exclusivity a debtor is allowed to submit a plan of reorganization. Prior to the enactment of the Bankruptcy Code in 1978, the debtor was the sole party with the ability to propose a plan of reorganization.²⁴ This prompted creditors to complain that they were held hostage to the debtor's agenda.²⁵ As a result, Congress sought to limit what was perceived as a debtor's unfair bargaining position by creating the concept of limited exclusivity.

Between 1978 and 2005, a debtor had the exclusive right to file a Chapter 11 plan of reorganization for the first 120 days after filing for Chapter 11. If the debtor failed to file its plan before the expiration of the 120-day period, or if the debtor failed to confirm its plan within 180 days after filing the Chapter 11, any party in interest, such as a trustee, creditor or creditors' committee could submit a plan of reorganization for consideration. While it was the intent of Congress to limit a debtor's control over the time period for submitting a plan of reorganization, the bankruptcy courts were given broad discretion to extend the period of exclusivity for a debtor to file its plan if the debtor could show adequate cause. As a practical matter, bankruptcy courts routinely granted extensions and debtors could and did stretch out the exclusivity period for a number of years.²⁶

With the enactment of BAPCPA, Congress, once again, limited what was perceived as the debtor's unfair bargaining position by taking away the bankruptcy court's discretion in extending the debtor's period of exclusivity. Under BAPCPA, Congress has placed outside limits on the period of exclusivity a court may grant a debtor to file a plan of reorganization (18 months) and solicit votes for the plan of reorganization (20 months).²⁷

²³ *In re Viking Offshore (USA) Inc.*, No. 08-31219-H3-11, 2008 WL 782449 at *3 (Bankr. S.D. Tex. 2008).

²⁴ MARK G. DOUGLAS, ASSESSING THE IMPACT OF NEW CHAPTER 11 EXCLUSIVITY DEADLINE (Jones Day), January/February 2007, http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S3936.

²⁵ *Id.*

²⁶ JEFFREY M. SCHLERF, BAPCPA'S IMPACT ON EXCLUSIVITY IS HARD TO GAUGE (Turnaround Management Association), July 1, 2007, <http://www.turnaround.org/Publications/Articles.aspx?objectID=7797>.

²⁷ 11 U.S.C. § 1121(d)(2).

B. Impact of BAPCPA

BAPCPA time limitations on exclusivity could have a profound impact on certain types of large, complex bankruptcy filings, such as the airline and automobile industry, where debtors must deal with collective bargaining agreements with multiple unions (difficult even outside of bankruptcy) and special interest creditors, whose agreements are not usually renegotiated in a short period of time.²⁸

Almost two years after the enactment of the new time limitations, the impact of the new limited exclusivity period remains difficult to gauge. One reason is that many troubled entities, such as Northwest Airlines and Delta Air Lines, filed bankruptcy in the days leading up to the enactment of BAPCPA to avoid, among other things, the limited exclusivity issue.

It is likely too early to tell the long-term effects of the limitations on the negotiating process: Will it make debtors more likely to bring creditors into the plan process earlier? Or will non-debtor parties use the limited exclusivity period to wait out the debtor and put forth a competing agenda? Anecdotal evidence suggests that pre-negotiated and prepackaged bankruptcies are on the rise,²⁹ which may mean debtors are conferring with creditors early in the restructuring process in an effort to avoid running up against the shorter time limitations on exclusivity.

IV. Assumption and Rejection of Executory Contracts – Retail Leases

Stricter limitations on exclusivity will also impact the behavior of debtors, especially retail debtors, as they must juggle the new limitations on plan reorganization with the new limitations on the assumption/rejection of leases and executory contracts. The issue of assumption and rejection of real estate leases is of particular importance in retail cases as large retailers may have literally hundreds of locations and leases with which to contend.

A. History

With regard to the balance of power in landlord-tenant disputes in bankruptcy, Congress, as it did with the issue of limited exclusivity, has slowly tilted the balance of power away from debtor/tenants in favor of creditor/landlords with each amendment to the Bankruptcy Code.

Among a creditor/landlord's greatest concerns is the maintenance of restrictive covenants within a lease to ensure the right tenant mix for each shopping center. Beginning with the Bankruptcy Reform Act of 1984, Congress required assignees of lease contracts to honor the

²⁸ See SCHLERF, *supra* note 26.

²⁹ DOUGLAS M. FOLEY AND JAMES E. VAN HORN, PREPACKS ON THE RISE IN CHAPTER 11 BANKRUPTCIES PRENEGOTIATED PLANS CAN ACCELERATE REORGANIZATIONS (Turnaround Management Association), August 27, 2008, <http://www.turnaround.org/Publications/Articles.aspx?objectId=9655> (stating that in 2007 only a total of four pre-pack cases had been filed, but that nine pre-pack cases had been filed as of August 2008).

restrictions bargained for by the landlord and debtor/tenants.³⁰ However, debtors-in-possession were granted significant extensions of time to assume or reject leases by the bankruptcy courts.³¹ For many debtor/tenants, the extensions of time granted by the courts allowed them the opportunity to determine which of their locations were profitable and/or marketable to third parties before being forced to reject properties.

However, with the passage of BAPCPA, Congress further restricted a debtor/tenant's ability to assign its leases. Based on creditor/landlord complaints of being left in limbo without recourse for extended periods of time while debtors considered their options, Congress amended section 365(d)(4) by placing strict time limits on a debtor making decisions whether to assume or reject.

B. Options Available to Tenant-Debtor

A debtor/tenant has three options when determining how to deal with non-residential lease.

The debtor/tenant's first option is to reject the lease. Under this scenario, a creditor/landlord has a claim against the bankruptcy estate that consists of three parts: (i) unpaid pre-petition rent; (ii) unpaid post-petition, pre-rejection rent; and (iii) rejection damages capped by section 502(b)(6).³² A landlord is also entitled to an administrative claim under section 503(b)(7) in the event a debtor assumes a lease and later, during the bankruptcy case, rejects the same lease. Under section 503(b)(7), a creditor/landlord's administrative claim against the bankruptcy estate is limited to the monetary obligation due under the lease for a period of two years from the later of the rejection of the lease or the surrender of the premises.³³

The debtor/tenant's second option is to assume the lease. In order to assume the lease, the debtor/tenant must obtain court approval by demonstrating that the debtor can (i) cure all defaults; (ii) compensate the landlord for any actual pecuniary loss the landlord suffered as a result of the default (*i.e.*, attorneys' fees incurred as a result of a debtor's breach or monetary damages suffered by a landlord in the reduction of rent received from non-debtor tenants'

³⁰ Pamela Smith Holleman and Magdalena Ellis, *Solvent Shopping Center Tenants: Reexamination in Light of In re Trak Auto Corp.: Part I*, AM. BANKR. INST. J. (December/January 2004), available at http://www.abiworld.org/AM/Template.cfm?section=December_January1&template=/MembersOnly.cfm&ContentID=39176; see also FAYE B. FEINSTEIN AND MARIA APRILE SAWCZUK, LANDLORDS FLEX MUSCLE IN ONGOING TUG-OF-WAR OVER LEASES BAPCPA IMPOSES 'STATUTE OF LIMITATIONS' ON ASSUMPTION, REJECTION (Turnaround Management Association), February 1, 2007, www.turnaround.org/Publications/Articles.aspx?objectID=7158.

JEFFREY M. SCHLERF, BAPCPA'S IMPACT ON EXCLUSIVITY IS HARD TO GAUGE (Turnaround Management Association), July 1, 2007, <http://www.turnaround.org/Publications/Articles.aspx?objectID=7797>

³¹ Robert N.H. Christmas, *Designation Rights—A New, Post-BAPCPA World*, AM. BANKR. INST. (February 1, 2006), <http://www.abiworld.org/AM/Template.cfm?Section=Search&template=/CM/HTMLDisplay.cfm&ContentID=42452>.

³² JAMES S. CARR AND ROBERT L. LEHANE, GAINING GROUND: THE LANDLORD PERSPECTIVE ON RETAIL BANKRUPTCY CASES IN THE WAKE OF THE 2005 BANKRUPTCY CODE AMENDMENTS, Practising Law Institute, Real Estate Law and Practice Court Handbook Series, PLI Order No. 8781, October-December 2006, p. 965, 976-978.

³³ 11 U.S.C. §503(b)(7).

invocation of certain terms of their lease based on the debtor's actions); and (iii) provide adequate assurance of future performance under the lease.³⁴

The debtor/tenant's final option is to assume and assign the lease. Under this option, the debtor/tenant must comply with all the requirements for the assumption of the contract *and* the proposed assignee must be able to provide adequate assurance of future performance.³⁵

1. *Assignment of Leases*

In order for a proposed assignee to assume a non-residential lease, it must demonstrate adequate assurance of future performance by comporting with the four requirements of section 365(b)(3). That is, the proposed assignee must demonstrate that (i) its financial condition and operating performance is similar to the debtor;³⁶ (ii) that the percentage rent due on the lease will not decline substantially;³⁷ (iii) that the assignment is subject to the terms of the lease and does not breach the leases of other tenants;³⁸ and (iv) that the assignment does not disrupt the tenant mix.³⁹ Further, section 365(f) invalidates any provisions in the lease that seek to prohibit, condition or restrict the assignment of the lease.

How the Courts have interpreted and reconciled the apparent contradiction between sections 365(b)(3) and 365(f)⁴⁰ has varied over the years. Among the most controversial decisions is the *Rickel Home Centers, Inc.* case.⁴¹ In *Rickel*, several landlords objected to the debtor's proposed assignment of 41 leases to Staples, Inc., an office supply store, arguing, among other things, that the proposed assignment would violate the use restriction provision in the lease, which only allowed for a home improvement store, and would upset the tenant mix of the shopping centers.⁴² In order to overcome the language of section 365(b)(3) related to adequate assurance, the *Rickels* court read section 365(b)(3) in conjunction with section 365(f).⁴³ Relying on prior case law interpreting section 365(f) rendering unenforceable lease provisions that were considered so restrictive that they constituted de facto anti-assignment provisions, the

³⁴ 11 U.S.C. §365(b)(1).

³⁵ 11 U.S.C. §365(f)(2)(A).

³⁶ 11 U.S.C. §365(b)(3)(A).

³⁷ 11 U.S.C. §365(b)(3)(B).

³⁸ 11 U.S.C. §365(b)(3)(C).

³⁹ 11 U.S.C. §365(b)(3)(D).

⁴⁰ Pre-BAPCPA section 365(f) stated as follows:

[N]otwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts or conditions, the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph 2 of this subsection . . .

11 U.S.C. § 365(f) (2004).

⁴¹ *In re Rickel Home Centers, Inc.*, 240 B.R. 826 (D. Del. 1999).

⁴² *Id.* at 830-31.

⁴³ *Id.* at 831.

Rickel Court concluded it was “appropriate to permanently strike” the use provisions from the leases.⁴⁴ The *Rickel* Court based its decision, in part, on the un rebutted testimony of the debtor’s president and chief executive officer. The testimony proffered stated that home improvement centers, such as the debtor’s, were obsolete as a result of the “advent of warehouse type home improvement stores like Home Depot,” and as a consequence, no viable candidate would ever be found that could comply with the use restrictions of the lease.⁴⁵ Much to the dismay of creditor/landlords, many bankruptcy courts subsequently cited to the *Rickel* opinion in striking down restrictive use provisions.

