Everything-Must-Go Sale: The Ins and Outs of Retail Bankruptcies

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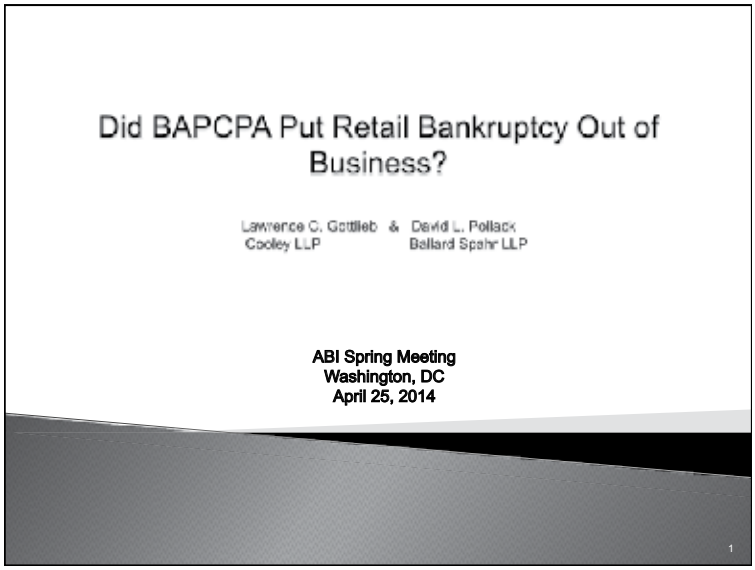

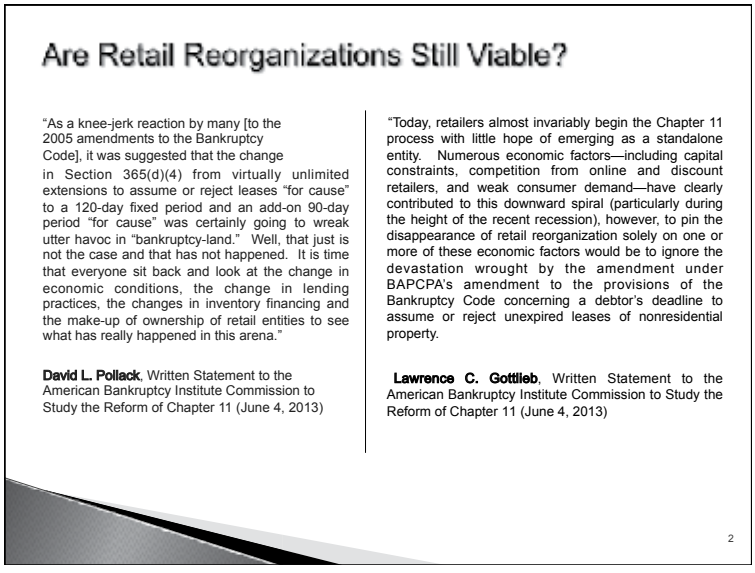

Are Retail Reorganizations Still Viable?

Suggested Factors Contributing to Decline in Retail Reorganizations

- Poor/changing economy?
- 2005 amendments to the Bankruptcy Code (BAPCPA)?
- Changes in lending practices and the growth of the second lien market?
- Changes in the ownership structure of retailers?
- Overreaction by lenders toward risky borrowers following years of lending laxity?
- Continuing dominance of the largest discount retailers at the expense of specialty stores or also-rans?
- Declining value of retail real estate and leases?
- Diminishing concentration of company-wide operating losses coming from a relatively small cluster of stores?

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Are Retail Reorganizations Still Viable?

BAPCPA

Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

- Have the 2005 amendments to the Bankruptcy Code resulted in a decline of retail reorganizations?
  - Is extended postpetition financing available to retailers?
  - Why not?

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Are Retail Reorganizations Still Viable?

Congressional Subcommittee on Commercial and Administrative Law:
"Is Chapter 11 Bankruptcy Working?"
September 26, 2008

Mr. Gottlieb: I would suggest, and I think as you suggested, when the business bankruptcy provisions were put into [BAPCPA], they were put into this big consumer bill, and I think a lot of them were probably done quickly . . .

Congressman Delahunt: You're being kind. They were done without any or minimal thought and analysis. That's the honest response.

Mr. Gottlieb: Right. And so you had individual provisions that were lobbied for, but no one, I suspect, looked at all these provisions together, as one unit, and said: How will this affect business bankruptcies?

Congressman Delahunt: [BAPCPA] was driven by the credit card industry. Everybody understands that.

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Are Retail Reorganizations Still Viable?

BAPCPA

- Revised Section 365(d)(4): Real Estate Leases
  - Prior to BAPCPA, a debtor enjoyed an initial period of 60 days to determine whether to assume or reject its real estate leases and bankruptcy courts routinely extended this period, sometimes through plan confirmation
    - § Debtor was provided with adequate time to analyze their individuals stores, monetize valuable commercial leases, if any, and design and implement a reorganization strategy
    - § Lenders were happy to assist, because they knew that as long as they were receiving interest payments and as long as their collateral base was not declining, there would be ample time at the end of the day to conduct Going-Out-Of-Business ("GOB") Sales at the debtor's locations if the reorganization could not ultimately be achieved

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Are Retail Reorganizations Still Viable?

BAPCPA

- Revised Section 365(d)(4): Real Estate Leases
  - After BAPCPA, a debtor must decide whether to reject its real estate leases within 210 days of the commencement of the case and the bankruptcy court may **not** extend beyond this period, regardless of whether the debtor operates 10 stores or 1,000 or if a one day extension means the difference between a reorganization or a liquidation that would cause 100,000 job losses
  - As a result, lenders no longer confident that if a reorganization fails, a debtor will still have enough time to conduct GOB sales in its own locations before having to reject its leases
    - § GOB sales must be planned, approved by the Bankruptcy Court (after parties in interest are provided with sufficient notice), and conducted in manner that maximizes value. All told, preparing and conducting a GOB sale takes at least 120-days in most cases.
    - § The 210-day limit set by BAPCPA therefore leaves a debtor with less **than three months** after the commencement of its case before GOB sales must be implemented.
  - Net Result: Lenders are no longer assured of sufficient time to conduct store closing sales or liquidation sales on site (that would serve to maximize the value of their collateral) in the event the reorganization fails.

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Are Retail Reorganizations Still Viable?

BAPCPA

- Revised Section 365(d)(4): Real Estate Leases
  - 210-day period can be extended with landlord consent. In some cases, landlords have consented to an extension of the 210-day period in exchange for various consideration:
    - § *Hancock Fabrics* (Del) – Approximately 80% of landlords agreed to extend assumption deadline in exchange for debtors' payment of three months rent on an administrative basis regardless of whether lease was rejected during extended period
    - § *Linens 'n Things* (Del) – Approximately 90% of landlords agreed to extend assumption deadline in exchange for debtors' release of preference actions against such landlords
    - § *Movie Gallery* (Del) – Debtors receive approval of "opt in" lease extension protocol by which $100 checks were sent out to landlords along with a letter from the debtors requesting consent to the extension. Endorsing and cashing the check by a set deadline constituted a grant of the requested extension
  - Is possibility of extension enough for secured lenders?

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Are Retail Reorganizations Still Viable?

BAPCPA

- Revised Section 365(d)(4): Real Estate Leases
- Most postpetition financing facilities either (i) expire within the first few months of the case, (ii) include "milestones" or "trigger notices" requiring the Debtors' to follow a strict path towards liquidation or a sale, (iii) include substantial reductions in the advance rate as the case extends beyond a certain length, or (iv) employ some combination of the above.
  - *Steve & Barry's* (SDNY) – DIP financing facility required the debtors to have commenced a full chain liquidation by just the **fifth week** of the case to the extent no sale of the business as a going-concern had been consummated
  - *Mervyn's* (Del.) – DIP financing facility entitled lenders to establish a borrowing reserve to reflect the value of all inventory at the debtors' store and warehouse locations to the extent such leases had not been assumed by the **fourth month** of the case
  - *Boscov's* (Del.) – DIP financing facility tied debtors' borrowing availability to a preset "inventory advance rate" intentionally designed to drop so precipitously during the first few months of the case, that Boscov's was essentially guaranteed to lose all borrowing availability less than **90 days** after the bankruptcy filing

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Are Retail Reorganizations Still Viable?

- *Circuit City* (ED Va.) – DIP financing facility required debtors to file a plan of reorganization just **four months** into the case
- *School Specialty, Inc.* (Del.) – Overleveraged and short of cash, this debtor had no choice but to accept a lifeline extended by its second lien secured lender, a private investment fund. The DIP loan provided by the lender contained covenants that required the sale to be approved by the bankruptcy court less than **two months** after the commencement of the case.
- *THQ, Inc.* (Del.) – DIP financing facility required closing of sale of substantially all of the Debtors' assets within approximately **6 weeks** of the petition date.
- *Dots, LLC (NJ)* – DIP financing required court approval of sale of substantially all of the Debtors' assets within approximately 2 months of the petition date. Company had been shopped pre-petition. Only stalking horse bidder was liquidator.
- *F&H Acquisition (Fox & Hound/Champps) (Del.)* – DIP financing required court approval of sale of substantially all of the Debtors' assets within approximately 2 months of the petition date. Affilliate of second lien holder purchased debtor's assets
- *Sbarro, LLC (SD NY)* – Prepack with lender taking over company after "dumping" 150 +/- leases and no distribution proposed for unsecured creditors

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Are Retail Reorganizations Still Viable?

BAPCPA

Has amended section 503(b)(9) affected a retailer's ability to reorganize?

- Section 503(b)(9): 20-Day Claims
  - Prior to BAPCPA, a debtor's failure to pay for goods received within the 20 days prior to the filing gave rise to a prepetition claim, subject to very limited reclamation rights
  - Now, vendors receive an administrative claim for goods sold to and received by the debtor within this 20-day window
  - Debtors are now required to have available at confirmation funds sufficient to pay this new and potentially massive class of administrative claims
  - Section 503(b)(9) has resulted in significant litigation over, among other things, the interplay between 503(b)(9) claims and (i) setoff, (ii) preferences, and (iii) the distinction between goods and services.

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Are Retail Reorganizations Still Viable?

BAPCPA

- Section 503(b)(9): 20-Day Claims
  - *Circuit City*
    - § Amount of 503(b)(9) claims filed against Circuit City totaled $350 million. To put that number in perspective, Circuit City's DIP facility provided for new borrowing of only $50 million
    - § For large retailers like Circuit City who receive high volumes of inventory with a reasonable turnover rate, 503(b)(9) may compel the already distressed debtor to raise substantially more capital than was required pre-BAPCPA

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Are Retail Reorganizations Still Viable?

BAPCPA

- Section 503(b)(9): 20-Day Claims
  - "Pay to Play"
    - § In order to use the bankruptcy process to liquidate collateral, lenders often are asked (usually by creditors' committees) to *"pay to play"* – meaning the lenders must at least ensure that administrative expense claims will be paid in full in the case
    - § Some lenders have recognized, and some bankruptcy courts have reinforced, the "necessity of making some distribution available to other creditors as the price of a court-approved sale." *In re Encore Healthcare Assocs.*, 312 B.R. 52, 57 n. 10 (Bankr. E.D. Pa. 2004)
  - "I generally have held in the past that you can run a case for the benefit of a secured creditor. It's the crime of having collateral that some people seem to say that they can't. They've got to pay the freight, and the freight is, at least -- the freight is not necessarily a tip to the unsecureds, but the freight is certainly an administratively solvent estate. And while there's not a guarantee, there has to be something other than a wing and a prayer on the payment of the admin claims. . . It doesn't need to be in the DIP budget, necessarily, but there has to be something -- and again, not a guarantee, but something, some evidence that there's a possibility -- probability that they'll be paid." *In re NEC Holdings Corp., et al.*, Case No. 10-11890(CSS), Docket No. 224, Transcript of July 13, 2010 hearing.

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Are Retail Reorganizations Still Viable?

BAPCPA

Have the amendments concerning a debtor's exclusive periods to file a plan of reorganization affected a retailer's ability to reorganize?

- Section 1121: Exclusivity
  - Prior to BAPCPA, courts were given wide latitude to extend the debtor's exclusive periods to file a plan and solicit acceptances thereof
  - After BAPCPA, the Bankruptcy Code provides the debtor, in the absence of an order appointing a trustee or shortening the time, with an exclusive period of 120 days after the commencement of the case during which only the debtor may file a plan of reorganization and an exclusive period of 180 days after the commencement of the case during which the debtor may solicit creditor votes to accept the plan
  - These deadlines may be extended by the Bankruptcy Court for "cause", but only up to a maximum total extension of 18 months
    - § Court has no discretion

Retail debtors are selling their assets long before exclusivity expires. Is the need to avoid competing plans part of the strategic calculus leading to such quick sales?

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Are Retail Reorganizations Still Viable?

- The decline of reorganization has been met with a proportionate increase in the number of Section 363 sales of all or substantially all of a chapter 11 debtor's assets
- Section 363 of the Bankruptcy Code provides that a debtor "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." A sale of all or substantially all of a debtor's assets constitutes a transaction outside of the ordinary course of business.
- Not only does section 363 provide the lender with the most optimal location to liquidate its collateral, but it also provides numerous advantages to prospective buyers that result in bids that are higher than what would be offered outside of bankruptcy
    - Sales are free and clear of most liens, claims and interests
    - Tax exemptions
    - No successor liability
    - Ability to bind non-consenting constituencies
    - "Cherry pick" contracts and leases
- Can be significantly cheaper and quicker than a plan of reorganization

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Are Retail Reorganizations Still Viable?

"Tweaking" § 365 – Will It Help ?

- What effect would extending the time to assume or reject leases have on retail reorganization ?
    - If extended, for what period of time ?
- Would codifying a uniform rule to require payment of "stub rent" in all cases help ?
- Should Montgomery Ward be overturned legislatively ?
- When should "stub rent" be required to be paid ?
- Putting teeth into failure to fulfill post-petition obligations under §365(d)(3)

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Clean-up on Aisle 5: Retail Industry Reorganizations and Liquidations[1]

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[1] Much of these materials were originally prepared by Robert L. LeHane and Jeffrey N. Pomerantz for the panel "SOS for Retail: Only the Strongest Survive" for the 2009 ABI Spring Meeting. The panel would like to thank Messrs. LeHane and Pomerantz for their permission to use these materials.

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I. Introduction

As retailers continue to struggle through the worst economic recession in decades amidst continued market swings, rising unemployment, financial upheaval and an unprecedented lack of credit, the question confronting too many struggling retailers is whether there is any possibility of successfully reorganizing in this economic environment under the current version of the Bankruptcy Code. Supplementing the article by Larry Gottleib, Jay Indyke and Seth Van Alten prepared for the ABI's *Views from the Delaware Bench* in November 2008 (the " November Article"), these materials update the current state of retail bankruptcy cases as we work through the first half of 2009 and discusses recent case law addressing issues under §§ 503(b)(9), 366 and 365(d), as well as other interesting issues confronting many retail bankruptcy cases.

Since the Fall of 2008, despite massive government intercession and the inauguration of the new administration, the credit markets have thawed only slightly, if at all, and consumer spending has continued to decline. Retail sales continue to plummet and more retailers have filed for bankruptcy, including Circuit City, Filene's Basement, Sportsman's Warehouse, Gottschalk's, KB Toys, National Wholesale Liquidators, Fortunoff's, S&K Famous Brands, and Mattress Discounters. As of the second week of February, as many as a dozen retailers are poised to file for bankruptcy within the next 30-60 days. In addition, several companies that completed reorganizations or going concern transactions in the last year have re-filed. The provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") continue to significantly impede the ability of retailers to secure financing and provide adequate time to reorganize business operations after filing for bankruptcy. In short, BAPCPA "has had a devastating effect on the retailer's ability to reorganize."

II. Liquidity and the Unintended Consequences of Revised 365(d)(4)

The biggest problem confronting retailers is the impact on liquidity of revised § 365(d)(4), which creates a firm deadline by which a debtor must reject, assume or assign its leases. Debtors now have an initial period of 120 days to decide whether to assume or reject their leases and the bankruptcy court is limited to granting the debtor only one supplemental 90-day extension.[2] Subsequent extensions may only be granted with the prior written consent of the landlord.[3] The statute was not intended to put even more power in the hands of lenders, but to the detriment of retail debtors, that is precisely the result.

Without sufficient liquidity to make post-petition payments to vendors, common carriers, utility providers, employees and professionals, there is no way for a retailer to reorganize. Generally, lenders refuse to permit the use and disposition of their collateral, or to extend additional financing unless they have confidence in a debtor's ability to reorganize effectively without diminution in the value of their collateral. Lenders have little or no incentive to participate in a reorganization process that will not result in repayment of the present value of their indebtedness, which in most cases includes significant pre-petition borrowings. Wary of the looming tidal wave of liquidations, post-petition lenders push for an immediate sale of their

[2] 11 U.S.C. § 365(d)(4)(B)(i).

[3] 11 U.S.C. § 365(d)(4)(B)(ii).

collateral under § 363(b) rather than gamble on a going concern marketing effort or reorganization process that jeopardizes the value of their collateral.

Under § 365(d)(4) as it existed prior to BAPCPA, the debtor was required to decide whether to reject, assume or assign its leases within sixty days after the bankruptcy filing, unless otherwise extended by the court based on a showing of "cause."[4] The purpose of § 365(d)(4) was to impose a fixed deadline for the time to reject, assume or assign leases thereby reducing the "likelihood that provisions of the bankruptcy code will themselves add to the economic distress of retail merchants in shopping centers."[5] Notwithstanding Congress' intent, debtors routinely obtained numerous extensions of the § 365(d)(4) deadline beyond the initial 60-day period. Many debtors requested and were granted open-ended extensions of the deadline until plan confirmation, which was the law prior to the 1984 shopping center amendments, particularly in the Southern District of New York.[6] Other jurisdictions granted routine extensions, but usually limited them to 60 to 90 days at a time.[7]

Prior to BAPCPA, this willingness of bankruptcy judges to continuously extend the time to assume or reject leases had become a powerful tool that allowed debtors to downsize operations while sometimes adding considerable value to the estate. Retailers had enough time to analyze the value of their leases before making the decision to assume or reject and lenders had assurance that there would be adequate time to conduct orderly "going-out-of-business" ("GOB") sales in the event the reorganization process was terminated and the company had to liquidate. Although both issues are important, lenders demanding time to conduct GOB sales in post-petition lending arrangements since BAPCPA has had the most significant impact because it further reduces the already shortened time to assume or reject by an additional 10-12 weeks.

The impact on post-petition lending and liquidity resulting from revised § 365(d)(4), together with the unprecedented market conditions, has had a profound negative impact on the ability of retail debtors to reorganize. Most retail debtors, despite their best efforts to reorganize or effectuate a going concern transaction, see their assets sold to liquidators under § 363 of the Bankruptcy Code. Frequently, existing lenders are willing to provide only enough financing to position the debtor for a liquidation in the first few months of the case. Amended §365(d)(4) substantially enhanced lenders' leverage, enabling them to impose restrictive conditions 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. The result is the continuing trend of prominent

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4 11 U.S.C. § 365(d)(4) (1984) *amended by* 11 U.S.C. § 365(d)(4) (2005).

5 130 *Cong. Rec.* S8891, S8894-95 (daily ed. June 29, 1984) (Statement of Sen. Orrin G. Hatch), *reprinted in 1984 U.S. Code Cong. & Ad. News* 590, 598-601; *see, e.g., In re Channel Home Centers, Inc.*, 989 F.2d 682, 686 (3d Cir. 1993); *In re Sea Harvest Corp.*, 868 F.2d 1077, 1079 (9th Cir. 1989).

6 S*ee e.g. Nostas Associates v. Costich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18 (2d Cir. 1996) (dicta suggests that a debtor should not be compelled to decide whether to assume until the moment of confirmation of a plan of reorganization).

7 *Compare In re Ames Dept. Stores, Inc.*, 2002 WL 511556 (S.D.N.Y.) *with In re Victoria Station, Inc.*, 875 F.2d 1380, 1384-5 (9th Cir. 1989) *and Matter of American Healthcare Management, Inc.*, 900 F.2d 827 (5th Cir. 1990).

retailers disappearing after filing for a Chapter 11 bankruptcy with Linens 'n Things, Steve & Barry's, Circuit City, Mervyn's, and KB Toys all liquidating in the past few months. The liquidation of just these five retailers resulted in more than 70,000 lost jobs. Goody's,[8] one of only three retailers to emerge from Chapter 11 since BAPCPA,[9] has since been forced back into Chapter 11 bankruptcy and is in the process of liquidating all of its assets.

III. Section 503(b)(9) Issues as a Result of BAPCA

As discussed in the November Article, the enactment of § 503(b)(9) under BAPCPA[10] creates, especially in retail cases, a potentially tremendous tranche of administrative expense claims. Section 503(b)(9) is commonly cited as one of the principal hurdles placed by BAPCPA in the path of the successful reorganization of a large retailer (along with the unrealistically short period for lease assumption or rejection under the amended § 365(d)(4)). Not only may an ailing retailer lack the wherewithal to satisfy § 503(b)(9) claims on the effective date of a plan, but that very prospect may reduce the availability and tighten the terms of any debtor-in-possession financing it might otherwise have been able to attract.

The limited authority addressing § 503(b)(9) since its enactment is only beginning to address the nuances of its application.

A. Applicability of Section 502(d) to § 503(b)(9) Claims

In *Plastech Engineered Products*[11], the court held that § 502(d) of the Bankruptcy Code may not be used to disallow an administrative expense claim under § 503(b)(9). Section 502(d) disallows "any claim of any entity from which property is recoverable" under the avoidance provisions of Chapter 5 of the Bankruptcy Code. The court surveyed the mixed authority on whether § 502(d) applies generally to bar administrative expense claims requested under § 503(b),[12] then analyzed whether § 503(b)(9) claims in particular should be subject to such a defense.

> Although there are a number of reported decisions that address the issue of whether § 502(d) generally applies to § 503(b)

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8 *In re Goody's Family Clothing, Inc., et al.*, Case No. 08-11133 (CSS) (Bankr. D. Del. 2008).

9 *See also In re Hancock Fabrics, Inc., et al.,* Case No. 07-10353 (BLS) (Bankr. D. Del. 2008)*; In re Movie Gallery, Inc., et al.,* Case No. 07-33849 (DOT) (Bankr. E.D. Va. 2008).

10 Section 503(b)(9) allows an administrative expense for "value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business." 11 U.S.C. § 503(b)(9).

