Business Reorganization/Real Estate

Big and Little Boxes: The Ins and Outs of Retail Restructuring

Martin J. Bienenstock
Proskauer; New York

Jack Butler
Hilco Global; Northbrook, Ill.

Hon. Mary Grace Diehl
U.S. Bankruptcy Court (N.D. Ga.); Atlanta

Lorenzo Marinuzzi
Morrison & Foerster LLP; New York

David L. Pollack
Ballard Spahr LLP; Philadelphia

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RETAIL BANKRUPTCIES – NON-RESIDENTIAL LEASES AND MORE

INTRODUCTION:

The Panel has been tasked with discussing issues related to retail bankruptcies, and in particular non-residential real property leases and other issues which are more commonly found in retail bankruptcy cases. We start with a review of the current provisions of Section 365(d)(4) regarding the time in which a debtor has to either assume or reject non-residential real property leases in a Chapter 11 case, looking at the history of Section 365(d) from its inception through the BAPCPA Amendments in 2005. We also look at the recommendations of the ABI Commission to Study the Reform of Chapter 11 in light of current economic conditions and lending practices. We explore whether the proposed changes to Section 365(d)(4), in light of 2015 conditions, would change the outcome for most retail bankruptcy matters.

Section 365: Where Are We, How Did We Get Here and Where Are We Going

- The 2005 Amendments, Why did they come about

When the Bankruptcy Code was first enacted in 1978, Section 365 did not provide a specific time for the assumption or rejection of executory contracts and non-residential real property leases. Indeed, Section 365(d)(2) as originally enacted read as follows:

> (2) In a case under chapter 9, 11 or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of the debtor at any time before the confirmation of a plan, but the court, on request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

That provision, which allowed for an open-ended time to assume or reject leases, resulted in a flurry of activity from commercial landlords and their lobbyists. Indeed, the well documented statements of Senator Oren Hatch in the legislative history of the 1984 Amendments to the Bankruptcy Code set forth this problem as one of reasons for the initial amendments to Section 365. In an attempt to rectify what was perceived to be the havoc created by the original section, Section 365(d) was amended by adding Section 365(d)(4) providing that leases were to be assumed within sixty days following the date of the petition, unless the court on motion made extended that sixty day deadline.

While the landlord industry may have believed that the 1984 Amendments would provide a fix to the open-ended time limit to assume or reject leases, as matters turned out courts regularly granted either repeated extensions of time to assume or reject leases or simply extended the time to assume or reject the leases through confirmation of the debtor's plan of reorganization . . . and sometimes even later. Accordingly, in yet a further attempt to put a halt to unlimited extensions of time to assume or reject leases, landlords, particularly led by the shopping center industry, were successful in having Congress amend Section 365 to provide the current initial 120 day time to assume or reject followed by the ability to grant a further 90 day extension for cause. Any extension beyond the 210 day time period required the landlord's consent. In the landlords' minds, that would finally put a hard stop on the time to assume or reject leases. As we have seen, however, in at least a few cases, debtors have filed motions to assume leases within the 210 day period but were not forced to move forward on that motion, thereby further extending the period of time to assume or reject. In addition, at least one court has held that where the proposed assumption of leases was contained in the debtor's plan of reorganization, the filing of that plan of reorganization within the 210 days effectively stayed any automatic rejection of the affected leases until confirmation of the plan.

The 2005 Amendments setting the 210 day hard stop brought an immediate hue and cry from the debtors' side of the bar claiming that the change to Section 365(d)(4) would make it impossible to confirm a Chapter 11 retail bankruptcy case. Ten years later the debtor bar argues that empirical evidence has proven them correct and that there have been virtually no Chapter 11 reorganizations since the enactment of the 2005 Amendments. The landlord bar, on the other hand, argues that economic conditions, not the 210 day rule, and the positions taken by lenders as well as other factors (including the creation of Section 503(b)(9) claims) are the real culprit. The ABI Commission, in an attempt to address the issues raised by both sides of the aisle, proposes extending the time to assume or reject leases to a single one year period with no provision for further extensions for cause. That proposal is coupled with other proposed revisions such as the requirement of prompt payment and adoption of the accrual method of determining what rent is due. No specific language has thus far been suggested. *[See report of the Commission to Study the Reform of Chapter 11 at pages 129-135 attached hereto.]*

- Does the time to assume or reject really matter?
  - In today's economic environment, can retail cases be reorganized?
- Comparison of current law with ABI Commission recommendation.
  - Are businesses "too far gone" by the time the bankruptcy is filed?
  - Have all possibilities for reorganization been vetted prior to filing?

Administrative insolvency/pay-to-play.

- Should cases be run for the benefit of the secured lender alone?
- Section 503(b)(9) claims – are they really viewed as administrative?

Section 503(b)(9) Claims in Cases Under Section 363 of the Bankruptcy Code

With companies increasingly aware of the costs and uncertainty associated with "free fall" chapter 11 bankruptcies, would-be debtors have in recent years turned to speedier and more cost-effective strategies such as prepackaged plans and quick sales under section 363 of the Bankruptcy Code. The increased prominence of the latter has brought to the forefront the appropriate treatment of creditors holding claims under section 503(b)(9) of the Code. While the Bankruptcy Code affords section 503(b)(9) claims administrative priority, in sale cases with limited estate funds, such claimants may be concerned that a debtor may give preference to post-petition trade payables, claims of critical vendors and other administrative claims.

For their part, bankruptcy courts have varied as to when, if ever, a debtor must ensure payment in full of section 503(b)(9) claims. In *In re Townsend's, Inc.*, No. 10-14092 (CSS), the U.S. Bankruptcy Court for the District of Delaware initially refused to approve the debtors' post-petition financing package, finding that the prospects for payment of section 503(b)(9) claims were slim. *In re Townsend's, Inc.*, No. 10-14092 (CSS) (Bankr. D. Del.). The court there only approved the financing once the debtors' lender and the creditors' committee reached an agreement to pay section 503(b)(9) claims from the proceeds of the sale. By contrast, in *Allen Family Foods*, No. 11-11764 (KJC), the Delaware bankruptcy court approved the sale of the debtors' assets despite there being no assurance of full payment of allowed section 503(b)(9) claims due. *In re Allen Family Foods Inc.*, No. 11-11764 (KJC) (Bankr. D. Del.), Tr. of July 27, 2011 Hr'g at 44-45. Similarly, in *In re Real Mex Restaurants Inc.*, Case No. 11-13122 (BLS), the Delaware bankruptcy court approved a sale under section 363 despite the fact that the case was administratively insolvent. *In re Real Mex Restaurants Inc.*, Case No. 11-13122 (BLS) (Bankr. D. Del.), Tr. of Feb. 10, 2012 Hr'g.

In two cases decided in 2012, the Delaware bankruptcy court authorized sales pursuant to section 363 over objections relating to section 503(b)(9), but required the debtors to establish a reserve for 503(b)(9) claims from the sale proceeds. In In re Blitz USA, Inc., Case No. 11-13603 (PJW), the Delaware bankruptcy court approved the sale of a division of the debtors' businesses over the objection of the unsecured creditors committee, but required the debtors to establish a reserve for 503(b)(9) claimants from the sale proceeds pending a determination of the final outcome of the cases. *In re Blitz USA, Inc.*, Case No. 11-13603 (PJW) (Bankr. D. Del.), Tr. of April 19, 2012 Hr'g at 42. Notably, in *Blitz*, the bankruptcy court stated that "where all assets are subject to a security interest, and if a sale of the entire enterprise produces proceeds less than the amount of the secured claim, then no creditor other than the secured creditor is entitled to anything." *Id.* In *In re AFA Investment Inc.*, Case No. 12-11127 (MFW), the bankruptcy court approved the sale, but also required the debtors to reserve the sale proceeds above the amount necessary to satisfy the debtor-in-possession financing and the first lien lenders in order to determine whether 503(b)(9) claimants were entitled to such amounts above the second lien lenders. *In re AFA Investment Inc.*, Case No. 12-11127 (MFW) (Bankr. D. Del.) Tr. of July 12, 2012 Hr'g at 46. The bankruptcy court reserved on the question of whether the 503(b)(9) claimants were entitled to be paid from sale proceeds above the second lien lenders but indicated that the 503(b)(9) claimants had "paid the freight" in that case. *See id*.

More recently, the Delaware bankruptcy court addressed section 503(b)(9) claims in *In re NE Opco, Inc.*, No. 13-11483 (CSS). In *NE Opco*, the debtors had limited funds in their debtor in possession financing budget and a short timeframe within which to obtain a purchaser of their assets. Complicating the situation were the competing interests of the debtors' lender, the official committee of unsecured creditors, the debtors' non-debtor parent and the debtors' largest secured creditor. Without a prospective purchaser in place, the debtors negotiated a deal with the other parties that provided for, inter alia, the funding of a segregated escrow account for payment of allowed section 503(b)(9) claims. The debtors then filed a motion (the "9019 Motion") seeking approval of the agreement under Bankruptcy Rule 9019. At the hearing on the 9019 Motion, several creditors asserting section 503(b)(9) claims objected, arguing that despite the

Bankruptcy Code's conferral of priority upon such claims, the settlement between the parties provided no assurance that such claims would be paid in full and, in fact, the financial constraints of the case made it speculative as to whether section 503(b)(9) claims would be paid at all.

The bankruptcy court ultimately approved the settlement after careful consideration of a number of issues. Noting that a section 363 sale was the best way to maximize value for the estate and its constituents, the court found that the settlement was the most likely path to facilitate such a sale. *NE Opco*, Tr. of July 19, 2013 Hr'g at 96. The court rejected the notion that the settlement had to guarantee the payment in full of all section 503(b)(9) claims. *Id.* at 98-99. Instead, the court looked to whether there was a "reasonable likelihood, or more likelihood than not, that 503(b)(9) claims will be paid in full." *Id.* at 99. Having considered the extensive testimony and evidence that was presented at the hearing on the 9019 Motion, the bankruptcy court found that it was more likely than not that section 503(b)(9) claims would be paid. *Id.* at 99-100. The court acknowledged the concern that some administrative claimants may be paid more than others, but indicated that this was sometimes a business reality, but its mere possibility was not sufficient to decline to approve the settlement. *Id.* at 103-04.

The Delaware bankruptcy court's ruling in *NE Opco* is the next step in the development of the general treatment of section 503(b)(9) claims in sale cases under section 363 of the Bankruptcy Code. As Judge Carey stated in *Allen Family Foods*, "I don't think Congress ever really contemplated that section 363 sales would develop in quite the way they have. But they have, and courts have endorsed them, including this one." *In re Allen Family Foods, Inc.,* Tr. of July 27, 2011 Hr'g at 44. While recent developments indicate that assurances of full payment of section 503(b)(9) claims may not be necessary in order to obtain approval of debtor-in-possession financing or a quick sale under section 363, the law remains far from settled. Accordingly, debtors, secured lenders and committees must be wary of potentially disgruntled section 503(b)(9) claimants when negotiating section 363 sales, especially in cases with limited funds or where a debtor may be close to administrative insolvency.

Consumer issues:

- Gift cards and Notice issues (known creditors, equitable mootness)
- Privacy, warranties and loyalty programs
- July 28th *Wall Street Journal* "The Examiners". (See attachment)

Section 365(h) revisited and the interplay with 363 (*In re: Revel*)

The issue of the conflict between Bankruptcy Code Sections 363(f) and 365(h) came to the fore with the Seventh Circuit's decision in *Precision Industries, Inc. v. Qualitich Steel SBQ, LLC,* 327 F.3rd 537 (7th Cir. 2003). In that case, a tenant sought to invoke its rights to remain in its premises after the premises had been sold in a bankruptcy sale pursuant to Section 363(f) free and clear of all interests. After a ruling adverse to the tenant was reversed by the District Court, an appeal was taken to the Seventh Circuit as one of first impression as to the interplay between Sections 365(h) and 363(f). Based upon the specific facts of that case, including the tenant's failure to object to the sale free and clear, the Seventh Circuit ruled that the tenant's rights were, indeed, cut off by the 363(f) sale, notwithstanding the provisions of 365(h). Needless to say, a groundswell of attention arose in the real estate industry regarding what had been believed to have been an almost inviolate protection granted to tenants by Section 365(h). Many commentators wondered what the value was in Section 365(h) if a debtor could simply sell the underlying property after a lease was rejected and thereby cutoff all of the tenant's rights (subject, however, to the provisions of Section 365(e)).

There have been a number of cases that have been called upon to interpret this issue since *Precision Instruments*, but none of them have reached the Circuit Court level. Most recently, the United States Bankruptcy Court for the District of New Jersey considered the issue in *In Re Revel AC, Inc.*, 532 B.R. 216 (Bankr. D.N.J., 2015). In that case both the debtor and certain "tenants" filed cross-motions for determination of the tenants' rights under Section 365(h) where the tenants desired to remain in possession of their leasehold interests at a defunct and closed casino in Atlantic City, New Jersey. After first determining that the "tenants" were, indeed, tenants pursuant to "true leases" the Court ruled that a Section 363 sale does not and could not trump the rights granted to the tenants by Section 365(h). The Court stated "This Court previously has addressed the interplay between § § 363 and 365. In *In re Crumbs Bakeshop, Inc.*, 522 B.R. 766, 777 (Bankr. D.N.J. 2014), this Court held that nothing in § 363(f) trumps, supercedes, or otherwise overrides the rights of licensees under Section 365(n). The Court sees no reason to reach a different conclusion in the present case with regard to the tenants' rights under Section 365(h). . . . The *Crumbs* analysis is relevant here:

> It is well established that the appropriate way to construe a statute is to conclude that the specific governs over the general . . . *In re Churchill Properties III, Ltd. P'ship, 197 B.R. 283, 288 (Bankr. N.D. Ill. 1996).* In *Churchill*, the court recognized that § 365(h) is specific, as it grants a particular set of clearly stated rights to lessees of rejected leases. That is, Congress specifically gave lessees the option to remain in possession after a lease rejection. If the court were to allow a § 363(f) sale free and clear of the lessee's interest, "the application of [§ 365(h)] as it relates to non-debtor lessees would be nugatory." *In re Churchill Properties*, 197 B.R. at 288. Indeed, "it would make little sense to permit a general provision, such as [§] 363(f), to override [§ 365's] purpose. The Code is not intended to be read in a vacuum." *Id.*
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> Moreover, the legislative history of § 365(h) evinces that Congress had the desire to protect the rights of tenants.
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> > A 1978 Senate Report remarked that under the terms of § 365(h), "the tenant will not be deprived of his estate for the term for which he bargained." S.Rep. No. 95-989, at 60 (1978) . . . . The Section-by-Section Analysis of the 1994 amendments to the Bankruptcy Code further reflect a

> Congressional desire to protect the rights of those who are lessees of debtors:
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> > This section clarifies section 365 of the Bankruptcy Code to mandate that lessees cannot have their rights stripped away if a debtor rejects its obligation as a lessor in bankruptcy. This section expressly provides guidance in the interpretation of the term "possession" in the contest of the statute. The term has been interpreted by some courts in recent cases to be only a right of possession (citations omitted). This section will enable the lessee to retain its rights that appurtenant to its leasehold. These rights include the amount and timing of payment of rent or other amounts payable by the lessee, the right to use, possess, quiet enjoyment, sublet and assign.
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> *In re Zota Petroleums, LLC*, 482 B.R. 154, 161-62 (Bankr. E.D. Va. 2012) (citations omitted). The court in *In re Haskell L.P.,*, 321 B.R. 1 (Bankr. D. Mass. 2005) also noted the legislative history to § 365(h), and denied the debtor's motion to sell real property free and clear of a leasehold interest under § 363(f) because such a sale would permit the debtor to achieve under § 365(h), namely, stripping the lessee of its rights to possession. This line of reasoning fits squarely with Congressional intent, and with the principle of statutory construction that the specific governs over the general."

In re Crumbs Bake Shop, Inc., 522 B.R. at 777-78

It appears that there is a developing majority opinion that a tenant's rights under Section 365(h) should prevail in any Section 363(f) sale, at least where the tenant party to the contract raises the issue. Alternatively, perhaps the adequate protection to be afforded to the tenant under Section 363(e) in an attempt to sell property free and clear under Section 363(f) would be the identical rights granted under Section 365(h).

Because many of the cases involving this issue are very fact sensitive, attention should also be given to *In re Spanish Peaks Holdings II, LLC*, ______B.R. ____(MT 2014) where the court held on the specific facts of that case (involving leases between the debtors and its affiliates) that the tenants would not be afforded the protection of Section 365(h).

<u>Lessons learned: RadioShack, Anna's Linens, Family Christian, Dots.</u>

- First Day Issues:
  - What are we doing at the beginning of the case
  - Pre-filing Auctions

    - Collusive Bidding (Court's admonition in A&P)

- Highest and Best Bids – Human relations and public policy

<u>Structured dismissals and Conversions to Chapter 7</u>

<u>IN RE JEVIC HOLDING CORP., ET AL., OPINION DIGEST</u>

CASE: *Official Committee of Unsecured Creditors v. CIT/Business Credit, Inc. (In re Jevic Holding Corp., et al.*), Case No. 14-1465 (3d Cir. May 21, 2015)

JUDGES: Thomas M. Hardiman, Maryanne Trump Barry, Anthony J. Scirica

DECIDED: May 21, 2015

TOPICS: Structured Dismissals; Absolute Priority Rule

BACKGROUND: In 2006, following a decline in its business, Jevic Transportation ("Jevic") was sold to a subsidiary of Sun Capital Group ("Sun Capital") in a leveraged buyout, which was financed by a syndicate of lenders led by CIT Group/Business Credit Inc. ("CIT"). Despite its new ownership, Jevic continued to struggle for the next two years. Ultimately, on May 19, 2008, Jevic gave its employees termination notices, and on the following day, Jevic filed voluntary petitions for relief under chapter 11.

During Jevic's bankruptcy case, two primary adversary proceedings were initiated. First, a group of Jevic's terminated truck drivers (the "Drivers") filed a class action lawsuit against Jevic and Sun Capital alleging violations of the federal and state Worker Adjustment and Retraining Notification Acts ("WARN"). Additionally, on the behalf of Jevic's estate, the Unsecured Creditors Committee ("Committee") brought fraudulent conveyance actions against CIT and Sun Capital in connection with the leveraged buyout.

In March 2012, the Committee settled the fraudulent transfer claims against CIT and Sun Capital. The settlement included, among other things, that the parties would release their claims against each other, CIT would pay money into an account earmarked to pay administrative creditors, and Sun Capital would assign to a trust its remaining collateral for the benefit of tax and administrative creditors first and then for general unsecured creditors on a pro rata basis. However, the settlement did not provide for payment to any Drivers on account of their asserted priority wage claims.

The bankruptcy court found that the settlement provided the best result for the estate, approved the settlement over the objection of the Drivers and the United States Trustee (the "UST"), and dismissed the chapter 11 case. The Drivers and the UST appealed to the district court, claiming that the structured dismissal violated section 507(a)(4) of the Bankruptcy Code and further that the Bankruptcy Code does not provide for structured dismissals. The district denied the appeal and affirmed the bankruptcy court's decision. The Drivers and the UST then appealed to the Third Circuit. The Third Circuit also denied the appeal and affirmed the district court's decision.

DISCUSSION: Bankruptcy Rule 9019 authorizes settlements so long as they are "fair and equitable." *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson (TMT Trailer Ferry)*, 390 U.S. 414, 424 (1968). In *In re Martin*, the Third Circuit gleaned from *TMT Ferry Trailer* four factors for bankruptcy courts to consider when examining settlements: (1) the probability of success in litigation, (2) the likely difficulties in collection, (3) the complexity of the litigation involved and the expense, inconvenience and delay necessarily attending it, and (4) the paramount interest of creditors. 91 F.3d 389 (3d Cir. 1996).

Bankruptcy courts are authorized to dismiss cases for cause. One form of cause is the substantial or continuing diminution of the estate. *See* 11 U.S.C. §§ 1112(b)(1) and 1112(b)(4)(A). Section 349(b) explicitly authorizes bankruptcy courts to alter the effect of dismissal "for cause," meaning that the *status quo* can be altered. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 338 (1977); *see also Matter of Sadler*, 935 F.2d 918, 921 (7th Cir. 1991).

The Third Circuit explained that while bankruptcy courts can alter the effects of dismissal "for cause," the parties cannot use a structured dismissal to circumvent the chapter 11 plan requirements or to avoid a viable conversion. The Third Circuit noted that "[a]bsent a showing that a structured dismissal has been contrived to evade the plan confirmation or conversion processes, a bankruptcy court has the discretion to order such a disposition."

The Third Circuit also noted that when Congress codified the absolute priority rule, it did so with respect only to the confirmation of plans. The text of section 1129 deals specifically with plans, not settlements, textually removing the absolute priority rule of section 1129(b)(2)(B)(ii) from settlements. Furthermore, according to the Third Circuit, the case law requiring the adherence to the absolute priority rule involves the confirmation of plans, not the approval of settlements. In so holding, the Third Circuit agreed with the Second Circuit, instead of the Fifth Circuit, with respect to priority deviations. The Fifth Circuit determined that the absolute priority rule applies to settlements. *Matter of AWECO, Inc.*, 725 F.2d 293, 298 (5th Cir. 1984). The Second Circuit adopted a more flexible rule, allowing structured dismissals in certain instances. *In re Iridium Operating LLC*, 478 F.3d 453, 464 (2d Cir. 2007) ("[A] noncompliant settlement [can] be approved when "the remaining [*TMT Ferry*] factors weigh heavily in favor of approving a settlement[.]"). Notwithstanding a settlement's deviation from the priority rules of the Bankruptcy Code, the critical inquiry according to the Third Circuit is whether the settlement optimizes value for the benefit of the estate, not a particular group of creditors.

HOLDING: The Third Circuit held that bankruptcy courts may approve settlements that deviate from the priority scheme of the Bankruptcy Code and result in a structured dismissal where the courts have specific and credible grounds to justify doing so.

V. PROPOSED RECOMMENDATIONS: ADMINISTERING THE CASE

A. Executory Contracts and Leases

Section 365 of the Bankruptcy Code generally allows a debtor in possession to assume, assign, or reject executory contracts and unexpired leases in the chapter 11 case.[408] The debtor in possession typically makes this determination based on a variety of factors, including whether the contract or lease is above or below market, necessary to its ongoing business operations, and subject to assumption under the Bankruptcy Code. It also may consult with the unsecured creditors' committee on these issues or attempt to renegotiate the contract or lease with the nondebtor party. A debtor in possession's decision to assume, assign, or reject an executory contract or unexpired lease is subject to court approval, certain deadlines, and several other requirements detailed in section 365.[409]

1. Definition of Executory Contract

Recommended Principles:

- The Bankruptcy Code should define the term "***executory contract***" for purposes of section 365 as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other," provided that forbearance should not constitute performance. Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973). The contours of this definition are well developed under the case law and reflect an appropriate balance between the rights of a trustee to assume or reject contracts unilaterally under the Bankruptcy Code and the nondebtor's obligations and rights in those circumstances.

Definition of Executory Contract: Background

Section 365(a) provides that a debtor in possession,[410] "subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[411] The Bankruptcy Code does not define "executory contract," and the legislative history of section 365 provides little guidance.[412] Accordingly, the court on a case-by-case basis determines whether a particular contract is executory.

Courts traditionally have used what is commonly referred to as the "Countryman" definition of executory contracts.[413] This test was developed by Professor Vern Countryman and defines an

408 11 U.S.C. § 365.
409 *See, e.g., id.* § 365(b) (requirements for assumption); *id.* § 365(c) (contracts not subject to assumption or assignment); *id.* § 365(f) (requirements for assignments).
410 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.
411 11 U.S.C. § 365(a).
412 H.R. Rep. No. 95-595, at 347 (1977) ("Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides.").
413 *See In re* Baird, 567 F.3d 1207, 1211 (10th Cir. 2009); *In re* Columbia Gas Sys., Inc., 50 F.3d 233, 239 (3d Cir. 1995); *In re* Streets & Beard Farm P'ship, 882 F.2d 233, 235 (7th Cir. 1989); Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1045 (4th Cir. 1985); *In re* Select-A-Seat Corp., 625 F.2d 290, 292 (9th Cir. 1980).

executory contract for bankruptcy purposes as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[414] Although widely used, courts have recognized limitations and potential inconsistencies in the application of the Countryman test.[415] In addition, the test may not be a good fit for certain kinds of contracts.[416]

Given the noted flaws in the Countryman test, courts have developed alternative approaches to assess executoriness. For example, some courts use the "functional approach" to evaluate a debtor in possession's request to assume or reject an executory contract. Under this approach, developed by Professor Jay Westbrook, there is no threshold standard of "executoriness" that the debtor in possession must meet to assume or reject the contract.[417] Rather, the functional approach focuses on whether assumption or rejection would create a benefit for the bankruptcy estate and its creditors. The functional approach recognizes that courts often manipulate the threshold requirement of executoriness in order to produce the desired outcome.[418] Several courts have adopted the functional approach or used it in connection with the Countryman test.[419]

Another alternative approach is commonly referred to as the "exclusionary approach." This approach is a deviation from the Countryman test and was developed by Michael Andrew.[420] The following are the primary differences between the Countryman test and the exclusionary approach: (i) the concept of executoriness is irrelevant in the rejection context;[421] and (ii) a contract is executory if each party has unperformed obligations, and if the debtor's nonperformance eliminates its right

414 Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

415 *See, e.g., In re* Gen. Dev. Corp., 84 F.3d 1364, 1374 (11th Cir. 1996); *In re* RoomStore Inc., 473 B.R. 107, 111–12 (Bankr. E.D. Va. 2012).

416 Some courts have struggled with the application of the Countryman definition in the context of the following kinds of agreements: options and rights of first refusal; restrictive covenants (covenants not to compete; restrictive covenants on land); oil and gas agreements (*e.g.*, the oil and gas leases themselves and variations thereof, like farmout agreements;, and related agreements, like surface use agreements and joint operating agreements); licenses, distributor agreements, and trademark agreements; warranties; rights of first refusal; employment contracts; and severance agreements; arbitration clauses; forum selection clauses; distributor agreements; trademark agreements; and indemnity clauses; and settlement agreements. *See, e.g.,* Water Ski Mania Estates Homeowners Ass'n v. Hayes (*In re* Hayes), 2008 Bankr. LEXIS 4668, at *31–32 (B.A.P. 9th Cir. Mar. 31, 2008) ("[A]lthough restrictive covenants contain the characteristics of both a contract and an interest in land, the primary nature of such covenants is preservation of a land interest, not future duties in contract. Although there will almost always be some incidental continuing obligations under a restrictive covenant, those duties were not the kind of obligations Congress intended to impact in enacting § 365.") (citation omitted); Frontier Energy, LLC v. Aurora Energy, Ltd. (*In re* Aurora Oil & Gas Corp.), 439 B.R. 674, 680 (Bankr. W.D. Mich. 2010) ("The court's conclusion that the [oil and gas leases] qualify as 'leases' within the meaning of Section 365 makes it unnecessary to consider whether the [oil and gas leases] meet either the functional test or Countryman definition for executory contracts. Given the confusion in the case law, it is also improvident to opine on the question.") (citations omitted); *In re* Bergt, 241 B.R. 17, 29–31 (Bankr. D. Alaska 1999) (discussing the application of the Countryman test in recent case law to options); Bronner v. Chenoweth-Massie, P'ship (*In re* Nat'l Fin. Realty Trust), 226 B.R. 586, 589 (Bankr. W.D. Ky. 1998) ("The contingent nature of the obligations arising from an option agreement make them quite distinguishable from the typical contract. This distinction has puzzled many courts, resulting in two distinct lines of cases. The first line of cases, while recognizing the contingent nature of the obligations arising under option agreements, and while also expressly acknowledging that they are unilateral contracts until exercised, have nevertheless engaged in what could be described as analytical gymnasts to arrive at a finding that they are nonetheless executory contracts.") (citations omitted); Cohen v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 138 B.R. 687, 699 (Bankr. S.D.N.Y. 1992) ("Our readings persuade us that in each case, use of the Countryman test was neither necessary nor determinative. It was, rather, merely window dressing for results determined in the first instance by resort to another, sometimes unspecified criterion.") (analyzing case law regarding application of Countryman test to employment agreements). *See also infra* note 424.

417 Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 Minn. L. Rev. 227, 282–85 (1989).

418 *Id.* at 287.

419 *See, e.g.,* Route 21 Assoc. of Belleville, Inc., v. MHC, Inc., 486 B.R. 75 (S.D.N.Y. 2012); *In re* Majestic Capital, Ltd., 463 B.R. 289, 300 (Bankr. S.D.N.Y. 2012).

420 Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. Colo. L. Rev. 845 (1988); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. Colo. L. Rev. 1 (1991).

421 Andrew, *Executory Contracts in Bankruptcy*, *supra* note 420, at 894.

to the other party's performance.[422] Although courts have not adopted this approach, they have considered its factors in applying other tests.[423]

Definition of Executory Contract: Recommendations and Findings

The Commission conducted an in-depth review of the literature and case law on executoriness under the Bankruptcy Code. Some of the Commissioners noted their experience with litigation concerning the executoriness issue and the attendant uncertainty and expense. The focus of the executoriness inquiry is whether each party has significant unperformed obligations under the contract.[424] The Commissioners discussed examples of contracts when this issue may be of particular concern, such as options, covenants not to compete, and oil and gas leases.[425] Although executoriness is not necessarily a bright-line determination, the Commissioners generally agreed that courts resolve this issue fairly or parties are able to negotiate a resolution.

The Commission also considered the possibility of eliminating the concept of executoriness from the Bankruptcy Code. Both the advisory committee and the 1997 NBRC endorsed this position.[426] The Commissioners debated at length the potential utility to this approach. They discussed the meaningful benefits to refocusing contract disputes on the merits of the proposed assumption or rejection rather than extensive litigation on executoriness. The Commissioners supporting this approach emphasized the value to such a clean solution: with the distraction of executoriness off the table, parties could devote more attention on their rights, obligations, and remedies under the contract. Many Commissioners found the simplicity of this approach attractive.

Further deliberations about the elimination proposal revealed, however, the potential of unintended consequences of such a dramatic shift in a fundamental bankruptcy principle. The Commissioners noted the common law origins of the executoriness requirement of section 365,[427] and they also

422 *Id.* at 893.
423 *See, e.g., In re* Family Snacks, Inc., 257 B.R. 884, 905 (B.A.P. 8th Cir. 2001).
424 The Seventh Circuit Court of Appeals explained:

> The Bankruptcy Code's legislative history states that the term "executory contract" "generally includes contracts on which performance is due to some extent on both sides.' A common definition, which this court has cited with approval, states that a contract is executory for bankruptcy purposes where "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure to complete performance would be a material breach excusing the performance of the other."