In 2004, the Fourth Circuit Court of Appeals foreshadowed the changes that would eventually be wrought by the passage of BAPCPA by overturning lower court opinions in the *In re Trak Auto Corporation* case.⁴⁶ In *Trak Auto*, the debtor, an auto parts retailer, sought to assign its lease to a discount clothing store after it failed to receive any lease assumption bids from any auto parts retailers. The creditor/landlord objected to the assignment stating that the assignment would violate the use restriction provision of the lease. As with the debtor in *Rickel*, the debtor/tenant stated that the use restriction was so restrictive that it must be treated as an anti-assignment clause and stricken by the court. The Fourth Circuit did not agree with the debtor-tenant. In rendering its decision, the Fourth Circuit relied on legislative history discussing section 365(b)(3) and on the canons of statutory construction, holding that when two provisions of a statute are in conflict, the more specific provision (i.e., section 365(b)) controls the more general provision (i.e., section 365(f)).⁴⁷ While many believed the Fourth Circuit’s decision rejected *Rickel*, the Fourth Circuit specifically left open the possibility that, under certain circumstances, section 365(f) could be used to invalidate clauses prohibiting or restricting assignment in a shopping center lease.⁴⁸

The narrow opening left by the Fourth Circuit was firmly closed by Congress with the passage of BAPCPA. Under BAPCPA, Congress resolved the apparent contradiction between section 365(b) and section 365(f) by squarely subordinating subsection (f) to requirements of subsection (b). As with other recent battles, creditor/landlords were successful in completely overturning the *Rickel* decision through the legislative process.

2. Designation Rights

Traditionally, debtors have been able to generate immediate liquidity into their estates through the sale of designation rights. That is, a debtor will transfer to a third party its right to control the disposition of its leasehold interest and to assign the leases to the purchaser’s designees for a specified period of time, typically one year.⁴⁹ Under the typical designation rights contract, the debtor will file a motion seeking to allow a designation rights buyer to pay for

⁴⁴ *Id.* at 832.

⁴⁵ *Id.* at 831.

⁴⁶ *In re Trak Auto Corp.*, 367 F.3d 237 (4th Cir. 2004).

⁴⁷ *Id.* at 243.

⁴⁸ *Id.* at 245.

⁴⁹ CARR & LEHANE, *supra* note 32, at 994.

the right to market certain leases. The debtor will retain control of the leases during the period the designation rights buyer tries to market the property. Once a potential assignee of the lease is located, the debtor will file a notice or motion to assume and assign (or a motion to assume depending on the original contract with the designation rights buyer) the lease, or leases.⁵⁰ If the buyer is unable to locate a potential assignee, or a court declines to approve the proposed assignee, the designation rights will revert back to the debtor.⁵¹

For the debtor, the sale of designation rights is a win-win situation. The debtor is able to free itself from marketing unwanted leases in exchange for cash and immediate relief from its post-petition rent obligations (the designation rights buyer typically pays the post-petition rent for the period of time it seeks to market the leases).⁵² Some retail industry professionals have suggested that the passage of BAPCPA killed the designation rights market. Specifically, they assert that seven months is far too short a period of time for any party willing to buy the designation rights to turnaround, market the leases and make a profit.⁵³ Others have pointed out that BAPCPA did not kill the designation rights market, it merely made it imperative for debtors to have evaluated their lease agreements pre-petition. For instance, in 2006, two large retailers sold substantially all of their assets, including lease designation rights, within the first 60 days of their bankruptcy cases.⁵⁴ Whether the designation rights market survives will depend on whether true below-market leases are available. If bargains are abundant, designation rights purchasers may be willing to undertake the risk of agreeing to indemnify a debtor for the two-year administrative claim period allowed under section 503(b)(7) for the opportunity to market and profit from the sale of below-market leases.⁵⁵

3. *Time Frame to Assume or Reject Leases*

Prior to the enactment of BAPCPA, a debtor/tenant had 60 days to assume or reject non-residential leases. However, as a practical matter, many courts granted debtors multiple extensions of time to assume or reject leases, in some cases allowing extensions of over a year.

BAPCPA implemented strict time limits on the assumption and rejection of non-residential leases. In particular, debtors are granted 120 days from the order for relief to assume or reject a lease. While the 120 days is double the amount of time a debtor initially received under previous section 365(d)(4), the bankruptcy court has now lost its discretion to extend the assumption-rejection deadlines indefinitely. Now, the court is only allowed to grant a debtor a

⁵⁰ See, e.g., *BC Brickyard Assoc. Ltd v. Ernst Home Ctr. In. (In re Ernst Home Ctr. Inc.)*, 221 B.R. 243, 246 (BAP 9th Cir. 1998); *In re Ames Dept. Stores, Inc.*, 287 B.R. 112, 125-27 (Bankr. S.D.N.Y. 2002).

⁵¹ See, e.g., *Ernst Home*, *supra* note 50, at 246.

⁵² Holleman & Ellis, *supra* note 30.

⁵³ Christmas, *supra* note 31.

⁵⁴ CARR & LEHANE, *supra* note 32, at 995 (citing *In re Musicland Holdings Corp., et al.*, Case No. 06-10064 (SMB) and *In re G&G Retail Inc.*, Case No. 06-10152 (RDD)).

⁵⁵ *Id.*

one time maximum extension of time of 90 days.⁵⁶ Any further extension of time may only be granted if the creditor/landlord consents in writing to the extension of time.⁵⁷

Congress chose to amend section 365(b)(4) to remove the bankruptcy court's discretion to grant extensions of time for the retail debtor to assume or reject a lease, based on creditor/landlord complaints that the "limbo of endless extensions" destroyed their businesses.⁵⁸ In particular, creditor/landlords argue that when a large retailer goes "dark" at their shopping center, (i) it allows smaller tenants to invoke rent reduction clauses in their contracts with the creditor/landlord; and (ii) it lessens foot traffic at that shopping center, often to the detriment of smaller retailers, who also end up going "dark" as a consequence. The creditor/landlord suffers when the court allows debtor/tenants to delay decisions on assumption-rejection of non-residential leases.

Prior to the enactment of BAPCPA, many bankruptcy practitioners speculated that the changes wrought by BAPCPA would have the following consequences: (i) it would force debtors to make more rapid decisions regarding the assumption and rejection of leases which would either lead to the premature rejection of leases resulting in more liquidation cases than reorganization (as some would argue occurred with Sharper Image); or, (ii) it would lead to the premature assumption of leases, which would, in turn, increase an estate's administrative expenses by forcing a retailer to prematurely assume more leases and creating additional administrative expenses for the estate when the debtor ultimately rejected a lease. On the other hand, the changes could also promote more efficiency by forcing debtor/tenants to negotiate seriously with their creditor/landlords earlier and involve the creditor/landlord in any designation rights sale initiatives and complicated assumption and assignment issues.

To date, many of the concerns raised with the passage of new section 365(d)(4) have not yet materialized. This may be based in part on the dismal retail economy in general. For 2008, the International Counsel of Shopping Centers projected the closure of 144,000 establishments, a seven percent gain from last year and the biggest increase in fourteen years.⁵⁹ As more and more retailers file for Chapter 11 this year, landlords are struggling to find retailers to fill their empty shopping centers. Instead of forcing debtor-tenants to assume-reject leases within the 210 day period, many landlords are granting additional extensions of time to retail debtors to collect what post-petition rent they might be able to recover.

C. Stub Rent

When it comes to the debtor making a decision between assuming or rejecting of its retail leases, timing is everything. This is particularly true for a retail debtor where a single day in bankruptcy could cost the estate millions of dollars in rental payments.

⁵⁶ 11 U.S.C. § 365(d)(4)(B)(i)

⁵⁷ 11 U.S.C. §365(d)(4)(B)(ii)

⁵⁸ FEINSTEIN & SAWCZUK, supra note 30.

⁵⁹ *Checkout Time*, The Deal.com, (September 12, 2008), available at <http://thedeal.com/pipeline/tdd/ViewArticle.dl?id=10002172321>.

Take the following scenario as an example. A retail chain with 600 locations is deciding which locations to keep open and which to shut down. For each location, the debtor must decide whether to assume or reject the lease. Under each lease agreement, the debtor is obligated to make monthly payments of rent, taxes, and utilities on the first of that month. Rental payments for each lease may range from \$5,000 to \$50,000 per month, per location. Multiplied out by the number of locations, each day costs the debtor in excess of \$500,000.

To minimize these costs, the debtor may decide to vacate several of these properties within the first month of the filing. The debtor's counsel will have two crucial timing decisions to make: (1) which day of the month to file the case—before rent is due for the next month or just as soon as possible; and (2) once in bankruptcy, on which day of the month to reject the leases that have proven too costly for the debtor? But before spending too much time staring at the calendar, counsel for the debtor should do some research to determine *where* the case will be filed. While venue is always an important consideration for debtors' counsel for a number of reasons, the issue of how to characterize “stub rent” is yet another area where venue may play an even bigger role in where the debtor decides to place its case. As discussed below, there are diverging lines of cases interpreting section 365(d)(3) and the damages that landlords are entitled to claim as administrative expenses.

Section 365(d)(3) provides that:

The trustee [or debtor-in-possession] shall timely perform all obligations of the debtor . . . arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title.

In short, this provision entitles landlords to seek administrative expense claims for “all obligations” that arise during the period from the petition date until the debtor formally assumes or rejects the lease. This period is commonly known as the “stub period.” Most courts agree that “all obligations” as used in this context includes monetary obligations due under the terms of the lease – e.g., rent, utilities, taxes, insurance, and the like. However, the courts cannot seem to agree on what happens during the “stub periods.”

Under the majority of leases, rent will be due on the first of the month for that entire month. When the debtor files its case in the middle of that month, the issue becomes whether section 365(d)(3) entitles the landlord to an administrative expense claim for that portion of the month that falls *after* the bankruptcy petition date—the “stub period” after the petition date, but *before* the rejection date. The argument against allowing a section 365(d)(3) claim for this pre-rejection stub period is that the debtor's obligation to pay rent for that month came due *before* the petition date. Thus, the actual obligation to pay that month's rent is a pre-petition date, or one that *did not* arise “from and after the order for relief,” as section 365(d)(3) requires.⁶⁰

The other critical “stub period” is that period *after* the debtor formally rejects an unexpired lease of non-residential property until the end of the month (just before payment for

⁶⁰ See 11 U.S.C. § 365(d)(3).

the next month's rent comes due). One reading of section 365(d)(3) says that the debtor's formal rejection of a lease cuts off the obligation to pay rent under section 365(d)(3). Under that reading, there may be a significant portion of the month—the post-rejection “stub period”—where rent may accrue but will not qualify as an administrative expense claim under section 365(d)(3).

The alternative reading of that section indicates that the debtor's obligation to pay rent during that month is not cut off by an intervening rejection of the lease because the actual obligation to pay that month's rent came due *before* the debtor rejected the lease. Thus, the landlord may be entitled to an administrative expense claim for the entire month, including the portion which accrued *after* the debtor rejected the lease.

Generally speaking, courts have fallen into two camps: (1) the performance date approach and (2) the proration, or accrual, approach.

1. *Performance Date Approach*

Under the performance date approach, the court determines what lease obligations were *triggered* during the post-petition, pre-rejection stub period. Whatever obligations actually arose during that stub period are deemed administrative expenses that must be paid to the landlord under section 365(d)(3). The courts following this approach reason that the applicable provision of section 365(d)(3) is clear and unambiguous, stating that the absence of the word “accruing” and the actual use of the word “arising” preclude a proration of the rental payment, leaving a court to consider only when the rental payment formally came due under the lease terms. Courts adopting this approach find no textual support for the alternative proration approach discussed below. They conclude that either the full obligation falls within the reach of section 365(d)(3), or none of the obligation does.