11 *In re Plastech Engineered Products Inc*., 394 B.R. 147 (Bankr. E.D. Mich. Sept. 16, 2008).

12 *See, e.g., MicroAge, Inc. v. Viewsonic Corp. (In re MicroAge, Inc.)*, 291 B.R. 503, 508 (B.A.P. 9th Cir. 2002) ("Section 502(d) by its terms applies to 'any claim' of an entity that received an avoidable transfer, and the definition of a 'claim' in § 101(5) is sufficiently broad to include requests for payment of expenses of administration.") vs. *Camelot Music, Inc. v. MHW Advertising and Public Relations, Inc. (In re CM Holdings, Inc.)*, 264 B.R. 141 (Bankr. D. Del. 2000) (§ 502(d) does not apply to § 503(b) administrative expenses).

> administrative expenses, none of those cases involve its potential application to a § 503(b)(9) administrative expense.
>
> What makes the § 503(b)(9) wrinkle to this issue more complicated is the hybrid nature of this new § 503(b)(9) expense: it is a prepetition obligation of the debtor that is now elevated to an expense of administration of a bankruptcy estate by § 503(b)(9).
>
> Because of this wrinkle, the question also arises whether § 502(d) should apply to § 503(b)(9) administrative expenses even if it does not otherwise apply to § 503(b) administrative expenses.[13]

The court held that § 503 makes no distinction between § 503(b)(9) claims and other § 503 administrative expenses and thus "belies nothing to suggest that § 503(b)(9) claims are to be treated any differently than other administrative priority claims. Thus "[t]he distinction urged by the Debtor — *i.e*., that § 503(b)(9)'s are pre-petition in nature — although factually true, is not a distinction that makes any difference under § 503(b), or is even recognized by § 503(b). Nor is there any legislative history to suggest that Congress intended there to be such a distinction."[14] The court held that (1) the allowance of claims under § 502 is entirely separate from the allowance of administrative expenses under § 503, and (2) nothing about § 503(b)(9) changed this conclusion. "[A]lthough most of the cases that have considered the application of § 502(d) to § 503(b) administrative expenses have done so only where the administrative expense at issue arose as a post-petition obligation, their logic and reasoning are sound and should apply with equal force to this new class of administrative expenses under § 503(b)(9). The mere fact that § 503(b)(9) administrative expenses arise pre-bankruptcy does not change the analysis."

B. Availability of § 503(b)(9) to Secured Creditors

Can a creditor whose claim is secured also assert a right to administrative priority under § 503(b)(9)? *Brown & Cole Stores*,[15] says it can. The debtor argued that a claim that is secured cannot also be allowed as a § 503(b)(9) administrative expense. It observed that other § 503(b) claims are unsecured except for certain tax claims under § 503(b)(1)(B)(i), which BAPCPA amended by inserting "whether secured or unsecured," after "any tax [ ] incurred by the estate," and that the absence of the word "secured" in § 503(b)(9) creates an inference that such status was intended only for unsecured claims. The majority of the panel rejected that argument, finding that the language of the statute is plain and unambiguous.[16]

Judge Jaroslovsky dissented on this issue, based on the use of the phrase "whether secured or unsecured" in § 503(b)(1)(B)(i) but not in § 503(b)(9), invoking the tenet of statutory interpretation that it is "generally presumed that Congress acts intentionally when it includes

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13 *Id*. at 154

14 *Id*. at 163.

15 *In re Brown & Cole Stores LLC*, 375 B.R. 873 (9th Cir. BAP 2007).

16 *Id*. at 878.

particular language in one section of a statute but omits it from another."[17] As a matter of policy, Judge Jaroslovsky noted that the issue could have a substantial impact in a chapter 11 case, because secured claims can be crammed down, whereas § 503(b)(9) claims must be paid upon confirmation, giving a secured creditor with a § 503(b)(9) claim far greater leverage than one whose claim can be paid over time.

The majority responded that this increased leverage is what Congress intended, and that the position advocated in the dissent would make no difference – if a secured creditor wished to avail itself of such power, it could waive its security:

> Congress gave tremendous leverage to a twenty-day sales claimant such as AGI by permitting it to demand full payment as of confirmation, and in doing so, perhaps dramatically affecting the outcome of the case. The fact that the claim is also secured represents less leverage (albeit more than held by non-priority general unsecured claims) than having administrative priority. It is not our place to reallocate that leverage. In any event, if the dissent's view were the law, the holder of a twenty-day sales claim could simply waive its security, obtain administrative priority, and have equally powerful influence over the outcome of the case.[18]

C. Applicability of Setoff Rights to § 503(b)(9) Claims

Brown & Cole Stores addresses a second issue: whether § 553(a), which permits the setoff of mutual claims of a debtor and a creditor that "arose before the commencement of the case", applies to § 503(b)(9) administrative expenses. The debtor sought to reduce a § 503(b)(9) claim by the amount of its prepetition breach of contract claim against the supplier. The supplier argued that such a setoff was improper because its claim was an administrative claim. The panel ruled that the debtor could take such a setoff, reasoning that while other subsections of § 503(b) pertain to postpetition administrative expenses,[19] § 503(b)(9) claims do not arise postpetition, but are prepetition claims that Congress simply elevated in priority. Accordingly, the court held that debtors may setoff prepetition claims against § 503(b)(9) claims pursuant to § 553(a).[20]

The analysis adopted by the court in *Plastech Engineered Products* might be read to suggest the possibility of a future split in authority on the setoff issue, inasmuch as the

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17 *Id*. at 881.

18 *Id*. at 878 n. 8. The majority view is arguably supported by *In re Rio Valley Motors Company LLC*, 2008 Bankr. LEXIS 959 (Bankr. D. N.M. 2008), in which an administrative claim was asserted both as a §503(b)(1)(A) claim and a §503(b)(9) claim. While not directly addressed, no issue was raised that the claim could not be asserted on alternative grounds; in fact, the court resolved the issue by ruling that it did not matter which party's account was accurate because the creditor dealership would be entitled to either a §503(b)(1)(A) claim or a §503(b)(9) claim.

19 There is one minor exception: Section 503(b)(3) and (4) confer such status upon fees and expenses incurred by petitioning creditors.

20 *Supra* n. 14 at 878-79.

Michigan court reasoned that there was no basis for distinguishing § 503(b)(9) claims from other § 503(b) administrative expenses (and thus no basis for treating it any differently for setoff purposes).

Interestingly, however, it is unclear why the *Brown & Cole Stores* court undertook this analysis in the first place, inasmuch as the case involved a debtor's setoff rights. Section 553 addresses a *creditor's* setoff rights. Courts hold that a debtor's setoff rights are among the defenses preserved under § 558, and that the distinction between administrative and prepetition claims makes no difference in that context (since the amount owed to a creditor for postpetition goods or services is properly reduced by any amount owed to the debtor, whether it arose prepetition or postpetition.[21]

D. Pay to Play

An issue yet to be addressed is whether any distinction may be made between § 503(b)(9) claims and other administrative claims when a secured creditor consents to a carve-out from the proceeds of sale of its collateral. To grease the wheels of a sale of their collateral under section 363 (and obviate objections that the sale is being conducted solely for their benefit), lenders have accepted the "necessity of making some distribution available to other creditors as the price of a court-approved sale."[22] While this frequently entails the payment of administrative expenses, lenders will seek to avoid any obligation to pay what may be very substantial § 503(b)(9) claims, on the basis that such claims are not incurred administering the estate and thus are not a true cost of conducting a § 363 sale, nor are such claims for postpetition shipment of goods that added value to the estate. The *Plastech Engineered Products* analysis, however, would suggest that all § 503(b) claims should be treated alike. It may also be argued that goods received within 20 days prior to bankruptcy are likely to still be on hand, and so enhance the asset base just as much as post-petition sales, and that there is therefore no reason to disregard the equal priority status placed upon them by Congress.

IV. Stub Rent and § 365(d)(3) (another source of liquidity ?)

With liquidity in short supply, retailers and their landlords continue the ongoing argument in several jurisdictions over the application of § 365(d)(3) to stub rent (rent accruing under the lease from the first day of the case through the end of the first month of the case) and whether the 'billing date" method or the "accrual/pro-ration" approach is the correct interpretation. A quick recap: § 365(d)(3) of the Bankruptcy Code directs a trustee or "debtor in possession" to, "*timely* perform all the obligations of the debtor…arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding § 503(b)(1)."[23] A slight majority of the jurisdictions follow the "pro-ration" or "accrual" theory, which allows the debtor to pro-rate obligations under its leases and

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[21] *In re PSA, Inc.*, 277 B.R. 51, 54 (Bankr. D. Del. 2002); *In re TSLC I, Inc.*, 332 B.R. 476, 478-79 (Bankr. M.D. Fla. 2005).

[22] *In re Encore Healthcare Assocs*., 312 B.R. 52, 57 n. 10 (Bankr. E.D. Pa. 2004).

[23] 11 U.S.C. § 365(d)(3).

pay only that portion of an obligation that accrued after the bankruptcy filing.[24] In contrast, under the "billing date" theory, adopted by a substantial minority of the courts, if an obligation becomes due, or is billed, after the date of the bankruptcy filing and before the effective date of a rejection or assignment of the lease, regardless of when the obligation accrued, it is an obligation that the debtor must timely perform.[25]

A. Goody's - the Billing Date Approach in Delaware

In *In re Goody's Family Clothin*g,[26] ("Goody's") the Delaware Bankruptcy court followed the well-established billing date rule in the Third Circuit and denied landlord motions to compel immediate payment of stub rent, but held that such claims are entitled to administrative priority under § 503(b)(1). The debtor has subsequently taken appeals from these Orders granting administrative priority under § 503(b) where the lease was rejected, arguing that § 502(g) renders claims for stub rent under rejected leases pre-petition general unsecured claims.[27]

B. In Re Stone Barn f/k/a Steve & Barry's - Pro-ration Endorsed in Manhattan

On December 17, 2008, Judge Gropper in *In re Stone Barn f/k/a Steve & Barry's* [28] firmly endorsed the pro-ration approach in a detailed Memorandum of Decision that canvassed most of the case law on the issue. Judge Gropper focused on congressional intent to avoid forcing landlords to become involuntary post-petition unsecured lenders by requiring payment for the post-petition use and occupancy, and the fact that pro-ration is easy to apply and consistent with the overall goals of the Bankruptcy Code. Judge Gropper also noted that the billing date approach leads to absurd results, such as converting pre-petition tax obligations into administrative claims because they are due under the lease post-petition. Hoping for a decision from the Second Circuit on the issue, Judge Gropper stayed the enforceability of his order *sua sponte* and invited an appeal directly to the Second Circuit. To date an Order has not been entered and no appeal been filed.

C. Circuit City - Pro-ration and the Meaning of "Timely Perform"

In *In re Circuit City,*[29] filed in the Eastern District of Virginia (Richmond) on November 10, 2008, Judge Huennekens issued a ruling on numerous landlord motions to compel payment of stub rent that does not fit nicely into either the pro-ration or billing date approach.[30]

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24 *In re Furr's Supermarkets, Inc.*, 283 B.R. 60, 65-66 (10th Cir. 2002); *In re Handy Andy Home Improvement Ctrs.*, *Inc.,* 144 F.3d 1125, 1126-27 (7thCir. 1998).

25 *In re HA-LO Indus., Inc.*, 342 F.3d 794, 797 (7th Cir. 2003); *In re Montgomery Ward Holding Corp.*, 268 F.3d 205, 211 (3d Cir. 2001).

26 *In re Goody's Family Clothing, Inc., et al*, No. 08-11133 (CSS) (Bankr. D. Del. 2008).

27 *See, e.g.*, *Goody's Family Clothing, Inc., et al., v. Mountaineer Property Co. II, LLC, Stafford Bluffton, LLC, and Eastgate Mall, LLC,* Civil Action No. 08-585 (RMB) (D. Del. 2009).

28 *In re Stone Barn Manhattan (a.k.a. Steve and Barry's)* Case No. 08-12579 (ALG) (Bankr. S.D.N.Y. 2008).

29 *In re Circuit City Stores, Inc.*, et al., Case No. 08-35653 (KRH) (Bankr. E.D. Va. 2008).

30 *In re Circuit City Stores, Inc.*, 2009 Bankr. LEXIS 672 (Bankr. E.D. Va. Feb. 12, 2009).

Judge Huennekens held that despite the company's agreement with the landlords that the pro-ration approach would apply and that stub rent is entitled to administrative priority under § 503(b)(1) because it did not become due post-petition, that the company was not required to pay the stub rent immediately, or even within 60 days after the petition date. The Judge found that 'timely performance' meant, on a lease where the stub rent is due before the petition date on the first day of the month, that the lease did not require immediate payment. Judge Huennekens also held that immediate payment of the stub rent, or even payment within the first 60 days of the case, would improperly elevate stub rent claims to "super priority" status, contrary to prior decisions of the bankruptcy Court in *In re Trak Auto Corp.*[31] and *In re Virginia Packaging Supply Co.*[32] Finally, Judge Heunnekens agreed with the company that under *Trak Auto*, he had the discretion to order that stub rent be paid with other allowed administrative claims under § 507(a) of the Bankruptcy Code on the effective date of any plan of reorganization.

For debtors, the Circuit City stub rent decision represents the best of both approaches; avoid paying any charges that accrue pre-petition while providing significant liquidity boost by delaying the obligation to pay stub rent until confirmation. In contrast, aside from the finding that stub rent is entitled to priority as an administrative claim under § 503(b), this decision is not a favorable development for landlords.

D. Bally Total Fitness – Let's Just Wait and See What Happens

Bally Total Fitness,[33] ("Bally's") filed for bankruptcy protection on December 3, 2008. Immediately after the case was filed, Bally preempted the stub rent issue by filing a motion to defer payment of January rent until the 60th day of the case for cause and a motion to establish procedures for responding to anticipated landlord motions to compel immediate payment of stub rent under § 365(d)(3). Bally cited both the inability to obtain post-petition lending and a general lack of liquidity as cause for the extension and claimed that it would need months to respond to the dozens of landlord motions to compel payment of stub rent as the basis for a proposed briefing schedule stretching over 90 days. Although the company reported sufficient cash to immediately pay January on January 9, the Court granted Bally's request for an extension to pay by January 16. As of the second week of February, Judge Lifland has declined to rule on the substantive issue of whether stub rent must be paid immediately or at the latest within 60 days of the petition date and has also declined to set a briefing schedule or rule on the debtor's § 365(d)(3) procedures motion.

V. Adequate Assurance of Utility Payments Under § 366

In re Circuit City Stores,[34] rejects the argument that under the amended § 366, as amended by BAPCPA, a bankruptcy court may not determine the appropriate amount of

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31 *In re Trak Auto Corp.*, 277 B.R. 655, 668 (Bankr. E.D. Va. 2002), *rev'd. on other grounds*, 367 F.3d 237 (4th Cir. 2004).

32 *In re Virginia Packaging Supply Co.*, 122 B.R. 491, 494-95 (Bankr. E.D. Va. 2002).

33 *In re Bally Total Fitness of Greater New York, Inc., et al.,* Case No. 08-14818 (BRL) (Bankr. S.D.N.Y. 2008).

34 *In re Circuit City Stores, Inc.*, 2009 WL 484553 (Bankr. E.D. Va. Jan. 14, 2009).

adequate assurance until the debtor has first paid whatever amount the utility has demanded.[35] The debtor in *Circuit City* proposed in its first day motion to place $5 million in a blocked account as adequate assurance of payment of future utility bills, requested the court find that this constituted adequate assurance of payment, and proposed procedures for the resolution of future disputes.

The problematic language is contained in § 366(c)(2), as amended by BAPCPA, which provides: "Subject to paragraphs (3) and (4) . . . a utility . . . may alter, refuse, or discontinue utility service if, during the 30-day period beginning on the date of the filing of the petition, the utility does not receive from the debtor or the trustee adequate assurance of payment for utility service that is satisfactory to the utility."[36]

Notwithstanding this seemingly plain language, the court rejected the argument that adequate assurance must be satisfactory to the utility:

> Such an interpretation of § 366 is simply unworkable. It could lead to absurd results. For example, a utility may simply fail to respond to a debtor's offer of adequate assurance, or it may choose to respond on the thirtieth day. In either event, the result would be calamitous for a debtor in the throes of bankruptcy. The calamity is compounded for a debtor with thousands of utility accounts. Congress cannot have intended to place in peril the entire reorganization process by prohibiting courts from fashioning reasonable procedures to implement the protections afforded under § 366 of the Bankruptcy Code. *See In re Syroco, Inc*., 374 B.R. 60 (Bankr. D.P.R. 2007).[37]

Parsing the statute, the court observed that, notwithstanding the wording of § 366(c)(2), it is by its terms subject to subparagraphs (3) and (4), and § 366(c)(3)(A) provides that "[o]n request of a party in interest and after notice and a hearing, the court may order modification of the amount of an assurance of payment under paragraph (2)." Therefore, the court concluded, "the plain language of § 366 of the Bankruptcy Code allows the Court to adopt the Procedures set forth in the Utility Order. The statute does not prohibit a court from making a determination about the adequacy of an assurance payment until only after a payment "satisfactory to the utility" has been received from the debtor under § 366(c)(2). The first clause of § 366(c)(2) clearly renders the entire section subject to the court's authority outlined in § 366(c)(3)."[38]

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35 *See In re Lucre*, 333 B.R. 151 (Bankr. W.D. Mich. 2005) (holding that a debtor has no recourse to request a court order modifying the assurance of payment demanded by the utility until the debtor first pays what the utility demands, while arguably imposing a duty upon the utility to bargain in good faith).

36 11 U.S.C. § 366(c)(2) (emphasis added).

37 *Supra* n.12 at 5.

38 *Id* at 8-9.

The court also invoked the tenet of statutory interpretation that Congress does not write on a blank slate, and it may be presumed that its retention of the preexisting language reflects an intent to maintain preexisting law:

> Prior to the enactment of BAPCPA, courts had the discretion under § 366 to determine the amount, if any, of adequate assurance payments or collateral required to a utility company. [citation omitted] Section 366(c)(3) uses language almost identical as that employed in §366(b) in allowing courts to modify the amount of adequate assurance. It follows that courts retain similar discretion even after the enactment of BAPCPA. Congress is presumed to be aware of the state of the law when it amends a statute, and the legislative decision to retain the almost identical language evidences Congressional intent to maintain the state of the law post-amendment.[39]

The court also cited § 105(d) as permitting it to "issue orders prescribing limitations and conditions as the court deems appropriate to ensure that the case is handled expeditiously and economically."[40] Finally, it noted that it and several other courts had approved such procedures post-BAPCPA.[41]

VI. Trust Fund Taxes

Payment of sales taxes is an important issue for all retailers (and their management). On the petition date in any retail bankruptcy, sales taxes will have accrued prepetition and be payable as of the petition date or shortly thereafter. The usual rationale for immediate payment of such claims rests on the assumption that such taxes are so-called "trust fund" taxes that are required to be collected from third parties and held in trust for payment to tax authorities.[42] Funds held in trust for that purpose are not property of the bankruptcy estate.[43]

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39 *Id*. at 8.

40 *Id*. at 9 n. 17.

41 "This Court and other courts within this district have entered orders establishing similar procedures for the implementation of § 366 of the Bankruptcy Code in large Chapter 11 cases subsequent to the enactment of BAPCPA. *See, e.g., In re Movie Gallery, Inc., et al*., Case No. 07-33849 (Bankr. E.D. Va. Nov. 17, 2007); *In re Storehouse, Inc.*, Case No. 06-11144 (Bankr. E.D. Va. Oct. 23, 2006); *In re Rowe Furniture, Inc*., Case No. 06-11143 (Bankr. E.D. Va. Oct. 23, 2006); *In re The Rowe Cos*., Case No. 06-11142 (Bankr. E.D. Va. Oct. 23, 2006)." *Id*. at 11.

42 *See, e.g., DeChiaro v. N.Y. State Tax Comm'n*, 760 F.2d 432, 433 34 (2d Cir. 1985) (sales tax required by state law to be collected by sellers from their customers is "trust fund" tax); *Shank v. Wash. State Dep't of Revenue (In re Shank)*, 792 F.2d 829, 830 (9th Cir. 1986); *Rosenow v. Ill. Dep't of Revenue (In re Rosenow)*, 715 F.2d 277, 282 (7th Cir. 1983).

43 *Begier v. IRS*, 496 U.S. 53, 55-67 (1990) (taxes such as excise taxes, FICA taxes and withholding taxes are property held by debtor in trust for another and, as such, do not constitute property of estate); *In re Al Copeland Enters., Inc*., 133 B.R. 837 (Bankr. W.D. Tex. 1991) (debtor obligated to pay sales taxes plus interest, because such taxes were "trust fund" taxes), *aff'd*, 991 F.2d 233 (5th Cir. 1993).

Understandably, senior managers are reluctant to risk incurring "responsible person" liability if the taxes go unpaid.[44] While a degree of influence and control over the payment of such taxes is required, the responsible individual need not retain absolute control over corporate finances; the individual need only have significant control over the disbursement of funds and priority of payment to creditors.[45]

Sales taxes, however, are not trust fund taxes in all states. For an obligation to be a "trust fund tax," the obligation must be both: (1) a "tax"; and (2) taken from a third party for remission to the taxation authority on behalf of that third party. In large cases where such tax liabilities are substantial, it may be worthwhile to evaluate this issue on a state-by-state basis. In *Circuit City*, for example, the debtors filed two motions to pay $35 million in prepetition sales and use taxes within the first fifteen days of the case. The creditors' committee objected to the premature payment of such tax claims to the extent the funds were not trust funds, and the parties set about analyzing whether sales taxes constitute trust fund taxes on a state-by-state basis. Ultimately, the debtors and the committee agreed, and the court found, that sales and use taxes levied by Arizona, Arkansas, California, District of Columbia, Hawaii and Michigan were not "trust fund" taxes because (a) the applicable statutes do not require the debtors to collect the taxes from third parties for remission to the state tax authorities on behalf of such third parties, and (b) the applicable statutes levy the contested taxes directly upon the debtors as taxes for the privilege of conducting business, regardless of whether the debtors collect reimbursement from any other party.[46]

VII. Gift Certificates

While large retailers seeking to reorganize will seek authority in a first day motion to honor prepetition gift certificates, among other customer programs, the treatment of such claims in liquidation presents interesting unresolved issues.

The leading case on the treatment of gift certificate claims (actually, the *only* decision published in the official reports) is *In re Woodworkers Warehouse, Inc*.[47] Judge Rosenthal held that consumer claims on account of pre-petition gift certificates are entitled to priority status over general unsecured claims. Section 507(a)(7) gives priority status to:

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[44] The term "responsible person" for trust fund tax purposes is defined under federal law by Internal Revenue Code §6672(a) as: "Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over...." Individual state and local statutes also impose liability on those responsible for withholding taxes.