In re Crippin, 877 F.2d 594, 596 (7th Cir. 1989). *See also* Counties Contracting & Constr. Co. v. Constitution Life Ins. Co., 855 F.2d 1054, 1060 (3d Cir. 1988) ("The [Bankruptcy] Code does not define the term executory contract, however, courts have generally employed what has become known as the 'Countryman' definition of an executory contract, *i.e.*, a contract under which the obligations of both the bankrupt and the other party remain so far unperformed that failure of either to complete performance would constitute a material breach excusing performance of the other.") (citation omitted).
425 *See, e.g.,* COR Route 5 Co., LLC v. Penn Traffic Co. (*In re* Penn Traffic Co.), 524 F.3d 373, 380 (2d Cir. 2008) ("While some courts have held that options contracts under which the optionee fully paid its price for the option to buy property before the debtor filed for bankruptcy are not executory (because no performance is due from the optionor unless the option is exercised), . . . others treat such contracts as executory.") (citing conflicting case law) (citations omitted); Powell v. Anadarko E&P Co., L.P. (*In re* Powell), 482 B.R. 873, 877–78 (Bankr. M.D. Pa. 2012) ("Some courts have assumed that an oil and gas lease is an executory contract. Other courts have considered an oil and gas lease a transfer of an interest in real property and therefore not an executory contract.") (citing conflicting case law) (citations omitted); *In re* Teligent, Inc., 268 B.R. 723, 730–31 (Bankr. S.D.N.Y. 2001) ("As a rule, Delaware law treats the covenant not to compete and the reciprocal promise to pay as material. As a result, the failure to make payment will discharge the obligation not to compete. . . . Where the covenant is given in connection with the sale of a business, it is even more likely to be deemed material. A covenant not to compete is often included in a contract to sell a business to protect the purchaser and allow him to enjoy the built-up good will.").
426 *See* NBRC Report, *supra* note 37, at 21 ("Title 11 should be amended to delete all references to 'executory' in section 365 and related provisions, and 'executoriness' should be eliminated as a prerequisite to the trustee's election to assume or breach a contract.").
427 *See In re* Austin Dev. Co., 19 F.3d 1077, 1081 (5th Cir. 1994) ("Section 365 derives from § 70(b) of the former Bankruptcy Act, a provision that broadly codified the common law doctrine that allowed the trustee either to assume and perform the debtor's

perceived value in maintaining some type of gating feature to vet those contracts that a debtor in possession could assume, assign, or reject in the chapter 11 case. Thus, the elimination of the executoriness concept could simply shift, rather than reduce, the amount of litigation or uncertainty in the first instance under section 365. Moreover, many Commissioners believed that the assumption or rejection decision was largely irrelevant to contracts that have already been fully performed by at least one of the parties.

The Commissioners also discussed the functional approach to determining executoriness, but most perceived the test to be unfair toward counterparties and too heavily weighted in favor of the interests of the debtor and the estate. The Commissioners acknowledged the potential value of allowing a debtor in possession to assume or reject any contract that would provide a benefit to the estate. As with the elimination proposal, however, the Commissioners were concerned about diminishing the rights of the nondebtor counterparties under the contracts. Subjecting any contract to section 365 primarily, if not solely, for the benefit of the estate imposed a greater burden on nondebtor parties than necessary to achieve a fair result for the estate in a chapter 11 case.

On balance, the Commission voted to adopt the Countryman test and to recommend its express incorporation into the Bankruptcy Code. The Commission found that, although imperfect, the Countryman test strikes an appropriate balance between the rights of debtors in possession and nondebtor counterparties to a contract. If the parties have material unperformed obligations, it is fair and reasonable to allow a debtor to choose to assume, assign, or reject such an agreement under section 365. The Commission also determined that many of the potentially challenging issues under the Countryman test have been resolved by the courts and that this case law is a valuable resource that would guide the implementation of the codified standard.

2. General Rights of Private Parties to Executory Contracts and Unexpired Leases

Recommended Principles:

- A nondebtor party to an executory contract or unexpired lease with the debtor should be required to continue to perform under such contract or lease after the petition date, provided that the trustee needs such continued performance and pays for any products or services delivered after the petition date on a timely basis as required by the contract or lease. In paying for such products or services, however, the trustee should not be subject to any modifications or rate changes in the contract or lease triggered by the debtor's bankruptcy filing, insolvency, or prepetition default.
- Except as provided in section 365(d)(3) of the Bankruptcy Code (and the principles for that section, *see* Section V.A.6, *Real Property Leases*) and in section 365(d)(5) of the Bankruptcy Code, the trustee does not otherwise have an

leases or executory contracts or to 'reject' them if they were economically burdensome to the estate.").

obligation to perform, or to cure any defaults, under such contract or lease prior to the assumption of that contract or lease under section 365(a). The nondebtor party should be permitted to compel the trustee to perform other postpetition obligations under the contract or lease if the court determines, after notice and a hearing, that the harm to the nondebtor party resulting from the trustee's nonperformance significantly outweighs the benefit to the estate derived from such nonperformance. The court should limit the trustee's performance obligation to that which is necessary to mitigate the harm to the nondebtor party pending assumption or rejection. The nondebtor party should bear the burden of proof in any such hearing.

- The trustee should not be required to cure nonmonetary defaults that occur prior to the assumption of the executory contract or unexpired lease and that are impossible for the debtor to cure at the time of the proposed assumption under section 365(a) and (b).
- These principles governing the rights of parties to executory contracts and unexpired leases are intended to apply only to contracts and leases between private parties and should not affect the debtor's contracts or leases with any state or federal governments.

General Rights of Private Parties to Executory Contracts and Unexpired Leases: Background

In most chapter 11 cases, the debtor in possession[428] does not make its decision to assume, assign, or reject executory contracts and unexpired leases on, or even shortly after, the petition date. As such, there is a gap period between the petition date and the treatment decision under section 365. The Bankruptcy Code requires the debtor in possession to perform timely obligations arising under nonresidential real property leases, certain personal property leases,[429] and intellectual property licenses,[430] but does not otherwise address performance during the gap period.[431] In light of this silence, "most courts agree that before an executory contract is assumed or rejected under § 365(a), that contract continues to exist, enforceable by the debtor in possession, but not enforceable against the debtor in possession."[432]

428 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model.*

429 11 U.S.C. § 365(d)(5). This provision for personal property leases applies only in chapter 11 cases. *Id.* If the case is initially filed under chapter 11 and later converted to chapter 7, section 365(d)(5) will no longer apply. 3 Collier on Bankruptcy ¶ 365.04[2][c].

430 11 U.S.C. § 365(n).

431 *Id.* § 365(d)(3). The court "may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period." *Id.*

432 *See, e.g., In re* Nat'l Steel Corp., 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) (collecting cases). *See also* Howard C. Buschman III, *Benefits and Burdens: Postpetition Performance of Unassumed Executory Contracts,* 5 Bankr. Dev. J. 341, 343 (1988) (citing Douglas Bordewieck & Vern Countryman, *The Rejection of Collective Bargaining Agreements by Chapter 11 Debtors,* 57 Am. Bankr. L.J. 239, 332 (1983)); 2 Collier on Bankruptcy ¶ 365.03, 365-28, 365-29 (15th ed. 1988); 8 Collier on Bankruptcy ¶ 3.15(6) at 204 (14th ed. 1978).

Courts generally justify this one-sided performance requirement by emphasizing the importance of the breathing spell created by the automatic stay for the debtor in possession,[433] and the severe consequences that may result from a rushed or premature decision to assume, assign, or reject an executory contract or unexpired lease.[434] They also acknowledge the burden such one-sided performance may impose on the nondebtor party, but on balance find in favor of the estate. The nondebtor party may seek to compel performance or a treatment decision by the debtor in possession under section 365, and it frequently requests an administrative claim under section 503(b)(3) for any postpetition obligations that the debtor in possession fails to perform.[435]

Once a debtor in possession decides to assume an executory contract or unexpired lease, section 365(b) requires the debtor in possession to cure or provide adequate assurance of a prompt cure of any defaults under the contract or lease. Section 365(b)(1) indicates that nonmonetary defaults that are impossible to cure under unexpired leases for nonresidential real property do not require cure, "except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph."[436] Section 365(b)(2) further provides that a debtor in possession's general cure obligations under section 365(b)(1) do not apply to "the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease."[437] Some courts have interpreted section 365 to preclude the assumption of executory contracts and unexpired leases (other than real property leases) if non-curable historical nonmonetary defaults exist under the contract or lease.[438]

General Rights of Private Parties to Executory Contracts and Unexpired Leases: Recommendations and Findings

The chapter 11 filing can have significant negative implications for a nondebtor party's business. Accordingly, the Commission carefully scrutinized the postpetition needs of a debtor in possession with respect to executory contracts and unexpired leases. The Commissioners discussed the importance of a reliable, steady supply of goods and services used in the debtor's business to the debtor in possession's reorganization efforts. They also acknowledged that nondebtor parties frequently threaten to stop providing goods or services unless the debtor in possession satisfies certain conditions. Although the Commissioners understood the nondebtor party's desire for more

433 *See, e.g., In re* Cont'l Energy Assocs. Ltd. P'ship, 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995) ("Not only does this saddle an ailing company with an additional burden which it is unlikely to overcome, it pressures the Debtor to surrender the 'breathing space' normally allowed to it to consider the assumption or rejection of the contract.").

434 11 U.S.C. § 365(g)(2). Post-assumption rejection is treated as a breach at the time of rejection (*i.e.*, postpetition). *Id.* Where a contract or lease is assumed in a chapter 11 case that is later converted to a chapter 7 and then the contract or lease is rejected in the chapter 7 case, the rejection would be treated as having occurred immediately before the date of conversion. 1 Collier Handbook for Trustees & Debtors in Possession ¶ 14.07 (2012).

435 11 U.S.C. § 503(b). The extent of the nondebtor party's administrative claim, however, may be limited by the court under the "benefit to the estate" standard of section 503(b). *See* Mason v. Official Comm. of Unsecured Creditors (*In re* FBI Distrib. Corp.), 330 F.3d 36, 42–43 (1st Cir. 2003) ("[T]he nondebtor party will be entitled to administrative priority only to the extent that the consideration supporting the claim was supplied to the debtor in possession during the reorganization and was beneficial to the estate."); *In re* Nat'l Steel Corp., 316 B.R. 287, 301 (Bankr. N.D. Ill. 2004) ("Claims under § 503(b)(1)(A) are to be measured by the benefit received by the estate rather than the cost incurred by a claimant.").

436 11 U.S.C. § 365(b)(1).

437 *Id.* § 365(b)(2).

438 *See, e.g., In re* Carterhouse, Inc., 94 B.R. 271, 273 (Bankr. D. Conn. 1988) (holding that section 365(b)(1) "extends to nonmonetary as well as monetary breaches").

certainty and for some kind of adequate assurance, they found the general principles underlying the postpetition performance requirements to be sound.

Reflecting on the circumstances of nondebtor parties in these cases, however, the Commissioners considered various ways to mitigate the burden imposed by the general postpetition performance requirement. They did not believe that the debtor in possession should be required to provide adequate protection under section 361 of the Bankruptcy Code or to cure any historical defaults prior to assumption or rejection of the contract or lease. They also rejected full performance of the contract or lease by the debtor in possession, agreeing with courts that hold such a requirement undercuts the value of the automatic stay in the debtor in possession's reorganization efforts.

The Commissioners debated the feasibility of requiring the debtor in possession to pay for goods and services actually provided to the debtor in possession postpetition in accordance with the terms of the contract or lease. Some Commissioners commented that the debtor in possession may not have the liquidity to meet this standard on an immediate postpetition basis, while others indicated that the debtor in possession's needs in this respect could be factored into the postpetition financing budget.[439] The Commissioners stressed the need for any such payment obligation to be limited to those goods and services needed by, and provided to, the debtor in possession postpetition and that the nondebtor party should not be able to enforce more onerous payment terms from, or demand any other type of performance of, the debtor in possession pending assumption or rejection of the contract or lease.[440] The terms of the prepetition contract or lease should govern the timing and amount of the debtor in possession's postpetition payment obligations, unless the parties mutually agree to more beneficial terms for the estate.

The Commissioners also analyzed the circumstances under which nondebtor parties should be able to seek to compel full or greater postpetition performance by the debtor in possession under the contract or lease. The Commissioners generally believed that nondebtor parties should have this option, but that the standard of proof should be stringent and that the nondebtor party should bear the burden of proof, particularly in light of the Commission's recommendation to require some postpetition payment by the debtor in possession. The Commission ultimately determined that this standard was an appropriate balance and recommended the joint proposal of requiring payment solely for goods or services provided to the debtor in possession postpetition and placing a high evidentiary burden on the nondebtor party that seeks to compel further or other postpetition performance. The Commissioners also discussed the potential impact of these provisions on government contracts. In light of the different and varied interests that may be implicated by government contracts, the Commission agreed that these contracts be excluded from the recommended principles governing postpetition performance of executory contracts and unexpired leases and that such principles be limited to the rights of private parties to executory contracts and unexpired leases with a debtor.

439 Some of the Commissioners proposed incorporating an "adequate assurance" concept similar to Section 2-609 of the Uniform Commercial Code, but others believed that this would provide too much leverage for counterparties in terms of holdup value.

440 *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–4 (June 4, 2013) (stating that retailers are failing because of the reluctance of trade creditors to extend credit on reasonable terms and the difficulty of obtaining DIP and exit financing to support reorganization), *available at* Commission website, *supra* note 55; *id.* at 5 (citing the January 2013 Senior Loan Officer Opinion Survey on Bank Practices from the Federal Reserve which indicates that DIP lending is tight and trade vendors are unwilling to extend credit except on onerous terms).

Finally, the Commissioners addressed the continued confusion in the case law concerning a debtor in possession's obligation to cure historical nonmonetary defaults in order to assume the executory contract or unexpired lease. The Commissioners acknowledged that the BAPCPA Amendments to the Bankruptcy Code clarified this issue for real property leases, but that ambiguity remained for other kinds of leases and executory contracts. The Commissioners debated whether certain kinds of historical nonmonetary defaults were so central to a contract's or lease's purpose that their nonperformance should bar assumption. On balance, the Commission determined that, with respect to all executory contracts and unexpired leases, a debtor in possession should not be required to cure nonmonetary defaults occurring prior to the assumption decision that are impossible to cure at the time of assumption under section 365(b) of the Bankruptcy Code.

3. Rejection of Executory Contracts and Unexpired Leases

Recommended Principles:

- The rejection of an executory contract or unexpired lease should continue to constitute a breach of the contract or lease as of the time immediately preceding the commencement of the case under section 365(g) of the Bankruptcy Code. The trustee's rejection of an executory contract or unexpired lease should not, however, entitle the nonbreaching, nondebtor party to a right of specific performance or to retain possession or use of any property of the debtor or the estate.
- A nonbreaching, nondebtor party should be able to retain possession or continue to use property of the debtor or the estate if expressly authorized by a section of the Bankruptcy Code (*e.g.*, section 365(n)).
- If the nondebtor party to an executory contract or unexpired lease breaches the executory contract or unexpired lease prior to the trustee's assumption or rejection decision, the trustee may treat such contract or lease as breached and exercise any rights or remedies it may have under the contract or lease or applicable nonbankruptcy law.

Rejection of Executory Contracts and Unexpired Leases: Background

A debtor in possession[441] may reject (*i.e.*, disavow) most executory contracts and unexpired leases under section 365(a) of the Bankruptcy Code. A debtor in possession's decision to reject an executory contract or unexpired lease generally relieves the debtor in possession of further performance obligations under the contract or lease. Courts, however, have differed on whether rejection terminates the contract or lease or, rather, constitutes a breach by the debtor in possession of such contract or lease.

441 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

Section 365(g) of the Bankruptcy Code specifically provides that rejection "constitutes a breach of such contract or lease." As such, section 365(g) answers the initial question concerning the effect of rejection and expressly equates rejection with a breach of the contract or lease by the debtor.[442] In some cases, that determination may end the inquiry, but in other cases, questions still remain regarding what rights the nondebtor party may pursue under the contract or lease or under applicable nonbankruptcy law because of the debtor's breach. As explained by the Seventh Circuit in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,

> [w]hat § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. . . . The debtor's unfulfilled obligations are converted to damages; . . . But nothing about this process implies that any rights of the other contracting party have been vaporized.[443]

Courts and commentators agree that rejection gives the nondebtor party a right to assert monetary damages against the debtor in possession, which is deemed a prepetition claim against the estate.[444] They also generally agree that the nondebtor party cannot compel continued performance by the debtor in possession, unless otherwise specifically permitted by section 365.[445] They do not, however, agree whether the nondebtor party can enforce equitable remedies against the debtor in possession that such party otherwise would be able to assert under applicable nonbankruptcy law.[446] The court's perspective on this issue can have significant implications for the estate.

Rejection of Executory Contracts and Unexpired Leases: Recommendations and Findings

The Commission focused a substantial amount of time on the concept of rejection and whether a debtor in possession's decision to reject an executory contract or unexpired lease should trigger a breach or termination of such contract or lease. The Commissioners discussed the language of section 365 and specifically contrasted it with the chapter 5 avoiding powers of the debtor in possession. Congress did not intend section 365 to operate as an avoiding power that would allow a debtor in possession to terminate or unwind prepetition agreements or completely extinguish the rights of the nondebtor counterparty to an agreement. Such a result would be contrary to the language and structure of the Bankruptcy Code and well-settled federal policy that state law generally determines

442 *See, e.g.,* Sunbeam Prod., Inc. v. Chi. Am. Mfg, LLC, 686 F.3d 372 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012). Both the National Bankruptcy Conference's Bankruptcy Code Review Project in 1993 and the NBRC in 1997 expressly considered the question of whether rejection should result in termination and provided a negative answer. A.L.I.-A.B.A., Bankruptcy Reform Circa 1993 183–87 (Nat'l Bankr. Conf. 1993); NBRC Report, *supra* note 37, § 2.4.1.

443 Sunbeam Prod., Inc. v. Chi. Am. Mfg, LLC, 686 F.3d 372, 377 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012).

444 11 U.S.C. § 365(g)(1).

445 *See, e.g., In re* Walnut Assocs., 145 B.R. 489, 494 (Bankr. E.D. Pa. 1992) ("[N]on-debtor party to the contract subject to rejection is limited in its claims for breach to the treatment accorded to a debtor's general unsecured creditors. . . . [U]nless specific performance is available to the non-debtor party under applicable state law, the debtor cannot be compelled to render its performances required under the contract. However, if state law does authorize specific performance under the rejected executory contract, it means that the non-debtor should be able to enforce the contract against the Debtor, irrespective of his rejection of it.").

446 *See, e.g.,* Abboud v. Ground Round, Inc. (*In re* Ground Round, Inc.), 335 B.R. 253 (B.A.P. 1st Cir. 2005) ("[A] party is entitled to specific performance of a rejected executory contract if such remedy is clearly available under applicable state law."); *In re* Annabel, 263 B.R. 19 (Bankr. N.D.N.Y. 2001) (same with respect to covenant not to compete). *But see, e.g., In re* Register, 95 B.R. 73, 75 (Bankr. M.D. Tenn. 1989) (refusing to enforce covenant not to compete in rejected sale agreement). *See also* Route 21 Assoc. of Belleville, Inc. v. MHC, Inc., 486 B.R. 75 (S.D.N.Y. 2012) (injunctive relief could be reduced to monetary claim).

property rights in bankruptcy.[447] The Commission voted to reinforce the principle that rejection of an executory contract or unexpired lease constitutes a breach, not a termination, of such contract or lease.

The Commissioners fully vetted the potential consequences of equating rejection with breach of the applicable contract or lease, using various examples to explore the nuances and variances in possible results. In analyzing these scenarios, the Commissioners worked to balance the state law rights and interests of the nondebtor party with the federal interests that are central to the reorganization efforts of a debtor in possession. These federal interests include equal treatment of all similarly situated creditors, automatic stay of actions based on prepetition transactions and relationships with the debtor, and the ability of the debtor in possession to reject burdensome contracts and leases to facilitate its reorganization.[448]

The Commission considered the rejection of different kinds of contracts and leases, and identified the competing interests of the debtor in possession and the nondebtor, and the needs of the estate, following rejection. For example, the debtor in possession, on behalf of the estate, needs (i) any property that may be held by the nondebtor party to be returned; (ii) the ability to use such property free from restraints or limitations; and (iii) relief from any performance obligations under the contract or lease. Congress was aware of these needs and carefully balanced them against the interests of the nondebtor party. In specific instances when the interests of the nondebtor party outweigh the needs of the debtor in possession, Congress specified the nondebtor party's rights upon rejection. Specifically, these exceptions arise in the context of certain real property leases, timeshares, and intellectual property licenses.[449]

The Commission agreed that, other than the exceptions already made by Congress, the nondebtor party to the rejected contract or lease should be required to immediately return the debtor's property to the debtor in possession and should not be able to enforce any equitable or injunctive relief against, or otherwise require performance by, the debtor in possession. In addition to the factors previously noted, the Commissioners pointed to section 542 in support of requiring the counterparty to return personal property to the estate upon rejection.[450] They also believed that allowing the nondebtor party to enforce equitable or injunctive relief against the debtor in possession would elevate the rights of such counterparty beyond those of other similarly situated prepetition creditors. Indeed, general unsecured creditors typically are not entitled to relief from the automatic stay or to take actions affecting the debtor in possession's postpetition business operations, despite the terms of the creditors' prepetition contracts or applicable nonbankruptcy law. Accordingly, the Commission

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447 "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." Butner v. United States, 440 U.S. 48, 54 (1979).

448 *See, e.g., In re* Am. Suzuki Motor Corp., 494 B.R. 466, 477 (Bankr. C.D. Cal. 2013) ("The purpose of contract rejection under section 365 is to permit the debtor to receive the economic benefits necessary for reorganization (which includes liquidation under chapter 11) for the ultimate benefit of the estate and its creditors. State legislatively imposed buyback requirements, fair market value awards and treble-damages penalties are superimposed onto the normal contract damage remedy provisions under state common or statutory law. While Florida and many other states believe that their public policy should provide special protections for the economic interest of local car dealerships, in the area of federal bankruptcy law those remedies run counter to the federal policy of bankruptcy reorganization and are therefore preempted."); *In re* PPI Enters. (U.S.), Inc., 228 B.R. 339, 344–45 (Bankr. D. Del. 1998) ("In enacting the Bankruptcy Code, Congress made a determination that an eligible debtor should have the opportunity to avail itself of a number of Code provisions which adversely alter creditors' contractual and nonbankruptcy law rights.").

449 11 U.S.C. § 365(h), (i), (n).

450 *Id.* § 542(a) ("[A]n entity . . . shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.").

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endorsed the conclusions that rejection should constitute a breach, but it should not (i) deprive the debtor in possession of the right to possess or use estate property or (ii) require specific performance by the debtor in possession or the estate.

4. Intellectual Property Licenses

Recommended Principles:

- A trustee should be able to assume an intellectual property license in accordance with section 365(a) of the Bankruptcy Code notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement.
- The trustee should be able to assign an intellectual property license to a single assignee in accordance with section 365(f) notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement. If the trustee seeks to assign an intellectual property license under which the debtor is a licensee to a competitor of the nondebtor licensor or an affiliate of such competitor, the court may deny the assignment if the court determines, after notice and a hearing, that the harm to the nondebtor licensor resulting from the proposed assignment significantly outweighs the benefit to the estate derived from the assignment. The nondebtor licensor should bear the burden of proof in any such hearing.
- Foreign patents and copyrights should be included within the definition of "***intellectual property***" set forth in section 101(35A) and subject to section 365, including section 365(n). In addition, foreign trademarks should also be included in this definition, subject to the limitations and conditions imposed on domestic trademarks under the recommended principles in Section V.A.5, *Trademark Licenses*.

Intellectual Property Licenses: Background

A debtor's or the estate's assets often include intellectual property. The Bankruptcy Code defines "***intellectual property***" as a "(A) trade secret; (B) invention, process, design, or plant protected under title 35 [of the U.S. Code; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17 [of the U.S. Code]; or (F) mask work protected under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law."[451] In the context of section 365 of the Bankruptcy Code, debtors in possession[452] commonly face issues with respect to their ability to assume, assign, or reject their intellectual property licenses.[453]

451 11 U.S.C. § 101(35A).
452 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.
453 Courts generally characterize intellectual property licenses as executory contracts. *In re* Kmart Corp., 290 B.R. 614, 618 (Bankr. N.D. Ill. 2003) ("Generally speaking, a license agreement is an executory contract as such is contemplated in the Bankruptcy

A "***license***" is an agreement that generally allows an owner to monetize the value of its intellectual property. Licenses permit, often for a fee, a third party (licensee) to use the owner's (licensor's) intellectual property for a specified purpose, within a specified geographic region, for a specified time period, under specified conditions. Licenses range on a sliding scale from conferring very limited nonexclusive rights to all or essentially all rights to the intellectual property. Licenses are, in essence, a form of covenant by which the licensor agrees not to sue the licensee for using the licensor's intellectual property.

When a debtor in possession is the licensee under an intellectual property license, two potentially competing federal interests are at play: (i) the Bankruptcy Code generally allows the debtor in possession to unilaterally decide whether to assume, assign, or reject an executory contract; and (ii) the federal law on intellectual property licenses respects the right of the licensor to control its intellectual property.[454] Some courts have turned to section 365(c) of the Bankruptcy Code to address this potential conflict. Section 365(c) generally restricts the ability of a debtor in possession to assume or assign if "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."[455] Such contracts can be assumed or assigned by the debtor in possession only with the consent of the nondebtor party to the contract.

Courts applying section 365(c)(1) to the rights of a debtor in possession as a licensee under an intellectual property license are split regarding whether a debtor in possession may assume (*i.e.*, keep and perform under) the license, as opposed to assigning the license to a third party, without the consent of the nondebtor licensor. Courts that permit a debtor in possession to assume a license under these circumstances follow the "actual approach," which treats the debtor in possession as the same entity to which the third party licensor extended the license in the first instance.[456] Because the identity of the parties has not changed under this theory and the action would not be deemed an impermissible assignment under applicable nonbankruptcy law, these courts authorize the debtor in possession to assume such license under section 365(a) and (b).

Other courts, however, find the actual test in contravention of the statutory language. These courts follow the "hypothetical approach," which preclude the debtor in possession from assuming an agreement if applicable nonbankruptcy law would preclude the debtor from assigning the license to a third party, even if the debtor in possession has no intention of effecting such an assignment.[457] Some commentators have criticized the hypothetical approach as providing the nondebtor licensor

Code.'") (citations omitted).

454 *See* Unarco Indus., Inc. v. Kelley Co., Inc., 465 F.2d 1303, 1306 (7th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973) (citations omitted) ("[L]ong standing federal rule of law with respect to the assignability of patent licenses provides that these agreements are personal to the licensee and not assignable unless expressly made so in the agreement.").

455 11 U.S.C. § 365(c)(1).

456 The First and Fifth Circuits adopted the "actual test." *In re* Mirant Corp., 440 F.3d 238 (5th Cir. 2006); Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997), *abrogated by* Hardemon v. City of Boston, 1998 WL 148382 (1st Cir. Apr. 6, 1998), *superseded by* 144 F.3d 24 (1st Cir. 1998). *See also In re* Footstar, Inc., 323 B.R. 566 (Bankr. S.D.N.Y. 2005) (taking a slightly different approach but holding that section 365(c)(1)'s use of the word "trustee" does not include the debtor or debtor in possession when assumption is sought because assumption does not require the nondebtor party to accept performance from a new party other than the debtor or debtor in possession).

457 The Third, Fourth, Ninth, and Eleventh Circuits have adopted the "hypothetical test." *In re* Sunterra Corp., 361 F.3d 257 (4th Cir. 2004); *In re* Catapult Entm't, Inc., 165 F.3d 747 (9th Cir. 1999); *In re* James Cable Partners, L.P., 27 F.3d 534 (11th Cir. 1994); *In re* West Elec. Inc., 852 F.2d 79 (3d Cir. 1988).

with holdup power that can frustrate or completely derail the reorganization efforts of the debtor in possession.[458]

Conversely, when a debtor in possession is the licensor under an intellectual property license and decides to reject the license, section 365(n) of the Bankruptcy Code allows the nondebtor licensee to treat the license as either (i) terminated, or (ii) effective through the end of the remaining term. If the licensee elects to retain the license, it cannot compel any performance by the debtor, but it retains the ability to use certain of its rights under the license for the remaining term, for which it must continue to pay any royalties or other fees required by the terms of the license. Additionally, the nondebtor licensee may not assert any damages for nonperformance by the debtor through a setoff against any fees or payments it owes under the license. Notably, the definition of intellectual property does not include foreign intellectual property or trademarks, which often poses an issue under section 365(n). In the context of trademarks, the issue is particularly challenging when the trademarks are integrated into a license with intellectual property (as that term is currently defined under the Bankruptcy Code). The treatment of trademarks under section 365 is addressed separately in the following section.

Intellectual Property Licenses: Recommendations and Findings

Intellectual property licenses can represent valuable assets of the estate and may be necessary to the reorganization of the debtor in possession. Thus, the treatment of these licenses under section 365 of the Bankruptcy Code is often a critically important issue in the case. The Commission reviewed open issues relating to intellectual property licenses in chapter 11.

The Commissioners evaluated the statutory interpretation and practical issues raised by the debate between supporters of the hypothetical approach, on the one hand, and supporters of the actual approach, on the other hand, concerning the ability of a debtor in possession (as licensee) to assume (*i.e.*, keep and use) an intellectual property license without the consent of the nondebtor party (as licensor).[459] The Commissioners acknowledged that nondebtor licensors may have legitimate concerns about providing their intellectual property to a party other than the debtor, but those concerns should not exist when the debtor in possession proposes to assume and perform in accordance with the license. In those instances, the licensor would be receiving the benefit of its bargain. The Commissioners recognized that application of the hypothetical test results in artificial barriers to the reorganization of the debtor in possession — an outcome that directly undercuts a fundamental policy underlying the Bankruptcy Code. The Commission voted to reject the hypothetical approach and to adopt and codify the actual approach. The Commission further recommended that Congress amend the Bankruptcy Code to expressly authorize the debtor in possession to assume executory intellectual property licenses.

458 *See, e.g.,* David R. Kuney, *Intellectual Property in Bankruptcy Court: The Search for a More Coherent Standard in Dealing with a Debtor's Right to Assume and Assign Technology Licenses*, 9 Am. Bankr. Inst. L. Rev. 593 (2001).

459 *See Written Statement of Robert L. Eisenbach III, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–6 (June 4, 2013) (discussing the tests in practical terms), *available at* Commission website, *supra* note 55; *Written Statement of Lisa Hill Fenning, Partner, Arnold & Porter LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–6 (June 4, 2013) (discussing impact of bankruptcy law on intellectual property licenses), *available at* Commission website, *supra* note 55.