The performance date approach is typically more beneficial for landlords. Take, for example, a scenario where the debtor plans to reject several of its leases, close those stores and vacate those premises within the first few months of the case. As the case goes on, the debtor may run into obstacles preventing it from vacating the premises as planned. The rejection date will be crucial to the determination of whether the debtor will be obligated to pay the current month's rent for the properties where the debtor decides to reject the leases. If rent is due on the first of the month, but the debtor is unable to vacate a particular space until the second of the month, the debtor will be on the hook for the entire month's rental obligation for that property. That means that the debtor may have to pay almost a full month's rent even though the property was vacant for the vast majority of the month. Where the debtor is coordinating the rejection of hundreds of leases, the difference is not inconsequential.

But this draconian rule could work to the debtor's favor as well. All the debtor has to do is plan accordingly. If the debtor files the case on the second day of the month (assuming that rent is due on the first), the debtor has 29 rent-free days before the first of the following month. If the debtor has already decided which leases to reject, the debtor should move quickly to reject those leases before rent comes due for the following month. Assuming all goes according to

plan, the debtor can minimize its section 365(d)(3) exposure. All rejection claims under sections 365(g)(2) and 502(g) would be general unsecured claims.⁶¹

2. *Proration Approach*

A decided majority of courts, however, has adopted the alternative approach, commonly known as the proration approach or the accrual approach. As its name would indicate, this approach calculates the debtor's administrative expenses under section 365(d)(3) based not on *when* payment was due, but instead on the *pro rata* portion of the payment that actually accrues during the post-petition, pre-rejection stub period. Under this approach, neither the debtor nor the landlord could manipulate section 365(d)(3) obligations by filing or rejecting on a particular date. The debtor's poor timing is not as costly to the estate under this approach. Consider the above hypothetical. If the debtor files its petition on the second day of the month and rejects its leases before the first of the following month, the landlord may still claim an administrative expense for the 29 day stub period "from and after the order for relief . . . until such lease is assumed or rejected."⁶²

3. *No Ruling from the Fifth Circuit*

Now that the basic dispute is clear, the next practical question is which approach has the Fifth Circuit adopted. To date, the Fifth Circuit has not demonstrated a preference for either approach. The only notable decision from a court in the Fifth Circuit is an unpublished opinion written by Judge Barbara Houser in *In re FFP Operating Partners, LP*.⁶³ In that case, the issue was whether the landlord could compel the debtor to pay 2003 and 2004 taxes (the petition was filed on October 23, 2003). Judge Houser found the performance date approach to be the more compelling approach, though "somewhat reluctantly." She concluded that the proration approach, as espoused by Judge Gerber in *Ames Department Stores* and followed by several courts in the Second, Fourth, and Sixth Circuits, could not be squared with the language Congress actually chose when it adopted section 365(d)(3).⁶⁴ Most notably, she found two principal flaws in Judge Gerber's analysis.

⁶¹ *Cf. Healthcon Holdings, LLC v. Dunn Indus., LLC (In re Dunn Indus., LLC)*, 320 B.R. 86, 93 (Bankr. D. Md. 2005) ("While Montgomery Ward may provide a bright line rule [for the performance date approach], it will also promote the type of lawyering that should not be encouraged in our bankruptcy system. The billing method would prompt Maryland lessors to time their presentation of tax bills to tenants they anticipate might file bankruptcy in the hope of making the entire bill a post-petition priority expense, while prospective Debtors would time their bankruptcy filings based on the receipt of tax bills in order to render an entire years' tax obligation an unsecured pre-petition debt. Both behaviors are solely to obtain advantage and do nothing to preserve the relative positions of the parties on a level playing field while reorganizing. Neither contributes to the integrity of the system, and neither behavior should be promoted.").

⁶² See *Ha-Lo Indus., Inc. v. Ctr. Point Props. Trust*, 342 F.3d 794, 798-800 (7th Cir. 2003).

⁶³ Slip op., Case No. 03-90171, 2004 Bankr. LEXIS 884 (Bankr. N.D. Tex. June 16, 2004).

⁶⁴ 306 B.R. 43 (Bankr. S.D.N.Y. 2004) (Gerber, J.). Judge Gerber's well-reasoned opinion is followed by virtually all courts adopting this approach. Rather than ignoring Judge Gerber's logic or following the courts that had adopted the performance date approach, Judge Houser criticized Judge Gerber's foundation and explained why his approach was inferior. Like most courts adopting the proration approach, Judge Gerber concluded that section 365(d)(3) was ambiguous, finding that (1) he could not determine from the plain language of the provision whether "arising," as it is used in that section, must be read in absolutist terms or in the accrual sense; and (2) he could not

First, said Judge Houser, Judge Gerber ignored Congress' decision to use the word "arising" in section 365(d)(3) in favor of the word "accruing." Because Congress is presumed to act intentionally when it includes particular language in one section of a statute but not another, Judge Houser dismissed the possibility that the debtor's obligations under section 365(d)(3) could be calculated on an accrual basis. It then followed from that conclusion that the phrase "until such lease is assumed or rejected" must modify the word "obligation," clarifying the ambiguity found by Judge Gerber in the same phrase. Under this approach, section 365(d)(3) would only allow an administrative expense claim for obligations actually triggered during the pre-rejection stub period.⁶⁵

The second flaw Judge Houser points out from the *Ames* decision is the presumption that section 365(d)(3) must be read in conjunction with sections 365(g)(2) and 502(g):

[C]ourts adopting the proration approach conclude that § 365(d)(3) ought not to be interpreted in a manner which would convert some portion of what would otherwise be treated as a pre-petition unsecured claim upon rejection to an administrative expense. Significantly, however, § 365(d)(3) is addressing obligations of the debtor under those leases prior to rejection. In short, these three Code provisions address different issues. Section 365(d)(3) addresses the debtor's obligation to perform under its unexpired leases post-petition pending a decision to assume or reject, while § 365(g) says rejection constitutes a breach of the leases immediately before the date of the filing of the petition and § 502(g) says that claims arising from rejection shall be allowed in the bankruptcy case as if they arose before the bankruptcy case was filed.⁶⁶

decipher whether the phrase "until such lease is assumed or rejected" modified the word "perform" — as in, the debtor must continue to perform its obligations until it assumes or rejects the lease — or whether the phrase modifies the word "obligations" — meaning, section 365(d)(3) covers all obligations arising from the petition date until the rejection date. *Id.* at 67-68.

Because Judge Gerber could not resolve these ambiguities from the plain language, he looked to the legislative history of the provision, which was first added in 1984 to compensate landlords who provide services to the debtors during the gap period while the debtors decide what to do with their leases. Judge Gerber reasoned from the underlying intent behind this provision that section 365(d)(3) "lease obligations" must be prorated from the petition date until the rejection or assumption date. *Id.* at 64.

Judge Gerber and other courts adopting this Proration approach find support for their rationale in sections 365(g)(2) and 502(g) of the Code. Under these provisions, any damages arising from the rejection of an unexpired lease are treated as a pre-petition breach of the lease, entitling the landlord to a non-priority, unsecured claim. Accordingly, those rejection damages are treated as general unsecured claims. Judge Gerber found the Performance Date approach to contradict these other two provisions. He reasoned that the performance date approach effectively elevated post-rejection lease obligations to administrative priority, notwithstanding section 502(g)'s clear indication that post-rejection damages are to be treated as general pre-petition claims. To avoid this conflict, and to read all three provisions in harmony, Judge Gerber concluded that section 365(d)(3) requires a proration of those obligations. *See id.* 70-71.

⁶⁵ *In re FFP Operating Ptrs, LP.*, 2004 Bankr. LEXIS 884 at *11-14.

⁶⁶ *Id.* at *15-16.

In short, Judge Houser found that each provision covered different issues and could be applied consistently under a plain reading without finding any one provision to be ambiguous.⁶⁷

At the end of the day, both approaches seem to be well-reasoned interpretations of the law, which explains the dramatic split of authority from the circuit courts.⁶⁸ The 2005 amendments did little, if anything, to change section 365(d)(3).⁶⁹ Until the Code is modified to resolve the issue one way or the other, or until the Supreme Court rules on the matter, it seems the best approach is the more practical one—to know the adopted approach in all available forums. In the Fifth Circuit, the issue seems to be unresolved. Judge Houser’s unpublished opinion may reveal her view, but there is little way of knowing how other judges in the Fifth Circuit may decide the issue if presented to them.

⁶⁷ While adopting the performance date approach, however reluctantly, Judge Houser determined that the facts of that case did not support an allowance of an administrative expense claim for the 2003 and 2004 taxes because the lease did not require the debtor to escrow the taxes as they accrued. Instead, the lease only required the debtor to pay the taxes upon receipt of an invoice from the landlord. Because the landlord never sent the debtor an invoice, the debtor’s obligation to pay those taxes was never triggered, particularly not during the period after the petition date but before the rejection date. Thus, while Judge Houser sided with the landlord on the legal standard, the debtor actually won on the facts.

⁶⁸ Thus far, the Third, Sixth, and Seventh Circuits have adopted the performance date approach. *See, e.g., Centerpoint Props. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*, 268 F.3d 205, 209-10 (3d Cir. 2001) (split panel); *Koenig Sporting Goods, Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.)*, 203 F.3d 986, 989 (6th Cir. 2000); *Ha-Lo Indus., Inc. v. Ctr. Point Props. Trust*, 342 F.3d 794, 798-800 (7th Cir. 2003) (distinguishing from *Handy Andy*, an early Seventh Circuit decision, and concluding that because the debtor affirmatively elected to wait until after the first of the next month to vacate the leased premises, the terms of the lease as well as principles of equity and fairness required payment of the full month’s rent, even though the debtor only occupied the premises for two days of that month).

On the other hand, many courts throughout the Second, Fourth, Ninth, and Tenth Circuits have adopted the proration approach. *See, e.g., See Healthcon Holdings, LLC v. Dunn Indus., LLC (In re Dunn Indus., LLC)*, 320 B.R. 86, 93 (Bankr. D. Md. 2005) (citing *Rose’s Stores v. Saul Subsidiary I, L.P. (In re Rose’s Stores)*, 1998 U.S. App. LEXIS 15334, 1998 WL 393984 (4th Cir. 1998)); *In re Ames Dep’t Stores, Inc.*, 306 B.R. 43, 67-70 (Bankr. S.D.N.Y. 2004) (concluding that the proration approach is required by the Code, based on a finding of ambiguity that is resolved by a contextual reading of the Code); *In re NETtel Corp, Inc.*, 289 B.R. 486, 493 (Bankr. D.D.C. 2002); *El Paso Props. Corp. v. Gonzales (In re Furr’s Supermarkets, Inc.)*, 283 B.R. 60 (10th Cir. B.A.P. 2002); *Newman v. McCrory Corp (In re McCrory Corp.)*, 210 B.R. 934, 939-40 (S.D.N.Y. 1997); *In re Handy Andy Home Improvement Ctrs., Inc.*, 144 F.3d 1125, 1127 (7th Cir. 1998) (holding that the landlord’s invoice alone was not a sufficient reason to find a pre-petition tax assessment to be a post-petition, pre-rejection lease obligation that must be paid under section 365(d)(3)).

Some might say that the split among the circuits as to whether section 365(d)(3) is ambiguous is, in itself, evidence of ambiguity in section 365(d)(3). *See In re Rhodes, Inc.*, 321 B.R. 80, 88 (Bankr. N.D. Ga. 2005) (quoting *El Paso Props. Corp. v. Gonzales (In re Furr’s Supermarkets, Inc.)*, 283, B.R. 60, 66 n.9 (10th Cir. B.A.P. 2002)) (internal citations omitted). That remains to be seen. Until an attorney has binding precedent in hand, it is best to know what other courts are doing and to go into bankruptcy court prepared for either outcome.