[45] *See, e.g., Fernandez v. U.S.*, 130 B.R. 757, 761-63 (Bankr. W.D. Mich. 1991) (authority to bid and sign contracts and to make payments to employees and creditors represents control of the corporation sufficient for responsible person liability).

[46] *See Stipulated Order Regarding Payment of Certain Taxes Under Supplemental Order Pursuant to Bankruptcy Code Sections 105(a), 506(a), 507(a)(8), 541 and 1129 Authorizing the Debtors to Pay Prepetition Sales, Use, Trust Fund and Other Taxes and Related Obligations*, entered December 22, 2008.

[47] *In re Woodworkers Warehouse, Inc*., 313 B.R. 588 (Bankr. D. Del. 2004).

> allowed unsecured claims of individuals, to the extent of $2,425, for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided.

In Woodworkers Warehouse, the creditors held unused gift certificates issued pre-petition. The court concluded the purchase of a gift certificate should deemed a deposit entitled to priority under § 507(a)(7), rather than as a final and complete transaction giving rise to an unsecured claim.[48] In light of the legislative history,[49] the court opined that "to relegate gift certificate holders to the status of general unsecured creditors perpetuates the very problem Congress sought to remedy."[50] Specifically the court stated that "customers do not purchase gift certificates ... as the ultimate purchase," and that "[c]onsumers expect merchants to apply some or all of the face value of the gift certificate toward the ultimate purchase."[51]

Another court reached the opposite conclusion, on somewhat different facts. *In re Utility Craft, Inc*.,[52] the court ruled that a claim based upon an unused store credit that was given to a customer on account of defective merchandise, which credit covered the amount of the deposit, was not entitled to priority under § 507(a)(7), because the original deposit, delivery and payment for the couch constituted a completed transaction for purposes of § 507(a)(7), and "whether the Creditor decided to use the Store Credit is not part of the inquiry."

In the *Sharper Image* case,[53] the committee has objected to the treatment of gift certificate claims as priority claims, raising issues that go beyond the deposit issue addressed in *Woodworkers*. These include:

• Whether the maker of the underlying deposit is an "individual;"

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48 *Id*. at 595.

49 Congress stated that the section was "added as a result of testimony before the subcommittee on civil and constitutional rights concerning the problems that consumers have encountered with bankrupt retail businesses with whom the consumers have deposited money for goods and services." H.R.Rep. No. 95-595. The enactment of the section was in response to the failure of retailer W.T. Grant to honor scrip purchased by customers for use in the future purchase of merchandise. *See* Collier ¶ 507.08[1] (stating that the "drafters of the Code believed that it was appropriate to provide some protection to consumers ... [u]nlike businesses that knowingly extend credit and run the risk of nonpayment, consumers that make advance deposits on merchandise do not typically realize that they are extending credit when they make an advance payment for goods or services."). Specifically the legislative history cites to consumers paying money on a lay-away plan, placing a deposit on merchandise, buying a service contract, and buying a contract for lessons or a gym membership as examples of the sorts of situations section 507(a)(7) should remedy. *See* H.R.Rep. No. 95-595.

50 *Id*.

51 *Id*.

52 *In re Utility Craft, Inc*. Slip Copy, 2008 WL 5429667 (Bankr. M.D.N.C. 2008).

53 *In re Sharper Image Corporation*, 2008 WL 2795286.

• Whether the holder of the claim is an "individual;"

• Whether the maker of the underlying deposit and resulting claimholder is the same "individual;"

• Whether the deposit was made for the individual's "personal, family or household use;" and

• Whether the purchased goods or services were actually "delivered or provided" to the individual by Sharper Image.

The objection argues that § 507(a)(7), by its own terms, prioritizes the claims of "*individuals*" arising from the deposit of money in connection with the purchase, lease or rental of property or purchase of services, for the "*personal, family or household use of such individuals*, that were not *delivered or provided*." This makes for several arguments: (a) corporations and other entities are not entitled to priority;[54] (b) an individual asserting a Certificate claim is not entitled to priority unless such individual actually made the deposit;[55] and (c) an individual asserting a Certificate claim is not entitled to priority if the purchased goods were actually delivered or provided to such individual.[56]

VIII. Case Updates

The dismal success-rate of recent large retail filings highlights that the BAPCPA changes to the Code are compounding the impact of the economic downturn with terrible consequences for retail debtors. An update on the status of a few of the cases mentioned in the November Article and two other recent retail filings follows. Even though these cases are currently pending and their ultimate disposition has not yet been determined, none of them will result in the emergence of a reorganized company.

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54 *In re Carolina Sales Corp*., 43 B.R. 596, 597 (Bankr. E.D.N.C. 1984) (corporations are not "individuals" entitled to this priority).

55 "The modifying phrase "for the personal, family or household use of such individuals" evidences an intent by Congress to limit the priority to instances where the individual asserting the claim is the same individual who actually made the deposit - i.e., where the consumer and the claimant are one in the same. Accordingly, the statute denies priority to two important categories of claims." The objection contends that the same passage also "appears to limit priority entitlement to instances where the individual making the deposit is also the intended beneficiary (or at least one among a collective group of familial beneficiaries) of the goods or services to be provided on account of the deposit. Thus, an issue arises in the context of claims asserted on account of Certificates given to claimholders by friends, business associates, or even relatives that do not share a common household with the claimholder." Put differently, the objection contends that gift certificate claims, even if otherwise entitled to priority, would not be so entitled if the gift was given to a non-family member.

56 "The statute does not extend priority to individuals who receive, but then subsequently return, goods or services in exchange for the right to receive alternative satisfaction at some future time. *See In re Heritage Village Church & Missionary Fellowship*, 137 B.R. 888 (Bankr. D.S.C. 1991) (denying consumer deposit priority where claimants received bargained-for services prior to bankruptcy)."

A. Steve & Barry's

Steve & Barry's,[57] a case that exemplified the fast-track liquidation approach now taken by many retail lenders, included a post-petition financing arrangement that required the consummation of a sale transaction as either a going concern entity, or through an orderly liquidation under § 363(b), *barely a month* into the case. Less than 3 months after a sale transaction was approved by the Bankruptcy Court and consummated, and before the buyer, BH S&B had even exercised all of its lease designation rights, BH S&B filed a second Chapter 11 petition in the Southern District of New York and immediately liquidated all of the new company's assets.

B. Mervyn's

In the Mervyn's case,[58] the post-petition financing continued a pre-petition revolving credit facility with borrowing availability calculated as a percentage of inventory value, but the lender was authorized to take various "reserves" against the company's borrowing availability for, among other things, the value of inventory at leased locations with respect to which the leases had not yet been assumed, commencing 10 weeks before the deadline to assume or reject leases. The result was that Mervyn's had insufficient time to reorganize or market itself as a going concern, and the company was ultimately sold to liquidators. A small fraction of the 250 store leases were assigned to, among others, Forever 21 and Kohl's.

C. Boscov's

Boscov's[59] represents one of the bright spots in this season of retail failures. Although the post-petition financing arrangement provided an example of onerous liquidation-oriented covenants, which are now commonplace in post-petition financing language, the company was ultimately sold in a going concern transaction to a members of the Boscov and Lakin families.

D. Linens 'n Things

Linens 'n Things[60], which filed for bankruptcy May 2, 2008 in Delaware, entered bankruptcy with a post-petition financing facility that, among other restrictive covenants, required the company to obtain written consent from 80% of its landlords to extend the time to assume or reject leases from November 28, 2008 until March 9, 2009. Ultimately, over 90% of Linens 'n Things landlords agreed to the extension by the time to assume or reject imposed by the lenders. With the additional time under the lending facility, the company worked with vendors to build trade support around a $100 million letter of credit carved out of the post-petition lending facility and negotiated rent concessions from landlords to try to identify the most profitable 250 stores around which the company could reorganize. Notwithstanding these

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57 *In re Steve & Barry's Manhattan LLC et al*., Case No. 08-12579 (ALG) (Bankr. S.D.N.Y. July 9, 2008).

58 *In re Mervyn's Holdings, LLC, et al*., Case No. 08-11586 (KG) (Bankr. D. Del. 2008).

59 *In re BSCV, Inc. (f/k/a Boscov's, Inc.), a Pennsylvania Corporation, et al.,* Case No. 08-11637 (KG) (Bankr. D. Del. 2008).

60 *In re Linens Holding Co., et al.,* Case No. 08-10832 (CSS) (Bankr. D. Del. 2008).

additional reorganization efforts, the company's secured bondholders, which would have owned the company in a reorganization, decided that they would rather liquidate than risk owning a reorganized Linens 'n Things. Unable to find a going concern buyer, the company's inventory was sold to a consortium of liquidators and the leases were marketed for sale to end users. GOB sales concluded at most locations by December 31, 2008.

E. Circuit City

IX. Circuit City,[61] which filed in Richmond, Virginia on November 10, 2008, entered bankruptcy with a postpetition lending facility that required the company to file of a plan of reorganization or close on a sale transaction under § 363 by January 31, 2009, less than 90 days after the filing date. Under this timeline, the company continued turnaround efforts and a marketing campaign to sell the company as a going concern that were both commenced pre-petition. However, with the economy in free fall, the company's dismal post-petition performance made it almost impossible for the company to build the support of trade vendors or lenders to extend the deadlines imposed by the post-petition lending facility. Although the company was in discussions with several parties interested in purchasing significant portions of the company as a going concern, in the short time available, no hard going concern bid materialized, nor was there a clear path to a going concern transaction that justified extending any of the deadlines imposed by the lending facility. Delaying the liquidation would have significantly decreased the return to creditors. As a result, the company's inventory, valued at over $1 billion at cost, was sold to a consortium of liquidators. GOB Sales concluded on March 8, 2009.

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[61] *In re Circuit City Stores, Inc., et al.,* Case No. 08-35653 (KRH) (Bankr. E.D. Va. 2008).

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Bankruptcy Issues Affecting Retail Leases.
By David R. Kuney*

I. Introduction

These course materials examine a range of issues dealing with how landlords may protect their financial interests when a tenant in a commercial lease files for relief under Chapter 11 of the U.S. Bankruptcy Code.[1]

Tenant bankruptcies sharply increased in 2008. There were at least 18 major retail filings including Mervyn's, Linens & Things, Circuit City and many other well-known "brand names." The distinguishing characteristic of these cases in 2008 was that they were highly oriented toward liquidation and not reorganization. This meant that for landlords, there was a significant risk of lease rejection, abandonment, and damages.

Among the issues covered are lease guaranties, letters of credit and enforcement of a landlord's claims in bankruptcy.

Tenant bankruptcies take many forms. A tenant bankruptcy may arise where a tenant occupies only a single location in a commercial office building. Or, a tenant bankruptcy may arise in a large retail bankruptcy case in which the debtor has leased hundreds of retail stores. The financial risk and the legal strategies are mostly the same. Sophisticated counsel for debtors have developed streamlined first day motions and procedural motions which alter many fundamental Code provisions and may cause additional risk to landlords.

The financial risk to a landlord involves two discrete time periods in a typical bankruptcy case. The first risk concerns a landlord's ability to collect rent and enforce the lease prior to a debtor's decision to "assume" or "reject" the lease, both of which are described below. Because the debtor tenant is typically still in possession, and because the landlord cannot relet or market the space, the ability to collect rent and other current monetary obligations is critical. Despite certain statutory protections, explained below, a landlord may experience a substantial loss due to a debtor's ability to avoid these post-petition, pre-rejection obligations. These course materials will address how that occurs and how to minimize the risk.

In addition, landlords are subject to a risk of significant monetary loss in a bankruptcy which arises from the rejection of the lease and the resulting "claim" which comes into existence from the rejection. Most of these risks involve the nature and amount of the "claim" which a landlord may have against the debtor. Sometimes this is a claim for unpaid rent or future rent; sometimes it is a claim for real estate taxes, tenant fit up, or environmental contamination. The

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[1] All references are to 11 U.S.C. § 101 et seq. (the "Code").

dollar amounts can be huge. The notion of what is a bankruptcy "claim" itself is a complex question, which these materials will seek to clarify. Sometimes, and perhaps most frequently, the landlord suffers a monetary loss when a debtor exercises its statutory right to "reject" or terminate a lease, which is a special statutory right provided by section 365 of the Code. Despite this statutory right, there is much that landlords can do to minimize the loss, and these materials will try to identify some of the major strategies for landlords.

Commercial landlords typically have some form of credit protection, either in the form of a security deposit, a letter of credit or third-party guarantor. Despite their similarities, each of these forms of credit protection can lead to very different outcomes for a landlord. If a lease is rejected, the landlord may have a variety of claims against the debtor, and in this context, the use of guaranties, letters of credit, and security deposits becomes more significant. In addition, the landlord needs to understand and deploy effective strategies to protect its claim, even without the use of third-party guarantees, and letters of credit. Frequently, landlords are subjected to defenses and assertions and permit their rights to be lost.

The kinds of risk that confront landlords are not always perceived merely by reviewing reported decisions. Instead, debtors put into place, at the very outset of the bankruptcy case, operating procedures and rules as part of the "first day motions." [2] Frequently, landlords are confronted with complex motions to sell assets, which include related provisions concerning assumption and rejection of a lease. Whether landlords have a fair and complete opportunity to object to some of these procedures remains to be discussed. These course materials will explain how that may occur. Some of the strategies being invoked by large scale retail debtors, with hundreds of leases, involve aggressive, and possibly questionable legal theories, such as "retroactive rejection" and "premature rejection." Landlords must understand what these theories mean, and how they can cause the loss of huge claims for real estate taxes, construction damages, tenant fit up, and the like. One of the purposes of these course materials is to assist landlords and their counsel in protecting themselves from such loss.

Much of the law concerning landlord rights under the Bankruptcy Code is new. These materials will also address the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). BAPCPA was signed into law on April 20, 2005 and became effective as to most provisions on October 17, 2005. BAPCPA made at least three important changes to the law affecting commercial landlords: (1) it limited the debtor's time to assume or reject leases; (2) it increased the requirements for the assumption and assignment of shopping center leases; and (3) it changed which defaults must be cured prior to assumption, thus making it easier for a debtor to assume a lease despite an existing default.

Another important new development is the recent ruling by the Supreme Court which held that unsecured creditors (which may include landlords) are entitled to enforce a contract provision that enables attorney's fees to be paid. *See Travelers Casualty & Surety Co. of Am. v.*

[2] "First day motion(s)" refers to a typical group of pleadings, sometime over a dozen, which are filed in larger cases by many debtors on the first day of the bankruptcy. These motions are filed before any creditor or landlord has any notice of the case and before the formation of any creditors' committee. They are usually briefly reviewed by a court and frequently signed by the court without much review. They are rarely subject to rigorous adversarial scrutiny and as a result, may contain numerous provisions which are detrimental to landlords.

Pac. Gas & Elec. Co., 127 S.Ct. 1199 (2007). The Supreme Court left open some related issues which bear on the right to recover legal fees, but the impact of this decision may be very significant for landlords who incur substantial legal costs to protect their rights.

II. Protecting the Landlord's Right to Have a Debtor/Tenant Timely Perform Its Lease Obligations

A. The Statutory Duty of a Debtor/Tenant to "Perform" Its Lease Obligations.

In order to understand the strategy of a debtor/tenant when it files for bankruptcy it is necessary to understand the basic rights which Congress has given to landlords. It is essentially these special rights which are sometimes the focus of legal challenges and strategies by debtors/ tenants. In a word, what Congress has given to landlords, aggressive debtors seek to limit or eliminate. Such rights may be altered or lost through first day motions, and few landlords effectively challenge or understand how substantial a loss may occur if this is not monitored.

A lease is an executory contract and is governed by section 365 of the Code. An executory contract is a contract on which some material performance remains due and owing by both the debtor and the non-debtor when the case begins. Ordinarily, the non-debtor party to an executory contract is required to perform all of its duties, while the debtor itself is not required to perform its obligations pending assumption or rejection.

However, section 365 contains special provisions which are unique to landlords of commercial, non-residential real property. Most importantly, section 365 includes a statutory requirement that the debtor must timely perform all "obligations" of any "unexpired lease of nonresidential real property" which arise after the filing of the petition. 11 U.S.C. § 365(d)(3). Such obligations are determined by the terms of the contract, and hence the tenant is obligated to pay, on a current basis, the full amount of the contract rent until there is a judicial order approving a rejection of the lease. The rationale for this rule is that otherwise the landlord would be forced to provide services to the debtor—the use of its property, utilities, and other services—without payment. This is a critical obligation, because it creates a significant monetary obligation upon the debtor, and one which, if not paid, is entitled to priority as an administrative expense. As discussed below, debtors have invoked many strategies to avoid this obligation, particularly where it requires the debtor to pay pass through real estate taxes under the lease (and, in particular, for debtors with many retail locations).

The key language is "arising from and after the order for relief," and until rejection. That is, the duty of a tenant to perform its obligations depends on whether the duty "arose" after the order for relief and before the effective date of rejection. (See discussion below on retroactive rejection). This problem of understanding when an "obligation" arises is not the same as determining when a cause of action arises under normal rules of civil jurisprudence. Instead, specialized rules have arisen which can vary significantly from common law concepts of when a claim arises or accrues. .

B. Landlord's Right to Priority in Payment of Rental, Tax and Other Monetary Obligations

In addition, the debtor's duty to timely perform its post-petition lease obligations is given a statutory priority in payment. Landlords are entitled to have their rent and other lease

obligations paid prior to general unsecured creditors. In 1984, Congress added § 365(d)(3) to the Code, which states, in pertinent part, that:

> [t]he trustee shall timely perform all the obligations of the debtor . . .arising from and after the order for relief under any unexpired lease of non-residential real property . . . notwithstanding section 503(b)(1) of this title.

Landlords should understand and protect the significance of the priority payment. Because of section 365(d)(3), above, one of the most important rights of a landlord, and the one which is frequently the target of large retail debtors, is the right to be paid current rental and tax obligations, and other monetary obligations prior to the debtor's assumption or rejection of the lease. (If the lease is assumed, the obligation continues).

The landlord's right to be paid its current lease obligations is supported by the notion that the obligation is a "priority" obligation, meaning that a debtor must pay it before it can pay other unsecured creditors, and before it can make any distributions to equity holders. Equally important, a debtor cannot confirm a plan of reorganization unless the plan provides for payment in full of all administrative claims (unless a creditor agrees otherwise). Some view this as a form of "veto" over a plan. Thus, in theory the landlord's entitlement to have its post-petition obligations fully satisfied appears to be protected with valuable legal rights.

It is not always clear which statutory section(s) governs this priority payment. Some courts view the priority as arising under section 503 of the Code, which is the statute that establishes certain criteria for "administrative expense" in general, and which does not specifically address landlord claims, whereas other courts have held that the priority arises solely under section 365(d)(3). Section 503 also enumerates and governs administrative expense priorities. Administrative expense claims are generally obligations that arise from the debtor's post-petition activities and provide value to the bankruptcy estate. Section 503 of the Code defines administrative expense claims as including the "actual, necessary costs and expenses of preserving the estate, including wages, salaries or commissions for services rendered after the commencement of the case." 11 U.S.C. § 503(b). Section 507 (a)(1) of the Code grants first priority in the distribution of the assets of the estate to holders of administrative expense claims. Congress granted first priority in payment to administrative expenses in order to encourage creditors otherwise wary of dealing with a chapter 11 debtor to provide the goods and services required for successful rehabilitation.

The distinction between the obligations under section 503 and section 365(d)(3) may be critical to landlords. For example, a debtor will sometimes ask the court to subordinate all rights arising under section 503 to any debtor-in-possession financing as part of the first day motions. The Bankruptcy Code may permit subordination of the administrative claims arising under section 503, but arguably does not permit the same for priorities arising under section 365(d)(3). Nevertheless, debtors seek to subordinate the landlord's right to priority rent payments in many motions seeking approval of debtor-in-possession financing. This technique is questionable, but prevalent. On the other hand, there may be situations where a landlord is better off asserting that its claim for post-petition performance does arise under section 503, and that the debtor's plan cannot be confirmed unless these obligations are paid in full. 11 U.S.C. § 1129(a)(9)(A).

The case law on this issue is divided. The debtor's obligation to perform its lease obligations are viewed by a few courts as *sui generis* and not controlled by § 503 which, as discussed above, governs administrative priority claims in general. *See, e.g., Child World, Inc. v. Campbell/Mass. Trust (In re Child World, Inc.)*, 161 B.R. 571, 576 (Bankr. S.D.N.Y. 1993)[3] (holding that a post-petition, pre-rejection rent obligation is not technically an "administrative expense" but a special category of payment entitled to priority over all other administrative expenses). In *In re Child World, Inc.*, 150 B.R. 328, 331 (Bankr. S.D.N.Y. 1993), the bankruptcy court distinguished the lease obligation under section 365(d)(3) from administrative expenses arising under section 503 as follows:

> [a] debtor's obligation for post-petition rent under an unexpired lease for nonresidential real property is governed by 11 U.S.C. § 365(d)(3) . . . . In establishing the debtor's post-petition obligation at the level required by the unexpired lease of nonresidential property until it is either assumed or rejected, [section] 365(d)(3) alters the prior rule that the debtor is liable for post-petition use and occupancy only to the extent it reflects a necessary cost of preserving the estate and qualifies as an administrative expense under 11 U.S.C. § 503(b)(1)(A) . . . . Thus, 11 U.S.C. § 365(d)(3) does not require a determination of the reasonable value of the debtor's post-petition use and occupancy, and instead establishes the debtor's post-petition responsibility as comprising all the obligations under the lease until the lease is either assumed or rejected.

150 B.R. at 331, *rev'd* 161 B.R. 571;[4] *see also In re Duckwall-ALCO Stores, Inc*., 150 B.R. 965, 971 n.10 (D. Kan. 1993) (declining to characterize the payments due under section 365(d)(3) as "administrative expenses" given the differences between section 365(d)(3) and section 503). In *In re Cardian Mortgage Corp.*, 127 B.R. 14 (Bankr. E.D. Va. 1991), the court, in reaching the conclusion that the rental obligation is not governed by section 503, explained:

> [s]ection 365(d)(3) provides that the trustee, in this case the debtor-in-possession, must timely perform all post-petition obligations under a lease of nonresidential property until it is assumed or rejected. This court has already ruled in another case that obligations arising under a lease of nonresidential property after the petition is filed but before rejection of the lease are governed by the terms of the lease and are not subject to the requirements under 11 U.S.C. § 503(b) that the obligations be "actual [and] necessary costs and expenses of preserving the estate." *In re*

[3] *See also In re C.Q., LLC*, 343 B.R. 915, 918 (Bankr. W.D. Wis. 2005) (holding that rent under section 365(d)(3) is not administrative expense under section 503 because such rent is "payable, whether necessary or not, for the protection of landlords. It is not, nor is it intended to be, measured in any way by benefit to the debtor or the estate").