The Commissioners also critically analyzed whether the result of the hypothetical test (*i.e.*, no assumption without the consent of the nondebtor licensor) was good policy in the actual assignment context. Admittedly, the ability to exclude others from using your intellectual property is a key element of intellectual property ownership. This right provides intellectual property owners some control over the use of their property and a means to monetize at least some of the value of their property. The assignment by the debtor in possession of an intellectual property license, in accordance with the terms of section 365(f) (requiring, among other things, adequate assurance of future performance and assumption of the entire agreement), arguably does not significantly decrease the value of the licensor's right to exclude users.

The Commissioners debated the advantages and disadvantages of providing debtors in possession with more flexibility to assign intellectual property licenses under the Bankruptcy Code. Some of the Commissioners believed that this flexibility was necessary to maximize the value of the estate and to facilitate certain reorganization transactions. In considering the value of the license from both the licensor's and licensee's perspectives, they observed that U.S. assignment laws are more restrictive than those in many foreign jurisdictions.[460] Moreover, many of the Commissioners did not believe that the identity of the debtor, absent unusual circumstances, was *per se* a critical factor in the licensing relationship. Rather, factors such as the licensee's ability to pay, to maintain the desired integrity and quality of the intellectual property, and to comply with all obligations imposed by the license are likely more relevant and important.

The Commissioners acknowledged that the identity of the licensee could be critical if the proposed assignee was a competitor of the licensor. In those instances, nondebtor licensors should have the ability to block a proposed assignment by the debtor licensee. The Commission supported a proposal that would permit a debtor in possession to assign an intellectual property license freely under section 365(f)(1) and (2), subject to a nondebtor licensor's right to demonstrate that the hardship imposed on it by the proposed assignment to one of its competitors would significantly outweigh the benefit to the estate.

The Commission also reviewed the exclusion of foreign patents and copyrights from the definition of intellectual property in section 101(35A) of the Bankruptcy Code. Foreign patents and copyrights are excluded from this definition because they are not covered by title 35 or title 17 of the U.S. Code. The Commissioners believed that licenses for foreign patents, copyrights and trademarks (subject to the limitations proposed for U.S. trademarks below), although generally not governed by U.S. law, should receive the same treatment in bankruptcy as U.S. licenses. Moreover, licensees under licenses of foreign intellectual property should receive the same protections as licensees under U.S. licenses pursuant to section 365(n) of the Bankruptcy Code. The Commission found no reasonable basis for treating foreign intellectual property differently.

460 *See, e.g.,* M. Reutter, *Intellectual Property Licensing Agreements and Bankruptcy*, *in* Research Handbook On Intellectual Property Licensing 281 (Jacques de Werra ed., 2013).

5. Trademark Licenses

Recommended Principles:

- "Trademarks," "service marks," and "trade names," as defined in section 1127 of title 15 of the U.S. Code, should be included in the definition of "intellectual property" under the Bankruptcy Code. Section 101(35A) of the Bankruptcy Code should be amended accordingly.
- If a debtor is a licensor under a trademark, service mark, or trade name license and the trustee elects to reject that license under section 365, section 365(n) should apply to the license, with certain modifications. The nondebtor licensee should be required to comply in all respects with the license and any related agreements, including with respect to (i) the products, materials, and processes permitted or required to be used in connection with the licensed trademark, service mark, or trade name; and (ii) any of its obligations to maintain the sourcing and quality of the products or services offered under or in connection with the licensed trademark, service mark, or trade name. The trustee should maintain the right to oversee and enforce quality control for such products or services and should not be under any continuing obligation to provide products or services to the rejected licensee. In addition, the concept of "royalty payments" under section 365(n) should be expanded to include "other payments" contemplated by the trademark, service mark, or trade name license.

Trademark Licenses: Background

As noted above, trademarks are not included in the definition of "intellectual property" under section 101(35A) of the Bankruptcy Code. Congress made the conscious decision in the 1988 amendments to exclude this kind of intangible property because trademarks have slightly different characteristics as compared to other intangible property that is included in the definition of intellectual property. One key difference is that any transfer of a trademark, including a license or assignment, must include a transfer of the associated business operations (referred to as "good will" under applicable nonbankruptcy law).[461] In addition, trademark licenses raise other challenges, as explained by the legislative history of Bankruptcy Code section 365(n):

461 The relevant portion of the Lanham Act provides:

> (1) A registered mark or a mark for which an application to register has been filed shall be assignable with the good will of the business in which the mark is used, or with that part of the good will of the business connected with the use of and symbolized by the mark. Notwithstanding the preceding sentence, no application to register a mark under section 1051(b) of this title shall be assignable prior to the filing of an amendment under section 1051(c) of this title to bring the application into conformity with section 1051(a) of this title or the filing of the verified statement of use under section 1051(d) of this title, except for an assignment to a successor to the business of the applicant, or portion thereof, to which the mark pertains, if that business is ongoing and existing.
>
> (2) In any assignment authorized by this section, it shall not be necessary to include the good will of the business connected with the use of and symbolized by any other mark used in the business or by the name or style under which the business is conducted.

15 U.S.C. § 1060(a).

> [T]he bill does not address the rejection of executory trademark, trade name or service mark licenses by debtor licensors. While such rejection is of concern because of the interpretation of section 365 by the *Lubrizol* court and others, such contracts raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.[462]

Several commentators have discussed the uncertainty created for nondebtor licensees of a debtor's trademarks given the exclusion of trademarks from the definition of intellectual property and section 365(n). Courts have struggled with the treatment of trademark licenses and the consequences of rejection pursuant to section 365 by a debtor licensor of a license with a nondebtor licensee.[463] Some courts have determined that the rejection of such an agreement terminates the nondebtor licensee's rights to use the relevant trademarks and any associated goodwill, and grants the nondebtor party only the right to file a claim for monetary damages against the estate.[464] Other courts have determined that the debtor in possession's[465] rejection of a license constitutes only a breach of such agreement, which is consistent with section 365(g), and that the nondebtor licensee may continue to exercise its rights under the rejected agreement consistent with applicable nonbankruptcy law.[466] In addition, some courts have determined that trademark licenses are not executory contracts and therefore cannot be rejected.[467]

Similar to other intellectual property, a trademark license may be an integral component of a nondebtor's business — particularly in the franchising context. In the event that a licensor files for bankruptcy, a bankruptcy provision that automatically strips the nondebtor licensee of all rights to use the debtor's trademarks and any associated goodwill upon the debtor in possession's rejection of the trademark license could devastate the nondebtor's business. Conversely, the ability of the debtor in possession to reorganize successfully may hinge, at least in part, on its ability to repossess

462 S. Rep. No. 100–505, at 5 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3204 (citations omitted).

463 *See, e.g., In re* Old Carco LLC, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009), *aff'd sub nom.* Mauro Motors Inc. v. Old Carco LLC, 420 F. App'x 89 (2d Cir. 2011) ("Trademarks are not 'intellectual property' under the Bankruptcy Code . . . [, so] rejection of licenses by licensor deprives licensee of right to use trademark. . . ."); *In re* HQ Global Holdings, Inc., 290 B.R. 507, 513 (Bankr. D. Del. 2003) ("[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisees' right to use the trademark stops on rejection."); *In re* Centura Software Corp., 281 B.R. 660, 674–75 (Bankr. N.D. Cal. 2002) ("Because Section 365(n) plainly excludes trademarks, the court holds that [licensee] is not entitled to retain any rights in [licensed trademarks] under the rejected . . . Trademark Agreement.").

464 *See* Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1048 (4th Cir. 1985) (no right to continue to use mark upon rejection). Such a claim is treated as an unsecured prepetition claim.

465 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

466 *See* Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC, 686 F.3d 372, 377 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012) (holding that *Lubrizol* was wrongly decided and that the transfer of rights embodied in trademark or other IP licenses could not be "vaporized" by rejection). "[R]ejection is not the 'functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the position they occupied before the contract was formed.' It 'merely frees the estate from the obligation to perform' and 'has absolutely no effect upon the contract's continued existence.'" *Id.* (citations omitted).

467 *See also In re* Exide Techs., 607 F.3d 957 (3d Cir. 2010) (trademark license not executory and not subject to rejection under facts of case). Courts may use § 365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not — as occurred in this case — use it to let a licensor take back trademark rights it bargained away. This makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve. *Id.* at 967–68. *But see In re* New York City Shoes, Inc., 84 B.R. 947, 960 (Bankr. E.D. Pa. 1988) (exclusive trademark licensing agreement providing for annual royalties was executory).

its trademarks and any associated goodwill and then redeploy these assets in a more productive manner consistent with its reorganization efforts.

Trademark Licenses: Recommendations and Findings

The Commission considered whether adding trademarks to the definition of intellectual property under section 101(35A) of the Bankruptcy Code was a workable solution. Several Commissioners noted that the concerns underpinning the decision by Congress in the 1988 amendments to exclude trademarks from the definition of intellectual property still persist. Generally, applicable nonbankruptcy law continues to treat trademarks differently in comparison to other intangible property. These Commissioners did not believe that the process provided in section 365(n) would necessarily work for all trademark licenses or generate the fair result — considering both the interests of the estate and the nondebtor licensee — in every case.

The Commissioners recognized, however, the uncertainty surrounding the treatment of trademark licenses in chapter 11 cases. They discussed how these licenses, to the extent they are deemed executory contracts under the Bankruptcy Code, would be treated under the recommended principles for rejection of executory contracts and leases.[468] For example, the rejection of the trademark license would constitute a breach by the debtor. It would not terminate the license or eviscerate the nondebtor licensee's rights under the license. The rejection likely would require, however, the nondebtor licensee to turn over the right to use the trademark and any associated goodwill to the estate. Moreover, the nondebtor licensee would not be able to require performance by the debtor in possession or seek equitable or injunctive relief.

The Commission considered whether section 365(n) could be modified to accommodate the unique attributes of trademark licenses and the related concerns of both the debtor licensor and the nondebtor licensee. The Commissioners discussed the advantages and disadvantages of including trademarks within the definition of intellectual property under the Bankruptcy Code. Some Commissioners believed that such inclusion was problematic because of the goodwill associated with the marks and the frequent need of trademark licensees to have access to the related products or goods, or components thereof, to utilize the marks legitimately under the license. Moreover, these Commissioners raised concerns about a debtor licensor's need to monitor quality control of the use of any marks by a licensee. Other Commissioners believed that the statute could incorporate appropriate protections and limitations to protect debtor licensors and mitigate the valid concerns regarding goodwill and ongoing compliance with the license by the licensee. The Commissioners expressed concern about the ongoing ambiguity surrounding trademarks in bankruptcy, and the related costs imposed on a debtor in possession and the estate, as well as the potential harm to the nondebtor licensee's business.

After considering the alternatives and the 2014 Innovation Act proposed in Congress,[469] the Commission determined that trademark licenses should be included in the definition of intellectual property licenses under the Bankruptcy Code. In reaching this conclusion, the Commission agreed

468 *See* Section V.A.3, *Rejection of Executory Contracts and Unexpired Leases.*
469 *See* Innovation Act of 2013, H.R. 3309, 113th Cong. § 6(d) (1st Sess. 2013), *available at* https://www.congress.gov/113/bills/hr3309/BILLS-113hr3309rfs.pdf.

that section 365(n) should be amended to address certain unique aspects of trademark licenses, including a provision that would allow a debtor in possession to monitor quality control, but otherwise not impose obligations on the debtor in possession if the license is rejected. The Commission also agreed that section 365(n) needs to expressly require a nondebtor licensee electing to retain its rights under the trademark license to comply in all respects with the license and any related agreements, including with respect to (i) the products, materials, and processes permitted or required to be used in connection with the licensed marks; and (ii) any of its obligations to maintain the sourcing and quality of the products or services offered under or in connection with the licensed marks.

6. Real Property Leases

Recommended Principles:

- The trustee's time to assume or reject unexpired nonresidential real property leases under section 365(d)(4) of the Bankruptcy Code should be extended from 210 days to one year after the petition date or date of the order for relief, whichever is later, in the interest of enhancing prospects for reorganization.
- The calculation of postpetition rent under a real property lease should be calculated under the accrual method, allowing the trustee to treat rent accrued prior to the petition date as a prepetition claim and rent accrued on and after the petition date as a postpetition obligation. The trustee should be required to pay any such postpetition rent obligation on or before 30 days after the petition date or date of the order for relief, whichever is later. The trustee should pay all subsequent rent obligations accruing postpetition but prior to any rejection of the lease on a timely basis in accordance with the terms of the lease.
- A landlord's claim for unperformed obligations under section 365(d)(3) should apply only to monetary obligations. Such claim for unperformed monetary obligations should not receive superpriority treatment, but should instead constitute an administrative claim under section 503(b)(1) that is payable under section 507(a)(2).
- The meaning of the term "rent" under section 502(b)(6) should not be based on whether an obligation is labeled as "rent" under the lease. Rather, the Bankruptcy Code should define "***rent***" as any recurring monetary obligations of the debtor under the lease.
- The calculation of rejection damages for real property leases under section 502(b)(6) should be clarified as follows:

  The claim of a lessor for damages resulting from the termination of a lease of real property shall not exceed:

  (i) The greater of (A) the rent reserved for one year under the lease following the termination date and (B) the alternative rent calculation; plus
  (ii) Any unpaid rent due under the lease on the termination date.

For purposes of this section:

*The "**alternative rent calculation**" is the rent reserved for the shorter of the following two periods: (a) 15 percent of the remaining term of the lease following the termination date and (b) three years under the lease following the termination date.*

*The "**termination date**" is the earlier of the petition date and the date on which the lessor repossessed, or the lessee surrendered, the leased property.*

In calculating the rent due or reserved under the lease, such calculation should be done without acceleration.

- A landlord should be required to make reasonable efforts to mitigate damages in the event that the trustee rejects the lease under section 365, regardless of whether mitigation is required by applicable nonbankruptcy law. Any mitigation or cover received by, or security deposit held by, the landlord should reduce the landlord's prepetition claim for purposes of calculating the section 502(b)(6) claim. A landlord's obligation to mitigate damages should continue through the claims objection deadline or the date of the order allowing the claim, whichever is earlier.
- A landlord's claims for the debtor's acts and omissions resulting in damage to the real property, other than those claims relating to the rejection of the lease or for rent under the lease, should not be subject to section 502(b)(6). The landlord should be permitted to assert any such claim as a prepetition claim against the estate, subject to the trustee's or a party in interest's right to object and the general claims allowance process.

Real Property Leases: Background

Many chapter 11 debtors have one or more unexpired leases of nonresidential real property as of the petition date. These leases may be for the debtor's headquarters, stores, warehouses, or factories. They may be necessary to the debtor in possession's[470] reorganization efforts or otherwise represent valuable assets that the debtor in possession can use to maximize the value of the estate. Alternatively, they may be above-market leases or used in a part of the business being closed or downsized through the reorganization. In either scenario, a debtor in possession's ability to assume, assign, or reject unexpired leases of nonresidential real property is important to the resolution of its case.

The Bankruptcy Code includes several provisions that specifically address the rights and obligations of the debtor in possession and the nondebtor landlord under unexpired leases of nonresidential real property leases. For example, section 365(d)(3) requires the debtor in possession to timely perform obligations "arising from and after the order for relief under any unexpired lease of nonresidential real

470 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model.*

property, until such lease is assumed or rejected."[471] In addition, section 365(d)(4) requires the debtor in possession to assume or reject any nonresidential real property lease within 120 days after the petition date, with one 90-day extension of that deadline for cause.[472] The debtor in possession generally is given until plan confirmation to assume or reject executory contracts and other kinds of leases.[473]

Commentators and practitioners have raised issues concerning several of these provisions. Many commentators have criticized the shortened deadline for the debtor in possession to assume, assign, or reject a nonresidential real property lease under section 365(d)(4) of the Bankruptcy Code.[474] Prior to the BAPCPA Amendments, a debtor in possession had an initial 60 days to review its unexpired nonresidential leases, but it could obtain one or more extensions of this deadline for cause and with court approval.[475] Some commentators and landlords believed that courts were granting debtors in possession very lengthy extensions of the section 365(d)(4) deadline on a routine basis.[476] They believed that these open-ended extensions significantly impaired the landlords' rights under the leases and nonbankruptcy law, as well as their ability to identify substitute lessees and negotiate substitute leases in a timely manner.[477]

As a result of the BAPCPA Amendments, section 365 provides a debtor in possession with 210 days following the petition date to decide whether it will assume or reject each of its nonresidential real property leases, unless the applicable landlord consents to an extension of this deadline. Some commentators suggested, immediately following the BAPCPA Amendments, that this single change to the Bankruptcy Code would discourage large retail chains from filing chapter 11 petitions.[478] Large retail chains, in particular, frequently have hundreds of unexpired nonresidential real property leases as of the petition date, and the prospect of reviewing and making prudent assumption or rejection decisions for each location within 210 days of the petition date, according to these commentators, would likely be too daunting and thus discourage filings in the first place.[479] Empirical and anecdotal evidence since 2005 suggests that this change in a debtor in possession's time to assume or assign nonresidential real property leases is at least a contributing factor to both the decline in retail filings and the results that were achieved in certain retail debtor cases since 2005.[480]

471 11 U.S.C. § 365(d)(3).
472 *Id.* § 365(d)(4).
473 *Id.* § 365(d)(2).
474 *Id.* § 365(d)(4).
475 *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?, Hearing before the H. Subcomm. on Commercial and Administrative Law*, 111th Cong. 96 (2009) (statement of Professor Jack F. Williams, Robert M. Zinman ABI Resident Scholar (2008–09)) [hereinafter Williams Statement].
476 *See, e.g., Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (June 4, 2013) (discussion prior law), *available at* Commission website, *supra* note 55. *See generally Transcript, NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, *available at* Commission website, *supra* note 55.
477 "The deadline was originally enacted to address problems caused by extended vacancies or partial operation by a debtor of tenant space located in shopping centers which reduced customer traffic to other nondebtor tenants due to delays in debtors deciding whether to assume or reject real property leases." *In re* FPSDA I, LLC, 450 B.R. 392, 399 (Bankr. E.D.N.Y. 2011).
478 *See, e.g.,* Williams Statement, *supra* note 475, at 97 ("Professor Ken Klee suggests one other possible outcome — retail debtors with a significant number of leases will simply refuse to file voluntary petitions during slower periods and will instead wait to be forced into involuntary cases.") (citations omitted).
479 *See, e.g., id.* at 96–97; *Written Statement of John Collen, Partner, Tressler LLP: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 26, 2012) (stating that 210 days may not be sufficient for a debtor to make an informed decision), *available at* Commission website, *supra* note 55; *Written Statement of Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 8 (Nov. 15, 2012) (stating that the 210-day period to assume or reject a nonresidential lease is too short, discourages reorganization, and impairs secured creditor recoveries), *available at* Commission website, *supra* note 55.
480 *See* Kenneth Ayotte, *An Empirical Investigation of Leases and Executory Contracts*, (paper presented at 2014 symposium) (draft on file with Commission) (finding that BAPCPA is "associated with a significantly lower probability of reorganization for the most lease-intensive firms"). *See also Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 5 (Nov. 3, 2012) (arguing that the 210-day period is insufficient, particularly for retail debtors), *available*

Courts also take different approaches to calculating the timely payments a debtor in possession is obligated to make under its nonresidential real property leases pursuant to section 365(d)(3). Some courts determine the prepetition or postpetition status of rent amounts owed by a debtor in possession using a billing approach based on the landlord's invoice date.[481] Other courts take an accrual approach and allocate the outstanding amounts between the prepetition and postpetition periods accordingly.[482] Courts also differ on the priority accorded to any unpaid postpetition amounts due under section 365(d)(3).[483]

Similarly, if a debtor in possession rejects a nonresidential real property lease, the landlord's claim for rejection damages is generally subject to the cap provided by section 502(b)(6) of the Bankruptcy Code. Section 502(b)(6) generally "limits a landlord's 'damages resulting from the termination of a lease of real property' to an amount equal to the rent the debtor-tenant would have paid for a period of one to three years, depending on the remaining term of the lease."[484] The calculation of the section 502(b)(6) cap, as well as what constitutes rent or otherwise should be included in the calculation, often produces litigation and uncertain results in chapter 11 cases.[485] Notably, courts are split regarding the application of the section 502(b)(6) cap to nontermination damages relating to the lease, which could constitute millions of dollars and significantly impact unsecured creditors' *pro rata* share of estate assets.[486]

at Commission website, *supra* note 55; *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (testifying that the primary problem in retail reorganizations is lender control and stating that "[l]enders are sometimes willing to provide *only* enough financing to position a debtor for liquidation in the first few months of the case, and then impose restrictive covenants in post-petition financing agreements that either direct an immediate liquidation of the company, or include covenants or borrowing reserve rights that effectively allow the lender to 'pull the plug' on the retailer only a few months into the case"), *available at* Commission website, *supra* note 55; *Written Statement of Lawrence C. Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (explaining the tension in the timing regarding the desire of the secured creditor to liquidate the debtors' assets and the ability of the debtor to effectively conduct going-out-of-business ("***GOB***") sales at its retail locations; given the 210-day limit set by BAPCPA and given the fact that a GOB sale takes at least 120 days in most cases, the debtor has 30 to 90 days to sell its company; landlords are also unwilling to negotiate, which increases the prevalence of quick liquidations in retail cases), *available at* Commission website, *supra* note 55; *Written Statement of Holly Felder Etlin: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013) (stating that the 210-day limit to assume or reject nonresidential leases puts retailers in a timing pinch; because GOB sales generally take at least 120 days and must take place in their retail locations, the 210-day limit to assume or reject leases puts inordinate pressure on debtors to decide within 90 to 120 days after filing to either quickly file a chapter 11 plans while complying with all their lenders' requirements, or to liquidate; also stating that the 210-day deadline to assume or reject nonresidential leases means it is nearly impossible for a middle-market retail company to do anything but conduct a GOB sale), *available at* Commission website, *supra* note 55.

481 *See* Centerpoint Props. v. Montgomery Ward Holding Corp. (*In re* Montgomery Ward Holding Corp.), 268 F.3d 205, 209–10 (3d. Cir. 2001); *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 6–8 (June 4, 2013) (describing how this "stub rent" problem means that landlords are, perhaps unfairly, losing money because of the timing of debtors' bankruptcy filings), *available at* Commission website, *supra* note 55.

482 *See In re* Stone Barn Manhattan LLC, 398 B.R. 359, 362–65 (Bankr. S.D.N.Y. 2008) (using the accrual method but providing historical overview and case cites of the accrual versus billing date approach).

483 *Compare In re* Oreck Corp., 506 B.R. 500 (Bankr. M.D. Tenn. 2014) (holding that debtor's obligation to pay occurred prepetition was not subject to priority treatment) *with In re* Leather Factory Inc., 475 B.R. 710 (Bankr. C.D. Cal. 2012) (holding that "stub rent" owed to landlord was a priority administrative claim).

484 11 U.S.C. § 502(b)(6); Michael St. Patrick Baxter, *The Application of § 502(b)(6) to Nontermination Lease Damages: To Cap or Not to Cap?*, 83 Am. Bankr. L. J. 111 (2009).

485 *See, e.g., In re* Heller Ehrman LLP, 2011 WL 635224 (N.D. Cal. Feb. 11, 2011) (discussing challenges in determining remaining term of lease); *In re* Titus & McConomy, LLP, 375 B.R. 165 (Bankr. W.D. Pa. 2007) (holding that, because one year's rent was greater than 15 percent of remaining term of lease following petition date, section 502(b)(6)(A) determined amount of cap was equal one year's rent).

486 Baxter, *supra* note 484, at 113–14.

Real Property Leases: Recommendations and Findings

The Commission reviewed several issues relating to nonresidential real property leases. Several Commissioners voiced strong concerns regarding the shortened deadline for a debtor in possession to assume or reject nonresidential real property leases under section 365(d)(4). The Commissioners suggested that the current deadline is preventing potential debtors from using chapter 11, at least on a voluntary and timely basis, and is making it more difficult for retail chains to reorganize their businesses.[487] The Commissioners also noted that the 210-day deadline is misleading because postpetition lenders have been requiring debtors in possession to make their decisions about nonresidential real property leases as early as 120 to 150 days after the petition date to permit these lenders to preserve their security interests in the debtors' leaseholds before the expiration of the section 365(d)(4) deadline.[488]

Other Commissioners, while acknowledging these troubling facts, emphasized the need to balance the concerns raised by landlords before the BAPCPA Amendments when courts were granting very lengthy extensions.[489] They encouraged the Commission to find a compromise that would provide more flexibility to debtors in possession to secure financing and to review their unexpired leases within a reasonable time frame without eliminating the certainty that section 365(d)(3) currently

487 *See, e.g.,* Sharon Bonelli, Isabel Hu, Gregory Fodell, *U.S. Retail Case Studies in Bankruptcy Enterprise Value and Creditor Recoveries*, Fitch Ratings, Apr. 16, 2013; *Written Statement of Lawrence Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (June 4, 2013) ("The deadline established under BAPCPA for a debtor to assume or reject unexpired leases of nonresidential property has had a substantial and unfortunate affect on retailers' ability to meet liquidity needs and obtain extended postpetition financing — the lynchpin to any successful retail reorganization."), *available at* Commission website, *supra* note 55; *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) (noting that the maximum time limit to assume or reject nonresidential real property leases should be amended, as it takes time to thoroughly assess whether a lease should be maintained for the value of reorganization efforts), *available at* Commission website, *supra* note 55; *Oral Testimony of Grant Stein: AIRA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (June 7, 2013) (AIRA Transcript) (noting that the court should allow more time for the assumption or rejection if it is appropriate in the circumstances), *available at* Commission website, *supra* note 55; *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 8–9 (Nov. 15, 2012) ("Debtors and their secured and unsecured creditors must make decisions about whether to retain leases in a period of time that is often unrealistically short. As a result, businesses that might have been reorganized or sold as going concerns to new owners are liquidated instead. Because they know that debtors with significant leases will have difficulty reorganizing, lenders are less willing to support reorganizations with DIP financing. They do not want to begin lending money to a chapter 11 debtor only to have to choose, 7 months later, between agreeing to an unfavorable deal with a landlord that has such significant leverage and liquidating the debtor, possibly at a loss to the lender. So they simply refuse to provide DIP financing in the first place, forcing debtors to liquidate before they have had an opportunity to make operational changes, regardless of the potential for reorganization. In addition, going concern asset sales (a frequent form of 'reorganization' without a plan) become more difficult and less advantageous to creditors and owners because buyers have insufficient time to assess the value of an enterprise with important leases. Uncertainty about value always results in lower prices and therefore lower payments to creditors. Worse, such uncertainty can render going concern sales so difficult that they are not even pursued, again resulting in otherwise avoidable liquidations."), *available at* Commission website, *supra* note 55.

488 *See Written Statement of Lawrence C. Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (stating that the deadline should be expanded to allow time for a debtor to secure postpetition financing and conduct a going-out-of-business sale and stating that prepetition lenders often demand provisions that result in a liquidation sale before the expiration of the 210-day period), *available at* Commission website, *supra* note 55. *But see Written Statement of David L. Pollack, Partner, Ballard Spahr LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (June 4, 2013) (stating that neither section 365(d)(4) time limits nor commercial landlords are causing retailers to fail and providing specific case examples to support assertion; also noting that retailers are failing because of other reasons, such as DIP financing conditions and reluctance of trade creditors to continue to extend credit), *available at* Commission website, *supra* note 55. *See also* Ayotte, A*n Empirical Investigation of Leases and Executory Contracts*, *supra* note 480 (finding that the seven-month limit to assume or reject a commercial lease instituted by BAPCPA (absent an extension from the landlord) "accelerated real estate lease disposition decisions"). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

489 *See, e.g., Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (June 4, 2013) ("The 2005 amendments that created more certainty for shopping center owners now provide an important 'firewall' which prevents the failure of one retailer from cascading to other businesses. Under the prior law, lingering uncertainty caused neighboring stores to suffer from reduced traffic and sales while potential new tenants were reluctant to rent space in a shopping center with an uncertain future. For property owners, the contraction in credit has been even more problematic; a bankrupt tenant can cause a shopping center to default on a mortgage with no ability to cure the default. Such defaults include covenants to maintain minimum occupancy and debt service coverage."), *available at* Commission website, *supra* note 55.

provides to landlords.[490] After considering and debating different approaches that ranged from reversion to the pre-BAPCPA standard to maintenance of the *status quo*, the Commission voted to provide the debtor in possession one year from the petition date to make its assumption, assignment, or rejection decision with respect to nonresidential real property leases.

The Commission also discussed the split in the courts regarding the method — *i.e.*, the billing approach or the accrual approach — that should be used to determine whether certain rent owed under the lease should be deemed a prepetition or a postpetition obligation. The Commission reviewed case law citing both approaches to determine which approach should be adopted and codified, and focused its efforts on creating, first and foremost, a uniform standard. Ultimately, the Commission decided that the accrual method, which allocates rent between the prepetition and postpetition periods based on the date of filing, was a fair method and most closely aligned with the purpose of section 365(d)(3).

The Commission further considered the scope of a debtor in possession's obligations under section 365(d)(3). Some of the Commissioners commented on the ambiguity in the case law regarding which obligations were captured by section 365(d)(3) and how those obligations, if deferred or unpaid, should be treated. With respect to which obligations should be deemed "rent," the Commission reviewed the language of section 365(d)(3), which references section 365(b)(2), but not historical nonmonetary obligations in section 365(b)(1). The Commissioners debated whether this omission in the statute suggests that a debtor in possession should be required to perform all nonmonetary obligations on and after the petition date as provided in section 365(d)(3). Several Commissioners, however, highlighted that such a reading of section 365(d)(3) may be inconsistent with the Commission's recommended policies and approaches. Specifically, these Commissioners asserted that a debtor in possession (i) should not be required to perform under any executory contracts or unexpired leases, except to pay for postpetition goods and services (including rent), pending assumption or rejection; and (ii) should not be required to cure nonmonetary defaults that occurred prior to assumption. In light of these recommendations and the Commission's proposal for a relatively modest extension of the section 365(d)(4) deadline, the Commission decided to recommend limiting section 365(d)(3) to monetary obligations under the leases and to provide ordinary administrative priority (not superpriority) to any such unpaid or deferred obligations under section 365(d)(3).