⁶⁹ Sections 365(d)(3), 365(g)(2), and 502(g) were all left unaltered. The only relative change came in the addition of section 503(b)(7), which created a new administrative expense category for leases that were initially assumed but then later rejected by the debtor. That provision does not seem to affect the Stub Rent issue here.

V. Reclamation Claims

At common law, a reclamation right was the creditor's, or a seller's, literal right to reclaim, or to physically repossess, goods that it provided to a debtor on credit as a result of the debtor's misrepresentation of its insolvency.⁷⁰ That right was later expanded and codified in the Uniform Commercial Code (the "UCC"). Section 2-702(2) of the UCC provides that:

Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

UCC § 2-702(2).⁷¹ Under the UCC, vendors have the right to reclaim goods delivered to an insolvent debtor within 10 days of delivery. If the debtor misrepresented its insolvency to the vendor, the UCC gives the vendor three months, rather than 10 days, to make a written reclamation demand on the debtor for reclamation of those goods. Today, reclaiming vendors rarely seek actual repossession of the delivered goods. They more commonly seek to recover the *value* of those goods in the form of monetary reimbursements.⁷² In Texas, if reclamation of the actual goods is no longer possible—e.g., one vendor's goods have been commingled with other vendors' goods—a vendor may recover the identifiable proceeds from the goods it delivered instead.⁷³

⁷⁰ See generally *Stowers v. Mahon (In re Samuels & Co.)*, 510 F.2d 139, 144-45 (5th Cir. 1975) (discussing the diverging sellers' rights under common law for cash sales and credit sales), *rev'd by* 526 F.2d 1238, 1244-45 (5th Cir. 1976) (en banc) (concluding that a prior perfecting lien is superior to a cash seller's reclamation rights in the goods sold); see also *B. Berger Co. v. Contract Interiors, Inc. (In re Contract Interiors, Inc.)*, 14 B.R. 670, 673 (Bankr. E.D. Mich. 1981) (discussing the background behind section 546(c) and sellers' rights under state and common law).

⁷¹ See TEX. BUS. & COMM. CODE § 2.702(b) (Vernon 2008). Texas has adopted most portions of the UCC, particularly those provisions relevant to this discussion. References to the UCC and the Texas Business and Commerce Code are thus used interchangeably here.

⁷² See *Crown Quilt Corp. v. HRT Industries, Inc. (In re HRT Industries, Inc.)*, 29 B.R. 861, 862 (Bankr. S.D.N.Y. 1983) ("No matter how the complaints of these unpaid vendors are clothed, the principal alternative relief sought of return of merchandise or money damages based on invoice price or an administrative claim is essentially the stuff of reclamation (a misnomer, as seldom if ever is property actually returned or reclaimed in a reorganization case in lieu of other available relief).").

⁷³ *United States v. Westside Bank*, 732 F.2d 1258, 1263-64 (5th Cir. 1984) (concluding that, under Texas law, a seller's reclamation rights attach to identifiable proceeds following the foreclosure sale of those goods, likening the seller's rights to that of an unperfected lienholder or a priority claim holder). There seems to be some confusion about what kind of seller has the right to reclaim goods sold. The *Westside* court distinguished from its earlier *en banc* opinion in *In re Samuels & Co.* by clarifying that the dispute in *Samuels & Co.* was between an Article 9 lien holder and a vendor who sold goods to the debtor on a cash basis. *Id.* at 1261. In *Samuels & Co.*, the sale was a cash deal because the seller received a check (from a third-party financier) that was subsequently dishonored. *Id.*

Since the inception of the Bankruptcy Code, section 546(c) has recognized sellers' rights to reclaim goods sold to an insolvent debtor as a limitation on the trustee's or the debtor-in-possession's strong-arm powers.⁷⁴ In other words, vendors' reclamation rights were superior to the debtor-in-possession's power to bring property into the bankruptcy estate. Reclamation rights, however, are limited. For instance, under the UCC, a vendor's right to reclaim the goods it delivers to a debtor is subject to secured creditors with prior perfected liens on those goods.⁷⁵ A prime example of such a lender is a shop floor lender, who finances the debtor'

In retail bankruptcy cases, the debtor will almost always have a shop floor lender with a floating lien that attaches to the debtor's inventory. In those cases, the shop floor lender's lien attaches to inventory subsequently delivered to the debtor, giving the lender rights superior to those of reclaiming vendors. One issue that is common to retail bankruptcy cases is what rights the reclaiming vendors have with respect to the debtor's shop floor lender's floating lien.

Outside of bankruptcy, the answer is simple. Unless there is a single, reclaiming vendor who asserts a reclamation claim against inventory with a value exceeding the shop floor lender's floating lien—a highly unlikely scenario—there will not be any unencumbered inventory for the vendor to reclaim. In that case, it is said that the reclamation claim is zero, or valueless.

Once inside bankruptcy, however, a number of occurrences could alter this result. First, a section 363(f) sale could result in previously encumbered inventory becoming unencumbered and thus potentially subject to reclaiming vendors' claims.⁷⁶ Second, some courts have held that post-petition lenders' rights may be *lower* in priority than reclamation claims.⁷⁷ Third, recent changes to section 503(b) of the Code have given reclaiming vendors additional rights, which may overlap with common law reclamation rights and cause some confusion for retail debtors.

Unfortunately, these issues have yet to be discussed by any courts in the Fifth Circuit. However, the following discussion comes from cases in other circuits where courts have struggled to answer these questions with definitive answers. As a practical matter, there may be no right answer to these questions. The following discussion simply lays out some practical considerations when dealing with reclamation claims in the context of a retail chain debtor.

The *Samuels & Co.* court acknowledged that cash sellers' rights differ from credit sellers' rights, because a cash seller retains its ownership rights with respect to the goods delivered to the debtor. *See In re Samuels & Co.*, 510 F.2d at 145. A vendor who sells goods to a debtor on credit takes a risk by relinquishing all ownership rights in the goods to the debtor. *See id.* The credit seller's reclamation rights under common law gave the seller the right to rescind the sale contract and reclaim the goods delivered. *See id.*

⁷⁴ *See* 11 U.S.C. § 546(c)(1).

⁷⁵ TEX. BUS. & COMM. CODE § 2.702(c).

⁷⁶ The UCC ensures that goods obtained by subsequent *bona fide* purchasers who give value for the debtor's goods are not subject to reclamation claims. *See id.* However, in the context of a bankruptcy sale, where liens attach to sale proceeds rather than the sold assets, the debtor should consider how the sale will affect the value of the reclamation claims.

⁷⁷ *See, e.g., In re Phar-Mor, Inc.*, 301 B.R. 482, 489-497 (Bankr. N.D. Ohio 2003) (concluding that the reclaiming vendors' claims were not subject a prior perfected lien because the post-petition lender's lien was new and thus later in time), *aff'd by Phar-Mor, Inc. v. McKesson Corp.*, 534 F.3d 502 (6th Cir. 2008)).

A. Valuing Reclamation Claims According to Other Liens

The first matter to consider is how to minimize the number and amount of reclamation claims when a debtor accepts delivery of goods on a regular basis. For example, would it be practical to advise the debtor to stop accepting delivery of goods during the 20 day period preceding the bankruptcy filing?⁷⁸ Another issue to consider is how much the vendors' reclamation claims are worth, if anything. The UCC makes clear that a vendor's right to reclaim delivered goods is subject to a previously perfected lien on those goods.⁷⁹ In the context of a retail bankruptcy case, the debtor's shop floor lender often holds a prior perfected lien that attaches to all subsequently delivered inventory, including the goods that would otherwise be subject to the vendors' rights of reclamation. If the debtor's entire inventory is encumbered by prior perfected liens, reclaiming vendors are left without any goods to reclaim. But that may change if the shop floor lender's liens are extinguished by a section 363 sale or by post-petition financing.

To demonstrate these dilemmas, consider the scenario where a debtor seeks post-petition financing. One way to enable the debtor to obtain a DIP loan is to free up pre-petition collateral so that it can serve as collateral for the post-petition debt. In this scenario, the pre-petition lender may release its liens in exchange for an immediate pay-off using proceeds of the post-petition loans. Under this arrangement, the debtor's inventory will be temporarily "liberated" from all prior perfected liens so that the DIP lender's liens may attach to the same collateral. The dilemma in arranging the post-petitions loans in this manner is that the DIP lender's lien will be a *new* lien and cannot attach or be perfected until *after* most vendors have asserted their reclamation rights. This sort of transaction is not an assignment, an assumption, or a sale of the pre-petition lender's floating lien. It is simply a release in exchange for payment.⁸⁰ Thus, assuming that the vendors exercise their reclamation rights before the post-petition financing is approved, the vendors' reclamation rights may *not* be subject to any prior perfected liens. There may indeed be unencumbered inventory to satisfy the reclamation claims in this scenario, as some courts have held.⁸¹

This consequence may be preventable, however. By arranging the DIP financing differently, a debtor may be able to eliminate reclamation claims all together. If the DIP lender's lien is perfected before vendors assert their reclamation rights, the reclamation claims will be subject to the DIP lender's liens. The dilemma here is how a post-petition lender may obtain a lien that was perfected weeks before the debtor files its bankruptcy petition. The solution is

⁷⁸ If the debtor can last 20 days without receiving new inventory, it may reduce the number of administrative claims under § 509(b)(9), but that does not stop vendors from asserting their reclamation rights, which now allow the vendor to look back 45 days. Compare 11 U.S.C. § 503(b)(9) with *id.* § 546(c)(1). Can a retail chain, already struggling with poor sales, realistically go 45 days without accepting delivery of new inventory? If so, a halt on new deliveries is one way to reduce the risk of administrative insolvency caused by overwhelming amounts of reclamation claims.

⁷⁹ TEX. BUS. & COMM. CODE § 2.702(c); see also U.C.C. § 2-702(3).

⁸⁰ See *In re Dana Corp.*, 367 B.R. 409, 420 (Bankr. S.D.N.Y. 2007) (discussing *In re Phar-Mor, Inc.*, 301 B.R. 482, 489-497 (Bankr. N.D. Ohio 2003), *aff'd* by *Phar-Mor, Inc. v. McKesson Corp.*, 534 F.3d 502 (6th Cir. 2008)).

⁸¹ See *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128, 134-36 (Bankr. S.D.N.Y. 2003); see also *In re Phar-Mor, Inc.*, 301 B.R. at 497.

quite simple, actually. Rather than paying off the pre-petition lender in exchange for a release of the pre-petition shop floor liens, the debtor could arrange the post-petition lending facility to have the pre-petition lenders *assign* their liens to the DIP lender. That way, the DIP lender receives a continuously perfected lien from the pre-petition lender, keeping the lien chain unbroken.⁸² With a fully integrated transaction, the vendors' rights remain subject to the DIP lender's continuously perfected lien. As a result, as in the out-of-bankruptcy context, reclaiming vendors are left with nothing to reclaim, rendering their claims valueless.⁸³

The difference between assigning pre-petition liens to post-petition lenders versus releasing pre-petition liens to allow post-petition liens to attach to the same collateral may seem to be a matter of semantics. The result, however, is much more significant and demonstrative of problems that can arise when pre-petition liens are extinguished or attach to other sources of collateral. In large retail cases, with hundreds or thousands of vendors, reclamation claims could reach several millions of dollars. If there is no unencumbered inventory to satisfy those claims, a court may value those reclamation claims at zero. If there is any inventory that subsequently becomes subject to reclamation, reorganization or liquidation under chapter 11 becomes significantly more expensive for retail chain debtors.