[4] *See also Paul Harris Stores, Inc. v. Mabel L. Salter Realty Trust*, 148 B.R. 307 (S.D. Ind. 1992); *In re RB Furniture, Inc*., 141 B.R. 706 (Bankr. C.D. Cal. 1992); *In re Coastal Dry Dock & Repair Corp*., 62 B.R. 879 (Bankr. E.D.N.Y. 1986); *In re Swanton Corp*., 58 B.R. 474 (Bankr. S.D.N.Y. 1986).

> *Virginia Packaging Supply Co.*, 122 B.R. 491, 494 (Bankr. E.D. Va. 1990). *Virginia Packaging* also ruled that § 363(d)(3) obligations are entitled to priority under § 507(a).

Id. at 15 (footnote omitted).

C. Strategic Observations

A debtor will often file a motion establishing an administrative bar date. This means that if the landlord does not file a claim for an administrative claim prior to the established bar date, it may lose it. Landlords may not always be attentive to this right. However, the loss of an administrative claim means not only the potential loss of dollars, but the loss of a right to insist on full payment as a condition to plan confirmation.

III. Sale of designation rights

A. Introduction

The sale of what has come to be known as "designation rights" is now a relatively common practice in many large retail bankruptcy cases. There is no explicit concept of "designation rights" in the Bankruptcy Code. However, the phrase has been defined as "the right to direct the debtors to assume and assign . . . unexpired leases . . . to third parties qualifying under the Bankruptcy Code." Robert N.H. Christmas, Designation Rights—A New, Post-BAPCPA World, 25 Feb, 2006, AM. BANKR. INST. J. 10. One of the primary goals of the debtor is to realize the equity value which may exist in leases with a sufficient remaining term and which are set at below market rental rates.

The procedure for the sale of designation rights typically involves a motion for a sale under Code sections 105, 363 and 365 (usually in an auction style sale) of the right of third-party lease purchasers to first acquire an interest in certain leases, to then market the space to prospective tenants, and later, to seek assumption and assignment of the leases. For a recent example, see the Motion of Rhodes, Inc., et al seeking court approval to sell its retail furniture business including "authorizing the purchaser to exercise designation rights over certain real property leases . . . ."[5] The process can involve three discrete steps (a bidding procedures motion; sale hearing; and later, an assumption and assignment hearing).

The estate and its constituents typically favor the sale of designation rights, and indeed rely heavily upon it. While the debtor could market the leases itself, it typically is not in the business of selling leases, lacks the staff to do so, and under most such procedures, requires the designation buyer to pay rent while it searches for new tenants.

Landlords sometimes object on various grounds, including the loss of the equity in the lease and the sense of being "steamrolled" in a fast moving process which may generate a new tenant that is not acceptable, and with "cure" issues sometimes dealt with in an incomplete or unfair fashion.

[5] *In re Rhodes, Inc., et al.*, (Cases Nos. 04-78434- 04-78436), filed in the United States Bankruptcy Court for the Northern District of Georgia.

The sale of designation rights may become more widespread in 2009 as more large scale retail debtors use bankruptcy for a partial or full liquidation. Yet, the effective use of the sale of designation rights has become more difficult as designation purchasers are discovering that there is often little or no market for new tenants. These issues are addressed below.

B. Is the sale of designation rights lawful?

A leading case which endorses the right of a debtor to sell designation rights is *In re Ames Dep't Stores, Inc.*, 287 B.R. 112 (Bankr. S.D.N.Y. 2002). In *Ames*, the debtor agreed to sell the "designation rights" to a third-party. The designation purchaser was then obligated to market the leases to an ultimate end user and to pay the rental and carrying costs during the marketing period. The designation purchaser had the right to "direct" the debtor to assume the lease and then to assign the lease to the end-user. The important second step is that the court would then hold a second hearing, after notice to the landlords of the relevant locations, to consider and rule upon the motion to assume and assign, thus giving the landlord a right to object to the assumption and assignment. This requirement for a two-hearing process is key to protecting the rights of landlords.[6]

The court in *Ames* permitted the sale of designation rights based on the following underlying principles: (i) the equity in a lease is property of the bankruptcy estate and may be sold or disposed of like any other property; (ii) the sale of the designation right is not the sale of a federally created right; (iii) the procedure protects the estate and landlords by providing that all operating costs are paid by the buyer during the period the leases are being marketed; (iv) equity in a lease belongs to the estate and is for the benefit of the creditors; (v) the anti-assignment provisions in the Bankruptcy Code protect that equity and permit the debtor to sell an interest in a lease and to benefit from the equity in the lease; and (vi) landlords may lack standing to object to the sale of designation rights. No other case has cited to *Ames* for the relevant point. The only published decisions citing to *Ames* and mentioned designation rights were subsequent opinions in the same chapter 11 cases. In these subsequent opinions, the court merely noted its earlier decision to permit the sale of designation rights.

Does a debtor actually have a right to sell designation rights? One author has recently written that, "The permissibility of the sale of designation rights is essentially settled law." Christmas, *supra* at 10. Christmas notes that the highest court which has addressed the issue is a Bankruptcy Appellate Panel, but that at least 15 bankruptcy court decisions have approved the practice. *Id*. *See also In re Ernst Home Ctr. Inc.*, 209 B.R. 974 (Bankr. W.D. Wash. 1997), *appeal dismissed*, *BC Brickyard Assoc. Ltd. v. Ernst Home Ctr. Inc. (In re Ernst Home Ctr. Inc.)*, 221 B.R. 243, 248-56 (BAP 9th Cir. 1998) (Russell, J. concurring). Christmas' description is correct. In *Ernst Home Ctr.*, the court approved the debtors' motion to sell 59 leases and allowed the purchaser 14 more months to decide whether to assume or reject each lease. The BAP dismissed the appeal on the basis of mootness. Judge Russell's concurring opinion, however, reached the merit of the lease and agreed with the bankruptcy court's holding.

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[6] *See id.* at 115 ("while. . . a sale of designation rights with respect to leases cannot and does not result in an exemption from the requirement of section 365. . . as to which the rights of lessors necessarily must be honored—those matters can be addressed separately. . . at such time as the assignment. . . of a particular lease is proposed").

Could a landlord challenge the sale of designation rights, and if so, on what grounds? Landlords may be able to challenge some of the sales procedures, as opposed to the right itself. (But note discussion below on the impact of recent decisions on whether sale orders are effectively non-appealable). For example, landlords might consider challenges to any attempt by a debtor to obtain consent to a cure amount or assumption through the issuance of check endorsements that contain waiver or release language, or omnibus motions which set unfair or unrealistically low cure amounts. More broadly, at least one well known scholar has raised issues regarding whether the powers of a debtor-in-possession can always be sold to third parties or, in the words of Professors Warren and Westbrook, "is everything for sale?" Elizabeth Warren & Jay L. Westbrook, *Selling the Trustee's Powers*, 23-Sep. 2005,AM. BANKR. INST. J. 32 n.4. The Supreme Court recently suggested that certain statutory powers of a debtor cannot be transferred to third persons. *Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 120 S.Ct. 1942 (2000); *cf. Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir. 2003).[7]

While the right to sell designation rights may be "settled law," there may still be a risk that landlords will challenge whether the debtor may sell the "equity" in the lease. Further, while the sale of designation rights has avoided appellate scrutiny because of the "mootness" provisions in the Code, this too may change based on a recent decision by the 9th Circuit Bankruptcy Appellate Panel. Both issues are discussed below.

C. How does the sale of designation rights work?

Typically, the process begins with the debtor filing a motion, which may be styled as a motion to approve bidding procedures and a sale of substantially all of the debtor's assets. The motion may attach a previously negotiated "stalking horse" contract which the debtor proposes to enter into, but only after an auction of the rights and a determination that the contract is the "highest and best" price. The designation buyer will agree to pay the rent during the period in which it is searching for the new end user. In this sense, the designation process is beneficial to the landlord as well.

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[7] In *Hartford Underwriters*, the Supreme Court held that section 506(c) of the Bankruptcy Code permitted only the trustee, and not any other party, to recover the cost of preserving a secured party's collateral from the value of such collateral. The issue addressed in *Hartford Underwriters* was whether a third party (in this case, an insurer which provided insurance to the debtor post-petition) had an "independent right" to seek payment pursuant to section 506(c)-- and not whether the trustee could transfer *its* rights under section 506(c) to such third party. *Hartford Underwriter*, 530 U.S. at 13 n.5.

In fact, the Third Circuit held in *Cybernetics* that *Hartford Underwriters* did not prohibit a bankruptcy court from allowing a creditors' committee to pursue an avoidance action on behalf of the estate even though section 544 of the Bankruptcy Code, like section 506(c), only mentions *the trustee*'s right to act on behalf of the estate. *Cybernetics*, 330 F.3d at 552.

However, at least one subsequent bankruptcy case relied on *Hartford Underwriter* to deny the assignment of the trustee' avoidance power to a third party. *See In re Pro Greens Inc.*, 297 B.R. 850 (Bankr. M.D. Fla. 2003) (disallowing the assignment of the right to pursue a fraudulent transfer claim); *see also*, *In re Metropolitan Electric Manu. Co.*, 295 B.R. 7 (Bankr. E.D.N.Y. 2003) (disallowing the sale of avoidance actions under section 544(b) to a creditor).

A key procedural issue involves the obligation of an assignee of a debtor's lease to cure pre-petition monetary defaults. This is because Code § 365(b)(1)(A) states that if there has been a default in a lease, the debtor cannot assume or assign it unless, at the time of the assumption, the debtor or its assignee cures the default or provides adequate assurance that it will promptly cure. Sometimes the motion will include a "cure schedule" which identifies the amount which an assignee would have to pay in order to permit assumption and assignment. The "cure schedule" may show all amounts as "zero." A different procedure involves the designation purchaser notifying a landlord of a proposed assumption by written notice, and then giving the landlord a very short period (say five days) in which to object to a proposed "cure" amount.[8] A debtor may argue later that the designation purchaser can thus find a buyer who knows what the purchase "price" will be and will not later be surprised by a determination that there is a cure obligation.[9]

The designation buyer will be limited in how much time it has to find a new tenant by the time limits imposed by Congress under BAPCPA for assumption of a commercial lease. Section 365(d)(4) provides that a lease must be assumed with 120 days following the petition date, and that it can be extended only for an additional 90 days, and for "cause." Any further extension requires the landlord's consent.

Congress apparently believed that by shortening the time to 210 days (without consent) it would benefit landlords and protect them from what had become over-long periods in which the lease was neither assumed nor rejected, as occurred frequently prior to the passage of BAPCPA. In addition, part of the motivation for this shortened period was the sense that some debtors had been "steamrolling" landlords with omnibus motions which permitted assumption and assignment under terms that may have been unfavorable or which sought to limit the amount of any cure obligation required to be paid as part of the assumption and assignment. The new seven month period "will likely prove to be a difficult and even impossible time frame for any multi-location or 'big box' premises-holding debtor." Christmas, *supra*, at 63. This shortened period may mean that debtors will have to involve landlords in the process and may have to make concessions in the terms of assignment and assumption and cure payments in order to obtain the requisite consent for an extension.

In summary, under BAPCPA, the stricter time period for assumption or rejection calls into question whether the designation procedure will encounter serious difficulties. Experts who participate in this field may find that the accelerated dates are not a problem. Debtors may have to develop a strategy for obtaining a landlord's consent to the extension of time to assume or reject the lease, perhaps through offering economic concessions to the landlords in the proposed auction and designation procedure. Nevertheless, landlords will need to be vigilant about reviewing pleadings and time frames and will continue to have to deal with large, omnibus motions which may affect their rights.

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[8] *See, e.g.*, Motion of Rhodes Inc. seeking authority to permit purchaser to exercise designation rights, dated July 25, 2005, (Docket Number 1098).

[9] An issue might arise as to who has the "cure" obligation after the lease has been assigned, where the court's determination on cure occurs after the assignment. The obligation to "cure" is on the debtor under section 365(b)(1)(A), but once a lease is assigned, the estate is relieved of any liability for any breach occurring after such assignment.

D. Challenging the profit sharing aspect of the sale of designation rights and the ability to appeal from the sale order.

A key aspect to the sale of designation rights is the notion that the debtor has the right to retain and sell the equity value in a lease, regardless of what the lease may otherwise say. Of course, this implies that market rents are rising, and the economic turmoil of 2008-2009 may reflect a decline in many markets. Nevertheless, without the ability to sell the "Profits" in the lease, there would be much less reason to sell leases other than (a) to relieve the estate of the burden or (b) to obtain a price for the assumption that arguably is not based on market rents. Without the ability to sell the equity in a lease, many retail bankruptcy cases would lose their raison d'etre. Indeed, the notion that that debtors are not entitled to the equity value in the lease may be entirely counter-intuitive to the generally accepted notion that such equity is property of the estate.[10]

Pre-BAPCPA case law supports the view that a clause which requires payment of the equity to the landlord is not enforceable under section 365(f) because such clauses are viewed as being in the nature of an "anti-assignment" clause. *See, e.g., In re Boo.com North America, Inc.*, 2000 WL 1923949 (Bankr. S.D.N.Y. Dec. 15, 2000). In *Boo.com* the debtor's primary asset was an unexpired office lease, for which it paid $27.50 per square foot. The market rent for such space was close to $50.00 per square foot. The lease contained a provision which stated that in the event the tenant obtained consent to sell all or a portion of its space, "the Tenant shall pay to the Landlord, monthly, as additional rent, one hundred (100%) percent of all Subleasing Profits." *Id*. at *2. The landlord contended that the provision was enforceable. The bankruptcy court held that it was not enforceable under § 365(f) which states as follows:

> (1) Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease or paragraph (2) of this subsection.

The bankruptcy court in *Boo.com* stated that, "[T]he Profit Sharing clause in the lease hinders the Debtor's effort to realize the full value of its assets and would result in a diminished distribution to all other creditors. Such an outcome would clearly be contrary to bankruptcy policies which try to balance the interests of all parties involved." *Id*. at *3.

The court in *Boo.com* noted that the bankruptcy court in New York had reached a similar result in *In re Jamesway Corp.*, 201 B.R. 73, 79 (Bankr. S.D.N.Y. 1996). It also cited with approval the decision from the Ninth Circuit Bankruptcy Appellate Panel in *South Coast Plaza v. Standor Jewelers West, Inc. (In re Standor Jewelers West, Inc.)*, 129 B.R. 200, 202 (Bankr. 9th Cir. 1991), which found that the enforcement of an "allocation provision in [the lease] would adversely affect the ability of the debtor in its rehabilitation effort in contravention of § 365(f)." *Id.* at *2.

[10] Would lenders which have taken an assignment of the lease also claim to have a senior right to the equity? Why should a debtor be able to sell the value of the lease and retain the proceeds if a mortgage lender has a lien on the leases?

There is an argument that BAPCPA may have changed the result of *Jamesway* and *Boo.com* when a shopping center lease is involved. Specifically, section 365(f) has been changed to now read, "Except as provided in subsections (b) and (c) of this section . . . ." Subsection (b)(3) contains language defining what is required to show adequate assurance of future performance for a shopping center lease and requires a showing that "assumption or assignment of such lease is subject to all the provisions thereof . . . ." If the assumption is subject to "all" of the provisions of a shopping center lease, then arguably section 365(f) does not permit assignment unless such assignment is subject to the profit sharing clause as well. However, because (i) the language of section 365(b)(3) only relates to the required adequate assurance of the *assignee's* future performance, and (ii) profit sharing is generally a duty of the *debtor/assignor*, the BAPCPA's additional reference to section 365(b) arguably has no effect on existing case law on profit sharing clauses.[11] There do not appear to be any reported cases that deal with the effect of BAPCPA on the profit sharing issue.

E. Appealing from the sale order

Another risk from recent case law is that the sale of designation rights may be subject to more appellate scrutiny should the courts apply the recent ruling from the 9th Circuit BAP on whether a sale order is truly "moot" and immune from reversal on appeal if no stay of the order is obtained.

The recent case of *In re PW, LLC (Clear Channel Outdoor v. Nancy Knupfer)*, 391 B.R. 25 (9th Cir. BAP 2008) may affect the appealability of sale orders. On May 30, 2008 the Ninth Circuit Bankruptcy Appellate Panel issued its decision in *In re PW, LLC*. This decision is likely to affect real estate lenders and others who are desirous of using the bankruptcy sales process as a method of effectively selling assets free and clear. This case arguably may make the use of chapter 11 more problematic for real estate lenders and borrowers.

PW was a developer of real property in Burbank, California. Its first trust lender was DB Burbank LLC, an affiliate of a large public hedge fund that had lent the developer over $40 million. Clear Channel held a junior lien of $2.5 million. DB worked with the chapter 11 trustee and organized a campaign to sell all of the assets of the debtor free and clear of all claims and encumbrances under 363. A sale was held under section 363(b). DB agreed to credit bid its loan amount plus some additional cash for various carve outs and expenses of $800,000. The lender bid in its loan as a credit bid and was the winning bidder.

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[11] Specifically, section 365(b)(3) defines adequate assurance of future performance under shopping center leases for the purpose of sections 365(b)(1) and 365(f)(2)(B). Section 365(b)(1) requires cure and adequate assurance when a debtor seeks to assume a contract or lease despite an existing default. Section 365(f)(2)(B), on the other hand, requires "adequate assurance of future performance by the *assignee* of such contract or lease" before the trustee is permitted to assign an executory contract or unexpired lease whether a default exists or not.

As such, in the context of assignment, the additional reference to section 365(b) in the BAPCPA arguably pertains only to provisions, such as land use restrictions and radius restrictions, that relate to the future performance of the *assignee* under the assigned lease and not to any additional duties of the assignor to share the profits resulting from the assignment.

The bankruptcy court entered an order that provided that the sale was free and clear of all liens, including the lien of Clear Channel. The order was issued under section 363(f)(5). Clear Channel appealed to the Ninth Circuit BAP and argued that despite the express finding of the bankruptcy court, its lien had not been extinguished and that the sale order was not moot. The appeal was heard by the Ninth Circuit Bankruptcy Appellate Panel despite the mootness provisions of section 363(m). The BAP held that while the mootness provision protected the transfer of title—and could not be undone, the mootness did not protect what it called the "lien stripping." The court held that while section 363(m) immunized the transferee from having the transfer of title undone, it did not protect the "terms of the sale."

Will landlords seek to use *PW* to argue that while the designation transfer cannot be undone, the terms of the transfer are open to challenge, and those terms include the notion that the sale is free and clear of the landlord's equity interest? It may be that the serious financial condition of the economy will compel landlords to make such arguments.

IV. Lease Rejection

A. Introduction

While a debtor has an obligation to perform its lease obligation, that duty only continues until the debtor determines to assume or reject a lease. 11 U.S.C. § 365(d)(3). A debtor has a statutory right to 'reject' a lease of nonresidential real property. The rejection is a breach and gives rise to a claim for the breach. However, the claim for breach is limited or capped, as discussed below. The rejection right, coupled with the statutory cap on the damages that may be "allowed" to a landlord, makes bankruptcy an extremely effective reorganization device from the perspective of a retail or commercial tenant. Most of the issues which arise concerning a landlord's claim deal with the rejection of a lease.

A debtor's right to reject a lease is said to be "vital to the basic purposes of a chapter 11 reorganization, because it can release the debtor's estate from burdensome obligations that can impede a successful reorganization." *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984); *see also In re BankVest Capital Corp.*, 360 F.3d 291, 296 (1st Cir. 2004) (citing *In re Carp*, 340 F.3d 15, 25 (1st Cir. 2003)) ("By permitting debtors to shed disadvantageous contracts but keep beneficial ones, § 365 advances one of the core purposes of the Bankruptcy Code: to give worthy debtors a fresh start").

The meaning of "rejection" continues to be debated. At its most basic level, the rejection of a lease constitutes a "breach" of the lease, and thus gives rise to a claim for payment in favor of the landlord. This "breach" is treated as if the breach had occurred immediately prior to the filing of the bankruptcy case, and thus makes the claim by the landlord for breach a pre-petition, unsecured claim. The timing of when the breach is deemed to occur, and the cap on damages, make the claim subject to being "treated" in a bankruptcy plan, and thus reduced to a *pro rata* amount equal to what other unsecured creditors will be receiving in the case.

An open issue is whether rejection is a breach, or a termination of the lease. Although some highly regarded scholars agree that rejection is *not* a termination for most types of executory contracts, some courts have held that the rejection of a commercial real estate lease should be viewed as a termination. Under state law, a breach of the lease does not cause the real property interest of the tenant to be extinguished, and conversely, a tenant remains obligated to continue to pay rent for the life of the lease. A "termination" ends the leasehold estate and gives the landlord a claim for contractual damages only, not rent. Differences in the two theories may arise under rules pertaining to mitigation of damages. One may have a duty to "mitigate" damages, but conversely, one does not typically have to mitigate an obligation to pay rent. The termination issue also affects the courts' view of the rights of third parties that are derivative of the lessee's rights, such as sub-tenants and leasehold mortgagees.

Generally, a debtor's motion to reject a lease will be granted on a minimal showing, and will prove difficult to contest. Landlords' efforts to interject conditions upon the rejection have not met with success. *See, e.g., In re Ames Dep't Stores, Inc.*, 306 B.R. 43, 52 (Bankr. S.D.N.Y. 2004) ("It would frustrate the entire purpose of rejection if, in order to reject and thereby be relieved of a burdensome executory contract, the debtor were required, as a condition to doing so, to comply with one of the very aspects of the agreement that is burdensome.").

Where landlords have sought to "condition" rejection on payment of past due amounts, payment of administrative claims, and payment for clean-up costs, courts have held that a debtor's statutory right to reject a lease cannot be qualified or conditioned by requirements not contained in the Code.