In addition, the Commissioners evaluated the inconsistent application of section 502(b)(6) to calculate the maximum amount of a landlord's rejection damages. The Commission agreed with courts that have held that whether a given obligation is labeled as "rent" under a lease should not determine whether such obligation is subject to the section 502(b)(6) cap. The Commissioners identified obligations that have been commonly considered as "rent" (*e.g.*, monthly payments for occupying the property (including base rent, additional rent, percentage rent), common area

490 *Id.* at 2 (June 4, 2013) (stating that the time limits for debtors to assume or reject a nonresidential lease introduced by BAPCPA have "provid[ed] shopping center owners with reasonable certainty as to the disposition of leases, have prevented deterioration in shopping center properties and helped owners have access to credit to finance construction and renovation"), *available at* Commission website, *supra* note 55; *Oral Testimony of the Honorable Melanie Cyganowski (Ret.), former U.S. Chief Bankruptcy Judge, E.D.N.Y.: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 19 (Nov. 15, 2012) (CFA Transcript) (stating that it would be beneficial to the court and will encourage more secured lenders to support middle-market borrowers if the BAPCPA Amendments relating to lease and plan deadlines were repealed, or at a minimum amended to provide judicial discretion to be exercised to modify the deadlines as appropriate), *available at* Commission website, *supra* note 55.

maintenance charges, taxes, and insurance) and determined that the definition of "rent" suggested by the advisory committee — "any recurring monetary obligations of the debtor under the lease" — adequately captured these obligations. The Commissioners also analyzed the varying interpretations and applications of the formula for calculating the cap on rejection damages under section 502(b)(6). The Commission agreed that many courts have confused or misapplied the formula and that, simply stated, the cap should be the rent reserved under the lease for the greater of (i) one year and (ii) the shorter of 15 percent of the remaining term and three years, plus unpaid rents. Accordingly, the Commission voted to recommend clarifying the calculation formula.

Finally, the Commission considered the treatment of nontermination damages that a landlord may assert against the estate. These claims typically arise out of the debtor's use or occupancy of the property and are not related to the debtor's rejection of the lease. Notably, section 502(b)(6) applies to, and limits, "the claim of a lessor for damages resulting from the termination of a lease of real property." Accordingly, the Commission agreed that a landlord should be able to file a prepetition claim against the estate, to the extent that the landlord can establish a legal basis and adequate factual support for such claim, for damages not resulting from the rejection of the lease. Such claim would be subject to the claims objection and allowance process under the Bankruptcy Code.

B. Use, Sale, or Lease of Property of the Estate

Section 363 of the Bankruptcy Code addresses the debtor in possession's use, sale, or lease of property during the chapter 11 case. Section 363(c) permits the debtor in possession to engage in certain of these transactions in the ordinary course of business without court approval.[491] If the debtor in possession wants to use, sell, or lease property outside the ordinary course of business, section 363(b) requires, among other things, notice and a hearing, and prior court approval.[492] Section 363(f), in turn, allows the debtor in possession to sell property free and clear of any interest in such property under certain circumstances.[493]

1. General Provisions for Non-Ordinary Course Transactions

Recommended Principles:

- Except in the context of a sale of all or substantially all of a debtor's assets (*i.e.*, a section 363x sale), the court should approve the use, sale, or lease of a debtor's assets outside the ordinary course of business only if the court finds by a preponderance of the evidence that the trustee exercised reasonable business judgment in connection with the proposed transaction. This approach often is

491 11 U.S.C. § 363(c)(1). Nevertheless, if a debtor is selling, leasing, or using assets that constitute "cash collateral," then the debtor must obtain the secured creditor's consent or court approval. *Id.* § 363(c)(2).
492 *Id.* § 363(b).
493 *Id.* § 363(f).

Syllabus

NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Timber & Lumber Co.,* 200 U. S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

REED ET AL. *v.* TOWN OF GILBERT, ARIZONA, ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 13–502. Argued January 12, 2015—Decided June 18, 2015

Gilbert, Arizona (Town), has a comprehensive code (Sign Code or Code) that prohibits the display of outdoor signs without a permit, but exempts 23 categories of signs, including three relevant here. "Ideological Signs," defined as signs "communicating a message or ideas" that do not fit in any other Sign Code category, may be up to 20 square feet and have no placement or time restrictions. "Political Signs," defined as signs "designed to influence the outcome of an election," may be up to 32 square feet and may only be displayed during an election season. "Temporary Directional Signs," defined as signs directing the public to a church or other "qualifying event," have even greater restrictions: No more than four of the signs, limited to six square feet, may be on a single property at any time, and signs may be displayed no more than 12 hours before the "qualifying event" and 1 hour after.

Petitioners, Good News Community Church (Church) and its pastor, Clyde Reed, whose Sunday church services are held at various temporary locations in and near the Town, posted signs early each Saturday bearing the Church name and the time and location of the next service and did not remove the signs until around midday Sunday. The Church was cited for exceeding the time limits for displaying temporary directional signs and for failing to include an event date on the signs. Unable to reach an accommodation with the Town, petitioners filed suit, claiming that the Code abridged their freedom of speech. The District Court denied their motion for a preliminary injunction, and the Ninth Circuit affirmed, ultimately concluding that the Code's sign categories were content neutral, and that the Code satisfied the intermediate scrutiny accorded to content-neutral regulations of speech.

Held: The Sign Code's provisions are content-based regulations of speech that do not survive strict scrutiny. Pp. 6–17.

(a) Because content-based laws target speech based on its communicative content, they are presumptively unconstitutional and may be justified only if the government proves that they are narrowly tailored to serve compelling state interests. *E.g., R. A. V.* v. *St. Paul*, 505 U. S. 377, 395. Speech regulation is content based if a law applies to particular speech because of the topic discussed or the idea or message expressed. *E.g., Sorrell* v. *IMS Health, Inc.*, 564 U. S. ___, ___–___. And courts are required to consider whether a regulation of speech "on its face" draws distinctions based on the message a speaker conveys. *Id.,* at ___. Whether laws define regulated speech by particular subject matter or by its function or purpose, they are subject to strict scrutiny. The same is true for laws that, though facially content neutral, cannot be " 'justified without reference to the content of the regulated speech,' " or were adopted by the government "because of disagreement with the message" conveyed. *Ward* v. *Rock Against Racism*, 491 U. S. 781, 791. Pp. 6–7.

(b) The Sign Code is content based on its face. It defines the categories of temporary, political, and ideological signs on the basis of their messages and then subjects each category to different restrictions. The restrictions applied thus depend entirely on the sign's communicative content. Because the Code, on its face, is a content-based regulation of speech, there is no need to consider the government's justifications or purposes for enacting the Code to determine whether it is subject to strict scrutiny. Pp. 7.

(c) None of the Ninth Circuit's theories for its contrary holding is persuasive. Its conclusion that the Town's regulation was not based on a disagreement with the message conveyed skips the crucial first step in the content-neutrality analysis: determining whether the law is content neutral on its face. A law that is content based on its face is subject to strict scrutiny regardless of the government's benign motive, content-neutral justification, or lack of "animus toward the ideas contained" in the regulated speech. *Cincinnati* v. *Discovery Network, Inc.,* 507 U. S. 410, 429. Thus, an innocuous justification cannot transform a facially content-based law into one that is content neutral. A court must evaluate each question—whether a law is content based on its face and whether the purpose and justification for the law are content based—before concluding that a law is content neutral. *Ward* does not require otherwise, for its framework applies only to a content-neutral statute.

The Ninth Circuit's conclusion that the Sign Code does not single out any idea or viewpoint for discrimination conflates two distinct but related limitations that the First Amendment places on government regulation of speech. Government discrimination among viewpoints is a "more blatant" and "egregious form of content discrimination," *Rosenberger* v. *Rector and Visitors of Univ. of Va.*, 515 U. S. 819, 829, but "[t]he First Amendment's hostility to content-based regulation [also] extends . . . to prohibition of public discussion of an entire topic," *Consolidated Edison Co. of N. Y.* v. *Public Serv. Comm'n of N. Y.*, 447 U. S. 530, 537. The Sign Code, a paradigmatic example of content-based discrimination, singles out specific subject matter for differential treatment, even if it does not target viewpoints within that subject matter.

The Ninth Circuit also erred in concluding that the Sign Code was not content based because it made only speaker-based and event-based distinctions. The Code's categories are not speaker-based—the restrictions for political, ideological, and temporary event signs apply equally no matter who sponsors them. And even if the sign categories were speaker based, that would not automatically render the law content neutral. Rather, "laws favoring some speakers over others demand strict scrutiny when the legislature's speaker preference reflects a content preference." *Turner Broadcasting System, Inc.* v. *FCC*, 512 U. S. 622, 658. This same analysis applies to event-based distinctions. Pp. 8–14.

(d) The Sign Code's content-based restrictions do not survive strict scrutiny because the Town has not demonstrated that the Code's differentiation between temporary directional signs and other types of signs furthers a compelling governmental interest and is narrowly tailored to that end. See *Arizona Free Enterprise Club's Freedom Club PAC* v. *Bennett*, 564 U. S. ___, ___. Assuming that the Town has a compelling interest in preserving its aesthetic appeal and traffic safety, the Code's distinctions are highly underinclusive. The Town cannot claim that placing strict limits on temporary directional signs is necessary to beautify the Town when other types of signs create the same problem. See *Discovery Network*, *supra,* at 425. Nor has it shown that temporary directional signs pose a greater threat to public safety than ideological or political signs. Pp. 14–15.

(e) This decision will not prevent governments from enacting effective sign laws. The Town has ample content-neutral options available to resolve problems with safety and aesthetics, including regulating size, building materials, lighting, moving parts, and portability. And the Town may be able to forbid postings on public property, so long as it does so in an evenhanded, content-neutral manner. See *Members of City Council of Los Angeles* v. *Taxpayers for Vincent*, 466 U. S. 789, 817. An ordinance narrowly tailored to the challenges of protecting the safety of pedestrians, drivers, and passengers—*e.g.,* warning signs marking hazards on private property or signs directing traffic—might also survive strict scrutiny. Pp. 16–17.

707 F. 3d 1057, reversed and remanded.

THOMAS, J., delivered the opinion of the Court, in which ROBERTS, C. J., and SCALIA, KENNEDY, ALITO, and SOTOMAYOR, JJ., joined. ALITO, J., filed a concurring opinion, in which KENNEDY and SOTOMAYOR, JJ., joined. BREYER, J., filed an opinion concurring in the judgment. KAGAN, J., filed an opinion concurring in the judgment, in which GINSBURG and BREYER, JJ., joined

SUPREME COURT OF THE UNITED STATES

No. 13–502

CLYDE REED, ET AL., PETITIONERS *v.* TOWN OF GILBERT, ARIZONA, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

[June 18, 2015]

JUSTICE THOMAS delivered the opinion of the Court.

The town of Gilbert, Arizona (or Town), has adopted a comprehensive code governing the manner in which people may display outdoor signs. Gilbert, Ariz., Land Development Code (Sign Code or Code), ch. 1, §4.402 (2005).[1] The Sign Code identifies various categories of signs based on the type of information they convey, then subjects each category to different restrictions. One of the categories is "Temporary Directional Signs Relating to a Qualifying Event," loosely defined as signs directing the public to a meeting of a nonprofit group. §4.402(P). The Code imposes more stringent restrictions on these signs than it does on signs conveying other messages. We hold that these provisions are content-based regulations of speech that cannot survive strict scrutiny.

[1] The Town's Sign Code is available online at http://www.gilbertaz.gov/departments/development-service/planning-development/land-development-code (as visited June 16, 2015, and available in Clerk of Court's case file).

I

A

The Sign Code prohibits the display of outdoor signs anywhere within the Town without a permit, but it then exempts 23 categories of signs from that requirement. These exemptions include everything from bazaar signs to flying banners. Three categories of exempt signs are particularly relevant here.

The first is "Ideological Sign[s]." This category includes any "sign communicating a message or ideas for noncommercial purposes that is not a Construction Sign, Directional Sign, Temporary Directional Sign Relating to a Qualifying Event, Political Sign, Garage Sale Sign, or a sign owned or required by a governmental agency." Sign Code, Glossary of General Terms (Glossary), p. 23 (emphasis deleted). Of the three categories discussed here, the Code treats ideological signs most favorably, allowing them to be up to 20 square feet in area and to be placed in all "zoning districts" without time limits. §4.402(J).

The second category is "Political Sign[s]." This includes any "temporary sign designed to influence the outcome of an election called by a public body." Glossary 23.[2] The Code treats these signs less favorably than ideological signs. The Code allows the placement of political signs up to 16 square feet on residential property and up to 32 square feet on nonresidential property, undeveloped municipal property, and "rights-of-way." §4.402(I).[3] These signs may be displayed up to 60 days before a primary election and up to 15 days following a general election. *Ibid.*

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[2] A "Temporary Sign" is a "sign not permanently attached to the ground, a wall or a building, and not designed or intended for permanent display." Glossary 25.

[3] The Code defines "Right-of-Way" as a "strip of publicly owned land occupied by or planned for a street, utilities, landscaping, sidewalks, trails, and similar facilities." *Id.,* at 18.

The third category is "Temporary Directional Signs Relating to a Qualifying Event." This includes any "Temporary Sign intended to direct pedestrians, motorists, and other passersby to a 'qualifying event.'" Glossary 25 (emphasis deleted). A "qualifying event" is defined as any "assembly, gathering, activity, or meeting sponsored, arranged, or promoted by a religious, charitable, community service, educational, or other similar non-profit organization." *Ibid.* The Code treats temporary directional signs even less favorably than political signs.[4] Temporary directional signs may be no larger than six square feet. §4.402(P). They may be placed on private property or on a public right-of-way, but no more than four signs may be placed on a single property at any time. *Ibid.* And, they may be displayed no more than 12 hours before the "qualifying event" and no more than 1 hour afterward. *Ibid.*

B

Petitioners Good News Community Church (Church) and its pastor, Clyde Reed, wish to advertise the time and location of their Sunday church services. The Church is a small, cash-strapped entity that owns no building, so it holds its services at elementary schools or other locations in or near the Town. In order to inform the public about its services, which are held in a variety of different loca-

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[4] The Sign Code has been amended twice during the pendency of this case. When litigation began in 2007, the Code defined the signs at issue as "Religious Assembly Temporary Direction Signs." App. 75. The Code entirely prohibited placement of those signs in the public right-of-way, and it forbade posting them in any location for more than two hours before the religious assembly or more than one hour afterward. *Id.,* at 75–76. In 2008, the Town redefined the category as "Temporary Directional Signs Related to a Qualifying Event," and it expanded the time limit to 12 hours before and 1 hour after the "qualifying event." *Ibid.* In 2011, the Town amended the Code to authorize placement of temporary directional signs in the public right-of-way. *Id.,* at 89.

tions, the Church began placing 15 to 20 temporary signs around the Town, frequently in the public right-of-way abutting the street. The signs typically displayed the Church's name, along with the time and location of the upcoming service. Church members would post the signs early in the day on Saturday and then remove them around midday on Sunday. The display of these signs requires little money and manpower, and thus has proved to be an economical and effective way for the Church to let the community know where its services are being held each week.

This practice caught the attention of the Town's Sign Code compliance manager, who twice cited the Church for violating the Code. The first citation noted that the Church exceeded the time limits for displaying its temporary directional signs. The second citation referred to the same problem, along with the Church's failure to include the date of the event on the signs. Town officials even confiscated one of the Church's signs, which Reed had to retrieve from the municipal offices.

Reed contacted the Sign Code Compliance Department in an attempt to reach an accommodation. His efforts proved unsuccessful. The Town's Code compliance manager informed the Church that there would be "no leniency under the Code" and promised to punish any future violations.

Shortly thereafter, petitioners filed a complaint in the United States District Court for the District of Arizona, arguing that the Sign Code abridged their freedom of speech in violation of the First and Fourteenth Amendments. The District Court denied the petitioners' motion for a preliminary injunction. The Court of Appeals for the Ninth Circuit affirmed, holding that the Sign Code's provision regulating temporary directional signs did not regulate speech on the basis of content. 587 F. 3d 966, 979 (2009). It reasoned that, even though an enforcement officer would have to read the sign to determine what provisions of the Sign Code applied to it, the "'kind of cursory examination'" that would be necessary for an officer to classify it as a temporary directional sign was "not akin to an officer synthesizing the expressive content of the sign." *Id.*, at 978. It then remanded for the District Court to determine in the first instance whether the Sign Code's distinctions among temporary directional signs, political signs, and ideological signs nevertheless constituted a content-based regulation of speech.

On remand, the District Court granted summary judgment in favor of the Town. The Court of Appeals again affirmed, holding that the Code's sign categories were content neutral. The court concluded that "the distinctions between Temporary Directional Signs, Ideological Signs, and Political Signs . . . are based on objective factors relevant to Gilbert's creation of the specific exemption from the permit requirement and do not otherwise consider the substance of the sign." 707 F. 3d 1057, 1069 (CA9 2013). Relying on this Court's decision in *Hill* v. *Colorado*, 530 U. S. 703 (2000), the Court of Appeals concluded that the Sign Code is content neutral. 707 F. 3d, at 1071–1072. As the court explained, "Gilbert did not adopt its regulation of speech because it disagreed with the message conveyed" and its "interests in regulat[ing] temporary signs are unrelated to the content of the sign." *Ibid.* Accordingly, the court believed that the Code was "content-neutral as that term [has been] defined by the Supreme Court." *Id.,* at 1071. In light of that determination, it applied a lower level of scrutiny to the Sign Code and concluded that the law did not violate the First Amendment. *Id.*, at 1073–1076.

We granted certiorari, 573 U. S. ___ (2014), and now reverse.

II
A

The First Amendment, applicable to the States through the Fourteenth Amendment, prohibits the enactment of laws "abridging the freedom of speech." U. S. Const., Amdt. 1. Under that Clause, a government, including a municipal government vested with state authority, "has no power to restrict expression because of its message, its ideas, its subject matter, or its content." *Police Dept. of Chicago* v. *Mosley*, 408 U. S. 92, 95 (1972). Content-based laws—those that target speech based on its communicative content—are presumptively unconstitutional and may be justified only if the government proves that they are narrowly tailored to serve compelling state interests. *R. A. V.* v. *St. Paul*, 505 U. S. 377, 395 (1992); *Simon & Schuster, Inc.* v. *Members of N. Y. State Crime Victims Bd.*, 502 U. S. 105, 115, 118 (1991).

Government regulation of speech is content based if a law applies to particular speech because of the topic discussed or the idea or message expressed. *E.g., Sorrell* v. *IMS Health, Inc.*, 564 U. S. ___, ___–___ (2011) (slip op., at 8–9); *Carey* v. *Brown*, 447 U. S. 455, 462 (1980); *Mosley*, *supra,* at 95. This commonsense meaning of the phrase "content based" requires a court to consider whether a regulation of speech "on its face" draws distinctions based on the message a speaker conveys. *Sorrell*, *supra,* at ___ (slip op., at 8). Some facial distinctions based on a message are obvious, defining regulated speech by particular subject matter, and others are more subtle, defining regulated speech by its function or purpose. Both are distinctions drawn based on the message a speaker conveys, and, therefore, are subject to strict scrutiny.

Our precedents have also recognized a separate and additional category of laws that, though facially content neutral, will be considered content-based regulations of speech: laws that cannot be "'justified without reference to the content of the regulated speech,'" or that were adopted by the government "because of disagreement with the message [the speech] conveys," *Ward* v. *Rock Against Racism*, 491 U. S. 781, 791 (1989). Those laws, like those that are content based on their face, must also satisfy strict scrutiny.

B

The Town's Sign Code is content based on its face. It defines "Temporary Directional Signs" on the basis of whether a sign conveys the message of directing the public to church or some other "qualifying event." Glossary 25. It defines "Political Signs" on the basis of whether a sign's message is "designed to influence the outcome of an election." *Id.,* at 24. And it defines "Ideological Signs" on the basis of whether a sign "communicat[es] a message or ideas" that do not fit within the Code's other categories. *Id.,* at 23. It then subjects each of these categories to different restrictions.

The restrictions in the Sign Code that apply to any given sign thus depend entirely on the communicative content of the sign. If a sign informs its reader of the time and place a book club will discuss John Locke's Two Treatises of Government, that sign will be treated differently from a sign expressing the view that one should vote for one of Locke's followers in an upcoming election, and both signs will be treated differently from a sign expressing an ideological view rooted in Locke's theory of government. More to the point, the Church's signs inviting people to attend its worship services are treated differently from signs conveying other types of ideas. On its face, the Sign Code is a content-based regulation of speech. We thus have no need to consider the government's justifications or purposes for enacting the Code to determine whether it is subject to strict scrutiny.

C

In reaching the contrary conclusion, the Court of Appeals offered several theories to explain why the Town's Sign Code should be deemed content neutral. None is persuasive.

1

The Court of Appeals first determined that the Sign Code was content neutral because the Town "did not adopt its regulation of speech [based on] disagree[ment] with the message conveyed," and its justifications for regulating temporary directional signs were "unrelated to the content of the sign." 707 F. 3d, at 1071–1072. In its brief to this Court, the United States similarly contends that a sign regulation is content neutral—even if it expressly draws distinctions based on the sign's communicative content—if those distinctions can be "'justified without reference to the content of the regulated speech.'" Brief for United States as *Amicus Curiae* 20, 24 (quoting *Ward, supra*, at 791; emphasis deleted).

But this analysis skips the crucial first step in the content-neutrality analysis: determining whether the law is content neutral on its face. A law that is content based on its face is subject to strict scrutiny regardless of the government's benign motive, content-neutral justification, or lack of "animus toward the ideas contained" in the regulated speech. *Cincinnati* v. *Discovery Network*, *Inc.,* 507 U. S. 410, 429 (1993). We have thus made clear that "'[i]llicit legislative intent is not the *sine qua non* of a violation of the First Amendment,'" and a party opposing the government "need adduce 'no evidence of an improper censorial motive.'" *Simon & Schuster, supra,* at 117. Although "a content-based purpose may be sufficient in certain circumstances to show that a regulation is content based, it is not necessary." *Turner Broadcasting System, Inc.* v. *FCC*, 512 U. S. 622, 642 (1994). In other words, an innocuous justification cannot transform a facially content-based law into one that is content neutral.

That is why we have repeatedly considered whether a law is content neutral on its face *before* turning to the law's justification or purpose. See, *e.g., Sorrell*, *supra,* at ___–___ (slip op., at 8–9) (statute was content based "on its face," and there was also evidence of an impermissible legislative motive); *United States* v. *Eichman*, 496 U. S. 310, 315 (1990) ("Although the [statute] contains no explicit content-based limitation on the scope of prohibited conduct, it is nevertheless clear that the Government's asserted *interest* is related to the suppression of free expression" (internal quotation marks omitted)); *Members of City Council of Los Angeles* v. *Taxpayers for Vincent*, 466 U. S. 789, 804 (1984) ("The text of the ordinance is neutral," and "there is not even a hint of bias or censorship in the City's enactment or enforcement of this ordinance"); *Clark* v. *Community for Creative Non-Violence*, 468 U. S. 288, 293 (1984) (requiring that a facially content-neutral ban on camping must be "justified without reference to the content of the regulated speech"); *United States* v. *O'Brien*, 391 U. S. 367, 375, 377 (1968) (noting that the statute "on its face deals with conduct having no connection with speech," but examining whether the "the governmental interest is unrelated to the suppression of free expression"). Because strict scrutiny applies either when a law is content based on its face or when the purpose and justification for the law are content based, a court must evaluate each question before it concludes that the law is content neutral and thus subject to a lower level of scrutiny.

The Court of Appeals and the United States misunderstand our decision in *Ward* as suggesting that a government's purpose is relevant even when a law is content based on its face. That is incorrect. *Ward* had nothing to say about facially content-based restrictions because it involved a facially content-*neutral* ban on the use, in a city-owned music venue, of sound amplification systems not provided by the city. 491 U. S., at 787, and n. 2. In that context, we looked to governmental motive, including whether the government had regulated speech "because of disagreement" with its message, and whether the regulation was "'justified without reference to the content of the speech.'" *Id.,* at 791. But *Ward*'s framework "applies only if a statute is content neutral." *Hill*, 530 U. S., at 766 (KENNEDY, J., dissenting). Its rules thus operate "to protect speech," not "to restrict it." *Id.,* at 765.

The First Amendment requires no less. Innocent motives do not eliminate the danger of censorship presented by a facially content-based statute, as future government officials may one day wield such statutes to suppress disfavored speech. That is why the First Amendment expressly targets the operation of the laws—*i.e.,* the "abridg[ement] of speech"—rather than merely the motives of those who enacted them. U. S. Const., Amdt. 1. "'The vice of content-based legislation . . . is not that it is always used for invidious, thought-control purposes, but that it lends itself to use for those purposes.'" *Hill, supra,* at 743 (SCALIA, J., dissenting).

For instance, in *NAACP* v. *Button*, 371 U. S. 415 (1963), the Court encountered a State's attempt to use a statute prohibiting "'improper solicitation'" by attorneys to outlaw litigation-related speech of the National Association for the Advancement of Colored People. *Id.,* at 438. Although *Button* predated our more recent formulations of strict scrutiny, the Court rightly rejected the State's claim that its interest in the "regulation of professional conduct" rendered the statute consistent with the First Amendment, observing that "it is no answer . . . to say . . . that the purpose of these regulations was merely to insure high professional standards and not to curtail free expression." *Id.,* at 438–439. Likewise, one could easily imagine a Sign Code compliance manager who disliked the Church's substantive teachings deploying the Sign Code to make it more difficult for the Church to inform the public of the location of its services. Accordingly, we have repeatedly "rejected the argument that 'discriminatory . . . treatment is suspect under the First Amendment only when the legislature intends to suppress certain ideas.'" *Discovery Network,* 507 U. S., at 429. We do so again today.

2

The Court of Appeals next reasoned that the Sign Code was content neutral because it "does not mention any idea or viewpoint, let alone single one out for differential treatment." 587 F. 3d, at 977. It reasoned that, for the purpose of the Code provisions, "[i]t makes no difference which candidate is supported, who sponsors the event, or what ideological perspective is asserted." 707 F. 3d, at 1069.

The Town seizes on this reasoning, insisting that "content based" is a term of art that "should be applied flexibly" with the goal of protecting "viewpoints and ideas from government censorship or favoritism." Brief for Respondents 22. In the Town's view, a sign regulation that "does not censor or favor particular viewpoints or ideas" cannot be content based. *Ibid*. The Sign Code allegedly passes this test because its treatment of temporary directional signs does not raise any concerns that the government is "endorsing or suppressing 'ideas or viewpoints,'" *id.*, at 27, and the provisions for political signs and ideological signs "are neutral as to particular ideas or viewpoints" within those categories. *Id.*, at 37.

This analysis conflates two distinct but related limitations that the First Amendment places on government regulation of speech. Government discrimination among viewpoints—or the regulation of speech based on "the specific motivating ideology or the opinion or perspective of the speaker"—is a "more blatant" and "egregious form of content discrimination." *Rosenberger* v. *Rector and Visitors of Univ. of Va.*, 515 U. S. 819, 829 (1995). But it is well established that "[t]he First Amendment's hostility to content-based regulation extends not only to restrictions on particular viewpoints, but also to prohibition of public discussion of an entire topic." *Consolidated Edison Co. of N. Y.* v. *Public Serv. Comm'n of N. Y.*, 447 U. S. 530, 537 (1980).

Thus, a speech regulation targeted at specific subject matter is content based even if it does not discriminate among viewpoints within that subject matter. *Ibid.* For example, a law banning the use of sound trucks for political speech—and only political speech—would be a content-based regulation, even if it imposed no limits on the political viewpoints that could be expressed. See *Discovery Network, supra,* at 428. The Town's Sign Code likewise singles out specific subject matter for differential treatment, even if it does not target viewpoints within that subject matter. Ideological messages are given more favorable treatment than messages concerning a political candidate, which are themselves given more favorable treatment than messages announcing an assembly of like-minded individuals. That is a paradigmatic example of content-based discrimination.

3

Finally, the Court of Appeals characterized the Sign Code's distinctions as turning on "'the content-neutral elements of who is speaking through the sign and whether and when an event is occurring.'" 707 F. 3d, at 1069. That analysis is mistaken on both factual and legal grounds.

To start, the Sign Code's distinctions are not speaker based. The restrictions for political, ideological, and temporary event signs apply equally no matter who sponsors them. If a local business, for example, sought to put up signs advertising the Church's meetings, those signs would be subject to the same limitations as such signs placed by the Church. And if Reed had decided to display signs in support of a particular candidate, he could have made those signs far larger—and kept them up for far longer—than signs inviting people to attend his church services. If the Code's distinctions were truly speaker based, both types of signs would receive the same treatment.

In any case, the fact that a distinction is speaker based does not, as the Court of Appeals seemed to believe, automatically render the distinction content neutral. Because "[s]peech restrictions based on the identity of the speaker are all too often simply a means to control content," *Citizens United* v. *Federal Election Comm'n*, 558 U. S. 310, 340 (2010), we have insisted that "laws favoring some speakers over others demand strict scrutiny when the legislature's speaker preference reflects a content preference," *Turner,* 512 U. S., at 658. Thus, a law limiting the content of newspapers, but only newspapers, could not evade strict scrutiny simply because it could be characterized as speaker based. Likewise, a content-based law that restricted the political speech of all corporations would not become content neutral just because it singled out corporations as a class of speakers. See *Citizens United, supra*, at 340–341. Characterizing a distinction as speaker based is only the beginning—not the end—of the inquiry.

Nor do the Sign Code's distinctions hinge on "whether and when an event is occurring." The Code does not permit citizens to post signs on any topic whatsoever within a set period leading up to an election, for example. Instead, come election time, it requires Town officials to determine whether a sign is "designed to influence the outcome of an election" (and thus "political") or merely "communicating a message or ideas for noncommercial purposes" (and thus "ideological"). Glossary 24. That obvious content-based inquiry does not evade strict scrutiny review simply because an event (*i.e.,* an election) is involved.

And, just as with speaker-based laws, the fact that a distinction is event based does not render it content neutral. The Court of Appeals cited no precedent from this Court supporting its novel theory of an exception from the content-neutrality requirement for event-based laws. As we have explained, a speech regulation is content based if the law applies to particular speech because of the topic discussed or the idea or message expressed. *Supra,* at 6. A regulation that targets a sign because it conveys an idea about a specific event is no less content based than a regulation that targets a sign because it conveys some other idea. Here, the Code singles out signs bearing a particular message: the time and location of a specific event. This type of ordinance may seem like a perfectly rational way to regulate signs, but a clear and firm rule governing content neutrality is an essential means of protecting the freedom of speech, even if laws that might seem "entirely reasonable" will sometimes be "struck down because of their content-based nature." *City of Ladue* v. *Gilleo*, 512 U. S. 43, 60 (1994) (O'Connor, J., concurring).

III

Because the Town's Sign Code imposes content-based restrictions on speech, those provisions can stand only if they survive strict scrutiny, "'which requires the Government to prove that the restriction furthers a compelling interest and is narrowly tailored to achieve that interest,'" *Arizona Free Enterprise Club's Freedom Club PAC* v. *Bennett*, 564 U. S. ___, ___ (2011) (slip op., at 8) (quoting *Citizens United*, 558 U. S., at 340). Thus, it is the Town's burden to demonstrate that the Code's differentiation between temporary directional signs and other types of signs, such as political signs and ideological signs, furthers a compelling governmental interest and is narrowly tailored to that end. See *ibid*.