To make matters more interesting, BAPCPA gave reclaiming vendors additional options, which are discussed below. Because there are no decisions from courts in the Fifth Circuit, however, the following discussion, much like the foregoing discussion, provides a general background to consider when dealing with these issues in the future.

B. Additional Rights Under BAPCPA Amendments

Under the 2005 amendments, two significant changes to portions of the Bankruptcy Code have extended our reclamation discussion.⁸⁴ First, the Code was amended to give vendors more time to exercise their reclamation rights—45 days under section 546(c)(1), rather than the 10 days provided by the UCC.⁸⁵ If a vendor senses its customer swirling around the bankruptcy

⁸² See TEX. BUS. & COMM. CODE § 3.310(c); *In re Dana Corp.*, 367 B.R. at 421.

⁸³ *Id.* Under this theory, the prior perfected lien defense is not a matter of priority, it is a matter of determining whether the debtor held unencumbered goods and, if so, the value of those goods. Even if the defense is inapplicable, the lender will have a perfected security interest in the debtor's collateral. The difference is that if the debtor's collateral is fully encumbered by prior perfected liens, there would be no unencumbered goods available to satisfy any reclamation claims, rendering all reclamation claims at a value of zero. On the other hand, if the debtor's collateral is encumbered by a lien that was perfected *after* the vendors provided goods to the debtor (*e.g.*, if the pre-petition lenders release their liens, and the post-petition lenders receive *new* liens on the same collateral), the vendors will have the theoretical right to repossess the goods it provided to the debtor. Thus, the reclamation claims may have some value greater than zero.

⁸⁴ See generally David L. Woods, *Reclamation Under BAPCPA: Model for Uniformity?*, 26-6 AM. BANKR. INST. J. 40 (Aug. 2007).

⁸⁵ Under the UCC, vendors had 10 days to make a written reclamation demand on the debtor, unless the vendor was defrauded into selling the goods to the debtor on credit based on a misrepresentation about the debtor's solvency. Under the 2005 amendments, vendors have 45 days to make such a demand (or 20 days after the petition date if the petition is filed before the 45 day deadline). Failure to make a timely written demand, however, does not result in a forfeiture of the reclamation claim. It simply means that the vendor *must* look to § 503(b)(9) as an alternative remedy. 11 U.S.C. § 546(c)(2).

vortex, the vendor can rest assured by a longer period of time with which to make written reclamation demands on the debtor. Take the following scenario. The vendor delivers goods to the debtor on November 1 and again on December 1. By December 15, the debtor still has not paid its November invoices, and payment does not seem likely any time soon. Sensing that the debtor may soon file bankruptcy, the vendor sends the debtor a written demand to reclaim the goods it shipped. Under the section 2-702(2) of the UCC, this demand would be untimely, as it was sent more than 10 days after both shipments. But what if the debtor enters bankruptcy some time thereafter?⁸⁶ In that case, the vendor will have a valid reclamation claim for *both* shipments.

The second significant change from the BAPCPA affecting reclaiming vendors is section 503(b)(9). This new provision gives vendors an alternative remedy. It enables vendors to request an administrative priority claim for the value of goods they delivered to the debtor *before* the bankruptcy case.⁸⁷ That means that vendors can seek a 503(b)(9) claim even if they failed to make timely demands for reclamation.⁸⁸ Unlike ordinary reclamation claims, this new category of administrative priority claim is *not* subject to the prior perfected lien defense. Thus, a 503(b)(9) claim may not be wiped out by a floating lien on all the debtor's inventory.⁸⁹

Like reclamation claims, section 503(b)(9) claims must be for goods sold to the debtor in the ordinary course of the debtor's business. But section 503(b)(9) claims differ from straight reclamation claims in a few significant ways. First, the reach back period for section 503(b)(9) claims is only 20 days prior to the petition.⁹⁰ Second, the vendor need not make a formal written demand on the debtor to seek an administrative expense claim. Third, there is no requirement

⁸⁶ If the debtor waits until December 16 to file its bankruptcy case, section 546(c) will not provide a 20 day extension to assert a reclamation claim. The demand would only be timely for the December shipment. On the other hand, if the debtor does file before December 15 (less than 45 days after the November 1 shipment), all vendors who shipped goods to the debtor on November 1 will have another 20 days to make valid reclamation demands under section 546(c) of the Bankruptcy Code.

⁸⁷ See 11 U.S.C. §§ 546(c)(2) ("If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9)."). The new provision allows vendors to request administrative expenses for:

the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which goods have been sold to the debtor in the ordinary course of such debtor's business.

11 U.S.C. § 503(b)(9).

⁸⁸ Note, however, that the deadline to request an administrative claim under section 503(b)(9) is unclear. See Carl N. Kunz III, *Section 503(b)(9) Claims and Bar Dates: Creditors Should Be Vigilant*, 27-6 Am. Bankr. Inst. J. at 20, 80 (Aug. 2008). It may be the ordinary claims bar date or some other date set by the court. See *id.* Generally speaking, if the debtor files a case within 20 days of receiving goods from its vendors, all of those vendors will immediately assert their rights to reclaim the goods delivered. Section 503(b)(9) is just one of a few different options for the vigilant creditor. See *id.*

⁸⁹ See Woods, *supra* note 84.

⁹⁰ As a practical matter, debtors' counsel may consider whether it should advise its client to stop accepting delivery of goods for the 20 day period immediately before filing a petition.

that the debtor be insolvent at the time it received the goods in order for the vendor to qualify as an administrative claimant.⁹¹

This new administrative expense provision, however, is not without its own list of issues. Section 503(b)(9) allows, as an administrative priority expense, pre-petition expenses that are not necessarily related to the administration of the bankruptcy case.⁹² Essentially, this provision took what was once a general, unsecured claim and converted it to something more. The impact of this new category of administrative expenses is far from clear.

Another issue commonly discussed by courts addressing this provision is *when* the debtor must pay section 503(b)(9) claims. Even after a court allows a claim under section 503(b) as an administrative expense, the court has the discretion to decide whether the debtor should pay the claimant immediately or whether the debtor should defer payment until a later time.⁹³ Most courts to address the issue have concluded that section 503(b)(9) claimants must wait until confirmation to receive payment.⁹⁴

Yet another section 503(b)(9) issue is the effect these claims have on the confirmation of chapter 11 plans. A plan cannot be confirmed unless it proposes to pay all administrative priority claims in full on the effective date of the plan.⁹⁵ Because BAPCPA converted what were once general unsecured claims into what are now administrative priority claims, confirmation may be significantly more expensive in retail cases where the debtors' vendors hold large amounts of 503(b)(9) claims. In most cases, a debtor will need to procure additional financing just to exit bankruptcy. Depending on how many trade vendors have been allowed administrative priority claims under section 503(b)(9), a debtor may find it difficult, if not impossible, to propose a feasible plan paying all administrative priority claims in full on the

⁹¹ This difference proves less significant, however, because the debtor is presumed to be insolvent during the 90 day period immediately preceding the petition date, at least in the context of avoidable preference actions. *See* 11 U.S.C. § 547(f); *see also Sandoz v. Fred Wilson Drilling Co. (In the Matter of Emerald Oil Co.)*, 695 F.2d 833, 838 (5th Cir. 1983) (quoting Fed. R. Evid. 301) (noting that the presumption of the debtor's insolvency within 90 days of filing does not shift the burden of proof or non-persuasion in a preference avoidance action but merely requires the opposing party to come forward with summary judgment evidence to rebut or meet the presumption); *Gasmark Ltd. Liquidating Trust v. Louis Dreyfus Nat. Gas Corp.*, 158 F.3d 312, 315 (5th Cir. 1998) (stating that, when a movant for summary judgment relies on a statutory presumption for part of its prima facie case, the non-movant must, at the very least, "raise a genuine issue of material fact concerning whether it rebutted the presumption").

⁹² *See In re Plastech Eng. Prods., Inc.*, --- B.R. ---, 2008 WL 4294279 at *3, 2008 Bankr. LEXIS 2336 at *8-9 (Bankr. E.D. Mich. Sept. 16, 2008). Before BAPCPA, section 503(b) contained a non-exclusive list of six types of administrative expenses. Generally, those categories covered post-petition expenses incurred by the debtor, the trustee, or certain creditors to professionals in the course of preserving or administering a bankruptcy estate. Section 503(b)(9) is an anomaly in that it allows the debtor to pay pre-petition, ordinary course expenses as though they are post-petition expenses incurred as reasonable and necessary to preserve or administer the estate. *Compare id.* § 503(b)(9) *and id.* §§ 503(b)(1)-(6).

⁹³ *See, e.g., Garden Ridge Corp.*, 323 B.R. 136, 143 (Bankr. D. Del. 2005) (discussing factors courts should consider when deciding whether to require immediate payment of allowed administrative expense claims).

⁹⁴ *See, e.g., In re Global Home Prods., LLC*, 2006 WL 3791955, 2006 Bankr. LEXIS 3608 (Bankr. D. Del. Dec. 21, 2006); *In re Bookbinders' Restaurant, Inc.*, 2006 Bankr. LEXIS 3749, 2006 WL 3858020 (Bankr.E.D.Pa. Dec.28, 2006).

⁹⁵ 11 U.S.C. § 1129(a)(9)(A).

effective date of the plan. If the debtor cannot propose a feasible plan, the case may be dismissed or converted to Chapter 7. This result may actually prove detrimental to trade vendors, because Chapter 7 imposes no specific obligation to pay 503(b)(9) claimants in full. Thus, aggressive creditors may end up with *less* than they bargained for.⁹⁶

Other important issues, though perhaps less outcome-determinative, are how vendors should request section 503(b)(9) claims,⁹⁷ how to value the goods delivered, whether the vendor is a provider of goods or services,⁹⁸ what constitutes “delivery” of goods,⁹⁹ whether a partially secured vendor also has reclamation or 503(b)(9) rights,¹⁰⁰ and whether under section 553 the debtor may setoff these 503(b)(9) administrative expenses against amounts owed to the debtor.¹⁰¹

Vendors who are forced to deal with their customers in a Chapter 11 case must consider all of these factors when deciding how best to protect their rights without pushing the debtor’s case over the cliff. Although BAPCPA provides significantly greater rights for vendors who have sold goods to the debtor on credit, vendors should exercise their rights with some caution. A debtor’s ability to reorganize effectively may depend on a number of delicately balanced interests. Tilting this balance too far in the wrong direction may result in a lesser recovery for all parties. The best return for section 503(b)(9) claimants may likely come from a Chapter 11 plan, due to section 1129(a)(9)(A)’s payment-in-full requirement. But if the administrative costs of reorganizing or liquidating a debtor through a Chapter 11 plan become too high, a Chapter 11 plan may not be feasible. Vendors should be advised to consider these factors before acting.

VI. Auctions & Going Out of Business Sales

Whether due to the amendments to the Bankruptcy Code in 2005, or due to economic conditions that have persisted in the past several years in the retail industry, it is increasingly common for a sale to occur early in the case, either to a liquidator or to a going concern buyer. While the use of auction procedures is not unusual in bankruptcy, there are unique issues which

⁹⁶ In some cases, these “503(b)(9) creditors,” as they are called, have banded together to form formal committees. Not only do these creditors now have greater rights under the Bankruptcy Code, but their decisions at the outset of the bankruptcy case may be determinative of whether the debtor will be able to exit bankruptcy with a confirmable Chapter 11 plan. It is unclear whether this was an intended consequence of section 503(b)(9).