B. When Does "Effective" Rejection Occur? The Requirement for Express Court Approval

An important issue to landlords is the effective date of rejection. The rejection date ends the landlord's right to insist upon full performance of the lease, including payment of rent, taxes and other charges. Prior to rejection, the landlord has a right to current payment, usually stated to be an administrative priority. After rejection, the landlord will have a "claim" for future rent (discussed below). Thus the effective date of rejection is key to landlords. The case law initially reflected various rules as to when rejection was effective, including: (i) when a trustee's intent to reject is unequivocally communicated to the lessor; (ii) when a motion to reject is filed; (iii) when the court grants a motion to reject; and (iv) when an order approving the rejection is entered on the court's docket.[12]

The better rule is that rejection occurs when the order approving the rejection is entered on the docket. The court in *In re Revco D.S., Inc.*, 109 B.R. 264 267-68 (Bankr. N.D. Ohio 1989), explained that the effective date of a lease rejection is when the court enters an order because [u]nilateral acts or decisions of a debtor do not constitute a rejection of a lease," and "[t]he requirement of express court approval in order to reject an executory contract or unexpired lease under § 365(a) is well supported by case law."[13]

The court in *In re Federated Dep't Stores, Inc.*, 131 B.R. 808 (S.D. Ohio 1991) identified several policy reasons for conditioning rejection on the entry of a court order. First and foremost, factual certainty is needed in determining the date of rejection. Second, by making rejection effective only upon a court order, the landlord knows with certainty when it is free to re-let the debtor's space. In *Federated*, the debtor argued that it was unfair to force the debtors to pay for space during the time that the court was considering a motion to reject, but the court

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[12] S*ee, e.g., In re Joseph C. Spiess Co.*, 145 B.R. 597 (Bankr. N.D. Ill. 1992); *In re Mid Region Petroleum, Inc.*, 111 B.R. 968 (Bankr. N.D. Okla. 1990), *aff'd.*, 1 F.3d 1130 (10th Cir. 1993) (holding that rejection is effective when the lessor receives unequivocal notice of the trustee's intent to reject and denying administrative priority for rents due after the date of the notice); *In re 1 Potato 2, Inc.*, 58 B.R. 752 (Bankr. D. Minn. 1986).

[13] *See also In re Hejco, Inc.*, 87 B.R. 80, 82 (Bankr. D. Neb. 1988); *Guardian Equip. Corp. v. Whiteside (In re Guardian Equip. Corp.)*, 18 B.R. 864, 867 (Bankr. S.D. Fla. 1982); *In re National Oil Co.*, 80 B.R. 525, 526 (Bankr. D. Colo. 1987) ("the plain, unequivocal language of § 365(a) indicates that court approval is required before a lease can be rejected"); *Sealy Uptown v. Kelly Lyn Franchise Co. (In re Kelly Lyn Franchise Co.)*, 26 B.R. 441, 444, 446 (Bankr. M.D. Tenn. 1983) ("the explicit requirement of court approval is now clear under the language of § 365(a) of the Code," and "the lease in this case remains property of the estate until the court approves a rejection"); *Frank C. Videon, Inc. v. Marple Publ'g Co. (In re Marple Publ'g Co.)*, 20 B.R. 933, 935 (Bankr. E.D. Pa. 1982) ("any assumption or rejection of an unexpired lease is devoid of validity without the court's approval"); s*ee also* 2 Lawrence P. King, *Collier on Bankruptcy* ¶ 365.03(2) at 365-30 (15th ed. 1989) ("[I]n a chapter 11 case, rejection can only come about upon order of the court under § 365(a) or by virtue of the provisions of a confirmed plan. As long as rejection is not ordered, the contract continues in existence.").

rejected this argument. *Id.* at 814-16: *see also Paul Harris Stores, Inc.*, 148 B.R. 307; *Virginia Packaging*, 122 B.R. 491; *In re Garfinckels, Inc.*, 118 B.R. 154 (Bankr. D.D.C. 1990).

In *Thinking Machines*, the First Circuit reviewed the various conflicting theories, and in an effort to mend "the seeming rift in the case law" and after reviewing the cases on both sides, held that "section 365(a) is most faithfully read as making court approval a condition precedent to the effectiveness of a trustee's rejection of a nonresidential lease." *In re Thinking Machines*, 67 F.3d 1021, 1028 (1st Cir. 1995). Generally, bankruptcy courts authorize rejection to be effective as of the date the order approving rejection is entered. *See In re Fleming Cos.*, 304 B.R. 85, 96 (Bankr. D. Del. 2003) ("Normally, the effective date of rejection is the date the Order is entered.").

C. Debtor Strategy: Using Retroactive Rejection to Limit the Landlord's Right to Post-Petition Rent, Taxes and Other Obligations

Even though most courts hold that a rejection can only occur with a formal court order, some courts have found that the effective date of the rejection can be earlier than the date of the order, that is, the rejection can be retroactive. A retroactive rejection is one which obtains an effective date of rejection that is earlier than the order permitting the rejection. There are two distinct kinds of retroactive rejection. Some retroactive rejection cases are based on the equities of the case, and permit retroactive rejection to the date the debtor surrendered the premises. Another and more serious form is where the rejection is made retroactive to the petition date, thus enabling the debtor to avoid all post-petition obligations, including the duty to pay rent, real estate taxes, and other charges. This issue is thus of paramount importance to landlords.

Landlords are adversely affected by retroactive lease rejection because of the effect it may have on their entitlement to priority payments. Rejection is deemed a breach of the lease as of the time immediately prior to the bankruptcy filing. However, the period between the commencement of the case and date of rejection constitutes a period in which the debtor is obligated to make rental payments, and in which the landlord is entitled to an administrative priority for the failure to make such payments. However, if the debtor makes rejection retroactive to the first day of the case, then the debtor may have effectively eliminated all post-petition rental obligations, and thus eliminated all administrative priority. This is because section 365(d)(3), which creates the landlords' priority, is only effective until such lease is assumed or rejected. And section 365(g) states that rejection is a breach which occurs immediately before the case is filed—which some courts view as meaning the lease is terminated immediately before the case is filed.

D. The Courts Are Divided On Retroactive Rejection

The courts are divided on the issue of retroactive rejection. Some courts have held that retroactive rejection is improper. *See, e.g., Federated*, 131 B.R. at 814-15 (retroactive rejection was not permitted even if a delay was caused by a creditor opposing the rejection motion); *In re Worths Stores Corp.*, 130 B.R. 531, 533-34 (Bankr. E.D. Mo. 1991) (finding that retroactive rejection was not allowable because: (i) parties must have an opportunity to be heard; (ii) it would render the rejection order a meaningless formality; and (iii) the burden was on the debtor to schedule a timely hearing). The court in *Federated* cited *Revco*, *supra*, for supporting the

view that "to set the effective date of rejection earlier than the order approving it would put the lessor in an unfairly awkward position: even though the debtor-in-possession may already have left the premises and may no longer be paying rent, the lessor would be ill-advised to relet the property because the court may not approve the rejection." *Federated*, 131 B.R. at 815.

However, in 1995 the First Circuit ruled that retroactive rejection was not precluded by the Code. In *Thinking Machines*, the First Circuit stated that "nothing in our holding today precludes a bankruptcy court, in an appropriate section 365(a) case, from approving a trustee's rejection of a nonresidential lease retroactive to the motion filing date." *Thinking Machines*, 67 F.3d at 1028. The rule in *Thinking Machines* is as follows: "rejection under section 365(a) does not take effect until judicial approval is secured, but the approving court has the equitable power, in suitable cases, to order a rejection to operate retroactively." *Id.* at 1029.

Various bankruptcy courts have followed *Thinking Machines'* approach. These courts hold that section 365 merely states that rejection of an unexpired lease is subject to court approval, but that the Code does not expressly state that rejection cannot be applied retroactively, or that there are restrictions as to the manner in which the court can approve rejection. *Accord Stonebriar Mall Ltd. P'ship v. CCI Wireless, LLC* (*In re CCI Wireless, LLC*), 297 B.R. 133, 138 (D. Colo. 2003) ("[N]othing in [section 365] establishes the effective date of rejection."); *Paul Harris Stores, Inc. v. Mabel L. Salter Realty Trust* (*In re Paul Harris Stores, Inc.*), 148 B.R. 307, 309 (S.D. Ind. 1992) ("The statute . . . fails to make clear just when is a lease rejection deemed effective . . . ."); *Pacific Shores Dev., LLC v. At Home Corp. (In re At Home Corp.)*, 392 F.3d 1064, 1071 (9th Cir. 2004); *Thinking Machines*, 67 F.3d at 1028. ("[N]othing in our holding today precludes a bankruptcy court, in an appropriate section 365(a) case, from approving a trustee's [retroactive] rejection of a nonresidential lease . . . .") (quoting *Thinking Machines*., 67 F.3d at 1028); *CCI Wireless*, 297 B.R. at 138 ("I concur with the authority from other courts holding that section 365 does not prohibit the bankruptcy court from allowing the rejection of leases to apply retroactively.") (citing *Jamesway*, 179 B.R. 33).[14] However, *Thinking Machines* did not address rejection back to the petition date nor whether the "equities" of a case would support such rejection.

[14] *See also BP Energy Co. v. Bethlehem Steel Corp.*, No. 01-15288, 2002 WL 31548723, at *3 (S.D.N.Y. Nov. 15, 2002) ("As we find no support for appellant's contention that a bankruptcy court is prohibited as a matter of law from assigning a retroactive rejection date under section 365(a), we conclude that the Bankruptcy Court was not unauthorized from doing so."); *New Valley Corp. v. Corporate Prop. Assocs. (In re New Valley Corp.)*, No. 98-982, 2000 WL 1251858, 2000 U.S. Dist. LEXIS 12663 (D. N.J. Aug. 31, 2000) (holding that rejection may be retroactive based on equitable considerations.). Even those courts that deny retroactive relief do so as a matter of discretion, rather than as a matter of law. *See, e.g., In re Chi-Chi's, Inc.*, 305 B.R. 396, 399 (Bankr. D. Del. 2004) ("[T]he Court finds that it will not exercise its equitable power to deem the Landlords' leases rejected as of the Petition Date.").

E. The Second Circuit Permits Retroactive Rejection in *Adelphia Business Solutions, Inc*[15]

The issue of retroactive rejection in the context of a commercial lease was recently considered by the Second Circuit in *Adelphia Business Solutions, Inc., v. Abnos (In re Adelphia Business Solutions, Inc.*), 482 F.3d 602 (2d Cir. 2007), in which the issue of the power of the court to ever permit retroactive rejection was raised as both a broad jurisdictional question and as a matter of equity and judicial discretion. While the Second Circuit permitted retroactive rejection, the unique facts make its application somewhat more limited.

The facts in *Adelphia* are unique. Adelphia filed for bankruptcy protection on March 27, 2002. Abnos was Adelphia's landlord for the Firestone Building. Adelphia had signed two leases for the Firestone Building, with one being for two floors in the main building (the "Building Lease") and the second lease being for an annex of the same property (the "Annex Lease"). Adelphia filed a motion stating it wanted to reject the Building Lease and that it had vacated the premises. In the same motion it also sought to extend the time to assume or reject the Annex Lease. Abnos, the landlord, objected to the motion on the grounds that the two leases were actually one lease, and had to be treated the same. A hearing was held on May 29, 2002 in which the bankruptcy court declined to authorize the rejection, and stated it needed to review the matter further to determine if the leases were actually a single lease. However, during the hearing on the debtor's motion, the bankruptcy judge stated that if he approved the rejection of the Building Lease it would be effective as of the hearing date. At the hearing, the judge also relieved Adelphia of its obligation to pay post-petition rent, but stated that if he declined to permit rejection, then Abnos could file a claim for post-petition rent with an administrative priority. The court stated it would render a decision as quickly as possible.

The motion then languished for over two years. The bankruptcy court later admitted that it had permitted the motion to fall off its radar screen. *Id*. at 605. Then, on March 10, 2005, the bankruptcy court ruled that the Building Lease and Annex Lease were separate leases, and it authorized Adelphia to reject the Building Lease. The order did not specify whether it had retroactive effect. *Id.* at 604. On April 11, 2005, after the time for appeal had lapsed, Abnos filed a motion seeking payment of almost $700,000 for post-petition rent up to the date of the lease rejection on March 10, 2005. On May 29, 2005, the bankruptcy court then ruled that its decision to grant the lease rejection was retroactive to May 29, 2002, almost three years earlier. *Id.* at 605. The bankruptcy court based its decision on several factors including that Adelphia had surrendered the premises, that neither party had alerted the court to the pendency of the motion for two years, and that Abnos made no effort to relet the vacant premises despite "little risk that Adelphia would have objected." *Id*. at 605.

[15] Generally, courts in the Southern District of New York have ruled that some forms of retroactive rejection are permissible. *See Jamesway*, 179 B.R. at 39; *Bethlehem Steel*, No. 01-15288, 2002 WL 31548723, at *3, (S.D.N.Y. Nov. 15, 2002); *TRST N.Y., Inc. v. B. B. Ballew Sales Corp. (In re B. B. Ballew Sales Co.)*, No. 96-4267, 1996 WL 551663 (S.D.N.Y. Sept. 26, 1996); *see also In re Atkins Nutritionals, Inc.*, No. 05-15913 (Bankr. S.D.N.Y. Aug. 18, 2005); *In re Footstar, Inc.*, No. 04-22350, (Bankr. S.D.N.Y. Mar. 3, 2004); *In re Acterna Corp.*, No. 03-12837 (Bankr. S.D.N.Y. May 30, 2003); *In re Ames Dep't Stores, Inc*., Case No. 01-42217 (Bankr. S.D.N.Y. Sept. 28, 2001).

The landlord appealed the decision to the district court, which affirmed, and then appealed to the Second Circuit where the case was heard by a three judge panel including retired Supreme Court Justice Sandra Day O'Connor. Abnos first argued that the bankruptcy court lacked the equitable authority to reject a lease retroactively because this sort of equitable power has no statutory authorization and is not within the equitable authority conferred on the courts by the Judiciary Act of 1789, 1 Stat. 73 (1789). Abnos relied upon *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308, 119 S.Ct 1961 (1999), in which the Supreme Court held that a preliminary injunction issued under Fed.R.Civ.P. 65 had to be within the district court's equitable authority under the Judiciary Act of 1789, which conveyed only "an authority to administer in equity suits the principles of the system of judicial remedies which had been devised and was being administered by the English Court of Chancery at the time of the separation of the two countries." *Adelphia*, 482 F.3d at 606-607.

The Second Circuit declined to consider the argument under *Grupo Mexicano* on the grounds that it had not been raised in the lower courts. The Second Circuit noted however, that two other circuit courts had held that bankruptcy courts have the equitable power to order retroactive rejection, although without consideration of the *Grupo Mexicano* issue,[16] and that another circuit has "suggested" that the courts have such power.[17]

The Second Circuit agreed that there was a sufficient showing of equitable considerations to support the ruling by the bankruptcy court. Two key factors were that the debtor had vacated the premises and that Abnos was on notice of the court's intention to use the surrender date as the rejection date. *See Adelphia*, 482 F.3d at 608-609. The court observed that "[b]y reletting Abnos could have mitigated the risk of which he was on notice." *Id*. at 608. The bankruptcy court had plainly signaled its intention to permit rejection as of the hearing date, so the landlord was on notice. Abnos argued that he was barred from unilaterally reletting the premises. To this argument, the court responded with some pragmatic insight: "Abnos very likely could have relet by requesting court-ordered relief from the stay." *Id*. at 609. Accordingly, the court held that "[a]ssuming that the bankruptcy courts have the authority to issue orders like the one at issue, we must give them generous latitude to shape equitable relief under § 365." *Id.* at 610.

F. Retroactive Rejection May Be Ordered Early in the Case in a Generic Procedural Motion that Applies to All Future Motions

Landlords may not always be aware that they are at risk of retroactive rejection. An example of how retroactive rejection rights are obtained, and how fast the tenant can achieve this, is illustrated in the recent bankruptcy case of Copelands' Enterprises, Inc. ("Copelands"). Copelands filed for bankruptcy protection on August 14, 2006. *In re Copelands' Enterprises, Inc.*, No. 06-10853 (Bankr. D. Del. 2006). Copelands was a leading specialty sporting goods retailer, with 31 stores in California, Oregon and Nevada. Six weeks after it filed for bankruptcy, Copelands filed a motion to approve procedures for rejection of executory contracts (the

[16] *See Pacific Shores Dev., LLC v. At Home Corp. (In re At Home Corp.)*, 392 F.3d 1064, 1071 (9th Cir. 2004); *Thinking Machines*, 67 F.3d at 1028.

[17] *See EOP Colonnade of Dallas Ltd. P'ship v. Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260, 273 (5th Cir. 2005).

"Rejection Motion").[18] In its Rejection Motion, Copelands sought to establish a set procedure that would govern all rejection issues going forward, and by so doing, to establish the governing legal standard. The Rejection Motion included a somewhat innocuous provision, set out in single spaced type, in the middle of the motion that referred to a "Rejection Notice" which it would send to a landlord if it wanted to reject a lease. A landlord would then have seven days to object. Then, regardless of when the court entered an order permitting rejection, the rejection date would be effective on the later of the date the Rejection Notice was sent and the date on which the Debtor vacated the premises. Thus, if a hearing was held a month or two later, and if the landlord objected, but lost, then the rejection would still be said to have occurred on the date the notice was given or when the debtor vacated the premises.

Westfield, LLC, one of the landlords objected to the retroactive rejection. In its opposition it wrote, "[T]he majority of courts to consider the issue have determined that retroactive rejection is not available under any circumstances. *See, e.g.,* Federated, 131 B.R. 808, 814-15 ((S.D. Ohio 1991) (retroactive rejection is not permitted even if a delay is caused by a creditor opposing the rejection motion)); In re Worths Stores Corp., 130 B.R. 531, 533-34 (Bankr. E.D. Mo. 1991) (retroactive rejection not allowable because: parties must have an opportunity to be heard; it would render the rejection order a meaningless formality; and the burden is on the debtor to schedule a timely hearing)."[19] Despite this, the bankruptcy court entered an order which provided for the requested retroactive rejection. *See* Order, October 18, 2006 (Docket No. 266).

Landlords might argue that a blanket "procedures" motion should never be a basis to order or permit retroactive rejection. If retroactive rejection is to be permitted it should rely on the equities of a specific case, not a blanket motion.

G. Can Rejection Be Retroactive to the Petition Date?

A more difficult question might arise if the debtor files a first day motion seeking to retroactively reject many leases, with the effective date being the petition date. This issue surfaced in *In re Musicland*, No. 06-10064 (Bankr. S.D.N.Y). On a first day motion in *Musicland*, the debtor requested the court to allow rejection of certain leases retroactive to the petition date. Mot. to Reject Lease, Jan. 12, 2006 (Docket No. 22). During the first day hearing, a landlord objected to the motion on the basis that the landlord might not be able to take actual possession of the relevant leased property on the effective date of the rejection (*i.e*., the petition date). January 13, 2006 H'rg Tr. 93-95, Jan. 25, 2006 (Docket No. 316). In response to the ensuing discussion, the court entered an order which provided that the rejection would be deemed effective on the petition date only if the debtors actually vacated the premises and turned over the keys prior to petition date. Specifically the order stated that the rejection would be effective on the later of "(i) the Petition Date, (ii) the date that the Debtor actually vacates or vacated the premises and surrenders possession of the premises by delivering the keys to the landlord at the mall manager's office, or (iii) in the case of an objection, on the date set by the court or otherwise agreed to by the parties." Order Authorizing Rejection 2, Jan. 17, 2006

[18] Rejection Mot., Sept. 28, 2006 (Docket No. 208).

[19] Limited Objection by Westfield, LLC and Affiliates to Debtor's Motion Oct. 11, 2006 (Docket No. 249).

(Docket No. 61). Thus, *Musicland* suggests that rejection could be deemed effective retroactive to the petition date if the debtor/tenant had already surrendered the leased property to the landlord before the petition date.

The court in *In re Amber's Stores*, 193 B.R. 819, 827 (Bankr. N.D. Tex. 1996) also granted rejection retroactive to the petition date. Specifically, although the court found that the effective date of rejection is the date the rejection order is granted by a court, it held that the lease in the present case was deemed rejected retroactive to the petition date "for the purpose of establishing the amount of [the landlord's] administrative claim". *Id.* Therefore, the landlord did not have an administrative claim for post-petition rent payments. *Id.* The *Amber's Stores* decision seems to rely on the fact that the debtor turned over the keys and vacated the premises at least one month before the petition date, served the landlord with the rejection motion on the petition date, and filed the rejection motion three days thereafter. Under this scenario, the court found that "based on the equities of the facts in this case, the [lease] should be deemed rejected to the petition date for the purpose of establishing the amount of the [landlord's] administrative claim." *Id.*

If rejection occurs the day before the bankruptcy case is filed, then there is no post-petition rent and no post-petition priority – including for taxes, even if there has been post-petition occupancy and use. For example, if a debtor closes a retail store, but does not reject the lease or surrender the premises for two months, it would ordinarily be obligated to pay the rent and other monetary obligations that arose during those two months. However, if retroactive lease rejection is permitted, then those two months of post-petition rent may become unsecured claims, and may receive only a modest distribution, equal to other general unsecured creditors. The second adverse consequence deals with real estate taxes. If the court permits retroactive rejection to the day before the case was filed, then even a bill sent after the petition date will be deemed to have been sent after rejection, and hence, may defeat the effect of the billing date rule.

H. Strategy Recommendations

Several lessons emerge from these cases. First, while the power of a court to permit retroactive rejection is not definitively resolved, there is now substantial authority that has permitted it, at least where the equities support the debtor. Counsel for landlords may wish to review *Grupo Mexicano*, 527 U.S. 308, 119 S.Ct 1961, and assess its viability as a defense to retroactive rejection. Second, a landlord should be on notice that the date of surrender may be the effective date of rejection, despite the requirement for a court order. A landlord should consider a motion for relief from the stay to evict or to re-let the premises if the debtor has already abandoned.

Procedural lessons are also key. Landlord's counsel must be very vigilant in reviewing orders which may appear to cover only bidding procedures or sales. In addition, motions filed very early in the case may govern procedures for rejection for many years, and hence counsel should be retained to participate in the bankruptcy case as early as the hearing on the first day motions. (Typically, a hearing on the first day motions is held one to two days after the bankruptcy filing)

Retroactive rejection to the petition date remains the most controversial, and landlords should review any such motion carefully and consider the need for a challenge. Retroactive rejection could cause landlord to lose large sums of money in real estate taxes and rent.

I. Premature Rejection

Most case law holds that rejection must be by court order and must be based on a determination that the debtor has exercised its sound business judgment. The question has arisen as to whether the debtor can ask the court to "authorize" it to reject leases at a later time, without further notice and a hearing, and regardless of whether circumstances have changed. This kind of court approval puts a landlord in a decidedly weakened position because the landlord is constantly under the threat of a possible termination.