The Town cannot do so. It has offered only two governmental interests in support of the distinctions the Sign Code draws: preserving the Town's aesthetic appeal and traffic safety. Assuming for the sake of argument that those are compelling governmental interests, the Code's distinctions fail as hopelessly underinclusive.

Starting with the preservation of aesthetics, temporary directional signs are "no greater an eyesore," *Discovery Network*, 507 U. S., at 425, than ideological or political ones. Yet the Code allows unlimited proliferation of larger ideological signs while strictly limiting the number, size, and duration of smaller directional ones. The Town cannot claim that placing strict limits on temporary directional signs is necessary to beautify the Town while at the same time allowing unlimited numbers of other types of signs that create the same problem.

The Town similarly has not shown that limiting temporary directional signs is necessary to eliminate threats to traffic safety, but that limiting other types of signs is not. The Town has offered no reason to believe that directional signs pose a greater threat to safety than do ideological or political signs. If anything, a sharply worded ideological sign seems more likely to distract a driver than a sign directing the public to a nearby church meeting.

In light of this underinclusiveness, the Town has not met its burden to prove that its Sign Code is narrowly tailored to further a compelling government interest. Because a "'law cannot be regarded as protecting an interest of the highest order, and thus as justifying a restriction on truthful speech, when it leaves appreciable damage to that supposedly vital interest unprohibited,'" *Republican Party of Minn.* v. *White*, 536 U. S. 765, 780 (2002), the Sign Code fails strict scrutiny.

IV

Our decision today will not prevent governments from enacting effective sign laws. The Town asserts that an "'absolutist'" content-neutrality rule would render "virtually all distinctions in sign laws . . . subject to strict scrutiny," Brief for Respondents 34–35, but that is not the case. Not "all distinctions" are subject to strict scrutiny, only *content-based* ones are. Laws that are *content neutral* are instead subject to lesser scrutiny. See *Clark*, 468 U. S., at 295.

The Town has ample content-neutral options available to resolve problems with safety and aesthetics. For example, its current Code regulates many aspects of signs that have nothing to do with a sign's message: size, building materials, lighting, moving parts, and portability. See, *e.g.,* §4.402(R). And on public property, the Town may go a long way toward entirely forbidding the posting of signs, so long as it does so in an evenhanded, content-neutral manner. See *Taxpayers for Vincent*, 466 U. S., at 817 (upholding content-neutral ban against posting signs on public property). Indeed, some lower courts have long held that similar content-based sign laws receive strict scrutiny, but there is no evidence that towns in those jurisdictions have suffered catastrophic effects. See, *e.g., Solantic, LLC* v. *Neptune Beach*, 410 F. 3d 1250, 1264–1269 (CA11 2005) (sign categories similar to the town of Gilbert's were content based and subject to strict scrutiny); *Matthews* v. *Needham*, 764 F. 2d 58, 59–60 (CA1 1985) (law banning political signs but not commercial signs was content based and subject to strict scrutiny).

We acknowledge that a city might reasonably view the general regulation of signs as necessary because signs "take up space and may obstruct views, distract motorists, displace alternative uses for land, and pose other problems that legitimately call for regulation." *City of Ladue*, 512 U. S., at 48. At the same time, the presence of certain signs may be essential, both for vehicles and pedestrians, to guide traffic or to identify hazards and ensure safety. A sign ordinance narrowly tailored to the challenges of protecting the safety of pedestrians, drivers, and passengers—such as warning signs marking hazards on private property, signs directing traffic, or street numbers associated with private houses—well might survive strict scrutiny. The signs at issue in this case, including political and ideological signs and signs for events, are far removed from those purposes. As discussed above, they are facially content based and are neither justified by traditional safety concerns nor narrowly tailored.

* * *

We reverse the judgment of the Court of Appeals and remand the case for proceedings consistent with this opinion.

It is so ordered.

SUPREME COURT OF THE UNITED STATES

No. 13–502

CLYDE REED, ET AL., PETITIONERS *v.* TOWN OF GILBERT, ARIZONA, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

[June 18, 2015]

JUSTICE ALITO, with whom JUSTICE KENNEDY and JUSTICE SOTOMAYOR join, concurring.

I join the opinion of the Court but add a few words of further explanation.

As the Court holds, what we have termed "content-based" laws must satisfy strict scrutiny. Content-based laws merit this protection because they present, albeit sometimes in a subtler form, the same dangers as laws that regulate speech based on viewpoint. Limiting speech based on its "topic" or "subject" favors those who do not want to disturb the status quo. Such regulations may interfere with democratic self-government and the search for truth. See *Consolidated Edison Co. of N. Y.* v. *Public Serv. Comm'n of N. Y.*, 447 U. S. 530, 537 (1980).

As the Court shows, the regulations at issue in this case are replete with content-based distinctions, and as a result they must satisfy strict scrutiny. This does not mean, however, that municipalities are powerless to enact and enforce reasonable sign regulations. I will not attempt to provide anything like a comprehensive list, but here are some rules that would not be content based:

Rules regulating the size of signs. These rules may distinguish among signs based on any content-neutral criteria, including any relevant criteria listed below.

Rules regulating the locations in which signs may be placed. These rules may distinguish between free-standing signs and those attached to buildings.

Rules distinguishing between lighted and unlighted signs.

Rules distinguishing between signs with fixed messages and electronic signs with messages that change.

Rules that distinguish between the placement of signs on private and public property.

Rules distinguishing between the placement of signs on commercial and residential property.

Rules distinguishing between on-premises and off-premises signs.

Rules restricting the total number of signs allowed per mile of roadway.

Rules imposing time restrictions on signs advertising a one-time event. Rules of this nature do not discriminate based on topic or subject and are akin to rules restricting the times within which oral speech or music is allowed.*

In addition to regulating signs put up by private actors, government entities may also erect their own signs consistent with the principles that allow governmental speech. See *Pleasant Grove City* v. *Summum*, 555 U. S. 460, 467–469 (2009). They may put up all manner of signs to promote safety, as well as directional signs and signs pointing out historic sites and scenic spots.

Properly understood, today's decision will not prevent cities from regulating signs in a way that fully protects public safety and serves legitimate esthetic objectives.

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*Of course, content-neutral restrictions on speech are not necessarily consistent with the First Amendment. Time, place, and manner restrictions "must be narrowly tailored to serve the government's legitimate, content-neutral interests." *Ward* v. *Rock Against Racism*, 491 U. S. 781, 798 (1989). But they need not meet the high standard imposed on viewpoint- and content-based restrictions.

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[June 18, 2015]

JUSTICE BREYER, concurring in the judgment.

I join JUSTICE KAGAN's separate opinion. Like JUSTICE KAGAN I believe that categories alone cannot satisfactorily resolve the legal problem before us. The First Amendment requires greater judicial sensitivity both to the Amendment's expressive objectives and to the public's legitimate need for regulation than a simple recitation of categories, such as "content discrimination" and "strict scrutiny," would permit. In my view, the category "content discrimination" is better considered in many contexts, including here, as a rule of thumb, rather than as an automatic "strict scrutiny" trigger, leading to almost certain legal condemnation.

To use content discrimination to trigger strict scrutiny sometimes makes perfect sense. There are cases in which the Court has found content discrimination an unconstitutional method for suppressing a viewpoint. *E.g., Rosenberger* v. *Rector and Visitors of Univ. of Va.*, 515 U. S. 819, 828–829 (1995); see also *Boos* v. *Barry*, 485 U. S. 312, 318–319 (1988) (plurality opinion) (applying strict scrutiny where the line between subject matter and viewpoint was not obvious). And there are cases where the Court has found content discrimination to reveal that rules governing a traditional public forum are, in fact, not a neutral way of fairly managing the forum in the interest of all speakers. *Police Dept. of Chicago* v. *Mosley*, 408 U. S. 92, 96 (1972) ("Once a forum is opened up to assembly or speaking by some groups, government may not prohibit others from assembling or speaking on the basis of what they intend to say"). In these types of cases, strict scrutiny is often appropriate, and content discrimination has thus served a useful purpose.

But content discrimination, while helping courts to identify unconstitutional suppression of expression, cannot and should not *always* trigger strict scrutiny. To say that it is not an automatic "strict scrutiny" trigger is not to argue against that concept's use. I readily concede, for example, that content discrimination, as a conceptual tool, can sometimes reveal weaknesses in the government's rationale for a rule that limits speech. If, for example, a city looks to litter prevention as the rationale for a prohibition against placing newsracks dispensing free advertisements on public property, why does it exempt other newsracks causing similar litter? Cf. *Cincinnati* v. *Discovery Network, Inc.*, 507 U. S. 410 (1993). I also concede that, whenever government disfavors one kind of speech, it places that speech at a disadvantage, potentially interfering with the free marketplace of ideas and with an individual's ability to express thoughts and ideas that can help that individual determine the kind of society in which he wishes to live, help shape that society, and help define his place within it.

Nonetheless, in these latter instances to use the presence of content discrimination automatically to trigger strict scrutiny and thereby call into play a strong presumption against constitutionality goes too far. That is because virtually all government activities involve speech, many of which involve the regulation of speech. Regulatory programs almost always require content discrimination. And to hold that such content discrimination triggers strict scrutiny is to write a recipe for judicial management of ordinary government regulatory activity.

Consider a few examples of speech regulated by government that inevitably involve content discrimination, but where a strong presumption against constitutionality has no place. Consider governmental regulation of securities, *e.g.,* 15 U. S. C. §78*l* (requirements for content that must be included in a registration statement); of energy conservation labeling-practices, *e.g.,* 42 U. S. C. §6294 (requirements for content that must be included on labels of certain consumer electronics); of prescription drugs, *e.g.,* 21 U. S. C. §353(b)(4)(A) (requiring a prescription drug label to bear the symbol "Rx only"); of doctor-patient confidentiality, *e.g.,* 38 U. S. C. §7332 (requiring confidentiality of certain medical records, but allowing a physician to disclose that the patient has HIV to the patient's spouse or sexual partner); of income tax statements, *e.g.,* 26 U. S. C. §6039F (requiring taxpayers to furnish information about foreign gifts received if the aggregate amount exceeds $10,000); of commercial airplane briefings, *e.g.,* 14 CFR §136.7 (2015) (requiring pilots to ensure that each passenger has been briefed on flight procedures, such as seatbelt fastening); of signs at petting zoos, *e.g.,* N. Y. Gen. Bus. Law Ann. §399–ff(3) (West Cum. Supp. 2015) (requiring petting zoos to post a sign at every exit "'strongly recommend[ing] that persons wash their hands upon exiting the petting zoo area'"); and so on.

Nor can the majority avoid the application of strict scrutiny to all sorts of justifiable governmental regulations by relying on this Court's many subcategories and exceptions to the rule. The Court has said, for example, that we should apply less strict standards to "commercial speech." *Central Hudson Gas & Elec. Corp.* v. *Public Service Comm'n of N. Y.*, 447 U. S. 557, 562–563 (1980). But I have great concern that many justifiable instances of "content-based" regulation are noncommercial. And, worse than that, the Court has applied the heightened "strict scrutiny" standard even in cases where the less stringent "commercial speech" standard was appropriate. See *Sorrell* v. *IMS Health Inc.*, 564 U. S. ___, ___ (2011) (BREYER, J., dissenting) (slip op., at ___). The Court has also said that "government speech" escapes First Amendment strictures. See *Rust* v. *Sullivan*, 500 U. S. 173, 193–194 (1991). But regulated speech is typically private speech, not government speech. Further, the Court has said that, "[w]hen the basis for the content discrimination consists entirely of the very reason the entire class of speech at issue is proscribable, no significant danger of idea or viewpoint discrimination exists." *R. A. V.* v. *St. Paul*, 505 U. S. 377, 388 (1992). But this exception accounts for only a few of the instances in which content discrimination is readily justifiable.

I recognize that the Court could escape the problem by watering down the force of the presumption against constitutionality that "strict scrutiny" normally carries with it. But, in my view, doing so will weaken the First Amendment's protection in instances where "strict scrutiny" should apply in full force.

The better approach is to generally treat content discrimination as a strong reason weighing against the constitutionality of a rule where a traditional public forum, or where viewpoint discrimination, is threatened, but elsewhere treat it as a rule of thumb, finding it a helpful, but not determinative legal tool, in an appropriate case, to determine the strength of a justification. I would use content discrimination as a supplement to a more basic analysis, which, tracking most of our First Amendment cases, asks whether the regulation at issue works harm to First Amendment interests that is disproportionate in light of the relevant regulatory objectives. Answering this question requires examining the seriousness of the harm to speech, the importance of the countervailing objectives, the extent to which the law will achieve those objectives, and whether there are other, less restrictive ways of doing so. See, *e.g., United States* v. *Alvarez*, 567 U. S. ___, ___–___ (2012) (BREYER, J., concurring in judgment) (slip op., at 1–3); *Nixon* v. *Shrink Missouri Government PAC*, 528 U. S. 377, 400–403 (2000) (BREYER, J., concurring). Admittedly, this approach does not have the simplicity of a mechanical use of categories. But it does permit the government to regulate speech in numerous instances where the voters have authorized the government to regulate and where courts should hesitate to substitute judicial judgment for that of administrators.

Here, regulation of signage along the roadside, for purposes of safety and beautification is at issue. There is no traditional public forum nor do I find any general effort to censor a particular viewpoint. Consequently, the specific regulation at issue does not warrant "strict scrutiny." Nonetheless, for the reasons that JUSTICE KAGAN sets forth, I believe that the Town of Gilbert's regulatory rules violate the First Amendment. I consequently concur in the Court's judgment only.

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[June 18, 2015]

JUSTICE KAGAN, with whom JUSTICE GINSBURG and JUSTICE BREYER join, concurring in the judgment.

Countless cities and towns across America have adopted ordinances regulating the posting of signs, while exempting certain categories of signs based on their subject matter. For example, some municipalities generally prohibit illuminated signs in residential neighborhoods, but lift that ban for signs that identify the address of a home or the name of its owner or occupant. See, *e.g.*, City of Truth or Consequences, N. M., Code of Ordinances, ch. 16, Art. XIII, §§11–13–2.3, 11–13–2.9(H)(4) (2014). In other municipalities, safety signs such as "Blind Pedestrian Crossing" and "Hidden Driveway" can be posted without a permit, even as other permanent signs require one. See, *e.g.*, Code of Athens-Clarke County, Ga., Pt. III, §7–4–7(1) (1993). Elsewhere, historic site markers—for example, "George Washington Slept Here"—are also exempt from general regulations. See, *e.g.*, Dover, Del., Code of Ordinances, Pt. II, App. B, Art. 5, §4.5(F) (2012). And similarly, the federal Highway Beautification Act limits signs along interstate highways unless, for instance, they direct travelers to "scenic and historical attractions" or advertise free coffee. See 23 U. S. C. §§131(b), (c)(1), (c)(5).

Given the Court's analysis, many sign ordinances of that kind are now in jeopardy. See *ante*, at 14 (acknowledging that "entirely reasonable" sign laws "will sometimes be struck down" under its approach (internal quotation marks omitted)). Says the majority: When laws "single[] out specific subject matter," they are "facially content based"; and when they are facially content based, they are automatically subject to strict scrutiny. *Ante*, at 12, 16–17. And although the majority holds out hope that some sign laws with subject-matter exemptions "might survive" that stringent review, *ante*, at 17, the likelihood is that most will be struck down. After all, it is the "rare case[] in which a speech restriction withstands strict scrutiny." *Williams-Yulee* v. *Florida Bar*, 575 U. S. ___, ___ (2015) (slip op., at 9). To clear that high bar, the government must show that a content-based distinction "is necessary to serve a compelling state interest and is narrowly drawn to achieve that end." *Arkansas Writers' Project, Inc.* v. *Ragland*, 481 U. S. 221, 231 (1987). So on the majority's view, courts would have to determine that a town has a compelling interest in informing passersby where George Washington slept. And likewise, courts would have to find that a town has no other way to prevent hidden-driveway mishaps than by specially treating hidden-driveway signs. (Well-placed speed bumps? Lower speed limits? Or how about just a ban on hidden driveways?) The consequence—unless courts water down strict scrutiny to something unrecognizable—is that our communities will find themselves in an unenviable bind: They will have to either repeal the exemptions that allow for helpful signs on streets and sidewalks, or else lift their sign restrictions altogether and resign themselves to the resulting clutter.*

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*Even in trying (commendably) to limit today's decision, JUSTICE ALITO's concurrence highlights its far-reaching effects. According to JUSTICE ALITO, the majority does not subject to strict scrutiny regulations of "signs advertising a one-time event." *Ante*, at 2 (ALITO, J., concurring). But of course it does. On the majority's view, a law with an exception for such signs "singles out specific subject matter for

Although the majority insists that applying strict scrutiny to all such ordinances is "essential" to protecting First Amendment freedoms, *ante*, at 14, I find it challenging to understand why that is so. This Court's decisions articulate two important and related reasons for subjecting content-based speech regulations to the most exacting standard of review. The first is "to preserve an uninhibited marketplace of ideas in which truth will ultimately prevail." *McCullen* v. *Coakley*, 573 U. S. ___, ___–___ (2014) (slip op., at 8–9) (internal quotation marks omitted). The second is to ensure that the government has not regulated speech "based on hostility—or favoritism—towards the underlying message expressed." *R. A. V.* v. *St. Paul*, 505 U. S. 377, 386 (1992). Yet the subject-matter exemptions included in many sign ordinances do not implicate those concerns. Allowing residents, say, to install a light bulb over "name and address" signs but no others does not distort the marketplace of ideas. Nor does that different treatment give rise to an inference of impermissible government motive.

We apply strict scrutiny to facially content-based regulations of speech, in keeping with the rationales just described, when there is any "realistic possibility that official suppression of ideas is afoot." *Davenport* v. *Washington Ed. Assn.*, 551 U. S. 177, 189 (2007) (quoting *R. A. V.*, 505 U. S., at 390). That is always the case when the regulation facially differentiates on the basis of viewpoint. See *Rosenberger* v. *Rector and Visitors of Univ. of Va.*, 515 U. S. 819, 829 (1995). It is also the case (except in non-public or limited public forums) when a law restricts "discussion of an entire topic" in public debate. *Consolidated*

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differential treatment" and "defin[es] regulated speech by particular subject matter." *Ante*, at 6, 12 (majority opinion). Indeed, the precise reason the majority applies strict scrutiny here is that "the Code singles out signs bearing a particular message: the time and location of a specific event." *Ante*, at 14.

Edison Co. of N. Y. v. *Public Serv. Comm'n of N. Y.*, 447 U. S. 530, 537, 539–540 (1980) (invalidating a limitation on speech about nuclear power). We have stated that "[i]f the marketplace of ideas is to remain free and open, governments must not be allowed to choose 'which issues are worth discussing or debating.'" *Id.*, at 537–538 (quoting *Police Dept. of Chicago* v. *Mosley*, 408 U. S. 92, 96 (1972)). And we have recognized that such subject-matter restrictions, even though viewpoint-neutral on their face, may "suggest[] an attempt to give one side of a debatable public question an advantage in expressing its views to the people." *First Nat. Bank of Boston* v. *Bellotti*, 435 U. S. 765, 785 (1978); accord, *ante*, at 1 (ALITO, J., concurring) (limiting all speech on one topic "favors those who do not want to disturb the status quo"). Subject-matter regulation, in other words, may have the intent or effect of favoring some ideas over others. When that is realistically possible—when the restriction "raises the specter that the Government may effectively drive certain ideas or viewpoints from the marketplace"—we insist that the law pass the most demanding constitutional test. *R. A. V.*, 505 U. S., at 387 (quoting *Simon & Schuster, Inc.* v. *Members of N. Y. State Crime Victims Bd.*, 502 U. S. 105, 116 (1991)).

But when that is not realistically possible, we may do well to relax our guard so that "entirely reasonable" laws imperiled by strict scrutiny can survive. *Ante*, at 14. This point is by no means new. Our concern with content-based regulation arises from the fear that the government will skew the public's debate of ideas—so when "that risk is inconsequential, . . . strict scrutiny is unwarranted." *Davenport*, 551 U. S., at 188; see *R. A. V.*, 505 U. S., at 388 (approving certain content-based distinctions when there is "no significant danger of idea or viewpoint discrimination"). To do its intended work, of course, the category of content-based regulation triggering strict scrutiny must sweep more broadly than the actual harm; that category exists to create a buffer zone guaranteeing that the government cannot favor or disfavor certain viewpoints. But that buffer zone need not extend forever. We can administer our content-regulation doctrine with a dose of common sense, so as to leave standing laws that in no way implicate its intended function.

And indeed we have done just that: Our cases have been far less rigid than the majority admits in applying strict scrutiny to facially content-based laws—including in cases just like this one. See *Davenport*, 551 U. S., at 188 (noting that "we have identified numerous situations in which [the] risk" attached to content-based laws is "attenuated"). In *Members of City Council of Los Angeles* v. *Taxpayers for Vincent*, 466 U. S. 789 (1984), the Court declined to apply strict scrutiny to a municipal ordinance that exempted address numbers and markers commemorating "historical, cultural, or artistic event[s]" from a generally applicable limit on sidewalk signs. *Id.*, at 792, n. 1 (listing exemptions); see *id.*, at 804–810 (upholding ordinance under intermediate scrutiny). After all, we explained, the law's enactment and enforcement revealed "not even a hint of bias or censorship." *Id.*, at 804; see also *Renton* v. *Playtime Theatres, Inc.*, 475 U. S. 41, 48 (1986) (applying intermediate scrutiny to a zoning law that facially distinguished among movie theaters based on content because it was "designed to prevent crime, protect the city's retail trade, [and] maintain property values . . . , not to suppress the expression of unpopular views"). And another decision involving a similar law provides an alternative model. In *City of Ladue* v. *Gilleo*, 512 U. S. 43 (1994), the Court assumed *arguendo* that a sign ordinance's exceptions for address signs, safety signs, and for-sale signs in residential areas did not trigger strict scrutiny. See *id.*, at 46–47, and n. 6 (listing exemptions); *id.*, at 53 (noting this assumption). We did not need to, and so did not, decide the level-of-scrutiny question because the law's breadth made it unconstitutional under any standard.

The majority could easily have taken *Ladue*'s tack here. The Town of Gilbert's defense of its sign ordinance—most notably, the law's distinctions between directional signs and others—does not pass strict scrutiny, or intermediate scrutiny, or even the laugh test. See *ante*, at 14–15 (discussing those distinctions). The Town, for example, provides no reason at all for prohibiting more than four directional signs on a property while placing no limits on the number of other types of signs. See Gilbert, Ariz., Land Development Code, ch. I, §§4.402(J), (P)(2) (2014). Similarly, the Town offers no coherent justification for restricting the size of directional signs to 6 square feet while allowing other signs to reach 20 square feet. See §§4.402(J), (P)(1). The best the Town could come up with at oral argument was that directional signs "need to be smaller because they need to guide travelers along a route." Tr. of Oral Arg. 40. Why exactly a smaller sign better helps travelers get to where they are going is left a mystery. The absence of any sensible basis for these and other distinctions dooms the Town's ordinance under even the intermediate scrutiny that the Court typically applies to "time, place, or manner" speech regulations. Accordingly, there is no need to decide in this case whether strict scrutiny applies to every sign ordinance in every town across this country containing a subject-matter exemption.

I suspect this Court and others will regret the majority's insistence today on answering that question in the affirmative. As the years go by, courts will discover that thousands of towns have such ordinances, many of them "entirely reasonable." *Ante*, at 14. And as the challenges to them mount, courts will have to invalidate one after the other. (This Court may soon find itself a veritable Supreme Board of Sign Review.) And courts will strike down those democratically enacted local laws even though no one—certainly not the majority—has ever explained why the vindication of First Amendment values requires that result. Because I see no reason why such an easy case calls for us to cast a constitutional pall on reasonable regulations quite unlike the law before us, I concur only in the judgment.

UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF MICHIGAN

In re:	Case No. GG 15-00643-jtg (Jointly Administered)
FAMILY CHRISTIAN, LLC, *et al.*,[1]	Chapter 11
Debtors.	Hon. John T. Gregg
_______________________________/	

MEMORANDUM DECISION REGARDING MOTION TO SELL SUBSTANTIALLY ALL ASSETS OF DEBTORS

COUNSEL

APPEARING: Erich Durlacher and Brad A. Baldwin, BURR & FORMAN, LLP, Atlanta, Georgia and A. Todd Almassian and Gregory J. Ekdahl, KELLER & ALMASSIAN, PLC, Grand Rapids, Michigan for the Debtors. Robert S. Hertzberg and Deborah Kovsky-Apap, PEPPER HAMILTON, Southfield, Michigan for Hilco/Gordon Brothers Joint Venture. Michael G. Menkowitz, FOX ROTHSCHILD LLP, Philadelphia, Pennsylvania, Paul J. Labov, FOX ROTHSCHILD LLP, New York, New York and John T. Piggins, MILLER JOHNSON, Grand Rapids, Michigan for the Official Committee of Unsecured Creditors. Jennifer C. Hagle and Gabriel R. Macconaill, SIDLEY AUSTIN, LLP, Los Angeles, California and Scott H. Hogan, FOSTER SWIFT COLLINS & SMITH, PC, Grand Rapids, Michigan for Credit Suisse AG, Cayman Islands Branch. Allison Bach, DICKINSON WRIGHT, PLLC, Detroit, Michigan for the Ad Hoc Consortium of Consignment Vendors. Steven L. Rayman, RAYMAN & KNIGHT, Kalamazoo, Michigan, Scott B. Lepene, THOMPSON HINE, LLP, Cleveland, Ohio and John F. Isbell, THOMPSON HINE, LLP, Atlanta, Georgia for FC Special Funding. Todd C. Meyers and Paul M. Rosenblatt, KILPATRICK TOWNSEND & STOCKTON, LLP, Atlanta, Georgia and Ronald A. Schuknecht, SMITH HAUGHEY RICE & ROEGGE PC, Traverse City, Michigan. Gordon J. Toering, WARNER NORCROSS & JUDD, LLP, Grand Rapids, Michigan for Infor (US), Inc. Thomas J. Salerno, STINSON LEONARD STREET, LLP, Phoenix, Arizona for Bridgestone Media. Marc M. Bakst, BODMAN, PLC, Detroit, Michigan for Provident Distribution, LLC. Ronald A. Clifford, BLAKELEY, LLP, Irvine, California for several consignment vendors. Michael V. Maggio and Michelle M. Wilson, OFFICE OF THE UNITED STATES TRUSTEE, Grand Rapids, Michigan for the United States Trustee. Robert F. Wardrop, II and Denise D. Twinney, WARDROP & WARDROP, PC, Grand Rapids, Michigan for Cole Mt. Clarksville, Indiana, LLC, Cole Mt. Canton Marketplace, LLC, Los Banos Gravel Company,

[1] The Debtors are Family Christian, LLC (Case No. 15-00643-jtg), Family Christian Holding, LLC (Case No. 15-00642-jtg), and FCS Giftco, LLC (Case No. 15-00644-jtg).

Whitehall Crossing A, LLC, and GE Fleet Services. David L. Pollack, BALLARD SPAHR, LLP, Philadelphia, Pennsylvania for Brixmor Property Group. Dustin P. Branch, KATTEN MUCHIN ROSENMAN, LLP, Los Angeles, California for GEM Realty Capital, Inc., Starwood Retail Partners, LLC, Prudential Insurance Company of America, and Acadia Realty Trust. Ronald E. Gold, FROST BROWN TODD, LLC, Cincinnati, Ohio for WP Glimcher and Belwether Enterprises. Paul S. Magy, CLARK HILL, PLC, Birmingham, Michigan for several landlords. David Mollicone, DAWDA MANN MULCAHY & SADLER, PLC, Bloomfield Hills, Michigan for RPAI Southwest Management LLC and RPAI US Management LLC. Eric Novetsky, JAFFEE RAITT HEUER & WEISS, PC, Southfield, Michigan for World Vision USA, IA South Frisco Village, LLC, IA Fultondale Promenade, LLC, MB Sioux City Lakeport, LLC, Greenville (Woodruff) WMB, LLC, and Inland Orland Lagrange Rd. Outlot, LLC. Lisa A. Hall, PLUNKETT COONEY, Grand Rapids, Michigan for DDR Corp., Regency Centers, LP, Rouse Properties, Slawson Companies, and Weingarten Realty. Elisabeth M. Von Eitzen, WARNER NORCROSS & JUDD LLP, Grand Rapids, Michigan for MAG Jewelry Company, Inc.

This matter comes before the court in connection with a motion to sell substantially all of the Debtors' assets and assume and assign certain executory contracts and unexpired leases pursuant to sections 363 and 365 of the Bankruptcy Code [Dkt. No. 487] (the "Sale Motion"), filed by Family Christian, LLC (the "Operating Debtor"), Family Christian Holding, LLC and FCS Giftco, LLC (collectively, the "Debtors").[2] For the following reasons, the court shall deny the Sale Motion.[3]

INTRODUCTION

The sale process in these cases has been prolonged, controversial and contested. The Debtors' proposed sale to the winning bidder, an indisputable insider, is subject to objection by

2 The Operating Debtor is wholly owned by Family Christian Holding, LLC, which in turn is wholly owned by a non-debtor parent company, Family Christian Resource Centers, Inc. (the "Non-Debtor Parent"). FCS Giftco, LLC is a non-operational entity wholly owned by the Operating Debtor. The Non-Debtor Parent, which ultimately owns the Debtors, is controlled by Richard Jackson, a businessman from Atlanta, Georgia.

3 The findings of fact are based upon the testimony of the witnesses, the exhibits admitted into evidence, and judicial notice of background evidence on the docket. Fed. R. Evid. 201. The following constitutes this court's findings of fact and conclusions of law pursuant to Fed. R. Bankr. P. 7052. Because the court has prepared this Memorandum Decision on an expedited basis with the interests of the Debtors, their creditors, and thousands of employees in mind, the court respectfully requests that any typographical errors be received without harsh criticism.

the second highest bidder, a national liquidation firm whose participation the Debtors solicited in order to maximize the value to their estates. The second highest bidder alleges that the sale process was "rigged" for the benefit of the winning bidder and insider. After two days of robust bidding, the second highest bidder, for a second time, refused to continue to participate in the auction. The second highest bidder demanded that the Debtors inform it of the value allocated to the going concern nature of the bid submitted by the winning bidder. Because the Debtors declined to ascribe such a value, the second highest bidder contends that the auction was flawed. The second highest bidder also objects to the structure of the proposed sale to the winning bidder.