⁹⁷ See Kunz, *supra* note 88, at 20, 80 (discussing the lack of instruction in section 503(b)(9) and questioning whether claimants should file a proof of claim on the standard form, generate a new form, or just file a motion requesting an administrative expense claim).

⁹⁸ See, e.g., *In re Samaritan Alliance, LLC*, 2008 WL 2520107, 2008 Bankr. LEXIS 1830 (Bankr. E.D. Ky. June 20, 2008) (concluding that the electricity supplied by the creditor to the debtor pre-petition was a service and not a “good” that would warrant the allowance of an administrative expense claim under section 503(b)(9)).

⁹⁹ See, e.g., *In re R.F. Cunningham & Co.*, 2006 WL 3791329, 2006 Bankr. LEXIS 3650 (Bankr. E.D.N.Y. Dec. 21, 2006) (concluding that the creditor did not have a valid reclamation claim because the debtor never took actual, physical, or constructive possession of the goods sold by the creditor).

¹⁰⁰ See, e.g., *Brown & Cole Stores, LLC v. Associated Grocers, Inc. (In re Brown & Cole Stores, LLC)*, 375 B.R. 873 (9th Cir. B.A.P Aug. 2007) (concluding that the vendor was entitled to an administrative expense claim under section 503(b)(9), notwithstanding the vendor’s lien on the goods sold, which was undersecured).

¹⁰¹ See, e.g., *id.* (concluding that section 553(a) did not preclude a debtor from setting off administrative claim allowed under section 503(b)(9) against debts owed to the debtor by that administrative expense claimant because, unlike all other administrative claims, section 503(b)(9) claims arise pre-petition).

arise almost immediately upon the filing of the bankruptcy case when the assets are comprised of inventory and leaseholds. One of the first things a debtor's counsel attempts to discover is the status of marketing efforts by management. The parties in any bankruptcy proceeding will expect debtor's counsel to know whether there were pre-petition marketing efforts by the company, the outcome of those efforts, the likelihood that a going concern buyer is available, and finally, the status of discussions with any of the liquidators.

Absent the prospect of reorganization or recapitalization, the most common way to resolve a retail chain bankruptcy case is to establish procedures for the sale of the company and/or its assets. In general, the preferred route is to sell the company to a going concern buyer. The reason for this is simple – if a going concern buyer appears, the debtor can avoid large lease rejection damages claims, and trade creditors (most of whom are vendors) will have a surviving customer in the “reorganized” debtor. Nevertheless, there are situations where liquidation is the likely fate of the debtor.

Recent large cases suffering that fate have included Bombay Companies,¹⁰² filed in Bankruptcy Court in Fort Worth and, on a national level, Linens ‘n Things,¹⁰³ filed in Delaware. But more commonly, it is unclear when the bankruptcy is filed whether a going concern buyer is out there and what value such a buyer might bring, contrasted with the value brought by a liquidator. Therefore, the most common method of resolution is to file a motion to approve bid procedures that contemplates pitting going concern bids against the bids by the liquidators.

The practitioner needs to consider the timing of the motion and the probable issues that such a motion presents. The following sections discuss those issues.

A. What Are the Legal and Practical Considerations in Connection with a Motion to Approve Bid Procedures?

As with most cases, retailers usually enter bankruptcy on tighter budgets, with little or no positive operating cash flow. In recent cases around the country and here in Texas, the lenders want a quick sale to staunch the loss of cash. Quick sales under the Bankruptcy Code have long been criticized, both by practitioners and the courts; nevertheless, they continue to occur. The reason that the quick sale is criticized is generally that, until the parties have had time to do extensive due diligence, it is unclear what value is appropriate. It is often also unclear what sales price is needed for any particular class of creditors to receive a distribution, especially early in

¹⁰² Pending before the Honorable D. Michael Lynn, Bankruptcy Judge for the Northern District of Texas, Ft. Worth Division, jointly administered under The Bombay Company, Inc., Case No. 07-44084-dml-11. Other cases jointly administered under the main case: The Bombay Furniture Company, Inc., Case No. 07-44085; BBA Holdings, LLC, Case No. 07-44086; Bombay International, Inc., Case No. 07-44087; Bailey Street Trading Company, Case No. 07-44088; and BMAJ, Inc., Case No. 07-44061.

¹⁰³ Pending before the Honorable Christopher S. Sontchi, Bankruptcy Judge for the District of Delaware, jointly administered under Linens Holding Co., Case No. 08-10832. Other cases jointly administered under the main case: Linens ‘n Things, Inc., Case No. 08-10833; Linens ‘n Things Center, Inc. Case No. 08-10834, Bloomington MN, L.T., Inc., Case No. 08-10835; Vendor Finance, LLC, Case No. 08-10836; LNT, Inc., Case No. 08-10837; LNT Services, Inc., Case No. 08-10838; LNT Leasing II LLC, Case No. 08-10839; LNT West, Inc., Case No. 08-10840; LNT Virginia LLC, Case No. 08-10841; LNT Merchandising Company LLC, Case No. 08-10842; LNT Leasing III LLC, Case No. 08-10843; Citadel LNT LLC, Case No. 08-10844.

the case before claims bar dates and before substantial participation by any creditors' committee. Finally, a sale is irrevocable. Once it occurs, there is no going back, so there is a concern by the parties that a quick irrevocable act in a case, if mistaken, can lead to losses which are irreparable.

The legal impediments to a quick sale include Bankruptcy Rule 6003, which essentially prohibits actions within 20 days of the bankruptcy filing without a finding by the Court that an action is necessary to prevent immediate and irreparable harm.¹⁰⁴

While not strictly speaking a legal impediment, most courts are very reluctant to authorize a sale until a creditors' committee has been formed and has had an opportunity to comment on the bid procedures.

B. What Is the General Standard for Permitting a Sale?

The standard enunciated by the Fifth Circuit for permitting a sale under 11 U.S.C. § 363 is the business judgment rule.¹⁰⁵ This is consistent throughout most circuits.¹⁰⁶ The business judgment rule merely requires evidence before the Court that it is the best business judgment of the debtor and its principals that the sale is likely to maximize the value of assets to be distributed to the creditors. The usual contest around a sale is not so much that a sale, itself, is the bad thing. The contest usually focuses around the price. Secured creditors who have a chance to exit early, sell off their collateral to mitigate the risk that value may fall during the case and, thus, are usually aggressive in pushing the debtor towards a quick sale. Creditors' Committees and equity stakeholders are usually the parties who are not in quite such a hurry. However, all parties' views are tempered by market conditions, history of pre-petition sales, and the like.

¹⁰⁴ See Fed. R. Bankr. P. 6003 (2008); see also *supra* Part II.A.

¹⁰⁵ See *Institutional Creditors of Continental Air Lines, Inc. v. Continental Air Lines, Inc. (In re Continental Air Lines, Inc.)*, 780 F.2d 1223, 1226 (5th Cir. 1986) (citing *inter alia In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983)).

¹⁰⁶ See, e.g., *In re Lionel Corp.*, 722 F.2d at 1071 (noting that in deciding whether a proposed sale is justified a court "should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike. He might, for example, look to such relevant factors as the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value. This list is not intended to be exclusive, but merely to provide guidance to the bankruptcy judge"); see also *See Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1311 (5th Cir. 1985); *Official Comm. of Unsecured Creditors of LTV Aerospace and Defense Co. v. LTV Corp. (In re Chateaugay Corp.)*, 973 F.2d 141, 143 (2d Cir. 1992).

In general, even through early sales are distasteful to many of the constituencies and the Court, it is becoming increasingly frequent that sales are held within the first 60 to 90 days of the retail case being filed.¹⁰⁷

C. What are the general contours of the sale?

1. *Braniff Issues*

In *Pension Benefit Guaranty Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*,¹⁰⁸ the Fifth Circuit upheld objections from a party which criticized a lower court's ruling in permitting a sale which would also have dictated the distribution of the proceeds from the sale. However, a close reading of the case does not indicate that the sale of substantially all of the assets of the debtor itself is prohibited; it is the sale, coupled with distribution scheme of the proceeds. The distribution of the proceeds should be pursuant to a plan or, alternatively, once

¹⁰⁷ See, e.g., *In re Bombay*, Slip Op., Case No. 08-44084, ECF No. 132 (Bankr. N.D. Tex. Sept. 26, 2007) (granting a motion on the sixth day of the case approving of the procedures for a liquidation sale).

By the Motion, Debtors ask approval of (1) the agreement with the Tiger JV, including the break-up fee; and (2) sale procedures. The latter would require bids by parties wishing to serve as an additional, going concern, stalking-horse bidder (as opposed to a liquidation bidder) by September 28, 2007. Debtors would then undertake to choose and document a going concern, stalking horse bid (if any satisfactory bid were received) by October 5, 2007. . . .

Although there is case law that suggests that disposition of estate property in a fashion dispositive of the results of a debtor's reorganization is inappropriate other than through a plan of reorganization, [see *In re Braniff Airways*, 700 F.2d at 935; see also *In re First S. Sav. Ass'n*, 820 F.2d 700, 714 (5th Cir. 1987),] there is also ample authority that section 363(b)(1) may be used to dispose of all or most of a chapter 11 debtor's assets through the sale in a going concern configuration or by liquidation. See, e.g., *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983); *In re Ames Dept. Stores, Inc.*, 136 B.R. 357, 359 (Bankr. S.D.N.Y. 1992); 3 COLLIER ON BANKRUPTCY ¶ 363.02[3] (15th ed. rev. 2005). Indeed, General Order 2006-02 of this court, establishing procedures for complex chapter 11 cases, contemplates such transactions even in the early days of a chapter 11 case.

Id.; see also *In re Bag 'n Baggage Corp.*, Case No. 08-32096, ECF No. 144 (Bankr. N.D. Tex. May 23, 2008) (order approving bid procedures on the 19th day of the bankruptcy case with the sale to occur within 33 days of the filing).

¹⁰⁸ 700 F.2d 935, 939-40 (5th Cir. 1983).

the proceeds are in the debtor's estate, the distribution can be through a chapter 7 trustee, after conversion.¹⁰⁹

2. *Asset Purchase Agreements*

When a motion to approve bid procedures is filed, or shortly thereafter, there is typically an asset purchase agreement that serves as the model platform off of which the bidders will submit their bids. The asset purchase agreement will be designed around a sale of the going concern value of the retail chain. There are a number of issues in connection with asset purchase agreements which typically arise. First, as in any negotiated asset sale, retail chain asset purchase agreements will contain the essential terms of the deal, including:

(a) Consideration

The first issue negotiated in the asset purchase agreement is the price. Prices are often subject to complex adjustment mechanisms. Primary assets of value in a retail case are the inventory, generally subject to the secured creditors' floating lien and the leasehold interests. With regard to the inventory, there has been little reported bankruptcy case law litigating price adjustments over inventory issues. However, price adjustment mechanisms which generally involve a count of the inventory at the time of the closing and an adjustment against the purchase price are often subject to lengthy negotiations. Such adjustment mechanisms address, *inter alia*: (i) inventory which has been unwrapped and used for display in the stores; (ii) damaged inventory which is no longer saleable; and (iii) lost or stolen inventory, or "shrink."