There is some case law that a landlord might use to challenge this result. *See, e.g.*, *In re U.S.* Airways *Corp*, 287 B.R. 643, 646 (Bankr. E.D. Va. 2002) ("As a conceptual matter there is obviously no way by which the court can make a meaningful determination whether the debtors in possession have exercised sound business judgment in seeking to abandon a particular encumbered aircraft or to reject a particular unexpired lease when the debtor has not yet elected which aircraft are to be abandoned and which leases are to be rejected. Furthermore to simply give a trustee or debtor-in-possession carte blanche to make that determination itself would be to abdicate the court's essential supervisory role over the reorganization process.").

V. The Landlords' Claim For Rent and Other Lease Obligations Due Prior to the Bankruptcy Petition

A. Introduction

If a tenant rejects a lease, the landlord will have a "claim." A claim is defined in the Bankruptcy Code as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." 11 U.S.C. § 101 (5)(A). A bankruptcy claim should be distinguished from the notion of a "claim" under state law which generally requires that all of the elements necessary to establish liability have arisen or accrued. A bankruptcy claim, however, is a "right to payment" even if that right is still contingent or unliquidated. The reason for this difference in definition is that the goal of a bankruptcy case is to treat and then discharge all of the many kinds of payment obligations, regardless of whether they would otherwise be "claims" under normal state law theories.

It is critical to understand the broad meaning of a claim, because all "claims" will be discharged in bankruptcy (unless, for example, a lease is assumed). A discharge is a permanent injunction against seeking to have a claim enforced. The claims will be "treated" in a plan of reorganization, which means that a landlord and other creditors will receive some form of distribution in lieu of the claim. The plan is binding on all creditors (including landlords) and has the same res judicata or finality as a final judgment issued in civil proceeding. Thus, how a debtor defines a claim, and how the debtor's plan of reorganization treats a claim are critical because the landlord is bound by the plan terms and once the plan is confirmed, has virtually no ability to challenge the treatment (absent an appeal from the order confirming the plan).

The first component of a landlord's claim arises under section 502(b)(6)(B) and covers compensation for the rent (and perhaps other items) that were due and owing as of the date of the filing of the bankruptcy petition. The amount due is determined without reference to any right of acceleration that might otherwise be provided for in the lease. The landlord's claim under this section may be confined to "rent reserved," although the courts are divided on this issue. This claim for unpaid rent, unlike the claim for future rent, is not subject to any monetary cap, although the limitation imposed by the term "rent" may prove to be significant. As discussed below, the landlord may still have an additional claim for the post-petition period prior to rejection and a claim for future rent that became due after the rejection date.

If a debtor rejects a lease, the landlord will have a claim under section 502. Section 502(b)(6)(B) provides, in pertinent part, as follows:

> (b) [T]he court…shall determine the amount of such claim…as of the date of the filing of the petition, and shall allow such claim in such amount . . . .
>
> (B)[for] any unpaid rent due under such lease, without acceleration, on the earlier of [the date of the filing of the petition or the date on which the lessor repossessed or the lessee surrendered the leased property].

B. <u>One View: No Limit on the Nature of the Pre-petition Claim</u>

In the event a debtor rejects a lease, the first "element" of damages is "any unpaid rent due under such lease" on the date the petition was filed or the lessee surrendered possession, pursuant to section 502(b)(6)(B). This claim is first calculated by reference to normal state law notions, except that an "acceleration" clause will not be honored. One issue that typically arises is whether the monies sought were "due" on the date of the petition. If so, the claim may be allowed as a general unsecured claim and paid *pro rata* with other unsecured creditors. A second issue is whether the claim for "unpaid rent" due under the lease includes all monetary claims of a tenant due to the landlord, or only those claims which satisfy the narrower definition of "rent" which includes the notion of a fixed, periodic payment. Each of these issues is discussed below.

The general rule is that a landlord's claim for pre-petition lease obligations is not subject to the statutory cap that governs the post-petition, future rent obligation.

> There is no limit on amounts owing under the lease as of the petition date. Hence, if a debtor lessee is delinquent on payments as of the petition date, that amount is allowed as an amount "due'' under such lease under § 502(b)(6)(B) and is not subject to the limitation of the prior subsection. Congress intended, through subparagraphs (A) and (B) of § 502(b)(6), to provide lessors with actual damages for past rent and to place a limit on damages for speculative future rent payments in long-term leases.

4 ALAN N. RESNICK & HENRY J. SOMMER, COLLIER ON BANKRUPTCY ¶ 502.03[7][e] (15th ed. rev., 2006).

An example of a court applying the "no limit" rule to the pre-petition claim can be found in *In re Clements*, 185 B.R. 895 (Bankr. M.D. Fla. 1995). There, the landlord argued that it was entitled to "all damages" that arose pre-petition, including taxes, maintenance, insurance and attorney's fees. The court held that such damages were not limited to rent, stating that "case law supports the idea that the landlord's claim is not merely the rent under the lease." *Id*. at 902. However, the court also noted and appeared to be at least partially persuaded by the fact that the lease was a "triple net lease" in which the debtor had agreed to pay all expenses and which defined the expenses involved as "additional rent."

The case of *In re Q-Masters, Inc.*, 135 B.R. 157 (Bankr. S.D. Fla. 1991), also supports the "no limit" rule finding that various payment obligations under the lease which are not specifically called "rent" may nevertheless be used in the calculation pursuant to section 502(b)(6)(B). In *Q-Masters*, the court held that a landlord was entitled to payments of pre-petition tax, utilities, insurance and attorney's fees due on a lease as "damages for unpaid rent" under section 502(b)(6)(B). *Id.* at 161. Like the *Clements* debtor, the *Q-Masters* debtor was obligated pay for such various costs according to the terms of its lease. *See id.* at 158. The terms of the lease specifically provided that "the debtor remained liable for the payment of rent plus applicable taxes; for the payment of all utilities; for the payment of real estate taxes; for maintaining insurance on the property; and for maintaining the premises in a good state of repair. Additionally, the debtor covenanted to indemnify and hold [the landlord] harmless from any and all damages that [the landlord] may incur with respect to the debtor's leasing of the premises." *Id*. The reported opinion in *Q-Masters* indicates that these additional costs were not defined as "rent" or "additional rent" under the lease. Thus, it seems that, under *Q-Masters*, all pre-petition obligations stemming from the debtor's breach of the lease agreement may be allowed under section 502(b)(6)(B) whether or not the lease terms specifically define such obligations as "rent." Indeed, the Court found that property damages provided for under the lease were recoverable under the landlord's section 502(b)(6)(B) claim. *See id.*

C. Contrary Rule: the Pre-Petition Claim for Rejection is Limited to "Rent"

Despite the general rule discussed above, some recent cases have held that the pre-petition portion of the claim may be limited by the definition of what is included within the term "unpaid rent." A leading case is *Smith v. Sprayberry Square Holdings, Inc.* (*In re Smith)*, 249 B.R. 328 (Bankr. S.D. Ga. 2000), which held that a landlord's pre-petition claim could only include "rent due" and that the term "rent due" is to be analyzed in the same manner as the term "rent reserved" under section 502(b)(6)(A). The court recognized that other cases have held that there is no limit, other than state law, on the pre-petition portion of the claim. Nevertheless, the court held that "total damages" does not mean "all damages." *Id*. at 336. "Here the Code has stated that claims by a lessor for pre-petition damages by a lessor are disallowed if they exceed 'unpaid rent'."

The *Smith* court adopted the definition of "rent" from *Kuske v. McSheridan (In re McSheridan)*, 184 B.R. 91 (BAP 9th Cir. 1995). In *McSheridan*, the Bankruptcy Appellate Panel adopted a three-part test that must be met for a lease charge to constitute "rent-reserved" under section 502(b)(6)(A):

1) The charge must be (a) designated as "rent" or "additional rent" in the lease or (b) provided as the tenant's/lessee's obligation in the lease;
2) The charge must be related to the value of the property or the lease thereon; and
3) The charge must be properly classifiable as rent because it is a fixed, regular or periodic charge.

Id. at 100-01.

The court in *Smith* acknowledged that the test adopted in *McSheridan* was focused on the definition of "rent reserved" for purposes of determining the cap for a claim for future rent under section 502(b)(6)(A). Nevertheless, the court held that the same test should apply to the pre-petition period, and hence acts as a limit on this claim. Given this test for what constitutes "rent," the court in *Smith* disallowed various items of the landlord's claim. First, the court disallowed recovery of "excused rent," which was free rent that was due and payable only upon default. "Excused rent only became due on default when it was levied as a one-time lump-sum charge. It does not have the rent characteristic of being a fixed, regular or periodic charge. If [the] debtor never defaulted, [the] landlord would not have received any excused rent monies. Therefore, excused rent is a penalty for default." *Smith*, 249 B.R. at 338. Second, the court disallowed the landlord's claim for the unamortized building allowance based on the terms of the lease, which provided that advances made to the tenant/debtor only had to be reimbursed if there was an event of default. This obligation did not qualify as rent because it was not a "fixed, regular or periodic charge." *Id.* at 337. Third, the court disallowed the landlord's claim for interest, late charges and attorney's fees on the grounds that such payments lacked the characteristics of "rent" as described above, even though they were defined as "additional rent." The court reasoned that the label given to the charges does not control, but rather the substance of the charges is what is important. Because late payments are a penalty for untimely payment, they are not allowed. *Id*. at 340.

In re Edwards Theaters Circuit, Inc., 281 B.R. 675 (Bankr. C.D. Cal. 2002), involved the issue of whether certain construction obligations may be allowed as part of a landlord's pre-petition claim for rejection of a commercial lease. There, the debtor entered into a commercial lease that contemplated that upon delivery of the "pad" site to the debtor, the debtor would, at its own cost, construct a movie theatre. The lease commencement date was defined as the earlier of when the tenant opened for business or when the construction was completed. The debtor filed for bankruptcy before construction had started and rejected the lease shortly after filing.

The landlord filed a claim for rejection damages, including a claim for $15 million representing the alleged cost of the construction of the theatre. The landlord argued that the damages were pre-petition damages under § 502(b)(6)(B) that should be allowed in full. The debtor objected and argued that the construction obligation was a "performance" obligation and not a "rent" obligation, and hence could not be allowed as part of the pre-petition claim. The court agreed with the debtor and accepted the definition of "rent" from *McSheridan*, *supra*. The court held that the construction obligation was not a rental obligation because it was not a "fixed, regular or periodic charge," and was not related to the value of the property and therefore disallowed the entire claim. *Edwards*, 281 B.R. at 684.

VI. Landlord's Claim for Rejection; the Claim for Future Rent and Problems with the Statutory Cap

A. Introduction

In addition to a general unsecured claim for rent due on the earlier of the petition date or date of surrender (the past-due rent), a landlord also has an unsecured (and non-priority) claim for damages resulting from the rejection of the lease. Such damages are typically the "future rent," which is due and payable when a lease is terminated before the expiration of its natural term. Damage claims may also include the costs necessary to restore the premises to a certain condition. This component of damages is subject to numerous statutory and judicial problems, concerning the statutory cap on damages.

B. The 15 Percent or One-Year Cap

The landlord's unsecured claim for termination damages is capped by section 502(b)(6)(A), which limits a landlord's claim to the rent reserved for the greater of one year or 15 percent of the remaining term not to exceed three years. Section 502(b)(6)(A) states as follows:

> (b) The court . . . shall determine the amount of such claim . . . except to the extent that —
>
> (6) such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds–
>
> (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of–
>
> (i) the date of the filing of the petition; and
>
> (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property.

11 U.S.C. § 502(b)(6)(A).

Two methods have emerged for determining the amount of the cap (which must be distinguished from the amount of a "claim," which is limited by both state law and the terms of the lease). One rule favors taking the balance of the dollar amount of rent that remains over the life of the lease and multiplying the amount by 15 percent (the "rent measurement" rule). Another line of cases holds that the 15 percent is based on "time" and hence looks to the rent that comes due in the immediately succeeding 15 percent of the remaining time or term left under the lease (the "term measurement rule").

C. Rent Measurement Method

It appears that the majority of courts use the "rent measurement" method, which calculates 15 percent of the total rent due over the remaining life of the lease. *See, e.g., New Valley Corp.*, No. 98-982, 2000 WL 1251858, 2000 U.S. Dist. LEXIS 12663 (D. N.J. Aug. 31, 2000) (citing with approval *In re Today's Woman of Florida, Inc.*, 195 B.R. 506, 507 (Bankr. M.D. Fla. 1996)). The rationale for this rule is that it is said to be more equitable and prevents skewing of the damage claim based on uneven rent periods, including free periods early in the lease, or large escalations that occur later in the lease term. *See In re Gantos, Inc.*, 176 B.R. 793, 794-96 (Bankr. W.D. Mich. 1995) (providing examples of why the rent measurement rule is more equitable); s*ee also In re Watkins Management Group, Inc.*, 120 B.R. 586, 587-88 (Bankr. S.D. Ala. 1990); *In re Farley, Inc.*, 146 B.R. 739, 744-45 (Bankr. N.D. Ill. 1992); *Q-Masters*, 135 B.R. at 160 (court took 15 percent of remaining rent obligation and calculated dollar value of claim).

D. Term Measurement Method

The other method is the term measurement method. The rationale behind this approach is to avoid "acceleration," which arguably would occur if a landlord was given 15 percent of all remaining rent. Free rent and rent escalators that occur during the first 15 percent of the term are included within the calculation. Under this approach, the 15 percent is applied to the time left on the lease, not to the dollars that remain unpaid.

The term measurement method is supported by *Sunbeam-Oster Co. v. Lincoln Liberty Avenue (In re Allegheny Int'l., Inc.)*, 145 B.R. 823 (Bankr. W.D. Pa. 1992). The court held that the 15 percent cap is measured by rent due under the first 15 percent of the remaining lease term, and not by 15 percent of the total rent due over the remaining term of the lease. Utilizing the term measurement method instead of the rent measurement method can be particularly significant where there is a free rent period in the next succeeding lease period, or where the rent escalates. The *Allegheny* court stated that:

> [a]fter carefully analyzing the statute and its legislative history, the bankruptcy court interpreted "the remaining term" to specifically refer to the total amount of time remaining in the term of the lease as opposed to the total amount of rent reserved under the lease . . . . The statute is written in terms of *time*. The bankruptcy court's analysis of the legislative history demonstrates that Congress intended the phrase "remaining term" to be a measure of time, not rent.

Id. at 828 (emphasis in original); The court in *In re Iron-Oak Supply Corp.*, 169 B.R. 414 (Bankr. E.D. Cal. 1994), also supported the term measurement rule, noting that

> [t]he correct interpretation, however, is that the Congress intended that the phrase "remaining term" be a measure of time, not rent. *Sunbeam-Oster*, 145 B.R. at 828, *aff'g. In re Allegheny Int'l., Inc.*, 136 B.R. 396, *cited with approval*, *Financial News*, 149 B.R. at

> 353. The statute is worded in terms of time periods. *Sunbeam-Oster*, 145 B.R. at 828; *Allegheny Int'l*, 136 B.R. at 402.
>
> The phrase "without acceleration" only makes sense in terms of a reference to the next succeeding periods under the lease. Taking 15 percent of all the rent for the remaining term, especially where escalation clauses are present, would be tantamount to effecting an acceleration.
>
> Thus, it is necessary to calculate the rent that would accrue in the absence of lease termination to the first 15 percent of the remaining term, here 14.21 months. Any escalators that would take effect during those 14.21 months are to be honored. *Id*. at 402; *see In re Bonwit, Lennon & Co.*, 36 F.Supp. 97, 99-100 (D. Md. 1940). Conversely, as in *Allegheny Int'l.*, any months of free or reduced rent scheduled under the lease during those months are similarly to be honored. *Allegheny Int'l.*, 136 B.R. at 402-03, *aff'd.*, *Sunbeam-Oster*, 145 B.R. at 828. Items specified in the lease as additional rent are to be treated as rent.

Id. at 420; *see also In re Blatstein*, No. 97-3739, 1997 U.S. Dist. LEXIS 13376 (E.D. Pa. 1997) (holding that the 15 percent is a measure of time).

E. Discounting to Present Value

A few cases have given extended consideration to whether the termination damage claim must be discounted to present value. In at least one case, the court rejected the view that the prohibition against "acceleration" meant that the claim was not only subject to a cap, but had to be discounted to present value. *Sunbeam-Oster*, 145 B.R. 823 (Bankr. W.D. Pa. 1992).

F. Strategic Observations

Both the rent measurement method and the term measurement method have problems. By looking merely to the "next" succeeding term, a landlord's claim can be arbitrarily reduced by items such as free rent in the early periods of a lease. Conversely, by using the rent measurement test, the claim is then measured by all prospective rent, including escalations and adjustments, and difficulties arise with calculating the value of future rental income, especially if there are escalations and percentage rent clauses. Because of the split of authority, landlords who are disadvantaged by the term measurement method should consider appellate review of any adverse bankruptcy court decision.

VII. The Cap on Landlord's Damages Based on Whether the Claim is "Rent"

A. The Notion of "Rent Reserved:" Two Different Views on the "Cap"

The 15 percent/one-year rule, discussed above, places a numeric cap on the amount of the damage claim. There is, however, another cap on the damage claim that looks not to the amount, but to the nature of the claim. Here we see that damages may be *further* limited by notions of what is included within the phrase "rent reserved." This issue arises because of the statutory

language in section 502(b)(6)(A), which states that a landlord's claim shall be disallowed to the extent it exceeds "rent reserved by such lease" [for the greater of one year or 15 percent, not to exceed three years]. Stated in another way, the issue is whether damages are allowed only to the extent that they constitute "rent reserved."

Two different views have emerged. One view is that a landlord's claim for future rent is limited to items that fall within the strict definition of rent under the *McSheridan* test, and other damages are not allowed at all. A second view is that items that are not "rent reserved" are not subject to any cap. Under this latter view, many items of damages, such as repair and maintenance damages, are not capped, but are in addition to the cap. *See, e.g., In re Best Products Co., Inc.*, 229 B.R. 673 (Bankr. E.D. Va. 1998). Each of these rules is further discussed below.

B. One View: Future Rent Claim Is Capped by Definition of "Rent Reserved"

As noted above, a leading decision on what kinds of damages may be included within a landlord's claim is *McSheridan*, 184 B.R. 91. In *McSheridan*, the BAP adopted a three-part test that must be met for a lease charge to constitute "rent-reserved" under section 502(b)(6)(A):

1) The charge must be (a) designated as "rent" or "additional rent" in the lease, or (b) provided as the tenant's/lessee's obligation in the lease;

2) The charge must be related to the value of the property or the lease thereon; and

3) The charge must be properly classifiable as rent because itis a fixed, regular or periodic charge.

Id. at 100-01.

The court in *McSheridan* found that rejection is functionally a breach of "each and every provision of the lease, including covenants." Thus, in its view, the damage cap applies to all covenants, and the statutory cap means that only "rent reserved" may be recovered. Other damages that are not "rent" are excluded and are not allowed.

C. A Second View: The Cap Only Applies to Future Rent, and Other Damages Are Not Subject to Any Cap

Not all courts follow the strict approach announced in *McSheridan*. Other courts have held that the cap on damages only applies to damages that the lessor would have avoided but for the lease termination and that other damages are free from any cap or limit. A leading case that rejects *McSheridan* is *Best Product. Co.*, 229 B.R. 673. In *Best Products Co.*, the landlord sought rejection damages for the debtor's failure to repair the premises. The lease was a triple net lease that expressly required the debtor to pay "all expenses of whatever nature, whether ordinary or extraordinary," and further provided that the debtor would, at its sole expense, "keep and maintain the premises in good repair." *Id.* at 674. Relying on *McSheridan's* restrictive definition of rent, the debtor argued that repair and maintenance damages should not be allowable because they are not "rent reserved."

The bankruptcy court disagreed with the debtor and allowed the claim, thereby rejecting *McSheridan's* narrow definition of rent. The court stated that the analysis in *McSheridan* "strike[s] me as resting upon a somewhat tortured analysis of the relevant Code sections." The court suggested that the "weight of authority" in reported cases supports the notion that section 502 was only meant to limit prospective future rent, not to limit ordinary contract claims, and therefore deferred maintenance and repairs are not subject to the cap of section 502(b)(6).[20] *See also In re Atlantic Container Corp.*, 133 B.R. 980, 993 (Bankr. N.D. Ill. 1991) ("[T]he Landlords' pre-petition claims for physical damages to the leased properties and for repair and maintenance expenses are not subject to the statutory cap of 11 U.S.C. § 502(b)(6)").

D. Removal, Environmental and Repair Obligations: Are They Rejection Claims?

A major and potentially costly concern to landlords arises when a tenant fails to restore the premises to a pre-occupancy condition and/or fails to remove environmental waste and hazardous materials upon rejection of a lease in a bankruptcy case. The landlord's right to recover damages in these instances has been treated inconsistently by the courts. On the one hand, it may be argued that repair and maintenance damage claims arise during the pre-rejection period, and hence should be entitled to administrative expense priority. On the other hand, many courts have held that such claims only arise upon termination and hence are rejection damages and are not entitled to administrative priority, and are subject to the cap.

In *In re National Refractories & Minerals Corp.*, 297 B.R. 614 (Bankr. N.D. Cal. 2003), the court viewed clean-up costs as pre-rejection claims. There, the debtor leased a manufacturing facility from the landlord. The debtor rejected the lease and abandoned the premises. The landlord recovered the site and filed an administrative claim to recover the costs to repair and clean up the facility, as well as post-petition rent and post-petition taxes. The repair costs included the cost of removing hazardous waste. The lease provision stated that the debtor was required "to restore the premises to a condition satisfactory to the lessor before abandoning the premises." *Id*. at 618. The debtor, citing to *In re Dant & Russell, Inc.*, 853 F.2d 700 (9th Cir. 1988), argued that such damages arose only upon termination, and hence should be viewed as rejection damages (*e.g.*, damages treated as a pre-petition unsecured claim). The court disagreed and held that the repair costs would be entitled to an administrative priority if the damage occurred pre-rejection and "if the debtor first brought . . . the hazardous material[s] onto the leased premises post-petition." *Id.* at 619; *see also Atlantic Container*, 133 B.R. at 992 (holding that (i) the landlords' claims for physical damages arose out of a breach of covenant and were not subject to the section 502(b)(6) cap because they were not lease termination damages; (ii) but that only the portion of such physical damages that "actually occurred after the filing of the bankruptcy petition" would be entitled to administrative priority).