The sale is also opposed by one of the Debtors' creditors who allegedly sold goods to the Debtors on consignment. According to the consignment vendor, the structure of the proposed sale violates two fundamental tenets of the Bankruptcy Code, equality of distribution among similarly situated creditors, and the prohibition on the release of insider claims outside the context of a plan.

The Debtors' selection of the insider as the winning bidder is, importantly, supported by the Official Committee of Unsecured Creditors, the Debtors' two secured lenders, an ad hoc committee of consignment vendors holding approximately $14 million in consignment claims, and numerous other parties who desire the Debtors' business to continue as a going concern.

JURISDICTION

The court has jurisdiction pursuant to 28 U.S.C. § 1334(b). This is a core proceeding under 28 U.S.C. § 157(b)(2)(N).

BACKGROUND

The Debtors sell religious merchandise such as books, music, movies and other supplies at more than 250 brick and mortar retail stores located throughout 36 states. As of the petition date, the Debtors maintained a labor force of approximately 3,100 employees. The Debtors operate as non-profit organizations whose collective mission is to donate their profits to the Non-Debtor Parent for charitable purposes such as disseminating bibles, supporting orphans and others in need, funding mission trips, and orchestrating natural disaster relief efforts.

A. The Debtors' Prepetition Lending Relationships

In 2012, the Debtors obtained a revolving line of credit up to the maximum principal amount of $40 million from JPMorgan Chase Bank, N.A. ("JP Morgan Chase"), as agent for a syndication of lenders. As security for the line of credit, the Operating Debtor granted to JP Morgan Chase an alleged first priority security interest in certain of its assets, including accounts receivable, inventory and cash collateral, and a subordinated security interest on the majority, if not all, of its remaining assets. At that time, the Debtors also received a term loan in the principal amount of $38 million from certain third party lenders (the "Term Lenders") for whom Credit Suisse AG, Cayman Islands Branch ("Credit Suisse") acts as agent. As security for repayment of the term loan, the Debtors granted to Credit Suisse an alleged first priority security interest in those assets in which JP Morgan Chase allegedly held a subordinated security interest, and a subordinated security interest in those assets subject to the alleged first priority security interest of JP Morgan Chase.

The Debtors apparently began to suffer financial distress in 2014, if not before, and were at risk of JP Morgan Chase terminating the line of credit. In order to allow for continued borrowing under the revolving line of credit, Richard Jackson, through his entity Jackson Investment Group, LLC, allegedly paid $7 million to JP Morgan Chase to avoid, or perhaps cure, an event of default. Thereafter, FC Special Funding, LLC ("FC Special Funding"), a special purpose entity under the control of Commenda Capital, LLC ("Commenda"), was created for the purpose of purchasing JP

Morgan Chase's position.[4] In exchange for payment of all indebtedness owed by the Debtors to JP Morgan Chase, FC Special Funding was assigned any and all rights under the revolving line of credit loan documents, after which FC Special Funding began advancing funds to the Operating Debtor.

B. The Debtors' Bankruptcy Filings

On February 11, 2015, the Debtors each filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. As of the petition date, the Debtors estimated that they owed approximately \$24 million to FC Special Funding on the revolver, approximately \$34 million to the Term Lenders, and at least another \$40 million to trade creditors.

Concurrently with their petitions, the Debtors filed various motions, including a motion for the use of cash collateral on an expedited and interim basis.[5] At the first day hearings, the parties presented a modified agreement for the use of cash collateral. The court, however, declined to approve certain adequate protection proposed for the benefit of FC Special Funding, including, among other things, a waiver of surcharge under section 506(c), without first hearing testimony. The court's decision was driven, in large part, by the failure of the Debtors to disclose their relationships with FC Special Funding and FCS Acquisition, LLC ("Acquisition") in their first day

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4 Commenda has been referred to as a merchant bank. FC Special Funding is a subsidiary of Commenda. Richard Jackson is the sole participant in the loans made by FC Special Funding to the Debtors.

5 Conspicuously absent from the first day motions filed by the Debtors was any express disclosure regarding the relationship among the Debtors, Richard Jackson, and FC Special Funding. At the first day hearings, the Debtors advised the court and parties in attendance of the relationships by and among the Debtors, FC Special Funding, Richard Jackson, and FCS Acquisition, LLC, an entity created by Richard Jackson for the purpose of purchasing the Debtors' assets. (First Day Hearing Tr. at p. 58-59 [Dkt. No. 164].) The Debtors' disclosure cannot be construed as entirely voluntary. Rather, the disclosure was made only after the United States Trustee persisted in exploring such relationships. Upon learning of these connections for the first time at the hearings, the United States Trustee proclaimed that Richard Jackson is wearing "three hats." (*Id.* at p. 71.) Not surprisingly, Credit Suisse and numerous other parties expressed frustration, if not anger, with this lack of candor.

pleadings.[6] In lieu of testimony, the parties again reformulated the interim cash collateral arrangement, which the court ultimately approved on the record [Dkt. No. 114].[7]

C. The Initial Sale Motion

One day after filing for bankruptcy, the Debtors filed a motion seeking to sell substantially all of their assets [Dkt. No. 30] to Acquisition, which was identified as a "stalking horse" bidder in the sale motion and related bidding procedures. The initial sale motion proposed to sell all of the Debtors' assets, including inventory allegedly sold on consignment to the Debtors by various vendors. In response to the initial sale motion, an ad hoc committee of consignment vendors (the "Ad Hoc Consortium") commenced an adversary proceeding in which they contested the Debtors' ability to sell goods provided to the Debtors on consignment.[8] Numerous creditors and other parties in interest, including the Ad Hoc Consortium, also objected to the proposed sale, because, among other things, the assets had not been properly marketed and the sale was to an insider. The Debtors eventually voluntarily withdrew their sale motion on March 16, 2015 [Dkt. No. 358].

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6 The court was particularly concerned because the Official Committee of Unsecured Creditors (the "Committee") had yet to be formed. While the Debtors were only seeking to use cash collateral and grant adequate protection on an interim basis, the court believed that oversight from the Committee, even as to interim use, was required given the insider nature of the relationships. On February 23, 2015, the United States Trustee appointed the Committee [Dkt. No. 158].

7 Since the tumultuous beginning to their cases, the Debtors have diligently pursued consensual resolutions and compromises with various constituencies and stakeholders. On multiple occasions, the Committee, the United States Trustee, the Ad Hoc Consortium and the Lenders have remarked that the Debtors have been transparent and extremely forthcoming with information. The efforts of all parties to date have been impressive.

8 *United Methodist Publishing House Inc. v. Family Christian, LLC*, Adv. Pro. No. 15-80062 (Bankr. W.D. Mich.). Since the initial filing of the adversary proceeding, several other consignment vendors have been permitted to intervene as plaintiffs [Adv. Dkt. Nos. 23, 53, 54]. Credit Suisse and FC Special Funding were also permitted to intervene as defendants to protect their alleged security interests in the consigned goods [Adv. Dkt. Nos. 51, 52]. The Committee, however, was not permitted to intervene. *United Methodist Publishing House Inc. v. Family Christian, LLC (In re Family Christian, LLC)*, 530 B.R. 417 (Bankr. W.D. Mich. 2015).

D. The Second Sale Motion and Bidding Procedures

Several weeks after the initial sale motion was withdrawn, the Debtors filed the Sale Motion. The Sale Motion requests authority to sell substantially all of the Debtors' assets free and clear of any liens, claims, interests and other encumbrances. The Sale Motion does not propose to sell the assets to Acquisition or any other stalking horse bidder; rather, as the Debtors explained in the Sale Motion and at various hearings before this court, the Debtors intended to expeditiously and aggressively market their assets through their investment banker, Brookwood Associates, LLC ("Brookwood") in order to identify potential bidders. Although the bidding procedures portion of the Sale Motion drew numerous objections, the Debtors diligently worked to resolve these objections. The court was ultimately presented with a consensual order establishing certain procedures, deadlines and rights in connection with the bidding and auction process, which the court entered on April 16, 2015 [Dkt. No. 597] (the "Bidding Procedures Order").[9]

The bidding procedures, which are incorporated into the Bidding Procedures Order, provide, among other things, the following:

- Potential bidders must disclose the true identity of the party submitting the bid, submit satisfactory evidence of financial ability to close, and demonstrate an ability to pay cure costs associated with assumption of leases or executory contracts in order to become a qualified bidder.
- In valuing "qualified bids," the Debtors, in consultation with the Consultation Parties (as defined below), may consider factors such as: (a) the purported amount of the bid, including its impact on all constituencies, any benefit to the Debtors' estates from assumption of liabilities or waiver of liabilities, and an analysis of non-cash consideration; (b) the value to be provided by the bid, including the net economic effect on the Debtors' estates; (c) contingencies with respect to the sale and ability to close the sale without delay, and any incremental costs to the Debtors resulting from

[9] The court amended and/or clarified the Bidding Procedures Order on three separate occasions [Dkt. Nos. 749, 764, 800].

delays in closing; (d) the ability to obtain necessary antitrust approvals for the proposed transaction; and (e) any other relevant factors.

- The Debtors reserve the right, in consultation with the Consultation Parties, to impose additional terms and conditions on "qualified bidders," provided such terms are not materially inconsistent with the bidding procedures or Bidding Procedures Order.

- The Debtors, after consultation with the Consultation Parties, shall determine what they believe to be the highest and best "qualified bid" as a "baseline bid" that will serve as a starting point for the auction.

- Professionals and representatives of the Consultation Parties, certain consignment vendors, and the United States Trustee (the "UST") will be permitted to attend and observe the auction.

- The Debtors may adopt rules for the auction, in consultation with the Consultation Parties, that they believe promote the goals of the bidding process and are not inconsistent with the bidding procedures, including auctioning of a subset of the Debtors' assets.

- The Debtors, in consultation with the Consultation Parties, are permitted, but not required, to ascribe a liquidation value to certain assets to assist in bid comparison, but may decline to do so if such value would be overly speculative.

- The Debtors reserve the right, in consultation with the Consultation Parties, to reject any bid that in their judgment is inadequate or insufficient, not in conformity with the Bankruptcy Code or the bidding procedures, or contrary to the best interests of the Debtors' estates.

- Prior to the conclusion of the auction, the Debtors, in consultation with the Consultation Parties, will review and evaluate each bid made at the auction on the basis of its financial and contractual terms and other factors including those affecting the speed and certainty of the consummation of the sale, designate a highest and best bid and next highest bid, and present those bids at the sale hearing.

- No additional bids may be submitted or considered after the auction unless the court orders otherwise.

The bidding procedures also designated the following persons as representatives of the Debtors at the auction: (i) Chuck Bengochea, the Debtors' Chief Executive Officer, (ii) Amy Forrestal of Brookwood, and (iii) Gary Murphey of Resurgence Financial Services, LLC

("Resurgence"), a financial advisor employed by the Debtors in these cases (collectively, the "Auction Team"). Importantly, the bidding procedures required the Debtors to consult with FC Special Funding, Credit Suisse, and the Committee (collectively, the "Consultation Parties") in order to establish procedures for the auction and to evaluate bids both prior to and during the auction. Upon request of the UST and the Ad Hoc Consortium, the Debtors agreed to permit them to attend the auction solely for purposes of monitoring the sale process and ensuring its fairness.

In sum, the bidding procedures establish certain rigid requirements while also granting the Debtors and the Consultation Parties some flexibility and discretion to ensure that the auction yields maximum value for the Debtors' estates.[10]

E. The "Qualified Bidders"

The Debtors, after conferring with the Consultation Parties, identified the following "qualified bidders" as required by the Bidding Procedures Order: (i) Yellen, (ii) a joint venture between Gordon Brothers Retail Partners, LLC and Hilco Merchant Resources, LLC ("GBH"), (iii) Great American Group, LLC ("Great American"), (iv) Acquisition, (v) Credit Suisse, and (vi) FC Special Funding.[11] Acquisition proposed to purchase the Debtors' business as a going concern, while GBH, Great American and Yellen were all seeking to liquidate the Debtors' assets.

In accordance with the bidding procedures, all qualified bidders were required to submit to the Debtors and the Consultation Parties an agreement stating the terms of the proposed

[10] With that in mind, the Debtors exercised their discretion when they agreed, but only after conferring with the Consultation Parties, to extend the bid deadline to permit Yellen Partners, LLC ("Yellen") to become a qualified bidder. As another example of the Debtors' attempts to create a fair auction process, the Debtors also agreed to extend the deadline by which to declare a baseline bid so as to allow Credit Suisse to evaluate the decision of the Debtors after input from the other Consultation Parties.

[11] FC Special Funding and Credit Suisse were permitted to credit bid the amount of their debt. *See* 11 U.S.C. § 363(k); *see also generally* Paul R. Hage, *et al*., Credit Bidding in Bankruptcy Sales – A Guide for Lenders, Creditors, and Distressed Debt Investors (Am. Bankr. Inst. 2015). Although the Committee initially objected to the ability of Credit Suisse to credit bid, the parties resolved the issue at a hearing before this court on May 15, 2015.

transaction. Acquisition submitted an asset purchase agreement which included a purchase price consisting of cash and the assumption of certain liabilities (the "Acquisition APA"). In the Acquisition APA, Acquisition committed to payment in full of all administrative expenses.[12] In addition, Acquisition proposed a means by which to resolve the claims of the Ad Hoc Consortium, as well as other consignment vendors, without the need for further litigation.

GBH, Great American and Yellen also submitted agreements as required by the bidding procedures. These agreements are not asset purchase agreements in the traditional sense. Rather, they are agency agreements whereby GBH, Great American, and Yellen proposed to act as the agent of the Debtors for purposes of liquidating a majority of the Debtors' assets. By their very nature, the agency agreements rely on a complex series of formulas and contingencies to arrive at an estimated amount of value for the Debtors' estates. The projected value to the Debtors' estates is never a sum certain, however. Instead, the agreements place a significant level of risk on the Debtors and their estates with respect to the sale of assets over a condensed period of time. As expert testimony during the sale hearing revealed, the estimated or projected value to the Debtors' estates under these agreements might significantly increase. As noted by the Debtors and other parties throughout this process, and conceded by that same expert, the estimated value could also significantly decrease. It can be fairly said that the agreements are not designed to provide a concrete minimum value to the Debtors and their estates. To do so would shift a significant portion of the risk from the liquidator to the Debtors' estates, which is seemingly exactly what these agreements are designed to avoid.[13]

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[12] On several occasions, this court has advised the parties that it is extremely concerned with the prospect of administratively insolvent estates.

[13] The court's observations in this regard should not be viewed as a criticism of liquidators or the structure of their preferred agreements, which are designed to provide protection given the short time frames in which liquidators are asked to submit bids for assets. To the contrary, these agreements are necessary to ensure that liquidators avoid losses from transactions offering limited recourse against bankruptcy estates.

F. The Auction (Day 1)

As detailed below, the auction process was, at times, nothing short of chaotic. The Debtors commenced the auction on May 21, 2015, with the Acquisition bid having been designated as the "baseline bid." The transcript of the auction [Dkt. No. 802], which this court has read and reread, reveals that the auction began with extensive discussion among the Debtors and the Consultation Parties regarding the initial bid valuations and the auction procedures.[14] With input from the Consultation Parties, the Debtors prepared initial valuation analyses in a spreadsheet format. These analyses were shared with all of the bidders, as well as the other parties in attendance.

The initial hours of the auction were, unfortunately, a sign of things to come. After one round of bidding, the Debtors declared the bid submitted by Yellen to be the "highest." However, GBH and Great American questioned such designation. As reflected in the transcript of the auction, GBH and Great American expressed displeasure with the Debtors' failure to designate a "highest and best" bid from the first round. In order to address these concerns, the Debtors engaged in a lengthy discussion with the Consultation Parties for approximately one hour. Ultimately, the Debtors reiterated that they believed Yellen to be the winning bidder in round one, with a bid valued at approximately $40.3 million.[15]

The second round commenced with a bid from GBH. GBH did not increase its bid by utilizing a cash component though. Instead, GBH made adjustments to its prior bid by reworking certain line items that were projected to yield proceeds to the Debtors' estates, albeit in contingent and uncertain amounts. The Debtors dutifully engaged in a discussion on the record with the

[14] The court has attempted to decipher the auction transcript, which is fairly disjointed in places due to numerous off the record discussions. As such, the court recognizes that its summary of the auction is also likely somewhat disjointed.

[15] It should be noted that the Debtors also incorporated the suggestions of Credit Suisse to capture the value of funds that would remain in the Debtors' estates as contemplated by both the Yellen bid and the GBH bid.

representatives of GBH regarding expenses related to occupancy as reflected in the agency agreement submitted by GBH. After analyzing the increase in value to the GBH bid on the record, the Debtors turned to Great American.

Great American submitted a bid intended to top GBH's bid by slightly more than the required bid increment of $100,000. Like the revised GBH bid, the revised Great American bid was not based on a cash adjustment. Instead, like GBH, Great American reworked the formulas in its agency agreement to increase value, albeit on a contingent basis. GBH objected to the calculation of Great American's revised bid because it was unclear how the revised bid would affect the "guaranty percentage" and "cost factor threshold" as set forth in the Great American agency agreement.

As a byproduct of this objection, the Debtors, in the presence of the Consultation Parties and the other bidders, discussed with GBH the speculative nature of the liquidation bids.[16] The Debtors emphasized that because the liquidation bids were wholly contingent on estimated inventory levels and other complex formulaic adjustments, the Debtors were concerned with the level of risk that would be placed on the Debtors and their estates under the agency agreements. As such, the Debtors expressed concern with the lack of a minimum value to the Debtors' estates under all three agency agreements, and to some extent the Acquisition APA.

Eventually, the discrepancies with the Great American bid were resolved. Yellen then submitted a further revised bid. Notwithstanding the earlier discussion between GBH and the

[16] At one point, GBH, in response to the Debtors' concerns, commented that "I don't think anyone at the end of the day is guaranteeing you that you are going to get $41 million. They are putting in guaranteed percentages and changing things that they will pay for or not pay for based on how you evaluate the bid. I don't think anyone is going to say you are going to get this dollar amount." In response, the Debtors stressed "[t]hat is what makes all the bids very speculative." (Auction Day One Tr. at pp. 44-45 [Dkt. No. 802-1].)

Debtors to which Yellen was privy, Yellen declined to provide any assurance of a minimum value for the Debtors' estates. Instead, Yellen increased its bid by adjusting percentages.

After the Yellen bid, Acquisition offered $40 million in value to the Debtors' estates. The revised bid promised that the Debtors' estates would receive value equivalent to no less than $40 million, regardless of any contingencies that had initially been included in the Acquisition APA. Acquisition's decision to include a minimum floor can be characterized, at least based on the transcript, as an attempt to eliminate contingencies in reaction to the Debtors' concerns regarding risk to their estates. After conferring with the Consultation Parties, the Debtors selected the Acquisition bid of $40 million as the highest and best bid in the second round. Although Credit Suisse objected, the Committee, FC Special Funding and the Ad Hoc Consortium supported the Debtors' decision.

At this point during the auction, the Debtors again advised the bidders that the Debtors were placing a great deal of significance on a guaranteed value to the Debtors' estates, as opposed to bids that were based on formulas and contingencies. The Debtors expressly asked all of the bidders if they would be willing to guarantee a minimum floor amount for their bid, as a sum certain would be, in the Debtors' business judgment, extremely beneficial to the Debtors' estates. The response of the liquidation bidders was less than enthusiastic. Instead of responding to the question – would they submit a bid not subject to fluctuation, at least with respect to a minimum value – the liquidation bidders questioned the financial ability of Acquisition to ever pay $40 million. Specifically, the liquidation bidders demanded to know whether Acquisition had offered to support their revised bid with collateral, a letter of credit, a certificate of deposit, or some other form of security. The Debtors responded that, to their knowledge, none had been offered. Again declining to provide the Debtors with a minimum amount or otherwise address the Debtors' concern with the contingent and formulaic nature of the agency agreements, the liquidation bidders concluded that their bids should be considered higher and better than the Acquisition bid.

Shortly after this contentious discussion, the Debtors attempted to commence a third round of bidding. The liquidation bidders, led by GBH, refused to participate and, instead, reserved their rights to object to the auction. After several more minutes of tense discussion, the liquidation bidders collectively asserted that the Acquisition bid could not be approved by the court because, among other things, the Debtors were ascribing value to an illusory "guarantee" in the Acquisition bid. The bidders, along with Credit Suisse, demanded that the auction be suspended so as to permit the parties to seek guidance from, or even intervention by, this court.[17]

G. The Emergency Status Conference

One day after the auction was suspended and leading into the Memorial Day weekend, the court conducted an emergency status conference. At the status conference, GBH raised two objections to the sale process.[18] First, GBH asserted that the auction was unfair, if not fraudulent, because the Debtors had allegedly always conspired to select Acquisition as the winning bidder. Second, GBH contended that the Acquisition bid could never be approved because it was, among other things, nothing more than a *sub rosa* plan. Credit Suisse also objected by asserting that the insider relationships were compromising the Debtors' fiduciary duty to their estates and echoed GBH's concerns with the *sub rosa* nature of the Acquisition bid. The Committee, the Ad Hoc Consortium and FC Special Funding supported the Debtors' decision and defended the Debtors'

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[17] Notably, all bidders were required to sign a statement that any objections to the auction procedures would be preserved for the sale hearing [Dkt. No. 802-6].

[18] Neither Great American nor Yellen attended the entire status conference, notwithstanding their refusal to continue the auction without further direction from the court.

conduct during the auction. Credit Suisse, GBH and the UST requested that the court supervise the resumed auction to ensure its fairness.[19]

After a nearly two hour status conference, the court declined to supervise the auction and instructed the parties to recommence the auction in accordance with the Bidding Procedures Order as soon as possible.[20] The court noted that although it had some concerns due to the allegations of GBH and Credit Suisse, it had no interest in exercising the business judgment of the Debtors (or any other estate representative, for that matter), thus placing itself in the unenviable position of approving its own decision. The court also found any objections to be premature, as the court had no testimony or other evidence before it to consider. Finally, the court noted that because the auction had technically only been suspended, no winning bidder had been identified.

H. The Auction (Day 2)

The auction resumed on May 26, 2015. After a discussion with the Consultation Parties and the bidders off the record, the Debtors made an adjustment to the auction procedures whereby the liquidation bidders would compete in "liquidator-only" rounds.[21] After completion of the liquidator-only rounds, the Debtors would evaluate the winning liquidator bid against any bid from Acquisition, FC Special Funding and/or Credit Suisse. The Debtors also adjusted the format of their written bid analyses so that bidders could compare and contrast their bids more easily.

After four rounds of bidding, all three liquidators made various formulaic adjustments to their bids. The court must again note that at no time did any of the liquidation bidders submit a

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19 At the status conference, the court specifically asked the UST if he had witnessed any impropriety or misconduct. The UST candidly advised the court that he had not, but also felt as though the accusations regarding the insiders were chilling the bidding.

20 The court made one change to the Bidding Procedures Order. It required the Debtors to designate a third highest bid.

21 The liquidation bidders had no objection to this change.

bid with a minimum value, as the Debtors had requested. At the conclusion of the fourth round, Yellen declined to increase its bid. In the fifth round, Great American sought to include a breakup fee of $250,000 in its bid which was purportedly designed to compensate it in the event that the Debtors ultimately selected the going concern bid of Acquisition. The Debtors took a recess and conferred with the Consultation Parties, after which they determined that the inclusion of a breakup fee would result in a material change to the bidding procedures which could not be accepted absent prior court approval. The Debtors encouraged Great American to revise its bid to remove the request for a breakup fee. Nonetheless, Great American declined to remove the breakup fee from the bid. The Debtors therefore designated the GBH bid as the highest bid after the fifth round.

Before the sixth round commenced, however, Great American renewed its request for a breakup fee. After another recess, the Debtors and the Consultation Parties again concluded that it would be improper to agree to a breakup fee without prior court approval. Great American, although it disagreed with this decision, submitted a revised bid without the breakup fee. This revised bid from Great American caused the Debtors to reconsider their previous selection of the GBH bid at the end of the fifth round. The Debtors selected the Great American bid (without the breakup fee) as the highest bid in the fifth round.

GBH and Great American bid for yet another round, after which GBH requested that the Debtors ascribe a value on the intellectual property bundle because it was included in Great American's bid, but not in GBH's bid. The Debtors and the Consultation Parties conferred, after which they reported that the Debtors would not ascribe a value to the intellectual property bundle. Rather, the Debtors preferred instead to rely on the auction process to monetize the value of those assets.[22]

[22] Seemingly in the interests of time, the Debtors also suggested that the remaining liquidator bidders submit simultaneous written bids in order to determine the highest and best bid. Great American and GBH strenuously

GBH and Great American continued bidding, with Great American finally declining to increase its bid at approximately 8:00 p.m. At the conclusion of the liquidation rounds, the value of GBH's bid was estimated to be approximately $43.9 million, while Great American's bid was estimated to be approximately $43.8 million.

At approximately 11:00 p.m., the auction resumed. At this point, Acquisition submitted a going concern bid that increased the minimum value of its bid from $40 million to $42 million. Acquisition also removed a condition in the Acquisition APA requiring the court to find that the consignment goods held by the Debtors are in fact property of the Debtors' estate, thereby eliminating any concern that the Debtors might have regarding title to the inventory. The Consultation Parties, with the exception of FC Special Funding, conferred for another hour to evaluate the most recent bid from Acquisition against the bid from GBH with an estimated value of $43.9 million. The Debtors, again with assistance from the Consultation Parties, selected the Acquisition bid as the highest and best bid. Although the Committee and the Ad Hoc Consortium supported the Debtors' decision, Credit Suisse again disagreed because of the structure of the Acquisition APA. According to Credit Suisse, the Acquisition APA violated the priority scheme of the Bankruptcy Code by allocating funds to subordinate creditors without first satisfying Credit Suisse in full.

At this point, GBH sought guidance from the Debtors by requesting that the Debtors ascribe a value to the going concern nature of the Acquisition bid. The Debtors declined to do so, admitting that they had contemplated, but could not monetize, such value. In the next round, GBH passed. FC Special Funding submitted a hybrid credit bid. The material terms of FC Special

objected to this change in the auction procedures, asserting that the liquidation bidding rounds were resulting in robust bidding. The Debtors and the Consultation Parties reconvened, ultimately listening to the concerns of Great American and GBH.

Funding's bid can be summarized as (i) a credit bid of approximately $23.3 million, (ii) a cash payment of $6.3 million in exchange for a general release similar to that included in the Acquisition APA, (iii) assumption of various liabilities, (iv) a settlement with consignment vendors on similar terms as contained in the Acquisition APA, and (v) payment in full of administrative expenses.

The Committee then somewhat arbitrarily raised a concern with GBH's bid in light of the unsettled nature of the consignment inventory issues and related adversary proceeding. The Committee asserted that the GBH bid could be subject to a significant reduction if the consignment inventory was ultimately determined not to be property of the Debtors' estates.

After a lengthy meeting with the Consultation Parties (other than FC Special Funding), the Debtors returned at approximately 2:00 a.m. and declared the Acquisition bid as the current highest and best bid with a value of approximately $46.8 million, $42 million of which would not be subject to adjustment. The Debtors also identified the GBH bid as the next highest bid with a value of approximately $49.8 million, and the FC Special Funding bid third with a value between $41.6 and $44.3 million.[23] GBH once again questioned the Debtors whether they were able to place a value on the going concern nature of the Acquisition bid, to which the Debtors responded that they could not. Credit Suisse once again objected to the Debtors' selection of the highest and best bid, asserting that the GBH bid should be designated as the highest and best bid. At this point, GBH refused to bid further, reserving its rights to challenge the Acquisition bid as not being the highest and best bid at the sale hearing. The remaining bidders passed and the Debtors concluded the auction, with Acquisition designated as the winning bidder.

[23] The auction transcript is less than clear at this point regarding the estimated values of the bids.

On May 27, 2015, the Debtors filed a notice of the auction results with the court [Dkt. No. 742]. The court has reviewed all three bids and their respective agreements, and summarizes them as follows:

1. *Acquisition Bid*

- Estimated value to the estates: $46.8 million
- Minimum amount of funds to the estates: $42 million
- Assets remaining in estates post-closing: none
- Administrative expenses: paid in full, including professional fees, subject to certain caps, and 503(b)(9) claims
- Consignment inventory settlement: payment to professionals for consignment adversary plaintiffs and choice of two options for payment on consigned inventory
- Ability to perform: non-binding commitment letter from FC Special Funding for three years, $50 million credit facility to fund continued operations
- Distribution to unsecured creditors: 5% to trade creditors who agree to trade terms with the business post-closing
- Recourse to purchaser: none

2. *GBH Bid*

- Estimated value to the estates: $49.8 million
- Minimum amount of funds to the estates: none, dependent on inventory levels
- Assets remaining in estates post-closing: causes of action, Debtors' cash on hand
- Administrative expenses: unknown if to be paid in full
- Consignment inventory settlement: payment to professionals for consignment adversary plaintiffs and choice of two options for payment on consigned inventory

- Ability to perform: 77.4% of proceeds of inventory to be paid shortly after closing; remaining amount secured by two letters of credit
- Distribution to unsecured creditors: unknown, dependent on inventory levels
- Recourse to purchaser: estates must indemnify against loss

3. *FC Special Funding Bid*

- Estimated value to the estates: $41.6 million - $44.3 million
- Minimum amount of funds to the estates: $6.3 million for settlement and release of actions against FC Special Funding and its affiliates
- Assets remaining in estates post-closing: causes of action, including avoidance actions, except for those against FC Special Funding and its affiliates; intellectual property
- Administrative expenses: professional fees to be paid, subject to certain caps; 503(b)(9) claims not to be paid
- Consignment inventory settlement: payment to professionals for consignment adversary plaintiffs and choice of two options for payment on consigned inventory
- Ability to perform: no information provided
- Distribution to unsecured creditors: unknown
- Recourse to purchaser: none

I. The Second Status Conference and the Emergency Hearing on the Motion to Compel

The court conducted a second status conference related to the Sale Motion on May 28, 2015. During that status conference, the court decided to reschedule the sale hearing so as not to prejudice parties in interest, including counterparties to executory contracts and unexpired leases, who had negotiated for a period of time during which to evaluate the winning bidder. It was also clear at the status conference that the sale hearing would be contested. The court advised the parties that it expected them to engage in good faith abbreviated discovery in advance of the sale hearing. The court invited the parties to contact it in the event of a discovery dispute.