Most companies keep their records of inventory on computer and the cost basis of each item of inventory is stored generally by SKU number. A typical example of an inventory adjustment mechanism is contained in the Asset Purchase Agreement executed in the Bag 'n Baggage case.¹¹⁰

(b) Assets Being Acquired

The next item subject to extensive negotiation is what exact assets are being sold. Again, primarily the assets to be sold are the inventory and the leasehold interests. While the inventory is simple enough, leasehold interests sometimes have a great deal of complexity. First, each lease is, by its nature, an executory contract and subject to restrictions on assumptions under 11 U.S.C. § 365. Any buyer will want to protect the leases at locations that it deems valuable,

¹⁰⁹ In particular, the court of appeals focused on how the terms of the sale (1) changed the composition of the debtor's assets; (2) dictated the terms of a potential plan of reorganization or liquidation, (3) altered the rights of the creditors, and (4) granted releases to parties of the transaction too broadly. Said the court: "The debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with the sale of assets." *Id.* at 940. To the extent the sale procedures *do* dictate allowable partial distributions to one or more creditors, the absolute priority rule applies. See *United States v. AWECO, Inc. (In re AWECO, Inc.)*, 725 F.2d 293, 298-99 (5th Cir. 1984) ("[A] bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors.").

¹¹⁰ See, e.g., *In re Bag 'n Baggage, Ltd.*, Case No. 08-32096, ECF Dkt. #439, Ex. A-1 (Bankr. N.D. Tex. Oct. 16, 2008), Ex. A-1 (the "Amended BnB APA").

which may require some period of time post-closing to analyze. The seller may wish to make certain that the buyer, if purchasing the entire chain, provides for some mechanism to promptly drop rejected leases so that there are no administrative burdens on the estate. This is usually resolved by a motion to assume and assign on a conditional basis.¹¹¹

(c) Representations and Warranties Concerning the Asset

The next hot ticket item, heavily negotiated in asset purchase agreements, is the representations and warranty provision. These provisions come about because the seller (or debtor) will want to have the sale termed an “as is, where is” sale, as will the creditors’ committee and secured lenders. However, the buyers generally push back and are able to extract some concessions with respect to representations and warranties before putting their money at risk. Although standard representations and warranties will usually be placed in the asset purchase agreement, such as organization and good standing of seller or the seller’s authority to sell title to assets, buyers often insist on numerous other provisions. For example, buyers will ask for a specific representation on status of inventory and pricing as well as customer credit obligations (e.g., gift cards, loyalty programs, etc.).¹¹²

(d) Default and Termination Provisions

Although the parties to an asset purchase agreement contemplate its closing, buyers are always wary of changing market conditions and will want to have a way to exit the deal. The seller, on the other hand, will want the buyer to have a hard commitment.¹¹³ At the same time, the potential buyer will want some assurance that its own due diligence will not go for naught. Most asset purchase agreements thus contain a fee to be paid to the first bidder in the event that another party offers a “better” bid. Courts considering this type of provision approve of such a

¹¹¹ For an example of such a motion, see *In re Bag ‘n Baggage, Ltd.*, Case No. 08-32096, ECF Dkt. #79 (Bankr. N.D. Tex. May 12, 2008) (“BnB Sale Motion”). The Going Out of Business Sale Procedures (“GOB Procedures”) are attached to attached to the BnB Sale Motion as Exhibit C.

¹¹² See, e.g., Amended BnB APA, *supra* note 110 art. VII, at 25-32 (“Representation and Warranties”).

¹¹³ To use an example from the Bag ‘n Baggage Case, the purchaser agreed to purchaser the debtor’s executory contracts and unexpired non-residential leases:

provided that the Transaction Documents shall provide that the Purchaser shall reserve the right, after due diligence and through and including the date that is forty-five (45) days after the Closing Date . . . within which to identify and designate those Executory Contracts that Purchaser desires to have assumed and assigned to it or its designee . . . [and]

provided, however, that subject to the grant to Purchaser of Designation Rights with regard to the Real Property Leases for the Designated Closing Stores . . . , Purchase shall reserve the right, after due diligence and through and including the Closing Date . . . within which to identify and designate those Real Property Leases that Purchaser desired to have assumed and assigned to it or its designee . . . ; *provided, further, however,* that Purchaser commits that not less than nineteen (19) of Seller’s retain store leases will be assumed by the Purchaser and/or a designee there.

Kairo’s Letter, *In re Bag ‘n Baggage, Ltd.*, Case No. 08-32096, ECF Dkt. #131, Ex. 9 (emphasis in original).

fee—often called a “topping fee” or “break-up fee”—to the extent that they encourage more competition among bidders relying on the first bidder’s due diligence.¹¹⁴

3. *Liquidation Agreements*

In addition to the asset purchase agreements contemplating a going concern sale, there are frequently competing bids from the liquidators. Although the liquidation bids are, by their nature, of lesser value because of issues like lease rejection damages claims, liquidation agreements from companies like Gordon Brothers, Hilco, and Great American are a world unto their own. The agreements have substantial representations and warranties regarding the state of the inventory and regarding any price reductions that were taken pre-petition. Bids by liquidators typically are so many cents on the cost dollar, as adjusted. In these practitioners’ collective experience, liquidators’ agreements are riddled with traps for the unwary. Unfortunately, most retail management teams have little experience with liquidators and cannot assist much in analyzing these agreements. Some issues concerning liquidation documents of which practitioners involved in these types of transactions should be aware:

(a) Pricing

- How is the price calculated?
- Are there additions to the price to cover the cost of freight?
- Are the seller’s cost files accurate?
- Are there any adjustments for pre-petition price reductions?

(b) Augment

- Can the liquidator bring in goods to sell through the stores being closed?
- What state or local laws exist to prevent this augment from occurring?

¹¹⁴ See *In re O’Brien Envtl. Energy, Inc.*, 181 F.3d 527, 536-37 (3d Cir. 1999). This issue is visited in Delaware and New York more so than in Texas. The *O’Brien* decision, however, is followed by most courts throughout the country. In *O’Brien*, the Third Circuit affirmed an order denying a break-up fee for an unsuccessful bidder on the debtor’s assets through a section 363 sale. The court noted that the only authority for awarding such a break up fee comes from section 503(b)(1)(A) (“actual, necessary costs and expenses of preserving the estate”). In that case, the unsuccessful bidder failed to prove that an award that included a break-up fee and payment of the bidder’s expenses was necessary to the preservation of the estate. Specifically, the court recognized that there was no evidence establishing that the break-up fee actually promoted more competitive bidding. Instead, the lower court had expressed its concerns that such a break-up fee would chill competitive bidding. The Third Circuit also pointed out that the bidder’s willingness to continue participating in the bidding process even in the absence of a guaranteed break-up fee demonstrated that it was the prospect of acquiring the debtor’s assets at a below-market price which promoted more competitive bids, not the prospect of obtaining a break-up fee. See also *The Official Committee of Subordinated Bondholders v. Integrated Resources, Inc. (In re Integrated Resources, Inc.)*, 147 B.R. 650 (S.D.N.Y. 1992), *appeal dismissed*, 3 F.3d 49 (2d Cir. 1993) (applying the business judgment rule to the appropriateness of a break-up fee); *but see S.N.A. Nut Company*, 186 B.R. 98, 104 (Bankr. N.D. Ill. 1995) (applying a stricter standard to break-up fee awards to ensure that break-up fees do not chill competitive bidding); *In re America West Airlines, Inc.*, 166 B.R. 908, 912 (Bankr. D. Ariz. 1994); *In re Hupp Industries, Inc.*, 140 B.R. 191, 194, 196 (Bankr. N.D. Ohio 1992); *In re Tiarra Motorcoach Corp.*, 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997).

(c) Advertising

- What types of advertising will be allowed at the stores?
- What is the landlord's attitude regarding GOB advertising?
- How likely is the Attorney General to get involved?

(d) Other Miscellaneous Questions

- Who is paying employees and covering benefits costs while GOB is taking place?
- Who is paying sales taxes?

VII. Miscellaneous Issues

The following are miscellaneous issues that tend to arise in retail bankruptcy cases. Each of these issues has, on occasion, consumed more debtor time and funds than would be generally anticipated.

A. Customer Loyalty Programs

One of the recent hot topics to emerge in retail bankruptcy cases is the issue of customer loyalty programs during the pendency of the case. Customer loyalty programs generally consist of programs to redeem gift cards and merchandise certificates, policies of allowing refunds and exchanges, and merchant rebates.

For a retailer seeking to reorganize, the inability to honor its customer loyalty programs is often considered the "kiss of death".¹¹⁵ As a result, many debtor/retailers file motions seeking to authority to honor their pre-petition customer programs as a "first day motion". Such motions typically rely on sections 105(a), 363(b), 503(b)(1) and 507(a)(7) of the Code.

Under section 503(b)(1), debtors argue that the allowance of customer loyalty programs, such as the redemption of gift cards, is an actual and necessary expense to preserve the estate by maintaining valuable relationships with customers, which frequently take many years to build. Debtors further argue that customer loyalty programs, such as gift certificates, are really priority claims that fall under section 507(a)(7),¹¹⁶ which grants a priority to "unsecured claims of individuals, to the extent of \$2,225 for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided."¹¹⁷ The rights of general unsecured creditors and other parties-in-interest are not harmed by allowing the debtor to honor these priority claims

¹¹⁵ *Consumer Groups Ask FTC to Protect Gift Cards in Bankruptcy*, DAILY BANKRUPTCY REVIEW, Sept. 15, 2008, at 5.

¹¹⁶ *In re WW Warehouse, Inc.*, 313 B.R. 588 (Bankr. D. Del. 2004) (finding gift certificate holders are entitled to priority status under section 507(a)(7)).

¹¹⁷ 11 U.S.C. § 507(a)(7).

early. Courts have clearly found the arguments persuasive, as many have granted the debtors' motions.¹¹⁸

While courts have been willing to authorize the continuation of customer loyalty programs, the orders are often written in such a way as to allow the debtors discretion in determining whether to continue a program. In the case of The Bombay Company, the debtor ultimately decided not to honor its gift cards as it proceeded into liquidation. In the case of Sharper Image, the debtor sought and obtained an order from the court to honor its gift certificates so long as consumers spent double the face amount of any gift card amount they sought to redeem.¹¹⁹

In response to debtor/retailers' liquidations and the decision not to honor gift cards, four consumer groups have asked the Federal Trade Commission to intervene in bankruptcy cases to protect consumer interests.¹²⁰ In particular, they have asked the FTC to (i) seek orders from courts ordering retail debtors to continue to honor gift cards as long as retailers' doors remain open; and (ii) to create new policies that would require all companies that issue gift cards to deposit all proceeds from the sale of gift cards into special accounts so that they would be honored even in the event of a retailer bankruptcy.¹²¹

B. Trademark & Licensing Issues

As more retailers go into bankruptcy, issues surrounding trademarks and the licensing of products and merchandise have begun to emerge.

Trademarks are protected by both federal (the Lanham Act¹²²) and state law.¹²³ The purpose of a trademark, which consists of words, phrases, logos and symbols, is to provide customers reassurance as to the quality and value of the goods or services that are provided under

¹¹⁸ See, e.g., *In re Linens Holding Co., et. al.*, Case No. 08-10832 (CSS) (Bankr. D. Del. May 2, 2008); *In re Sharper Image Corporation*, Case No. 08-10322 (KG) (Bankr. D. Del. March 12, 2008) *In re Hoop Holdings, LLC*, Case No. 08-10544 (BLS) (Bankr. D. Del. Mar. 28, 2008); *In re Buffets Holdings, Inc.*, Case No. 08-10141 (MFW) (Bankr. D. Del. Jan. 23, 2008).