A different result was reached in *In re Teleglobe Communications Corp.*, 304 B.R. 79 (D. Del. 2004). In that case, the lease contained a provision which required that upon termination of the lease, the tenant was required to remove all of its property from the premises and repair any damage caused by the removal. The landlord's estimate for repairing the premises was

[20] *Best Products* is unclear on one issue. It expressly refers to § 502(b)(6)(A), which is the "future rent" section, yet the claim for deferred maintenance would appear to be a claim that arose pre-rejection and hence might be entitled to administrative priority.

approximately $3.1 million. The district court held that the damages arising from the failure to remove and repair should be treated as rejection damages, and hence paid as general, unsecured claims. Arguably, the damages or acts had occurred pre-rejection, but the duty to remove did not exist until after the rejection.

More recently, in *Ames*, 306 B.R. 43, the court held that a landlord's cleanup costs following rejection are claims which arise upon rejection, and hence are not entitled to an administrative priority and are subject to the cap. The lease provided that, "at the termination of this lease, [tenant shall] remove such of the tenant's goods and effects as are not permanently affixed to the leased premises, to repair any damage caused by such removal, and peaceably to yield up the leased premises . . . clean and in good order, repair and condition." *Id.* at 49. The tenant in *Ames* failed to do so and admitted that it had left the premises with personal property still to be removed, mostly fixtures and shelving. The landlord argued that this was a breach of a pre-rejection obligation, but the court disagreed. The court ruled that such breaches are claims "arising from the rejection of a lease." Accordingly, they are governed and limited by section 502(g), which creates a cap for damages arising from a lease rejection. The court stated that:

> [t]hus §§ 365(g) and 502(g) provide, unambiguously, that rejection claims are pre-petition claims. And the claims in question here are plainly a species of rejection claims; like contractual claims for the rent that would be paid after rejection, these are contractual claims for damages that the landlords suffered after (and upon) the debtor's rejection and removal from the premises.

Id. at 60.

In *K-4, Inc. v. Midway Engineered Wood Products, Inc. (In re Treesource Indus., Inc.)*, 363 F.3d 994 (9th Cir. 2004), the court found that certain removal and maintenance obligations were not entitled to administrative priority on the theory that such claims only arise "upon termination" (or rejection) and hence must be viewed as only unsecured pre-petition obligations. In *Treesource Indus., Inc.*, the tenant constructed a new building on the leased site, which it was obligated to remove upon termination. The debtor rejected the lease and removed the building it had constructed on the site, but left a concrete slab. The question presented was whether the cost to restore the premises was a claim that arose during the post-petition, pre-rejection period, and hence was entitled to be treated as an administrative priority, or whether it was a rejection claim, and hence would only be treated as a general unsecured claim. The Ninth Circuit deemed the cost a general unsecured claim. The court concluded that the obligation to remove the slab only arose on termination based on the language of the lease, which stated that the "removal obligation," a defined term, arose "upon termination or expiration of the lease." *Id*. at 998.[21]

[21] The lease provided, in pertinent part, that "[u]pon termination or expiration of the lease, lessee shall remove all fixtures and equipment on the premises and shall, with respect to improvements made after March 1, 1997, remove such improvements, footings, floors, foundations and shall regrade the premises to natural contours after removing all debris and other incidental material brought onto the premises by lessee." *Treesource Indus., Inc.*, 363 F.3d at 996.

E. Strategic Observations: Landlords Should Demand Pre-Confirmation Resolution of the Nature of the Claim

One of the ways in which a debtor can minimize the landlord's claims leverage is to wait until post confirmation to object to a claim. By delaying the claims hearing until after a plan has been confirmed, a debtor can avoid having a landlord object to plan confirmation based on a failure to provide for payment in full of its administrative claim. This strategy by a debtor may diminish a landlord's leverage.

Landlords should consider filing a declaratory judgment action to determine the nature of their claim, or alternatively, objecting to the confirmation of a plan and disclosure statement where the nature of its claim is not disclosed nor described.

VIII. Application of the Cap on Damages to Third-Party Guarantors

Issues frequently arise as to whether the cap on a landlord's claim also applies to a non-debtor that guarantees the rent claim. Courts have consistently ruled that where the guarantor of the lease does not file for bankruptcy, but the tenant is in bankruptcy, the Bankruptcy Code's limitation on damages does not limit the guarantor's liability to the landlord. However, the cap does apply if the guarantor is in bankruptcy.

For example, in *Wainer v. A.J. Equities, Ltd.*, 984 F.2d 679 (5th Cir. 1993), the court stated that if a lease is rejected and the landlord's claim is discharged, the landlord may still pursue the guarantor as if there were no discharge. *See also Al Kopolow v. P.M. Holding Corp. (In re Modern Textile, Inc.)*, 900 F.2d 1184 (8th Cir. 1990); *Bel-Ken Associates Ltd. P'ship v. Clark*, 83 B.R. 357 (Bankr. D. Md. 1988).

Where both the tenant and the guarantor of the tenant's lease file bankruptcy, the Bankruptcy Code's limitation on damages applies to both debtors. *See In re Rodman*, 60 B.R. 334 (Bankr. W.D. Okla. 1986); *see also In re Loewen Group Int'l, Inc.*, 274 B.R. 427, 442 (Bankr. D. Del. 2002) ("I can see no reason why a guarantor-debtor's obligation on a claim as determined under § 502(b) should be any greater than the underlying obligation of the debtor-obligor."); *Revco*, 138 B.R. 528; *In re Henderson*, 297 B.R. 875, 886 (Bankr. D. Fla. 2003).

In *Farley, Inc.*, 146 B.R. 739, the court held that the cap applies to a guarantor if the guarantor is a debtor, and even if the tenant is not in bankruptcy. The court stated that:

> [f]or purposes of applying § 502(b)(6) to a landlord's claim, it is not legally relevant whether the debtor is defined as "tenant" or as "guarantor" of the lease. Section 502(b)(6) does not explicitly limit claims of a landlord against lease guarantors. The statutory language only limits the claims of a "lessor for damages from the termination of a lease." However, reading into this provision a distinction between tenants and guarantors is unwarranted, since

> either tenant or guarantor can be liable for "damages from the termination of a lease." From the language of § 502(b)(6), it is apparent that it is equally applicable to lessees and guarantors. *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 921 (2d Cir. 1944) ("the guaranty is a secondary obligation, it must be subject to the same limitations as the primary"); *In re Interco, Inc.*, 137 B.R. 1003, 1005-1006 (Bankr. E.D. Mo. 1992*)* ("[t]he purpose of 502(b)(6) is to compensate the landlord fairly while protecting other creditors. This rationale is applicable whether the debtor is the tenant or the guarantor of the lease.").

Id. at 745; *see also Arden v. Motel Partners (In re Arden)*, 176 F.3d 1226, 1227 (9th Cir. 1999); *In re Episode USA, Inc.*, 202 B.R. 691, 696-97 (Bankr. S.D.N.Y. 1996); *In re Thompson*, 116 B.R. 610 (Bankr. S.D. Ohio 1990).

IX. **Letters of Credit and the Statutory Cap**

A. Introduction

Most commercial landlords require that a tenant post a letter of credit as a form of collateral for performance under the lease, with the letter of credit often being described as part of the security deposit. Typically, such letters of credit cover at least one year's rent. The basis for the widespread use of a letter of credit is the "independence theory," meaning that letters of credit are "independent" obligations of a third-party and thus, to some extent, immune from a tenant's bankruptcy.[22]

In view of the independence principle, commercial landlords may believe that a letter of credit can be *fully* drawn upon in the event of a tenant's bankruptcy to compensate the landlord for any actual damages. In fact, such is not the case, and under most reported decisions, letters of credit have not achieved the full qualities of independence necessary to make them complete credit enhancements.

The issue of how the statutory cap is to be reconciled, if at all, with letters of credit has led to at least three different views (see below). One fairly recent case suggests that a commercial bank that issues a letter of credit may find that its right to reimbursement (and not the landlord's claim) is limited by the statutory cap on allowable damages under the Bankruptcy Code. As of this date, however, this view has not been adopted in any reported decisions.

B. The Letter of Credit Problem; Where it all Began

The problem with letters of credit began with the legislative history to the Code, as initially drafted and passed by Congress in 1978. The legislative history stated that section

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[22] "The issuer's obligation under the letter of credit is independent of the underlying contract. [U.C.C.]§ 5-103(d). . .Thus, the issuer's obligation 'does not depend on the fact of default, but upon the presentation of documents as evidence of default. As a result of the independence of letters of credit from their underlying contracts, neither the letter of credit nor its proceeds are property of the debtor's bankruptcy estate." *In re Mayan Networks Corp.,* 306 B.R. 295 (9th Cir. BAP, 2004).

502(b) "limits the damages allowable to a landlord of the debtor." The legislative history specifically endorses the Second Circuit case of *Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2d Cir. 1944), which requires that a security deposit count toward the total claim of a landlord. In agreeing with the holding in *Oldden*, the legislative history states that the landlord "will not be permitted to offset his actual damages against his security deposit and then claim for the balance under [§ 502(b)(6)]. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under this paragraph." H.R. Rep. No. 595 (1977) and S. Rep. No. 989 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 5787.

In view of this legislative history and the decision in *Oldden* various courts have come to the conclusion that the legislative history is correct; that a security deposit must be applied to the cap, and that a letter of credit functions in the same fashion as a security deposit, and hence, it too must be applied to the cap. *See In re Mayan Networks Corp.*, 306 B.R. 295 (9th Cir. BAP 2004).

C. The Uniform Commercial Code: UCC § 5-103 and the Independence Theory

Letters of credit are governed in all states by the applicable version of the Uniform Commercial Code, Article 5. The "independence theory" finds its home in UCC § 5-103, which states as follows:

> (d) Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.

The official comment underscores this independence theory, stating that "Only staunch recognition of this [independence] principle by the issuers and the courts will give letters of credit the continuing vitality that arises from the certainty and speed of payment under letters of credit. To that end, it is important that the law not carry into letters of credit transactions that properly apply only to secondary guarantees or to other forms of engagement." UCC § 5-103, cmt. 1.

The official comment further distinguishes a letter of credit from a surety or guaranty contract. Thus, while recognizing that a letter of credit is "similar" to such devices,

> it is important to recognize the distinction between letters of credit and those guarantees. It is often a defense to a secondary or accessory guarantor's liability that the underlying debt has been discharged or that debtor has other defenses to the underlying letter of credit In letter of credit law, on the other hand, the independence principle recognized throughout Article 5 states that the issuer's liability is independent of the underlying obligation. That the beneficiary may have breached the underlying contract to the applicant against the beneficiary is no defense for the issuer's refusal to honor.

This independence theory has led some commentators to refer to the letter of credit as being bankruptcy proof:

> [e]xcept in cases of fraud by the beneficiary, the account party cannot countermand the credit. . . . Consequently, the bank must pay even if the account party files for bankruptcy. This promise of immunity from bankruptcy has led to the popularity of the "standby letter of credit," which provides assurance of payment against this bankruptcy risk. Indeed, a letter of credit is often used in a structured finance transaction on the premise that the letter of credit will stand like "a galled rock" though "swilled with the wild and wasteful ocean" of the account party's bankruptcy.

David Gray Carlson & William H. Widen, *Letters of Credit, Voidable Preferences, and the "Independence Principle*, 54 BUS. LAW. 1661, 1661-62 (1999); *see also* Michael St. Patrick Baxter, *Letters of Credit and the Powerine Preference Trap*, 53 BUS. LAW. 65, 69 (1997) ("Indeed, courts have ruled almost universally that a letter of credit and the proceeds thereof are not property of the debtor's bankruptcy estate.").

As discussed below, the notion of the independent letter of credit and its bankruptcy proofing qualities has been challenged to some extent. Efforts to fully utilize letters of credit to avoid the cap on a landlord's damage claim continue to run into judicial roadblocks. Whether such rulings are correct is debatable.

D. Letters of Credit: Landlord Not Entitled to Full Amount of the Letter of Credit if Claim Exceeds the Statutory Cap

Perhaps the most important issue is whether a landlord who holds a letter of credit may draw upon it for all of its damages even if the damages exceed the statutory cap. The circuit courts are split on whether a letter of credit must be applied in reduction of the cap, although as of this date, no two cases have squarely addressed identical issues. In addition, a decision from the Ninth Circuit Bankruptcy Appellate Panel offers a distinctly different view.

One view, which has reasonably wide acceptance and which is supported by a decision from the Third Circuit, is that a letter of credit can only be used up to the amount of the statutory cap, and that any amount over the cap cannot be drawn (or if drawn, must be returned to the debtor). *See Solow v. PPI Enterprises (U.S.), Inc. (In re PPI Enterprises (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003). That is, the landlord's statutory cap on damages is first determined, then the letter of credit is applied to the cap. The letter of credit cannot be applied to actual damages that are in excess of the cap, even where those damages are fully allowable under state law.

In *PPI*, the lease provided that the letter of credit was "in lieu of PPI's cash security obligation in the leasehold agreement." *Id.* at 210. The tenant abandoned the premises in September 1991. Accordingly, the landlord drew on the letter of credit to cover monthly rental payments between October 1991 and July 1992, until the letter was exhausted, and then terminated the lease. The landlord filed an action and obtained a judgment as to liability in state court, but not as to damages. After years of settlement discussions, the landlord asked the court

to award damages. The day before the hearing, the tenant filed for bankruptcy with the claim still unpaid.

The landlord argued that the letter of credit should not be applied to the cap because the cap only "starts" once there is a bankruptcy case, and the letter of credit was fully drawn upon before the case started. The Third Circuit disagreed, stating that the "cap starts to operate on the date on which the lessee surrendered the leased premises." *Id.* at 208. Accordingly, the court found that the bankruptcy cap was effective from the time of surrender, even though the bankruptcy case was not filed until 1996, almost five years after the letter of credit had been drawn.

The Third Circuit based its decision on two grounds. First, it found that settled case law holds that a security deposit is to be applied to the capped claim. The bankruptcy court relied on *Oldden*, 143 F.2d at 921, which established the pre-Code practice of deducting security deposits from a landlord's capped claim. *See also* H.R. Rep. No. 95–595 at 354.[23] Second, the court found that the lease provisions signified the parties' intention that the letter of credit would serve as a security deposit.[24] It might be argued that the Third Circuit did not rule that *all* letters of credit would, as a matter of law, fall within this rule, but only that in the present case the parties intended the letter of credit to operate as a security deposit. *Id*. at 210 ("We need not decide the underlying question because it is clear the parties intended the letter of credit to operate as a security deposit."). Given the nature and purpose of a letter of credit, it seems doubtful that landlords will be able to draft around this ruling. Whether the ruling is correct is open to fair debate.

E. Landlord Can Draw Upon Full Letter of Credit If It Has Not Filed Proof of Claim

On November 8, 2005, the U.S. Court of Appeals for the Fifth Circuit issued its decision in *EOP-Colonnade of Dallas Limited Partnership v. SBTI (In re Stonebridge Technologies)*, 430 F.3d 260 (5th Cir. 2005) [25] holding that a landlord may draw on a letter of credit held as a

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[23] In *In re Handy Andy Home Improvement Centers, Inc.*, 222 B.R. 571 (Bankr. N.D. Ill. 1998), the court stated as follows: "[t]he House and Senate Reports state that the landlord 'will not be permitted to offset his actual damages against his security deposit and then claim for the balance under [§ 502(b)(6)]. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under this paragraph." H.R. Rep. No. 595 (1977) and S. Rep. No. 989 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 5787. It is "well settled that a security deposit held by a lessor on a rejected lease must be applied against the maximum claim for lease termination damages allowed to the lessor under § 502(b)(6)." *Id.* at 574 (citing *Atlantic Container*, 133 B.R. at 988; alteration in original; footnote omitted).

[24] The parties agreed to the following: "In lieu of the cash security provided for in Article 33A, tenant may deliver to landlord, as security pursuant to Article 33A, an irrevocable, clean, commercial letter of credit in the amount of $650,000 issued by a bank . . . which shall permit landlord (a) to draw thereon up to the full amount of the credit evidenced thereby in the event of any default by Tenant . . . or (b) to draw the full amount thereof to be held as cash security pursuant to Article 33A hereof if for any reason the Letter is not renewed . . . ." *PPI*, 324 F.3d at 210.

[25] *See also Two Trees v. Builders Transp., Inc. (In re Builders Transp., Inc.)*, 471 F.3d 1178 (11th Cir. 2006). In *Two Trees,* the debtor filed a turnover action, arguing that its claim for the return of the difference between the letter of credit amount and the lessor's actual damages is property of the estate. The assignee of the lessor argued, *inter alia*, that the its claim was not subject to the section 502(b)(6) cap because the lessor never filed a

security deposit and retain the proceeds, even if the proceeds are greater than the amount of damages permitted under the statutory cap of section 502 of the Code.[26] However, the ruling was limited to the situation where a landlord had not filed a proof of claim. *Id*. at 264. ("[b]ecause EOP [the landlord] did not file a claim in the bankruptcy case . . ." the court held that the § 502(b)(6) cap was not triggered"). The Fifth Circuit thus did not resolve the issue of whether a landlord may first draw upon a letter of credit for the full amount of its damages, even if they are in excess of the cap in those cases where it is seeking a claim for the balance from the estate.

In *Stonebridge*, the landlord, EOP, obtained a security deposit for a commercial office building consisting of $105,298.85 in cash and a letter of credit in the amount of $1,430,065.74. Less than a year later, Stonebridge filed for protection under chapter 11. At the time of the filing, the debtor owed the landlord $71,895.61 for miscellaneous charges and expenses plus rent for the month of September 2001. Shortly thereafter, EOP and the debtor agreed that the lease would be rejected effective October 2001. Prior to the court hearing to approve the rejection, however, EOP drew upon the letter of credit for the full amount. A few days later, the bankruptcy court approved the lease rejection, making the effective date retroactive.

Following this, the liquidating trustee, which was the successor to the debtor's claims, initiated an adversary proceeding against EOP alleging that it had prematurely drawn on the letter of credit and that it had retained proceeds in excess of the statutory cap. It was undisputed that the capped amount of damages was $1.3 million, whereas the amount drawn under the letter of credit was $1.4 million. *Id*. at 270. However, the actual damages were estimated to be $1.5 million to $1.6 million. *Id.* at 273. Both the district court and the bankruptcy court held that the landlord had violated section 502(b)(6) by retaining proceeds from the letter of credit that exceeded the capped amount, even though it was not disputed that the landlord's damages were greater than the capped amount.

The Fifth Circuit reversed the lower court rulings. It held that section 502(b) by its terms "applies only to claims against the bankruptcy estate." *Id.* at 269. Further, "the damages cap of § 502(b)(6) does not apply to limit the beneficiary's (the landlord's) entitlement to the proceeds of a letter of credit unless and until the lessor makes a claim against the estate." *Id.* at 270. Because the landlord had not filed a proof of claim for its rejection damages, but had instead drawn on the letter of credit, its damages were not governed by the statutory cap on damages. Further, the bankruptcy court held that section 502(b)(6) is not a self-effectuating avoiding power.

The second issue on appeal was whether the draw on the letter was premature, regardless of the cap. This is a persistent issue for landlords that arises whenever the accrued, unpaid rent is less than the letter of credit. At the time of the draw upon the letter of credit, the damages for unpaid rent were only for two months, which was substantially less than the letter of credit. Nevertheless, the landlord drew upon the entire letter of credit ($1.4 million) because the tenant

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proof of claim. The court noted the *Stonebridge* opinion, but held that the assignee's argument was irrelevant because, in *Two Trees*, the actual claims of the lessor did not exceed the section 502(b)(6) cap.

[26] 11 U.S.C. §502(b)(6).

had announced its intention to reject the lease, thus arguably giving the landlord a claim for future, accelerated rent.

The Fifth Circuit reversed the lower courts, which had ruled that the draw on the letter of credit was premature. It relied on two key lease provisions. The first relevant provision was the monetary default clause . This provision stated that Stonebridge would be in default if it failed to pay rent when due and failed to cure this default within five days after written notice. This notice provision was apparently a condition to being able to draw on the letter of credit. The landlord had filed a "motion for payment of rent" with the bankruptcy court, and the Fifth Circuit found this was sufficient notice.

The second provision was an acceleration clause, which provided that upon the occurrence of a "monetary default" the landlord was entitled to damages equal to the accrued rent through the date of termination and an amount equal to the total rent that would have been paid over the remainder of the lease term, discounted to present value, minus the present fair rental value of the premises, after deducting all anticipated costs of reletting. The Fifth Circuit held that this lease provision mirrored the correct amount of permitted damages in the event of rejection when not applying the statutory cap. *Id.* at 273 (citing *City Bank Farmers Trust Co. v. Irving Trust Co.*, 299 U.S. 433, 443, 57 S.Ct. 292 (1937)). Applying this formula, the court found that the accelerated damages under the lease (approximately $1.5 million) exceeded the value of the letter of credit.

F. The *Mayan* Concurring Opinion: Landlords May Draw Upon Letter of Credit Regardless of the "Cap"

A third approach to the letter of credit issue is found in the concurring opinion in the Ninth Circuit BAP decision of *In re Mayan Networks Corp.*, 306 B.R. 295 (B.A.P. 9th Cir. 2004). There, the debtor entered into a sublease of a large commercial office building. Two forms of security were provided: cash of approximately $350,000 and a letter of credit in the amount of $648,966. The debtor's obligation to reimburse the issuing bank if there was a draw on the letter of credit was secured by a pledge of over $650,000. The debtor filed for bankruptcy and then rejected the lease.

As a result of the debtor's rejection of the lease. the landlord had a claim of $2.7 million after applying the statutory cap to its damages. After the bankruptcy case was filed, the landlord drew on the letter of credit for payment of $648,966. The landlord sought to apply the letter of credit to its state law damages and then submited a proof of claim to the bankruptcy court for the full capped amount.

The issue presented was whether the draw on the $648,966 letter of credit should be applied in partial satisfaction of the $2.7 million capped claim. If the letter of credit was not applied to the $2.7 million capped claim, then the landlord would be allowed $648,966 over the cap. The court held that the letter of credit had to be applied to the capped claim and, thus, the letter of credit did not allow the size of the landlord's claim to exceed the cap.[27] The court found that Code section 502(b)(6) was ambiguous and hence justified resorting to the legislative

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history.[28] The legislative history supported the pre-code case of *Oldden*, which held that a security deposit must be applied to the claim after the damages under the statutory cap have been calculated. The majority portion of the decision reflects the current view of most courts. Whether that view is correct is open to fair debate.