Not surprisingly, on June 4, 2015, a discovery dispute arose. At approximately 5:00 p.m., GBH filed an emergency motion to compel Acquisition to provide certain financial documents [Dkt. No. 849]. The court held an emergency telephonic hearing on June 5, 2015 at 11:00 a.m. on GBH's motion to compel. In its response to the motion to compel filed less than one hour prior to the hearing, Acquisition asserted that GBH, as a frustrated bidder, lacked standing to object to the sale and therefore was not entitled to any discovery. GBH responded that it had purchased an administrative expense [Dkt. No. 817] and therefore had standing as a creditor of the Debtors' estates. GBH further argued that under Sixth Circuit precedent, frustrated bidders may challenge a sale where there is an allegation of fraud, unfairness or mistake. The court ultimately found that GBH had standing for the reasons explained in its bench opinion given at the conclusion of the emergency hearing [Dkt. No. 878].

J. The Sale Hearing

1. The Settlements Placed on the Record

On June 9, 2015, the court held a hearing on the Sale Motion. At the sale hearing, the parties requested additional time to attempt to resolve certain issues.[24] The Debtors eventually placed several significant settlements regarding the Acquisition bid on the record.[25] First, Credit Suisse agreed to withdraw its objection and support the sale to Acquisition in exchange for an increase in the "cash component" of the Acquisition APA that was allocated to Credit Suisse from

[24] The hearing on the Sale Motion was scheduled to begin at 9:00 a.m., but did not start until sometime after 11:00 a.m. and lasted until sometime after 11:00 p.m. The court again extends its appreciation to the Court Security Officers and Ms. Gail Beach, the court reporter, for their services.

[25] The court has summarized the material settlements placed on the record regarding the Acquisition bid; however, the Debtors also resolved several non-cure cost objections with counterparties to executory contracts and unexpired leases.

$2.7 million to $5.45 million.[26] The cash component would be paid into the Debtors' estates and paid to Credit Suisse at closing. Credit Suisse and the Debtors, on behalf of their estates, also agreed to execute mutual releases. Second, the UST agreed to withdraw certain aspects of his objection if, within a reasonable time after the sale to Acquisition, the Debtors agreed to file a plan of liquidation. Third, Acquisition agreed to increase the cap on the payment of professional fees by $75,000, presumably to account for the plan of liquidation.

Finally, with respect to the settlement with the consignment vendors contained in the Acquisition APA, the amount to be paid to the Ad Hoc Consortium was reduced from $500,000 to $475,000. In addition, Acquisition agreed to remove a condition requiring dismissal of the consignment vendor adversary proceeding by all plaintiffs.[27] Relatedly, the proceeds from post-petition sales of consigned goods currently being held in escrow by the Debtors pending resolution of the adversary proceeding would continue to be held in escrow by Acquisition for the benefit of any non-consenting consignment vendor.

After these settlements were placed on the record, only the objections of GBH and Bridgestone Multimedia Group ("Bridgestone"), a consignment vendor and intervening plaintiff in the consignment adversary proceeding, remained. GBH's objections can be summarized as follows: (i) the auction was unfair; (ii) its bid was superior to the bid of Acquisition; and (iii) the Acquisition APA is a *sub rosa* plan. Bridgestone contends that the releases to insiders are

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26 At the hearing, the Debtors stated that the settlement with Credit Suisse increases the value of the Acquisition bid by at least $2.85 million.

27 The basic terms of the consignment settlement in the Acquisition APA are that the plaintiffs in the consignment adversary proceeding will receive $500,000 upon a voluntary dismissal of their claims against the Debtors. In addition, a consenting consignment vendor may choose one of two options: (i) payment of its administrative expense under section 503(b)(9) within ten days of its allowance plus 10% of the book value of its transferred consigned inventory within thirty days of the sale of such inventory; or (ii) payment of 35% of the book value of its transferred consignment inventory within thirty days of the sale of such inventory.

inappropriate and without justification, and that the distribution of funds under the Acquisition APA is discriminatory.[28] The UST also remained concerned about the incomplete auction and releases granted to insiders under the Acquisition APA.[29]

2. *Admission of Exhibits into Evidence*

The parties filed a joint stipulation prior to the sale hearing [Dkt. No. 898] in which they stipulated as to the admissibility of seventy-two exhibits, some of which were duplicative. Although all of these exhibits were technically admitted into evidence, the parties only relied on the Acquisition APA, the GBH agency agreement, the Debtors' cash flow projections, the Debtors' bid valuations, GBH's bid analyses, and the transcripts of the auction and section 341 meeting.[30] In addition to the aforementioned exhibits, the court admitted two other exhibits into evidence – a loan commitment letter from FC Special Funding to Acquisition and a five year projection for Acquisition.

3. *Testifying Witnesses*

During the sale hearing, the following persons testified:

- Amy Forrestal, Partner at Brookwood
- Chuck Bengochea, Chief Executive Officer of the Operating Debtor
- Ken Dady, Vice President of Finance for the Operating Debtor
- Thomas L. Minick, Managing Member of Commenda

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28 Bridgestone also objected to the requirement in the Acquisition APA that the consignment vendor adversary proceeding be dismissed. As noted above, the Debtors and Acquisition have since clarified that non-consenting consignment vendors are not required to dismiss their claims from the adversary proceeding.

29 Although the UST did not term himself as a *per se* objecting party, he did engage in cross-examination throughout the proceedings and provided a compelling and animated closing argument.

30 Although all of these exhibits were admitted into evidence pursuant to stipulation, the parties did not direct this court's attention to specific content within those exhibits. The court declines to parse through thousands of pages of exhibits in order to determine the relevant portions thereof. For the most part, the court is only considering the exhibits which were the subject of testimony or oral argument during the sale hearing.

- Benjamin Nortman, Executive Vice President of Hilco Merchant Resources, LLC[31]
- Thomas E. Pabst[32]

The testimony of each witness is summarized below.

a. Amy Forrestal

Amy Forrestal of Brookwood, the Debtors' investment banker, was the first witness called by the Debtors. The court found Ms. Forrestal to be credible. Ms. Forrestal testified as to the intense marketing efforts undertaken by Brookwood on behalf of the Debtors, including attempts to contact approximately 230 parties in order to gauge their interest in the Debtors' assets. According to Ms. Forrestal, fifty of the parties contacted could be described as potential going concern purchasers, with the remainder considered to be liquidators. Ms. Forrestal stated that although the Debtors and Brookwood received preliminary interest from several potential going concern purchasers, Acquisition was the only party to submit a going concern bid.

Ms. Forrestal testified that she was not involved in the negotiations of the Acquisition APA. Instead, Mr. Bengochea, the Debtors' CEO, was the primary contact person with respect to Acquisition. She also stated that she never spoke with Richard Jackson, the principal for Acquisition. Ms. Forrestal testified that as a member of the Auction Team, she recommended during the first round that the Debtors select the Yellen bid as the highest and best bid. In the

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31 Mr. Nortman was qualified as an expert witness, albeit one with bias due to his position as an officer of Hilco and representative of the joint GBH bid. *See United States v. Jackson-Randolph*, 282 F.3d 369, 383 (6th Cir. 2002) (Quist, J.) (bias is a "relationship between a party and a witness which might lead the witness to slant, unconsciously or otherwise, his testimony in favor of or against a party") (citing *United States v. Abel*, 469 U.S. 45, 52 (1984)); *see also Sharp v. Chase Manhattan Bank (In re Commercial Fin. Servs., Inc.)*, 350 B.R. 520, 526 n.1, 528-29 (Bankr. N.D. Okla. 2005) (probing cross-examination of expert witness will permit assessment of expert's credibility and potential bias, especially in bench trial).

32 At the hearing, GBH objected to the Debtors' attempt to qualify Mr. Pabst as an expert witness due to, among other things, his lack of recent experience with retail liquidations. After considering the testimony of Mr. Pabst during direct examination and cross examination, the court sustained GBH's objection. *See* Fed. R. Evid. 702.

second round, she stated that she agreed with the Debtors' conclusion that the Acquisition bid was the highest and best bid due to its minimum floor when compared to the contingencies and variables in the agency agreements utilized by the liquidating bidders. Ms. Forrestal also testified that she continued to view the Acquisition bid as superior on the second day of the auction due to the uncertainty of the liquidator bids.

b. Chuck Bengochea

The court found the testimony of Chuck Bengochea, the Debtors' CEO, to be credible, but incomplete and perhaps lacking in conviction. Mr. Bengochea explained that he was hired to become the Debtors' CEO by Richard Jackson, among others, in the summer of 2014. During that time, the Debtors were already in considerable financial distress. He testified that in order to address prepetition concerns by Credit Suisse, the Debtors presented a five-year plan proposing to, among other things, close approximately fifteen stores and improve sales by expanding the Debtors' online presence. Mr. Bengochea was unable to answer several questions by providing any specific detail, instead deferring to those who reported to him, including Ken Dady. According to Mr. Bengochea, the Debtors elected to file for bankruptcy after negotiations with Credit Suisse reached an impasse.

Mr. Bengochea stated that he believed that Acquisition would use the same modified business plan as the Debtors when operating the business post-closing. He testified that he was in close contact with Richard Jackson throughout his employment with the Debtors, speaking with Mr. Jackson approximately once per week. In addition, Mr. Bengochea testified that he expected to continue as CEO of Acquisition if it purchased the Debtors' assets.

Mr. Bengochea stated that he was unable to attend the first day of the auction due to a family conflict, but had been available by telephone. He admitted that he (i) had not reviewed a financial statement for Acquisition, (ii) had not seen a commitment letter, (iii) was not aware of any collateral or other form of security supporting the bid, and (iv) had not seen any analysis regarding the value of avoidance actions and other causes of action, including those subject to releases, as contemplated by the Acquisition APA. Mr. Bengochea explained that although he signed the Acquisition APA and was generally familiar with it, he lacked specific knowledge that the court would expect from the chief executive officer of a debtor in possession. However, he also explained that he spoke weekly with Ms. Forrestal regarding identification of bidders, particularly going concern bidders.

Finally, Mr. Bengochea testified that he telephoned Richard Jackson and Larry Powell, another insider, at approximately 11:00 p.m. on the second day of the auction. According to Mr. Bengochea, he simply asked Mr. Jackson to increase the Acquisition bid during the telephone call and did not discuss any other bids.

c. Ken Dady

Ken Dady, the Debtors' Vice President of Finance, testified regarding the Debtors' past and current financial states, the projections presented to Credit Suisse prepetition, and, importantly, the Debtors' analysis with respect to the competing bids. The court found Mr. Dady to be credible, convincing and extremely knowledgeable. Mr. Dady testified that although the Debtors are currently cash positive, they will experience a liquidity crisis in July of 2015. Mr. Dady stated that he and his financial department prepared the bid analyses provided to the bidders. He noted that he did not have experience working with agency agreements, and found all of the bids submitted by the liquidation bidders to be quite complex, notwithstanding his many years of finance experience. Mr. Dady noted that although the Debtors had commenced an analysis with respect to preferential transfers and the insider causes of action being released in the Acquisition APA, such analyses had not been completed before the auction.

Mr. Dady further testified as to the numerous risk factors in the GBH agency agreement, including (i) occupancy and other expenses that remained with the Debtors while GBH liquidated assets, (ii) caps on GBH's liability for certain expenses, and (iii) required reimbursements from the Debtors for the difference between liquidation sale prices and promotional sale prices. He also indicated that the Debtors viewed the GBH bid with a high degree of uncertainty because GBH had not, as of the date of the auction, resolved issues with consignment vendors so that GBH could sell, as property of the Debtors' estates, the consignment inventory. Absent a resolution with the consignment vendors, Mr. Dady believed that the value of the GBH bid to the Debtors' estates could be reduced substantially.[33] In addition, he was concerned that the agency agreement utilized by GBH placed GBH in a position of control and, thus could potentially be manipulated by GBH to reduce the value of the bid to the detriment of the Debtors' estates.

Mr. Dady stated that some, but not all, of these risk factors were discussed with GBH at the auction. He testified that in order to have addressed the Debtors' concerns, GBH could have submitted an asset purchase agreement (as opposed to an agency agreement) or, at the very least, committed a minimum value to the Debtors' estates. He also noted that the Debtors were concerned about ascribing a value to the going concern component of the bid, because they did not want to artificially inflate the Acquisition bid, thereby chilling other bids. Mr. Dady was uncertain about his future, as he had not discussed his potential employment with Acquisition if it was ultimately the winning bidder. Finally, Mr. Dady stated that he rarely spoke to Richard Jackson, and that he was unaware that Chuck Bengochea had called Mr. Jackson during the auction.

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[33] Although GBH later entered into a settlement with consignment vendors on similar terms to Acquisition, at the time of the auction, no such settlement had been reached.

d. Thomas L. Minick

FC Special Funding called one witness, Thomas L. Minick, the managing member of Commenda. Mr. Minick, a banker for more than thirty years, was credible, concise, and knowledgeable. He stated that Commenda is a merchant bank that generally provides financing on a secured basis to various borrowers. He explained that Commenda is the sole owner of FC Special Funding, and that FC Special Funding has agreed to provide a credit facility of $50 million to Acquisition. Although the commitment letter between Acquisition and FC Special Funding was executed on June 3, 2015, Mr. Minick testified that drafts of the letter had actually been exchanged around the time of the auction.

e. Benjamin Nortman

GBH called only one witness, Benjamin Nortman, an executive with Hilco Merchant Resources, LLC, and the representative of the GBH joint venture. As noted above, the court qualified Mr. Nortman as an expert witness due to his extensive and recent experience in the retail liquidation field. The court found Mr. Nortman's to be credible, candid, and knowledgeable. His testimony was particularly credible because he acknowledged that the GBH agency agreement included potential fluctuations in value. Mr. Nortman also admitted that ambiguities in the drafting of the agency agreement could lead to some apprehensions for the Debtors. He expressed great frustration with the lack of information provided by the Debtors as to their concerns with the GBH bid and asserted GBH could have easily addressed these concerns had it been provided with this information. Mr. Nortman also expressed skepticism regarding certain risk factors allegedly considered by the Debtors at the auction. Mr. Nortman was adamant that these risk factors were created on a post-auction basis for the sale hearing.

Mr. Nortman noted that GBH had attempted to remain competitive at the auction by reacting to adjustments in other bids. He felt as though GBH had sufficiently addressed all concerns raised by the Debtors at the auction. He testified that 77.4% of the proceeds from the sale of the inventory of the Debtors would be paid in cash shortly after the closing of the "sale," and that the remaining amount of GBH's bid would be secured by two letters of credit. Mr. Nortman stated that the Debtors' failure to advise GBH of the amount by which to increase its bid to become the highest bidder caused GBH to stop bidding. Importantly, Mr. Nortman testified that GBH would be willing to resume bidding in the event that the auction is reopened.

At the conclusion of the sale hearing, the court took this matter under advisement. Upon careful consideration of the legal arguments presented, the exhibits admitted into evidence, and the testimony of all witnesses, the court concludes that it cannot grant the Sale Motion.

DISCUSSION

A. GBH Has Standing to Object to the Sale

As noted above, this court held that GBH had standing to file a motion to compel production of documents by Acquisition. In their brief and at the sale hearing, the Debtors sought to preclude GBH from objecting to the sale because it allegedly lacked standing. *Contra Pepper v. United States*, 562 U.S. 476, 506 (2011) (citation omitted) (when court decides upon rule of law, decision should govern same issues at later stages of same case); *Gen. Elec. Capital Corp. v. Hoerner (In re Grand Valley Sport & Marine, Inc.)*, 143 B.R. 840, 853 (Bankr. W.D. Mich. 1992) (citation omitted) (purpose of "law of the case" doctrine is to promote finality and prevent the relitigation of adjudicated issues).[34] Similar to the arguments made by Acquisition, the Debtors

[34] The court issued an oral ruling on this issue at the sale hearing so as not to further delay the process. The court is incorporating that ruling into this Memorandum Decision.

contended that GBH lacked standing to object to the proposed sale to Acquisition because it is nothing more than an aggrieved bidder.[35] Like Acquisition, the Debtors attempted to rely on two decisions from the Sixth Circuit in support of their position. *See Stark v. Moran (In re Moran)*, 566 F.3d 676 (6th Cir. 2009); *Squire v. Scher (In re Squire)*, 282 Fed. Appx. 413 (6th Cir. 2008) (Suhrheinrich, J.). Neither decision supports the Debtors' argument. To the contrary, these decisions hold that an aggrieved bidder has standing to object to a sale where it either has a pecuniary interest or alleges that the sale process was flawed.

In this case, GBH purchased an administrative expense [Dkt. No. 817] which remained unpaid as of the sale hearing. *See In re Embrace Sys. Corp.*, 178 B.R. 112, 120 (Bankr. W.D. Mich. 1995) (Gregg, J.) (Bankruptcy Code does not distinguish between prepetition creditors and administrative expense holders for purposes of pecuniary interest). GBH therefore held a pecuniary interest as of the date of the sale hearing that conveyed standing to object to the Sale Motion. *Id*. at 121. In addition, GBH asserted during the emergency hearing on May 22, 2015 and in its objection to the Sale Motion that it believed the auction process to have been unfair. The Sixth Circuit could not have been more clear – where a party has a pecuniary interest or challenges the fairness of an auction, such party has standing. *See In re Moran*, 566 F.3d at 681; *In re Squire*, 282 Fed. Appx. at 416. The court therefore rejects the Debtors' attempt to deny GBH standing at the sale hearing.[36]

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[35] The Debtors also asserted that a document executed by qualified bidders acknowledging that they hold no claim against the Debtors or their estates [Dkt. No. 802-6] precluded GBH from objecting at the sale hearing. The court does not interpret this acknowledgement to deny GBH standing, as it expressly states that objections to the results and process of the auction are to be preserved for the sale hearing.

[36] Although this court has recognized the standing of GBH given its allegations of unfairness and its pecuniary interest, GBH's standing does not exist in perpetuity. *See In re Embrace Sys.*, 178 B.R. at 121 (improper motive such as purposely seeking to destroy debtor may result in denial of standing). It is uncontroverted that the Debtors invited GBH to participate in the auction process. This court will not permit the Debtors to now argue that GBH is acting in bad faith by seeking to ensure that its bid receives proper consideration. At some point, however, GBH, which holds an allowed administrative expense, may lose its pecuniary interest or its standing due to improper motive.

B. The Auction Process Suffered from Mistakes

In its brief in opposition to the Sale Motion, GBH has made serious allegations with respect to the fairness of the auction process. While the Debtors clearly made mistakes at the auction, this court concludes that the allegations of fraud and unfairness are, in large part, unfounded.

The Debtors, in conducting the sale process, have a fiduciary duty to maximize the value of their estates. *In re Embrace Sys.*, 178 B.R. at 123-24. However, as this court has previously noted, that fiduciary duty does not require the Debtors to mechanically accept a bid with the highest dollar amount. *See In re Quality Stores, Inc.*, 272 B.R. 643, 647 (Bankr. W.D. Mich. 2002) (Gregg, J.) (uncertainty regarding financial status justified decision to deem lower offer as "best" offer). The Debtors are permitted, and in fact are encouraged, to evaluate other factors such as contingencies, conditions, timing, or other uncertainties in an offer that may render it less appealing. *See*, *e.g.*, *In re Scimeca Found., Inc.*, 497 B.R. 753, 779 (Bankr. E.D. Pa. 2013) (approving somewhat lower all-cash bid instead of higher bid with financing contingency); *In re Bakalis*, 220 B.R. 525, 532-33 (Bankr. E.D.N.Y. 1998) (approving lower bid instead of higher bid with contingencies and inherent risk).

If the court perceives any degree of fraud, unfairness or mistake with the sale, including any flaws with an auction process, the court should assess the impact of these factors on the sale when the offer is compared to the court's finding of valuation of the assets to be sold. *In re Embrace Sys.*, 178 B.R. at 123 (citation omitted). Where a proposed sale would benefit an insider of a debtor, the court is required to give heightened scrutiny to the fairness of the value provided by the sale and the good faith of the parties in executing the transaction. *See Ricker & Assocs., Inc. v. Smith (In re Rickel & Assocs., Inc.)*, 272 B.R. 74, 100 (Bankr. S.D.N.Y. 2002); *In re Embrace Sys.*, 178 B.R. at 126; *cf. Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 745 (6th Cir. 2001) ("Insider transactions are more closely scrutinized, not because the insider relationship makes them inherently wrong, but because insiders 'usually have greater opportunities for…inequitable conduct.'") (citing *Fabricators, Inc. v. Technical Fabricators, Inc. (In re Fabricators, Inc.)*, 926 F.2d 1458, 1465 (5th Cir. 1991)).

According to GBH, the auction was unfair because the risk factors identified by the Debtors at the sale hearing were nothing more than post-hoc rationalizations manufactured after the auction had closed to justify the Debtors' selection of the Acquisition bid. Even if these factors had been considered by the Debtors at the auction, GBH asserts that it was not informed of the risk factors by the Debtors so that it could increase the value of its bid. According to GBH, the Debtors improperly withheld information from GBH. GBH similarly faults the Debtors for failing to ascribe an exact monetary value to the going concern nature of the Acquisition bid. GBH also requests that this court infer that the previously undisclosed telephone call from Chuck Bengochea to Richard Jackson was an attempt to fix the auction to ensure that Acquisition was declared the winning bidder.

The UST separately asserts that the Debtors have not maximized the value for the estates because they closed the auction while parties were still willing to increase their bids, and they may have preferred insiders to the detriment of the other bidders by accepting a proposal which fails to ascribe value for avoidance actions and releases. As such, the UST suggests that the integrity of the bankruptcy sale process has been compromised.

The court does not find that the auction was unfair or fraudulent. After scrutinizing the transcripts of the auction and carefully listening to the testimony at the sale hearing, it appears that the Debtors properly conferred with the Consultation Parties throughout the process. Moreover, the Debtors attempted to prepare written analyses to facilitate bidding while, to the best of their ability, addressing concerns of the bidders. Importantly, the Debtors consistently identified various risks that they perceived with the liquidating bids. On numerous occasions, the Debtors advised the liquidation bidders that the Debtors were concerned with the contingent nature of the agency agreements. The liquidation bidders, however, elected not to conform their bids by providing a minimum value. The court finds that although mistakes were made as discussed below, they are not related to the Debtors' failure to conduct a transparent process.

The court does not find the Debtors' failure to provide GBH with a line item analysis of the perceived risks of its bid to be improper in any way. First, the court notes that the agency agreement submitted by GBH is exceedingly complex and requires application of formulas and consideration of a multitude of risks and contingencies in order to arrive at a hypothetical value of the bid. The Debtors, to their credit, strained to provide a value to the GBH bid on their bid analysis form. In addition, the Debtors repeatedly requested that the bidders restructure their bids to include a minimum value to the Debtors' estates. For whatever reason, GBH declined to provide the Debtors with a minimum value and instead challenged the ability of Acquisition to perform under the Acquisition APA.

This court finds the reasoning in *In re Bakalis*, 220 B.R. 525 (Bankr. E.D.N.Y. 1998) to be instructive when considering GBH's arguments. In *Bakalis*, a Chapter 7 trustee requested the court approve a sale of stock that comprised a controlling interest in a bank. *Id.* at 527. The proposed winning bidder, an entity formed for the purpose of acquiring the controlling shares of stock, was comprised of several officers and directors of the bank, as well as other investors. *Id.* at 528. At the end of the auction, the winning bidder made a cash offer, which was contingent only on regulatory approval, and provided for reimbursement of accrued interest if closing did not occur. *Id.* at 529-30.

The second highest bidder, a competitor of the bank, objected to the proposed sale to the winning bidder, asserting that its bid offered a higher value. *Id.* at 533. The trustee recommended the lower bid as the highest and best because the second highest bid was subject to numerous contingencies, which the trustee viewed as a substantial gamble for the estate. *Id.* at 530-31. In addition, the trustee expressed concern that in the event of a legal battle over the proposed merger, the value of the bank stock could be significantly reduced if the sale to the second highest bidder was not timely consummated. *Id.* at 532. The second highest bidder contended, among other things, that the trustee failed to disclose certain components that would permit the second highest bidder to top the winning bid. *Id*. at 534.

The court found that the trustee had appropriately exercised his business judgment in selecting the facially lower bid, noting that the trustee carefully weighed the competing bids and chose the bid that he viewed as the least risky to the estate. *Id.* at 532. The court rejected the second bidder's assertion that the bidding process was unfair because the trustee did not give bidders a precise quantification of the non-monetary and structural components of the winning bid. *Id.* at 534-35. Instead, the court stated that there is no requirement that competing bidders be given precise valuations of all of the non-dollar aspects of their bids, especially where the bidders are sophisticated entities who can assess the risks and benefits of their bids and the limits of the consideration they offer. *Id.* at 534-35 (citing *Consumer News & Business Channel P'ship v. Financial News Network Inc. (In re Financial News Network, Inc.)*, 134 B.R. 737, 738 (S.D.N.Y. 1991), *aff'd*, 980 F.2d 165 (2d Cir. 1992)). The court emphasized that the trustee had repeatedly discussed with the second highest bidder his concerns regarding risks, but the second highest bidder was determined to maintain its contingency clauses and walk away provisions, choosing to critique the winning bidder's bid protections as illusory instead. *Id.*

The discussion in *Bakalis* is highly persuasive to this court. GBH, like the second highest bidder in *Bakalis*, is an eminently sophisticated bidder whose own executive, qualified as an expert by this court, testified that he had been involved in hundreds of retail bankruptcy auctions, many of which were against a going concern bid such as that submitted by Acquisition. GBH, as the drafter of the agency agreement, was familiar with all of its provisions and could, based on its extensive experience in similar transactions, likely foresee where a seller might perceive risk.

Similar to the trustee in *Bakalis*, the Debtors repeatedly expressed a desire for GBH to provide a minimum value that would be provided to the estate if its bid were chosen as the winning bid. Instead of submitting a revised bid that would provide a minimum value to the estate, GBH, like the second highest bidder in *Bakalis*, chose to criticize the Acquisition bid as illusory and question the Debtors' business judgment. This court agrees with the *Bakalis* court. The Debtors were not required to provide a line-by-line analysis to each bidder. In fact, by imposing such a condition, this court would be unnecessarily slowing the process, thereby hindering the central purpose of the auction – to generate the highest and best bid for the Debtors' assets through competitive and robust bidding.

The court finds that the Debtors legitimately perceived risks in the GBH bid, many of which were disclosed, that caused the Debtors to deem the GBH bid less attractive despite its purportedly higher dollar amount. Mr. Dady's testimony revealed that the Debtors engaged in an extensive analysis of the risks and rewards of the bids before, during, and after the auction. Importantly, at the time the Debtors selected the Acquisition bid as highest and best, GBH and the consignment vendors had yet to agree to treatment of the consignment inventory, which, if excluded, could have significantly reduced the value of the GBH bid. In addition, the Debtors, likely in response to this court's repeated warnings about administratively insolvent estates, placed great emphasis on the fact that the Acquisition bid would ensure payment of all administrative expenses. As stressed by the Committee, the GBH bid has no such provision. Instead, GBH advised this court that it believes, based on its estimates, that administrative expenses would likely be satisfied. This is simply not good enough.

Regarding the failure of the Debtors to quantify the going concern nature of the Acquisition bid, the court credits the testimony of Mr. Dady that the Debtors genuinely did not have a dollar amount to provide and did not want to recklessly ascribe one for fear of chilling further bidding. Notably, the bidding procedures provide that the Debtors may, but are not required to, ascribe a liquidation value to certain assets. The bidding procedures provide that if the Debtors "believe that such value would be overly speculative under the circumstances," they may decline to ascribe a value. The Debtors cannot be faulted for seeking guidance from, and relying on, the Bidding Procedures Order entered by this court.

The court also notes that GBH was responsible for suspending the auction on both the first and second day because of its refusal to continue bidding. As the bidding procedures and the acknowledgement signed by all qualified bidders [Dkt. No. 802-6] expressly state, issues regarding the manner in which the auction is conducted shall be reserved for the sale hearing. It was therefore inappropriate for GBH to attempt to challenge the auction without first allowing the bidding to conclude. The Debtors' non-disclosure of certain perceived risks in the GBH bid and their views regarding the superiority of the Acquisition bid were not what ultimately resulted in a flawed auction. Rather, the Debtors made two mistakes during the auction.

First, the Debtors did not account for the value of the insider releases and the avoidance actions being "sold," as discussed in detail below. Regardless of whether this failure is considered a mistake or more properly considered in connection with the valuation of the Debtors' assets in relation to the purchase price, the Debtors' failure in this regard is fatal, even if the Committee supported the terms of sale. The Debtors' executives testified that an investigation had not been completed as to the value of the releases in the Acquisition APA or the avoidance actions proposed to be sold when the Acquisition bid was selected as the highest and best bid.[37] Had the investigation been completed, it might have required an adjustment to the bid valuations relied upon by the Debtors to credit the liquidation bids with a greater amount for causes of action left behind in the estate. Moreover, the Debtors were unable to articulate a basis for the granting of such releases, let alone their value, at the sale hearing. This lack of understanding is unacceptable given the insider relationship between Acquisition and the Debtors.[38]

Second, the court is troubled by the *ex parte* telephone call from Mr. Bengochea to Mr. Jackson during the second night of the auction. As an initial matter, this type of *ex parte* contact during an auction is completely inappropriate due to the insider relationship and clear conflict of interest that has infected Chuck Bengochea. Any requests for higher bids should have been placed on the record at the auction or communicated through legal counsel. Moreover, the request should have been made to all qualified bidders, not simply to an insider that has assured the Debtors' CEO of future employment.

The testimony and auction transcript reveal that around the same time that Mr. Bengochea placed the telephone call to Mr. Jackson, Acquisition submitted its final bid, after which it left the auction. Neither Acquisition nor any other party has provided an explanation for Acquisition's departure. The conduct of Mr. Bengochea and the departure of Acquisition leave this court with

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[37] The court notes that the parties described the sale of avoidance actions more as an abandonment of the estate's right to pursue such actions, rather than an assignment of the estate's rights to Acquisition.

[38] Similarly, the Debtors neglected to consider whether Acquisition had the ability to close the transaction and comply with its monetary obligations under the Acquisition APA. However, this may be a moot point after Mr. Minick confirmed that FC Special Funding had agreed to provide a credit facility as evidenced by the commitment letter.

the impression that Mr. Bengochea may have represented to Acquisition that it would be declared as the winning bidder, which it eventually was after a recess and an abrupt closing of the auction. While the court is without sufficient evidence to infer fraud on the part of Mr. Bengochea, the timing of the telephone call, the final Acquisition bid, and the closing of the auction cannot be ignored in light of the heightened scrutiny applied to insider transactions. Mr. Bengochea was, at the very least, reckless.

In sum, although the auction was not as unfair as GBH insists, it was flawed.

C. The Debtors Have Failed to Articulate a Sound Business Justification for the Sale to Any of the Bidders

As noted above, this court concludes that the Debtors have committed mistakes in connection with the auction process. However, even when a bankruptcy court finds the presence of fraud, unfairness or mistake, it retains the "discretion to approve the sale should the estate be so desperate for a buyer that rejection of the offer would be devastating to creditors." *In re Embrace Sys.*, 178 B.R. at 124 (citation omitted).