¹¹⁹ Supplement to Motion of Debtor Pursuant to Sections 105(a), 363(b), and 503(b)(1) of the Bankruptcy Code for Authorization to Honor Certain Prepetition Customer Programs, *In re Sharper Image Corporation*, Case No. 08-10322 (KG), (Bankr. D. Del. March 3, 2008) (Doc. No. 122) (citing to customer backlash it was experiencing based on its original decision not to honor gift certificates and efforts by competitor Brookstone to capitalize on this decision, Sharper Image sought court authority to honor its gift cards, albeit with more restrictive terms); Supplemental Order Pursuant to Sections 105(a), 363(b), and 503(b)(1) of the Bankruptcy Code for Authorization to Honor Certain Prepetition Customer Programs, *In re Sharper Image Corporation*, Case No. 08-10322 (KG), (Bankr. D. Del. March 7, 2008) (Doc. No. 189).

¹²⁰ *Consumer Groups*, *supra* note 115.

¹²¹ *Id.*

¹²² 15 U.S.C. §§ 1051-1141.

¹²³ Peter S. Menell, *Bankruptcy Treatment of Intellectual Property Assets: An Economic Analysis* (May 3, 2007). Berkeley Center for Law and Technology. Law and Technology Scholarship at 13 n.39, available at <http://repositories.cdlib.org/bclt/lts/32> (stating that in contrast to federal patent and copyright acts, the Lanham Act does not preempt state trademark protection.)

the trademark.¹²⁴ In order to safeguard a trademark license under the Lanham Act, a licensor is required to control the “nature and quality of the goods or services” sold by licensees.¹²⁵ As a consequence, in a bankruptcy setting, trademark licenses usually fall under the definition of an executory contract as both a licensor (with its continuing obligation to exercise quality control) and licensee (with its continuing obligation to make payments, market and prepare reports for the licensor) continue to have obligations to each other.¹²⁶

Pursuant to section 365(f), a debtor/licensee may assume and assign executory contracts. Thus, it becomes imperative for parties entering into a trademark licensing agreement to contemplate how a trademark license should be treated in the event either party goes into bankruptcy. In general, the law surrounding the assignability of intellectual property licenses is not settled.¹²⁷ The law surrounding the assignability of trademark licenses is even less settled.¹²⁸

To date, the courts have been split over the assignability of trademarks licenses. Some courts have found that trademark licenses are assignable. In *Quantegy, Inc.*,¹²⁹ the debtor sought to assume and assign three license agreements with Sony Corporation, Inc., which involved the use of Sony’s trademark and certain manufacturing processes.¹³⁰ Sony objected to the motion, basing its objection, among others, on section 365(c)(1), which limits the assignability of executory contracts under certain circumstances.¹³¹ Each of the Sony licensing agreements restricted the assignability of the licensing agreements.¹³² However, the *Quantegy* court found that public policy encouraged the assumption and assignment of executory contracts, and in order for Sony to succeed on its motion, it would need to meet both provisions of section

¹²⁴ *Id.* at 13.

¹²⁵ *Id.* at 13.

¹²⁶ *Id.* at 27.

¹²⁷ *See generally*, Menell, *supra* 127, at 45-47.

¹²⁸ *Id.* at 47.

¹²⁹ *In re Quantegy, Inc.*, 326 B.R. 467 (Bankr. M.D. Al. 2005).

¹³⁰ *Id.* at 469.

¹³¹ 11 U.S.C. § 365(c)(1) states:

The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1) (A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment;

Id.

¹³² *Quantegy*, 326 B.R. at 469 (requiring the written consent of Sony to assign the licenses *except* when the assignment was to a purchaser of the entire portion of the debtor's business relating to the subject license agreement).

365(c)(1).¹³³ The court concluded that Sony did not meet the requirements of section 365(c)(1)(A), specifically stating that “[t]rademark and patent law allows a licensor to expressly authorize the use of its name and intellectual property. Having done so, the licensor cannot be heard to complain that the same applicable law excuses him from the consequences of his own contract.”¹³⁴

In *Rooster*,¹³⁵ the debtor and Pincus, a corporation that the sole and exclusive licensee of the right to use Bill Blass’ name and trademark in connection with the sale of men’s apparel, fought over the debtor’s right to assign its sublicense to manufacture Bill Blass neckties.¹³⁶ The issue was framed in the context of a personal services contract. Specifically, was the trademark sublicensing agreement for the manufacturing and sale of neckties in the nature of a personal services contract? If the contract was in the nature of a personal services, applicable state law would render the contract unassignable and would excuse Pincus from accepting any assignment from the debtor under the exception allowed under section 365(c)(1)(A).¹³⁷ After reviewing the strict quality control standards imposed by Bill Blass and Pincus, the court found that the trademark license gave very little discretion to the debtor/sublicense. As a consequence, the trademark license was not in the nature of a personal services contract, did not fall into the exception under section 365(c)(1)(A), and was therefore assignable.¹³⁸

Other courts have found that trademark licenses not to be assignable. In *Wellington Vision, Inc.*,¹³⁹ the district court upheld the bankruptcy court’s decision denying the debtor’s motion to extend time to assume or reject a franchise agreement with Pearl Vision, Inc. (“PVI”) based on its finding that the terms of the franchise agreement did not allow the debtor to assume and assign the franchise agreement under any circumstances without the express authorization of PVI.¹⁴⁰ The terms of the franchise agreement provided that:

[T]his Agreement is personal being entered into in reliance upon and in consideration of the singular personal skill and qualifications of Franchisee, and the trust and confidentiality reposed in Franchisee by PVI. Therefore. . . neither Franchisee’s rights or privileges hereunder, nor the Franchise Business or any interest therein, may be transferred, assigned, sold, shared, redeemed, sublicensed or divided voluntarily or involuntarily,

¹³³ *Id.* at 470.

¹³⁴ *Id.* at 471.

¹³⁵ *In re Rooster, Inc.*, 100 B.R. 228 (Bankr. E.D. Penn. 1989).

¹³⁶ *Id.* at 231.

¹³⁷ *Id.* at 231-32.

¹³⁸ *Id.* at 232-235; *see also In re Sunrise Restaurants, Inc.*, 135 B.R. 149 (Bankr. M.D. Fla. 1991) (wherein the court found the operation of a Burger King retail establishment did not require special knowledge in the nature of a personal services contract and, therefore concluded, that the Burger King franchise agreement could be assumed and assigned.)

¹³⁹ *In re Wellington Vision, Inc.*, 364 B.R. 129 (S.D. Fla. 2007).

¹⁴⁰ *Id.*

directly or indirectly, by operation of law or otherwise, in any manner, without the prior consent of PVI . . .¹⁴¹

In upholding the lower court's decision, the district court distinguished the language in this case from that of the *Quantegy* case, where the agreement allowed for the assumption and assignment of trademark licenses in very narrow circumstances.¹⁴² Here, the franchise agreement did not allow for the assumption and assignment of the franchise agreement under *any* circumstances without PVI's consent.¹⁴³ As with the other cases discussed herein, the courts refer to the language of the licensing agreement to determine if a document is assumable and assignable.

The unsettled nature of the law on trademark issues should be of particular concern to trademark licensors who have the primary interest in protecting the perceived value and good will surrounding their trademarked products. To date, no Circuit Court of Appeals has decided the issue of whether a licensor has the power to reject performance by an entity other than the debtor/licensee under the federal common law of trademarks, and the lower courts have been left to wrestle with the language of the trademark licenses (oftentimes looking to state law) to determine whether a license is assignable. However, a circuit level opinion on this issue may be forthcoming. In the case of *In re N.C.P. Marketing Group*,¹⁴⁴ Billy Blanks, of Billy Blanks Tae Bo fitness program, was successful in having the district court reject a trademark license under the theory that contracts that cannot be assigned by the debtor without the non-debtor licensor's consent. Specifically, the district court found that trademarks are personal and non-assignable without the consent of the licensor.¹⁴⁵ The debtor appealed the decision to the Ninth Circuit. However, the matter was originally taken off the Ninth Circuit's hearing docket after the parties asked for time to seek approval of a proposed settlement agreement. The agreement was ultimately rejected by the bankruptcy court, and it appears that this matter may be taken up by the Ninth Circuit.

The assignability of a trademark is important in the context of a retail bankruptcy. Take for example, the sale of certain specialty or high end products such as a Titleist golf ball or a Hermes Kelly purse. Both are high-end specialty or luxury goods that are only carried in select locations. Vendors carrying these luxury goods typically enter into specific licensing and trademark agreements that control everything from pricing to display restrictions. On the occasion where a vendor carrying such goods files for bankruptcy, it may find itself in the position of liquidating assets for the benefit of its creditors. As discussed herein, many retailers sell their inventory at auction or in going out of business sales. In such a situation, trademark licensors find it difficult to enforce their trademark licenses in the rush to liquidate their assets. Therefore it is up to the trademark licensor to be an aggressive participant early on in any retail bankruptcy in order to protect its trademark.

¹⁴¹ *In re Wellington Vision, Inc.*, 364 at 132.

¹⁴² *Id.* at 136.

¹⁴³ *Id.*

¹⁴⁴ 337 B.R. 230 (D. Nev. 2005).

¹⁴⁵ *Id.* at 237.

As more retailers file bankruptcy and seek to assign their trademark licenses or liquidate their inventory, trademark licensors may find themselves without recourse in regard to actions that may devalue their trademarks (*i.e.*, assignment of their trademark licenses to third parties or sale of their trademarked products at price points well below their contracted rates).

C. State Lien Laws versus Creditor Rights

One final miscellaneous topic that has been raised in the context of retail bankruptcies is that of disputes which often arise between landlords and lessors of leased equipment. Typically, when a lease is rejected, debtor/tenants who may have leased equipment at the facility either return equipment to the equipment lessor or the equipment lessor seeks entry to the non-residential property to remove its property. If a fight subsequently ensues between parties, it is because the equipment has value. However, what happens in the instance where the liquidation value of leased equipment is less than its removal cost? Such is the dilemma encountered in *In re Plastech Engineered Products, Inc.*¹⁴⁶

In *Plastech*, the debtor rejected a non-residential lease and chose not to remove all leased equipment from the leased premises. The equipment at issue was large and difficult to remove. The equipment lessor was reluctant to remove the equipment, as the cost of removal would likely exceed the equipment's probable liquidation value. The landlord, who did not want the equipment, opposed the removal of the equipment for fear of damage to the property and demanded that the equipment lessor remove the equipment and compensate the landlord for any damage. The equipment lessor refused, citing the lack of any privity of contract between the landlord and lessor.¹⁴⁷

Both the equipment lessor and the landlord will have claims against the debtor. However, in the event that an estate is administratively insolvent, the equipment lessor and landlord are left to assess whether to commence litigation (*i.e.*, in the case of the equipment lessor, seeking a declaratory judgment that it does not have any obligations to the landlord, or in the case of the landlord, seeking damages for the removal of the equipment) or whether to cooperate and split the burden and cost of removing the equipment. Neither the Bankruptcy Code, the Uniform Commercial Code, or state law points to a predictable resolution to this dilemma. In the long run, given the unsettled state of the law in this type of situation, both the landlord and equipment lessor may be better off cooperating to reach a resolution as litigation will likely be unpredictable.

VIII. Conclusion

As discussed herein, the passage of BAPCPA changed the state of bankruptcy law and shifted the balance of power between creditors and debtors. How the market and bankruptcy practitioners adjust to the changes in this wave of new retail bankruptcy cases remains to be seen.

¹⁴⁶ Case No. 08-42417 (E.D. Mich. 2008).

¹⁴⁷ Typically a contractual relationship does not exist between an equipment lessor and landlord. To the extent any contractual relationship exists between a equipment lessor and a landlord, the document is a lien waiver or subordination agreement between the landlord and equipment lessor.