In order to approve a sale of substantially all of the Debtors' assets outside the ordinary course of business pursuant to section 363(b), the court must find that the Debtors have articulated a sound business justification for the sale. *Stephens Indus., Inc. v. McClung*, 789 F.2d 386, 389-90 (6th Cir. 1986) (citing *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1070 (2d Cir. 1983)). The Sixth Circuit has adopted the reasoning of *Lionel* and cited favorably to the following guidance from the Second Circuit:

> In fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather he 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-à-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.

Id. at 389 (quoting *In re Lionel Corp.*, 722 F.2d at 1071). The list set forth in *Lionel* and adopted by the Sixth Circuit is not exhaustive, however. Instead, a court must consider the unique facts and circumstances of each case as opposed to applying a "predetermined formula." *In re Embrace Sys.*, 178 B.R. at 125.

This court finds the following factors previously identified by this court and other courts to be instructive: (i) whether adequate and reasonable notice has been provided to parties in interest, including full disclosure of the sale terms and the debtor's relationship with the purchaser, (ii) whether the sale price is fair and reasonable, and (iii) whether the proposed buyer is proceeding in good faith. *See*, *e.g.*, *In re Exaeris Inc.*, 380 B.R. 741, 744 (Bankr. D. Del. 2008) (citing *In re Delaware & Hudson Railway Co.*, 124 B.R. 169, 176 (D. Del. 1991)); *In re Medical Software Solutions*, 286 B.R. 431, 439-40 (Bankr. D. Utah 2002); *see also In re Embrace Sys.*, 178 B.R. at 123 (citation omitted) (sale appropriate if in compliance with section 363, bid is fair, and sale is in best interest of debtor's estate and creditors).

As this court has consistently stated, a debtor must demonstrate that the proposed purchase price is not only the highest offer, but the highest and best offer. *See*, *e.g.*, *In re Embrace Sys.*, 178 B.R. at 123. When considering offers for the purchase of assets, the debtor's duty, and the primary concern of the bankruptcy court, is to ensure that the sale maximizes the value of the asset sold.

Id. (citing *In re Integrated Resources, Inc.*, 135 B.R. 746, 750 (Bankr. S.D.N.Y. 1992), *aff'd*, 147 B.R. 650 (S.D.N.Y. 1992)).

It is again worth noting that nothing within the Bankruptcy Code prohibits insiders from purchasing estate assets. *Sugarloaf Indus. and Mktg. Co. v. Quaker City Castings, Inc. (In re Quaker City Castings, Inc.)*, 337 B.R. 729, 2005 WL 3078607, at *6 (B.A.P. 6th Cir. Nov. 18, 2005) (citing *First of America Bank v. Conn. Gen. Life Ins. Co. (In re 255 Park Plaza Assocs. Ltd. P'ship)*, 100 F.3d 1214, 1217-18 (6th Cir. 1996); *In re Bakalis*, 220 B.R. at 537). Rather, the transaction is merely subject to heightened scrutiny. *See In re Exaeris Inc.*, 380 B.R. at 746-47; *In re Tidal Construction Co., Inc.*, 446 B.R. 620, 624 (Bankr. S.D. Ga. 2009) (applying heightened scrutiny and ultimately approving sale to insider).

Upon consideration of these factors, this court finds that the Debtors have not satisfied their burden under heightened scrutiny, as the insider nature of sale to Acquisition simply does not permit this court to approve the transaction, notwithstanding the overwhelming support from the Debtors' major stakeholders.[39] The court concludes that although the Debtors have satisfied several of the aforementioned criteria, they have not, overall, articulated a sound business justification for seeking to sell substantially all of their assets to Acquisition on the terms in the Acquisition APA.

First, it is uncontroverted that the Debtors' assets are decreasing in value. As the Second Circuit, and the Sixth Circuit by reference, stated, this is perhaps the most important factor. The testimony at the sale hearing from Ken Dady revealed that although the Debtors are currently cash positive, they will experience a liquidity crisis sometime within the next month. The projections

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[39] The court gives little, if any, weight to FC Special Funding's support for the Acquisition bid. As part of the sale to Acquisition, FC Special Funding would be the beneficiary of a release that it has valued at $6.3 million. Therefore, FC Special Funding is by no means disinterested.

relied upon by the Debtors at the sale hearing further indicate that their cash reserves are likely to be depleted by mid to late July, absent post-petition financing. It is undisputable that the Debtors are subject to a fairly onerous cash collateral order, which has been extended on a weekly basis [Dkt. Nos. 851, 913]. Finally, as this court has previously noted, the Debtors are experiencing a significant cash burn due to professional fees and other costs directly attributable to these bankruptcy cases. In the event that the Debtors' assets are not sold soon, it is unlikely that the Debtors will be able to continue as a going concern.[40]

Second, the court finds that a sufficient amount of time has elapsed since the petition date. The Debtors have explored their options with assistance from counsel, Resurgence and Brookwood. Since the filing of their petitions, the Debtors have conducted a vigorous marketing campaign, the byproduct of which was robust bidding at an auction.

Third, the Debtors cannot be said to be blindly following the desires of a vocal group of special interest creditors. In other cases this court has placed significant emphasis on the judgment of the debtor, its lenders, and the committee. *See In re Quality Stores, Inc.*, 272 B.R. at 647-48 (court recognized committee and secured lenders' support given great deference because they bore risk if sale not consummated). These cases are no different. The Debtors clearly have support from all of their major stakeholders, the Committee, Credit Suisse, FC Special Funding, and the Ad Hoc Consortium. Absent the insider relationships and lack of notice, the support of these stakeholders may have dictated a different outcome.

Fourth, the Debtors have properly advised this court and other parties in interest that they intend to file a plan of liquidation as soon as reasonably practical as part of an agreement reached

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[40] Prof. James J. White, *Harvey's Silence*, 69 AM. BANK. L.J. 467, 474 (1995) ("[T]he largest and most palpable costs of Chapter 11 arise from delay. . . Chapter 11—at least as practiced in large cases—appears to condone and even exaggerate delay and the attendant costs. . . The costs of delay are palpable and indisputable.").

with the UST. To this end, the Debtors negotiated with at least Acquisition for a sum certain that will be used for the wind down of the Debtors' estates, which presumably includes the filing of a plan after the sale is consummated. Moreover, at the sale hearing, no parties questioned the Debtors' representatives regarding the material terms of any plan. In the absence of any such questioning, the court will accept the Debtors' representations and will not require more. In sum, the Debtors have, through discussions with the UST, responsibly accounted for the need to file a plan of liquidation in the event the sale is approved.

While the aforementioned factors support a finding that a sound business justification exists for a sale to Acquisition, several other factors weigh heavily against such a sale. Notwithstanding the Debtors' looming liquidity crisis, none of the proponents of the sale to Acquisition have presented this court with evidence upon which the court can make an informed decision regarding the relationship of the sale price to the value of the assets being sold. This court would have expected the Committee to provide evidence as to the value of the releases and avoidance actions that are part of the transaction with Acquisition. However, no member of the Committee was present to testify at the sale hearing, nor was an affidavit even submitted that could provide this court with an explanation as to the value of these assets and the fairness of the sale price. Moreover, at the sale hearing, the Debtors confessed that they had yet to complete their analysis of the value of these assets. The court therefore finds that the Debtors have failed to satisfy their burden in this regard.

The Debtors have also failed to demonstrate, by a preponderance of the evidence, the good faith of Acquisition, an insider who negotiated the terms of the Acquisition APA. *See also Made in Detroit, Inc. v. Official Comm. of Unsecured Creditors (In re Made in Detroit, Inc.)*, 414 F.3d 576, 581 (6th Cir. 2005) (discussing good faith purchaser status under section 363(m)). As the court in *Exaeris* astutely observed, the Committee's involvement in the negotiations between the Debtors and Acquisition would normally lend support to a good faith finding. *In re Exaeris Inc.*, 380 B.R. at 745; *see In re After Six, Inc.*, 154 B.R. 876, 882 (Bankr. E.D. Pa. 1993) (noting that if both debtor and committee supported sale, court would defer to such judgment). Again however, the Committee provided no evidence as to its role in the negotiations. The court will not find good faith simply because the Committee has emphatically supported the transaction with legal arguments. Instead, given the insider relationships in these cases, the court would expect the Committee to present evidence in support of the alleged good faith nature of the proposed transaction.

With respect to the last factor that this court deems relevant, the court concludes that the proposed sale to Acquisition dictates terms of a future plan of liquidation. *See State of Ohio Dept. of Taxation v. Swallen's, Inc. (In re Swallen's, Inc.)*, 269 B.R. 634, 638 (B.A.P. 6th Cir. 2001) (after proper notice, court cannot bypass requirements of chapter 11 where party in interest objects). The insider nature of the relationship again requires this court to view this attempt to bypass certain requirements of a plan with heightened scrutiny. In their objections, GBH and, to some extent, Bridgestone have asserted that the proposed sale to Acquisition will result in a *sub rosa* plan as discussed many years ago by the Fifth Circuit. *See Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935, 939-40 (5th Cir. 1983). In *Braniff* the court found that the proposed transaction under section 363 would circumvent creditor protections such as full and complete disclosure, voting rights, and the confirmation requirements of section 1129, among other things. *See id.* at 940.

This court notes that in *Stephens Indus.*, the Sixth Circuit discusses *Braniff*, but does not necessarily adopt it. After independent investigation, this court has been unable to identify any published decision wherein the Sixth Circuit explicitly recognized a prohibition on "*sub rosa* plans" or endorsed *Braniff* in the same way it has *Lionel*. Regardless, this court believes that *Braniff* merits consideration. *See also In re Victoria Alloys, Inc.*, 261 B.R. 918, 921 (Bankr. N.D. Ohio 2001) (addressing but declining to find *sub rosa* plan); *In re Dow Corning Corp.*, 192 B.R. 415, 427-28 (Bankr. E.D. Mich. 1996) (same); *In re Baldwin United Corp*., 43 B.R. 888, 906-907 (Bankr. S.D. Ohio 1984) (same). In *Stephens Indus*. the Sixth Circuit clearly expressed similar concerns to those at issue in *Braniff* by adopting *Lionel* and instructing bankruptcy courts to consider the effect of the proposed disposition on future plans. *Stephens Indus*., 789 F.2d at 389.

In these cases, the Acquisition APA contains provisions which are more appropriately included within the plan of liquidation that the Debtors intend to file, especially in light of the insider relationship between the Debtors and Acquisition.[41] As a threshold issue and keeping in mind disclosure requirements, none of the proposed agreements from any of the three bidders were served on the matrix in these cases, although they were filed on ECF [Dkt. Nos. 742, 814]. Because the Debtors proposed a bidding process with no stalking horse bidder, creditors have never received notice of the post-auction terms of the proposed transaction. In light of the extraordinarily broad releases for officers, directors, and insiders of the Debtors included in the Acquisition APA, this court would have had difficulty approving the proposed transaction with Acquisition without more significant disclosure and justification for the releases being granted by the Debtors. *See In re Exaeris Inc.*, 380 B.R. at 746-47 (citing *In re Drexel Burnham Lambert Group, Inc*., 134 B.R. 493, 497 (Bankr. S.D.N.Y. 1991); *see also Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 657 (6th Cir. 2002) (discussing factors related to non-debtor releases). Absent a significant narrowing of the releases, the court doubts that it could

[41] This court makes no determination as to whether these elements might be acceptable under different circumstances and absent the insider relationships which pervade these cases.

approve them outside of a plan. *But see In re Swallen's, Inc.*, 269 B.R. at 638 (suggesting that absent any objection and upon proper notice, the circumstances may allow a court to temper plan requirements).

GBH and Bridgestone also assert that the Acquisition APA improperly violates the absolute priority rule because it purports to pay junior classes of creditors before paying Credit Suisse in full. 11 U.S.C. § 1129(b)(1). GBH points to what it terms a 5% "tip" provided to unsecured trade creditors. This issue may arguably have been resolved by the settlement on the record whereby Credit Suisse agreed to release its claims against the estate after payment of a settlement amount of $5.45 million. However, once again, the court must emphasize its unease with the Debtors' failure to provide notice to creditors and other parties in interest. *See Burtch v. Avnet, Inc.*, 527 B.R. 150, 156 (D. Del. 2015) (release granted by debtor to secured creditor as part of settlement should not have been approved by bankruptcy court without notice to parties); *see also In re Embrace Inc.*, 178 B.R. at 125 n.11 (noting problem when creditors receive insufficient disclosure because sale sought outside chapter 11 plan); *In re General Bearing Corp.*, 136 B.R. 361, 365 (Bankr. S.D.N.Y. 1992) (questioning whether creditors were properly notified of sale).

Finally, as emphasized by the UST and Bridgestone, the Debtors have not undertaken an adequate inquiry as to the value of the avoidance actions or the value of the incredibly broad releases being granted to insiders. This court is extremely mindful that the Sixth Circuit has explained that involuntary releases of third party claims against non-debtors are a "dramatic measure" and should be implemented only in "unusual circumstances." *In re Dow Corning Corp.*, 280 F.3d at 658 (citations omitted). The Sixth Circuit has seemingly inferred that this court should not approve similar releases unless complete disclosure has been made pursuant to a plan and *only* after seven elements are satisfied. *See id.* As such, absent full disclosure to general unsecured creditors, none of whom have been advised of the proposed releases being provided to insiders or the "sale," abandonment or waiver of avoidance actions (however the Debtors choose to characterize it), this court cannot approve the Acquisition APA.

In addition, the court notes that it cannot approve the sale to GBH, or to FC Special Funding, for that matter. After the settlements were placed on the record, GBH no longer had the support of Credit Suisse. The GBH agency agreement distributes funds to consignment vendors without paying Credit Suisse in full, unlike the Acquisition bid, which resolves the claims of Credit Suisse. According to GBH, such a transaction, at least when proposed by Acquisition, would violate the Bankruptcy Code. Moreover, the GBH agency agreement required the consent of both FC Special Funding, whose support it never had, and Credit Suisse, whose support was withdrawn at the sale hearing. Therefore, the GBH agency agreement does not seem feasible given GBH's requirements and the current alliances in these cases. Even if the GBH agency agreement did not face the aforementioned obstacles, the court would nonetheless decline to approve the sale to GBH. GBH has repeatedly stated that it was prepared to bid more at the auction, but elected not to due to the perceived, although relatively unsupported, concerns regarding fairness. Finally, GBH has failed to provide any firm commitment to this court regarding the payment in full of administrative expenses. The court therefore cannot conclude that the GBH bid is the highest and best bid.

Similarly, the court cannot approve the sale to FC Special Funding because after being privy to certain information as a Consultation Party, FC Special Funding attempted to remove itself from that role and join the auction as a bidder.[42] This court must infer that FC Special Funding gained an unfair advantage by initially participating as one of the Consultation Parties

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[42] Moreover, at one point during the auction, FC Special Funding recommended a bid in which it would receive a release of any and all claims against it by the Debtors' estates.

and thereafter submitting a bid. This conduct is similar to insider trading, and cannot be overlooked. The court also notes that FC Special Funding's bid does not ensure payment in full of all administrative expenses, among other things. The court will therefore not consider the current bid of FC Special Funding as eligible to be declared as the winning bidder at this time.

In sum, the Debtors have convincingly set forth many compelling reasons for the court to approve the sale to Acquisition. The Debtors have, in this court's view, properly pursued a sale of substantially all of their assets given their unstable financial condition and extensive marketing efforts, among other things. However, certain elements in the Acquisition APA are inappropriate in light of the insider relationships in these cases. In addition, the various settlements (*e.g.*, with consignment vendors and Credit Suisse) require notice to all creditors and parties in interest.

This is not a situation where the court is willing to exercise its discretion to approve the sale to an insider without being provided with any testimony or other evidence as to the value of the releases and, similarly, avoidance actions. This court is also unwilling to circumvent the due process rights of creditors and other parties in interest who have been denied the opportunity to assess the binding effects of the proposed transactions. The court therefore finds that the Debtors have not satisfied the standards as required by the Sixth Circuit to sell their assets to GBH, Acquisition or FC Special Funding.

CONCLUSION

Although the court cannot approve the Sale Motion as presented, the court is cognizant of the consensus that has developed in these cases. As noted above, the court places great significance on the support from the Debtors' major stakeholders, all of whom favor a sale of substantially all of the Debtors' assets to Acquisition. Therefore, the Debtors may wish to reopen the auction and resume acceptance of bids from GBH, Acquisition, and any other qualified bidders in accordance with the court's order denying the Sale Motion entered concurrently herewith.[43] The court strongly encourages the Debtors, as well as any potential purchaser, to be cognizant of the court's comments regarding the structure of any agreement and the constraints imposed by the Bankruptcy Code, from which this court will not deviate. The Debtors should further keep in mind that any proposed settlements must comply with the notice requirements of Fed. R. Bankr. P. 9019(a). *See Papas v. Buchwald Capital Advisors, LLC (In re Greektown Holdings, LLC)*, 728 F.3d 567, 575-76 (6th Cir. 2013) (McKeague, J.) (citation omitted) (identifying four factors to consider when evaluating fairness of bankruptcy settlements).

Lastly, as noted above, the UST requested that it be permitted to attend the auction to generally monitor the fairness of the process. The court has decided, given the UST's prior request, to expand the UST's role at any reopened auction. The UST shall monitor <u>all</u> aspects of the auction, including discussions by and among the Debtors and Consultation Parties, and file and serve a written report regarding the fairness of the auction as more fully described in this court's order denying the Sale Motion.

As an alternative to recommencing the auction, the Debtors may simply wish to file a plan of reorganization so as to avoid any allegations, or concerns from this court, that any proposed transaction fails to comport with the applicable provisions of the Bankruptcy Code.

For the foregoing reasons, the Sale Motion is denied. The court shall enter a separate order consistent with this Memorandum Decision.

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[43] Nothing contained in this Memorandum Decision or the related order entered by this court should be construed as requiring Acquisition, GBH, or any other previously qualified bidder to participate at any reopened auction.

Signed: June 18, 2015

John T. Gregg
United States Bankruptcy Judge

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First Glance
What's Your Bid?

*12 FAMILY CHRISTIAN: CAUTIONARY TALE OF BEST AUCTION PRACTICES

J. Scott Victor [a1]
SSG Capital Advisors, LLC; Philadelphia

Adam H. Isenberg [a1]
Saul Ewing LLP
Philadelphia

Monique Bair DiSabatino [a1]
Saul Ewing LLP
Philadelphia

While the number of chapter 11 filings continues to fan, the percentage of 363 sales in chapter 11 cases continues to rise. For example, the number of 363 sales in large public bankruptcy cases in 2014 rose 4 percent, to 38 percent of all chapter 11 cases filed during the year. [1] With this continued rise in asset sales comes an increase in the number of auctions held, raising the likelihood that auction participants will encounter a variety of pitfalls, conundrums and other issues.

Two such auction pitfalls were addressed in a recent decision by the U.S. Bankruptcy Court for the Western District of Michigan in *In re **Family Christian** LLC*. [2] This decision is a cautionary tale of what can go wrong at an auction and provides a helpful starting point in discussing other issues that may arise from the ever-increasing number of auctions held each year.

Family Christian

In ***Family Christian***, the debtors sought to sell substantially all of their assets pursuant to § 363 of the Bankruptcy Code. Several parties submitted bids for the assets, including (1) a joint venture between Gordon Brothers Retail Partners LLC and Hilco Merchant Resources LLC (together, "GBH"); and (2) an insider entity called FCS Acquisition LLC that was formed by Richard Jackson for the purpose of purchasing the debtors' assets. Jackson was considered an insider because he also controlled the nondebtor holding company that owned certain of the debtors.

The bids submitted by FCS Acquisition during the auction differed from the bids submitted by GBH and other liquidator bidders (together, the "liquidators") in several ways. For example, FCS Acquisition's bid included a broad release of avoidance actions and claims against the debtors' insiders and established a minimum value for the debtors' estates. In contrast, the liquidators' bids did not establish a concrete minimum value for the debtors' estates.

After several contentious rounds of bidding, GBH ultimately declined to bid further, and FCS Acquisition was declared to be the highest and best bidder. GBH and others objected to the proposed sale to FCS Acquisition, arguing, *inter alia*, that the auction was unfair and that the release of insider claims and avoidance actions contemplated in FCS Acquisition's bid was inappropriate.

Although the creditors' committee and other key constituents supported the sale, the court declined to approve the sale, finding that "the insider nature of sale to Acquisition simply [did] not permit [the] court to approve the transaction"[3] since the debtors did not articulate a sound business justification for the sale under the heightened standard applicable to insider transactions. The court also addressed the allegation that the auction process was unfair, finding that although such an allegation was unfounded, certain mistakes were made. These "mistakes," and other auction pitfalls, will be explored below.

The Pitfalls

No. 1: Failing to Value Insider Releases and Avoidance Actions

Although FCS Acquisition's bid contained a release of avoidance actions and insider claims, the debtors failed to value these releases, which the bankruptcy court viewed as "fatal." The court reasoned that if the debtors had valued the releases, they would have been able to adjust their bid valuations in order to credit the liquidators' bids for causes of action proposed to be left behind in the estates.

The court's finding is both clear and reasonable. Debtors, particularly in instances where an insider is participating in an auction, should work to establish a value for insider releases and avoidance actions before soliciting bids. These valuations should ideally reflect not only the face amount of any such claims, but also the strength of any defenses and the likelihood of recovery. Such valuations enable participants to be more specific as to the value left behind in a debtor's estate and lead to more meaningful bidding.

No. 2: The *Ex Parte* Phone Call

The second "mistake" identified in ***Family Christian*** was an *ex parte* phone call made by the debtors' chief executive officer (CEO) to Jackson on the final night of the auction. Specifically, the CEO testified that on the second night of the auction, he telephoned Jackson and another insider to ask Jackson to increase FCS Acquisition's bid. The bankruptcy court determined that this communication was inappropriate due to the insider relationship ***13** between Jackson and the debtors, as well as the relationship between Jackson and the CEO. Not only was the CEO hired by Jackson and others to serve in his capacity as CEO, but the CEO had also received reassurance that he would continue in his role if FCS Acquisition were the winning bidder.

The bankruptcy court reasoned that "[a] ny requests for higher bids should have been placed on the record at the auction or communicated through legal counsel."[4] The court also determined that the request for higher bids should have been made to *all* qualified bidders.

The court's conclusion with respect to the "*ex parte* phone call" is reasonable in many respects and troubling in others. During an auction, estate professionals frequently talk to representatives of bidders off the record as they work to negotiate asset-purchase agreement terms and stimulate further bidding. Certainly, it is not unusual for bidders to be asked to increase their bids, and such requests are not always on the record, in front of other bidders or addressed solely to legal counsel. One might accordingly argue that requiring auction participants and their professionals to observe these formalities would hamper the flexibility that is needed to drive up value during an auction.

Notably, ***Family Christian*** does not necessary prohibit *ex parte* communications, but instead highlights how, depending on the circumstances, such communications can undermine the propriety of the auction process. The bankruptcy court's troubles in ***Family Christian*** rested primarily with the fact that the telephone call was made to an insider by a CEO with a conflict of interest. There is no dispute that where an insider is involved, auction participants must take extra care in exercising formalities--such as avoiding *ex parte* communications or communications outside the presence of counsel--even if such steps appear to impede upon flexibility in negotiations, to avoid any appearance of impropriety.

No. 3: If You Bid $X, You Win

Family Christian describes two auction pitfalls, but the bankruptcy court's discussion of the "*ex parte* phone call" raises a third: whether it is appropriate to tell a bidder that it will win if it bids a certain amount or includes certain terms in its bid. In ***Family Christian***, after FCS Acquisition submitted its final bid, it left the auction despite the fact that the auction had not been closed. This conduct left the court with the impression that FCS Acquisition was informed that it would be declared the winning bidder if it increased its bid as requested.

The court's concern with this conduct raises the question of whether it is wrong to tell a bidder that it will win if it submits a specified bid. On the one hand, this approach may encourage a bidder to go "just a bit further," particularly where it appears that active bidding might be drawing to a close, and may generate additional value for the debtor. On the other hand, such a statement is arguably contrary to the purpose and spirit of the § 363 auction process. After all, who is to say that the increased bid from one party would not necessarily lead to a higher and better bid from another party? Promising one party that a bid on certain terms will ***71** lead to victory undercuts the possibility that another party might offer better terms than the predetermined winner and undercut the potential for increased value.

Whether it is appropriate to make promises such as this during an auction is a judgment call that estate professionals need the flexibility to make, depending on the circumstances at the time. ***Family Christian***, however, offers fair warning that such statements may be negatively construed by a court, particularly when made to an insider.

No. 4: Keeping a Party in the Game to Drive Up Bidding

Family Christian highlights just some of the pitfalls that may arise from the auction process, but there are others. A bid that is "highest" is not necessarily "best," and bids often include terms and conditions that prevent them from being considered "best" even if their consideration is highest. For example, a bid may be contingent upon receipt of third-party consents, may have financing contingencies or, as in ***Family Christian***, may not guaranty a minimum value to the estate. These structural issues, which are often known at the outset of an auction, raise difficult questions, including whether a debtor can appropriately keep a less-attractive bidder at the table and, more significantly, whether a debtor can or should declare such a bidder "highest and best" at any point during the auction. Less-attractive bidders, for example, may challenge the results of the auction by arguing that their bids, which were described as "highest and best" during the auction, remained "highest and best." A winning bidder may argue that it was inappropriately induced or "tricked" into increasing its bid in order to outbid a bidder that never stood a chance.

Estate professionals may reason that keeping a less-attractive bidder at the table is, at times, a necessary strategy. Nevertheless, to avoid allegations of unfairness, debtors should (to the best extent possible) quantify the risks and contingencies contemplated by particular bids so that the shortcomings of the bids, at each stage of the bidding process, are clear. Moreover, disclosure and transparency are key. Any potential taint caused by keeping a less-attractive bidder at the table will be diminished if *all* bidders are informed, on the record, and at each stage of the auction, that a particular bid suffers from certain defects. Accordingly, while estate professionals may choose to keep bidders with inherent risks at the table to ensure a robust auction, disclosure and, if possible, quantification of those risks is necessary to avoid any element of unfairness.

No. 5: Is It Collusive Bidding or Not?

One final auction pitfall to consider centers on collusive bidding and the determination of whether conduct is collusive or merely collaborative. Section 363 (n) of the Bankruptcy Code prohibits collusive bidding and provides that a trustee "may avoid a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale." [5]

A finding of collusive bidding has significant repercussions. Not only may the trustee set aside the sale or seek damages based on the loss in value, but the statute also contemplates the recovery of costs, attorneys' fees and expenses incurred in pursuing such relief, and, in certain instances, punitive damages.[6]

A full discussion of collusive bidding is well beyond the scope of this article. However, given the significant repercussions of collusive bidding, auction participants, particularly estate professionals, must be able to identify and prohibit collusive bidding. While the law is clear that a joint bid, by itself, is not sufficient to constitute collusion,[7] the determination of whether a joint bid is collusive can be tricky and largely depends on the facts of a particular case. For example, a bidder at a recent chapter 11 auction announced off the ***72** record, during a break in the auction, that it could not bid any higher, then left the auction. Several hours later, and without formally withdrawing from the auction as a standalone bidder or otherwise indicating that it was in discussions for a joint bid, the bidder returned and submitted a "higher and better" joint bid with another bidder that had remained at the auction. After significant discussion among interested parties, the joint bid was not accepted, but whether or not this outcome was proper is debatable.[8]

Several considerations may help professionals decide whether joint bidding is appropriate. In particular, estate professionals should focus on whether the joint bid will add value to a debtor's estate. Estate professionals should also consider the motivations of the parties to the joint bid, in addition to the terms of the deal, to determine whether the bid reflects an agreement to control price, or whether it is meant to achieve other objectives, such as enabling one or both bidders to overcome financial limitations that would otherwise inhibit them from bidding competitively on their own.[9] The parties' disclosure of the terms of the agreement to submit a joint bid is also important. Indeed, openness not only about the agreement to jointly bid, but the consideration and other benefits to be afforded to each joint bidder, may remove any taint that would otherwise apply to the bid.

Conclusion

There are many instances in which one can run into unexpected challenges at an auction. ***Family Christian*** shows that sensitivities to these challenges are heightened whenever a bidder is an insider and that irrespective of whether it is most efficient, certain precautions and formalities must be taken to avoid the types of mistakes that may ultimately lead a court to invalidate a sale.

The "pitfalls" described in this article are but a few of the many variations of pitfalls and ethical conundrums that one may face during an auction. No two auctions are alike, and with the number of § 363 sales steadily increasing each year, the challenges facing estate professionals and bidders in identifying and circumventing pitfalls such as these will only increase.

Footnotes

a1 *Scott Victor is a founding partner and managing director of SSG Capital Advisors, LLC in Philadelphia. Adam Isenberg is a partner and Monique DiSabatino is an associate in Saul Ewing LLP's Bankruptcy and Restructuring Practice in Philadelphia.*

1 *See* UCLA-LoPucki Bankruptcy Research Database, "363 Sales of All or Substantially All Assets in Large, Public Company Bankruptcies, as a Percentage of All Cases Disposed, by Year of Case Disposition," *available at* lopucki.law.ucla.edu/tables_and_graphs/363_sale_percentage.pdf (last visited Aug. 18, 2015). The database is co-supported by a grant from ABI's Anthony H.N. Schnelling Endowment Fund.

2 No. GG 15-00643-jtg, 2015 WL 3824980 (Bankr. W.D. Mich. June 18, 2015).

3 *Id*. at 21.

4 *Id*. at 19.

5 11 U.S.C. § 363(n) (2014).

6 *Id*.

7 *See* *In re Edwards*, 228 B.R. 552, 556 (Bankr. E.D. Pa. 1998); *In re GSC Inc*., 453 B.R. 132 (Bankr. S.D.N.Y. 2011).

8 *See* Transcript of Proceedings Before Hon. Brendan L. Shannon, at 28, 30, 49-55, *In re Hussy Copper Corp*. (Bankr. D. Del. 2011) No. 11-13010 (BLS).

9 *See, e.g*., *Boyer v. Gildea*, No. 05-CV-129-TLS, 2006 WL 2868924, at *15 (N.D. Ind. Oct. 5, 2006); *In re Edwards*, 228 B.R. at 564; *In re Bakalis*, 220 B.R. 525, 537 (Bankr. E.D.N.Y. 1998); *see also* Jason Binford, "Collusion Confusion: Where Do Courts Draw the Lines in Applying Bankruptcy Code Section 363(n)?," 24 *Emory Bankr. Dev. J*. 41, 66 (2008) (suggesting that bidders will probably not run afoul of § 363 (n) if motivated to collaborate for innocent reasons).

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