The court in *Mayan* made much of the fact that the letter of credit was supported by a pledge of collateral to secure the issuing bank's right to reimbursement if there was a draw on the letter of credit. For some reason, the court found that the cash collateral pledged to the bank was "really an attempt to circumvent *Oldden*." *Id.* at 300. Later, the court referred to "crafty draftsmanship." *Id.* The court was surprisingly offended by a landlord's efforts to secure a valid claim—not unlike what conventional lenders routinely do in financing transactions. Further, the court appears to have ignored the conventional structure of letters of credit in which an issuing bank typically requires a reimbursement agreement, in which the applicant (the debtor) promises to pay the bank in the event of a draw. Such reimbursement agreements are typically secured by a pledge of collateral. This hardly distracts from the bank's position as a "true third obligor who bears the substantial risk." *Id.* at 300. Guarantors and sureties may bear the initial risk of payment, but given the common law and contractual right of subrogation and contribution, are entitled to seek payment from the primary obligor.

In a concurring opinion, Judge Klein stated that while he agreed with the result reached by the majority, the reasoning underlying the majority opinion was incorrect and he cautioned that reliance on *Oldden* could lead to incorrect decisions. Judge Klein's analysis, while lengthy and complex, appears to support the notion that a landlord is entitled to draw fully on the letter of credit, but that the issuing bank's claim for reimbursement or subrogation is limited by the statutory cap. *Id.* at 310. As noted below, because he qualified his decision near the end, it is not entirely clear whether his views would support a full break with prior case law.

Judge Klein began his analysis by ruling that a letter of credit "functions as a guaranty" and that the issuer is a co-obligor. *Id.* at 307. Under the UCC, an issuing bank that has honored a draw request is "entitled to be reimbursed by the applicant in immediately available funds not later than the date of its payment of funds." UCC § 5-108(i). Issuing banks will typically require that the tenant sign a "reimbursement agreement," and will require that collateral be posted to secure the obligation. An issuing bank also has a right of subrogation or contribution, the same as any guarantor under the common law. Judge Klein stated that under the UCC § 5-117, the issuer of a letter of credit should be given the same legal treatment as any other third-party guarantor. UCC § 5-117 states that if an issuing bank honors the beneficiary's request for payment, the issuing bank is subrogated to the rights of the beneficiary to the same extent as if the issuing bank's duty to pay was a secondary obligation owing to the beneficiary. Viewed as a guarantor, the issuing bank is liable to the landlord for the full amount of the letter of credit. That is, the Bankruptcy Code's cap does not pertain to a claim against a guarantor. "In other words, the estate's cap shelters the estate but not co-obligors." *Mayan*, 306 B.R. at 306. When the issuing bank and the letter of credit are viewed as traditional third-party guarantors, it becomes plain, he stated, that a landlord should be permitted to draw upon a letter of credit in

[28] As later courts seek to resolve the letter of credit issue, this ruling that the code is ambiguous may be grounds for later courts to either (a) reach a different result or (b) apply a "plain meaning" view and reject the majority view. *See Oldden*, 143 F.2d 916.

full up to the amount of damages that would be allowed under state law, just as it could against any third-party non-debtor guarantor.

Judge Klein stated that under these circumstances, the issuing bank, once having paid the full amount under the letter of credit to the landlord, must bear the risk imposed by the statutory cap on damages. The issuing bank, which has the status of a guarantor, can only recover from the debtor the capped amount of the claim, even if the issuing bank holds collateral under a reimbursement agreement for additional damages. *Id.* at 310. When a guarantor of a debtor pays a claim, the guarantor has a right to reimbursement or contribution from the debtor under Bankruptcy Code § 502(e). However, this claim for reimbursement or contribution should be disallowed to the extent that the landlord's claim against the estate would have been disallowed. That is, if the landlord's claim would have been disallowed in part due to the cap, then the issuing bank's claim is disallowed to the same extent. Under this view, a landlord would be fully paid by drawing on the letter of credit. The issuing bank would take the credit risk of the cap. "Although landlords unquestionably get more out of their credit enhancements, the estate is never liable for more than the amount of the statutory cap." *Id*. at 310. The rationale is that § 502 means that the estate will not be liable for more than the statutory cap.

Given the above analysis, it is not entirely clear why Judge Klein concurred with the result. In somewhat cryptic fashion he stated that "under the facts of this case" the draw on the letter of credit triggered reimbursement from pledged funds that were property of the estate. *Id.* at 310. Further, the lease agreement stated that the letter of credit proceeds were part of the security deposit. *Id.* at 311.

> the draw on the letter of credit triggered reimbursement of the issuer from, under the facts of this case, the Debtor's pledged funds that were property of the estate and that were the source of the "immediately available funds" to which the statutory reimbursement obligation [under the UCC] applies. Moreover, the Landlord contractually agreed in the lease that letter of credit proceeds are part of the security deposit that must be refunded to the Debtor following faithful performance of the lease. Hence, the funds are unambiguously property of the estate and count against the § 502(b)(6) cap.

Id. at 310-11.

Judge Klein's rationale is not clear. Anytime a debtor pledges collateral for a letter of credit, the collateral is property of the estate. That can hardly be a meaningful distinction. Further, Judge Klein had noted earlier that if there is collateral, then the issuing bank must return any collateral in excess of the cap. Thus, is the only distinction that here the lease provided that the letter of credit was "part of the security deposit?" *Id.* at 311. That hardly seems meaningful. The letter of credit was, as Judge Klein spent many pages saying, not "part" of the security deposit, but a guaranty of the security deposit. Would better drafting have made a difference?

Despite the ambiguity of his concurrence, Judge Klein's concurring opinion provides support that landlords should be permitted to draw fully on letters of credit, and that the risk of

the cap should be borne by the issuing bank, regardless of whether the debtor has posted collateral with the issuing bank to secure its reimbursement obligation. As of this date, however, no other case has accepted this point of view.[29]

G. Strategic Observations

Landlords are often confronted with the dilemma presented in *PPI*, namely, a pre-bankruptcy tenant that has posted a large letter of credit. A landlord might believe that its best strategy is to declare a default, accelerate the lease payments, draw on the letter of credit and then terminate the lease. By drawing on the letter of credit prior to bankruptcy, a landlord might avoid the need to file a proof of claim, although this too has risks. However, *PPI* teaches that even a bankruptcy case filed many years after a termination still implicates the statutory cap, at least where the landlord is seeking a claim against the estate. The debtor may file for bankruptcy and argue that the statutory cap begins on the date when the premises were surrendered, and hence all of the payments are within the cap.

Stonebridge is good news for landlords, but some caution is required. The decision is inconsistent with the Third Circuit decision in *PPI*, 324 F.3d 197, and the 9th Circuit Bankruptcy Appellate Panel's decision in *Mayan*, 306 B.R. 295. The Fifth Circuit distinguished both cases by saying that in both the landlord had filed a proof of claim, thus suggesting that when a proof of claim is filed, the letter of credit lacks the full independence that landlords seek.

The Fifth Circuit unfortunately did not address head-on the larger issue of why a landlord cannot draw on a letter of credit regardless of whether it files a proof of claim and relies fully on the independence of the letter of credit. Judge Klein, who wrote the concurrence in *Mayan*, offers a compelling argument that the statutory cap should not apply to a landlord, when it draws on a letter of credit that is in the nature of a true third-party obligor, because this is not an action against the debtor or the bankruptcy estate. Instead, he argued that the cap should apply only to the issuing bank that seeks to enforce its reimbursement agreement against the estate, after it has paid on the draw under the letter of credit. The landlord's draw on the letter is never a claim against property of the estate in his view and hence never implicates the cap. Judge Klein's view may prove correct, and it avoids having the issue turn on whether a proof of claim was filed.

Landlords will be highly tempted to follow this case and to draw on the letter of credit either before or after the commencement of the case. Landlords may also be tempted not to file a proof of claim and seek to take advantage of the ruling. How risky is such an approach? Landlords should note that the liquidating trustee sued the landlord after plan confirmation and after the bar date had passed. In short, while the case is groundbreaking and good news in one sense, it also creates a potential "Sophie's Choice" for landlords.

In summary, because there was a default, notice of default, acceleration, and a letter of credit that was less than the accelerated damages, and because the landlord did not file a proof of

[29] The Ninth Circuit was asked to accept his view in *In re AB Liquidating Corp.,* 416 F.3d 961 (9th Cir., 2005) but found that it need not decide whether his views were correct or not.

claim, the landlord was permitted to retain the entire proceeds, even though they exceeded the amount of capped damages.

Once a landlord draws upon a letter of credit, the landlord then has a cash sum. That sum may exceed the amount of damages arising from any current default. Therefore, the landlord is now holding cash as collateral and effectively has transformed the letter of credit back into a cash security deposit. The result of this is that the cash is now "cash collateral" under the Bankruptcy Code. It also means that the cash has lost its status as being "independent" of the estate, and thus any further draws on the cash would be prohibited by the automatic stay, at least until relief from the stay is obtained.

H. Letters of Credit: Application Where Debtor Assumes the Lease

Most bankruptcy cases appear to deal with the use of a letter of credit where the tenant rejects the lease. But what happens if the lease is assumed and there is a monetary cure obligation? In *Musika v. Arbutus Shopping Center Ltd. Partnership ASCLP* (*In re Farm Fresh Supermarkets of Maryland, Inc.*), 257 B.R. 770 (Bankr. D. Md. 2001), the court confirmed the notion that a letter of credit is independent of the estate and should be viewed as a guarantee. However, the facts of the case did not invoke the issue of the rejection of a lease where there is a cap, but rather the general calculation of damages. In *Farm Fresh*, the landlord was the holder of a letter of credit that was to secure both "monetary and non-monetary defaults." *Id.* at 771. On the date of the filing of an involuntary bankruptcy petition, the landlord advised the debtor that it had committed both monetary and non-monetary defaults. Thereafter, the landlord made demand for cure under the lease (despite the automatic stay) and then drew upon the letter of credit. The trustee then assumed and assigned the lease, pursuant to which all cure amounts were paid, thus presumably leaving the landlord without any actual monetary damages.

Thereafter, the trustee initiated an action to recover the draw on the letter of credit as an invalid post-petition transfer. The trustee argued that since the landlord had not suffered any monetary damages, it was not entitled to the letter-of-credit proceeds. The court ruled in favor of the landlord and dismissed the complaint. The court held that "neither the letter of credit nor its proceeds were property of the debtor's estate." *Id.* at 772. The court found that the letter of credit was "more akin to a guarantee." *Id.* Further, the court held that "[w]hether or not the non-monetary defaults under the lease were significant events is irrelevant, because the lease and letter of credit permitted the funds to be drawn down in the event of non-monetary defaults." *Id.* *Farm Fresh* was not a section 502(b)(6) case; there was no statutory cap issue as such, because the lease was assumed and not rejected. However, the case illustrates that a letter of credit may retain its more robust notion of "independence" when it is used to compensate for damages in which no cap is implicated.

I. Drafting Suggestions

The cases that have addressed this issue of letters of credit and the statutory cap appear to rely on the notion that a letter of credit is a security deposit, suggesting that if the letter of credit is something else, it may not be subject to the statutory cap. However, there is no apparent drafting strategy that would make the letter of credit something other than collateral for

performance. It would therefore appear that drafting differences would be elevating form over substance.

Some commentators suggest that a letter of credit should not be applied to the cap where the lease states that the letter of credit is "in lieu of " a cash security deposit. *Stonebridge Technologies, Inc*., 291 B.R. at 69, *citing* Kimberley S. Winick, *Tenant Letter of Credit: Bankruptcy Issues for Landlords and their Lenders*, 9 AM. BANKR. INS. L. REV. 733, 752 (2001). However, the Third Circuit in *PPI* expressly found that by making a letter of credit "in lieu of " the security deposit, the parties had evidenced an intent that the letter of credit would "operate as a security deposit." *PPI*, 324 F.3d at 210.

In addition, the underlying lease should permit the landlord, not the tenant, to determine the form of security deposit – that is, as among bond, cash or letter of credit, the landlord should have the right to insist on a letter of credit. The landlord also should have the right to require a third-party guarantee as additional collateral under limited circumstances. A better strategy might be to create a third-party guarantor and have the guarantor issue the letter of credit. The letter of credit should secure all claims and obligations both monetary and non-monetary, not merely "rent."

X. Damages Following Assumption

Ordinarily, if a debtor assumes a lease, it means that the estate has agreed to undertake the full contractual liability imposed by the lease. This means that all of the post-petition rent should be entitled to an administrative priority under section 365. Thus, prior to BAPCPA, case law had generally supported the notion that if a debtor assumes a lease and then later "breaches" or rejects the lease, all of the damages are entitled to an administrative priority payment.

Under BAPCPA, Congress has changed this result and has now imposed a two-year limit on the portion of the claim that is entitled to administrative priority. Apparently, this was done as part of the other major change in BAPCPA, which requires that debtors decide to assume or reject more promptly, and which seeks to end the practice of permitting limitless extensions to the debtor for assumption or rejection.

Code section 503(b)(7) now states that the following is a permitted administrative expense:

> (7) with respect to a nonresidential real property lease previously assumed under section 365 and subsequently rejected, a sum equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of two years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor, and the claim for remaining sums due for the balance of the term of the lease shall be a claim under § 502(b)(6).

11 U.S.C. § 503(b)(7).

The reference to section 502(b)(6) means that the remaining term shall be subject to the statutory cap, discussed above. However, it should be noted that section 365(g)(2) provides that if there is a rejection after a lease has been assumed, then the rejection shall be deemed to have occurred at the time of the rejection, meaning that it is a post-petition breach. Whether this will create any tension in the application of this section remains to be seen.

XI. Plan of Reorganization

Courts have held that, when the landlord's lease rejection damage exceeds the section 502(b)(6) cap, allowance of the landlord's claim as capped by section 502(b)(6) does not render the landlord "impaired" for the purpose of section 1124. *See PPI*, 324 F.3d at 204 ("where § 502(b)(6) alters a creditor's nonbankruptcy claim, there is no alteration of the claimant's legal, equitable, and contractual rights for the purposes of impairment under § 1124(1)") (citing *In re American Solar King Corp*., 90 B.R. 808 (Bankr. W.D. Tex. 1988); *In re Smith*, 123 B.R. 863, 867 (Bankr. C.D. Cal. 1991)). Thus, landlords who are allowed a section 502(b)(6) cap amount for a lease rejection claim exceeding the cap would be "unimpaired" for the purpose of voting on confirmation under section 1124 of the Bankruptcy Code.

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IN THE UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	)	
	)	Chapter 11
	)	
WORLDCOM, INC. et al.,	)	Case No. 02-13533 (AJG)
	)	
	)	(Jointly Administered)
Debtors.	)	
	)	

RESPONSE OF CAMBRIAN COMMUNICATIONS LLC TO MOTION OF THE DEBTORS FOR AN ORDER ADJUDGING AND DETERMINING CAMBRIAN COMMUNICATIONS LLC TO BE IN VIOLATION OF THE AUTOMATIC STAY

Cambrian Communications LLC ("Cambrian"), by counsel, hereby files this Response (the "Response") to the Motion of WorldCom, Inc. ("WorldCom") for an Order Adjudging and Determining Cambrian to be in Violation of the Automatic Stay (the "Stay Motion") and in support hereof respectfully represents as follows:

Introduction

In the guise of a motion for violation of the automatic say, WorldCom urges this Court to preempt another United States Bankruptcy Court from hearing and determining a core matter pending before it. Cambrian, itself a Chapter 11 debtor-in-possession, has sought authority to

reject two related executory contracts that burden Cambrian's estate. The first contract (the "IRU Agreement") requires Cambrian to provide lit fiber service to WorldCom for at least the next 20 years. The second contract (the "Maintenance Agreement") requires Cambrian to provide operation and maintenance services with respect to the fibers for the same period. Unfortunately, Cambrian will soon cease operations and can no longer provide those services.

The sole issue properly pending before this Court is whether Cambrian's motion to reject the Agreement violated the automatic stay arising as a result of WorldCom's bankruptcy. WorldCom fails to provide any legal support for the position that a motion to reject an executory contract constitutes the violation of an automatic stay. Cambrian's effort to wind up its affairs by moving to reject a burdensome contract does not constitute a stay violation. Filing a motion to reject is not an act to control property of WorldCom's estate. Rather, as the Bankruptcy Code and caselaw make amply clear, rejection is merely a breach of contract, which does not implicate the automatic stay.

Lacking any authority for the sole pertinent issue, WorldCom essentially seeks to have this Court determine the merits of Cambrian's Rejection Motion. Venue for Cambrian's motion is in the Eastern District of Virginia ("Virginia Court"), where Cambrian's case is pending.

Furthermore, were this Court to entertain the merits of Cambrian's motion, the Court should conclude that the Agreement is executory and that Cambrian, as a liquidating debtor is entitled to reject it. The Agreement is executory for two reasons. First, the IRU Agreement, by its nature, is an executory contract and may be rejected in a bankruptcy case. Second, Cambrian never identified or assigned the six fibers to WorldCom. Thus, the Agreement remains executory. Cambrian has not acted in violation of the automatic stay and WorldCom's Stay Motion should be denied.

Background

1. Cambrian is in the business of providing both fiber paths and network solutions to communications companies, emerging service providers and major private network owners in the northeastern corridor of New York, Northern New Jersey, Philadelphia, Baltimore, Washington, D.C. and Virginia (through its affiliate Cambrian Communications of Virginia LLC).

2. Part of Cambrian's fiber network is known as the Baltimore Metro Area Network (the "Baltimore MAN"). The Baltimore MAN consists of four conduits that form a 36-mile ring running through Baltimore County, Maryland. One of the four conduits contains a 144-strand fiber optic cable.

3. To use the optical fibers on the Baltimore MAN, Cambrian's customers must access the network using equipment and facilities owned, operated, maintained and controlled by the Cambrian.

The Agreement

4. On or about June 4, 2002, Cambrian and WorldCom entered into the IRU Agreement and the Maintenance Agreement (collectively the "Agreement"). The IRU Agreement states that Cambrian is to "[o]n the terms and subject to the conditions set forth herein, upon WorldCom's final acceptance of the WorldCom Fibers, Cambrian shall sell, convey, transfer, assign and deliver to WorldCom and WorldCom shall accept and acquire from Cambrian all of Cambrian's beneficial title and interest in and to the WorldCom Fibers, including without limitation an exclusive, indefeasible right of use in the WorldCom Fibers." IRU Agreement § 2.01; *see also* IRU Agreement §§ 13.01, 13.02. Despite the language of conveyance, the IRU Agreement provides that "[u]nless earlier terminated in accordance with this IRU Agreement, the IRU shall terminate at the expiration of the Term." Agreement § 5.01.

The "Term" is 20 years from the "Effective Date." IRU Agreement § 1.06.

5. At the expiration of the 20-year Term, WorldCom would have the option to purchase legal title to the WorldCom Fibers by paying $10.00. IRU Agreement § 5.03. In the event the option was exercised, Cambrian would be required to "execute and deliver to WorldCom at that time such documents as are necessary to reflect the transfer of legal title in the WorldCom Fibers to WorldCom." *Id.* In the event that the option was not exercised, the WorldCom Fibers and all rights to the use thereof would revert to Cambrian. IRU Agreement § 5.04.

6. The IRU Agreement uses the defined term, "WorldCom Fibers," to describe the six optical fibers to be provided to WorldCom. Agreement § 2.02. However, the IRU Agreement does not specify which six of the 144 fibers comprising the Baltimore MAN would be allocated to WorldCom. *See* IRU Agreement, Ex. B. Rather, the IRU Agreement provides for the identification of such fibers by Cambrian after the fibers have been tested, accepted and payment has been made. *See* IRU Agreement § 7.05.

7. The IRU Agreement requires Cambrian to provide essential services to WorldCom for the duration of the Term. Section 8.01 of the IRU Agreement provides that Cambrian "shall control all activities concerning access to the Cambrian System Route, including the WorldCom Fibers." Section 8.02 of the IRU Agreement provides in relevant part that "[a]ny work required to connect the WorldCom fibers to the central offices as contemplated by this IRU Agreement, including, without limitation, splicing of the WorldCom Fibers or the installation of handholes or other access points along the Cambrian System Route, shall be undertaken only by Cambrian at WorldCom's request." Without Cambrian's performance of such services throughout the duration of the Term of the IRU Agreement, the WorldCom Fibers

would be functionally useless.

8. Although the IRU Agreement requires Cambrian's continued services throughout its Term in order for WorldCom to receive functional use of the WorldCom Fibers, the IRU Agreement attempts to avoid the impact of being an executory contract by characterizing the granting of the IRU as severable and non-executory. Section 4.01 of the IRU Agreement states "[n]otwithstanding anything to the contrary herein, upon payment of the IRU Fee and delivery of the WorldCom Fibers, the grant of the IRU shall be fully performed and shall be deemed severable and non-executory." Section 25.03 of the IRU Agreement elaborates as follows:

> 25.03 **Severability**. The Transfer of the WorldCom Fibers shall be deemed to be a separate transaction from any other provisions of this Agreement. Notwithstanding anything to the contrary herein, the agreement to grant an IRU to WorldCom in Article 2.01 of this Agreement shall be deemed severable, and such grant and the sale, assignment and transfer to WorldCom of all of Cambrian's beneficial right, title and interest in and to the WorldCom Fiber's [sic] shall be full performed and non-executory upon the parties' performance of their respective obligations under Articles II, IV and VII of this Agreement. The parties agree that once the obligations under Articles II, IV and VII of this Agreement have been performed all material obligations related to the transfer of the WorldCom Fibers shall have been fully performed and that these provisions of the Agreement are severable and are not executory within the meaning of the [sic] 11 U.S.C. Section 365.

9. As set forth in Section 25.03 of the IRU Agreement, to be deemed non-executory, the parties must have performed their obligations under Articles II, IV and VII of the IRU Agreement. Article II of the IRU Agreement requires Cambrian to "sell, convey, transfer, assign and deliver," and requires WorldCom to "accept and acquire," beneficial title and interest in and to the WorldCom Fibers. *See* IRU Agreement § 2.01. Article IV of the IRU Agreement requires WorldCom to pay an "IRU Fee" in the amount of $575,000. *See* IRU Agreement § 4.01 and Exhibit B.

10. Article VII of the IRU Agreement establishes a five-step process for constructing, testing and identifying to the contract the "WorldCom Fibers." First, Section 7.01 requires

Cambrian to have constructed and installed the WorldCom Fibers according to specifications. Second, Section 7.02 requires Cambrian to test the WorldCom Fibers in accordance with specified testing procedures and standards. Third, Section 7.04 requires Cambrian to provide a written notice of completion upon when it believes that the testing procedures have been satisfied. Fourth, Section 7.04 establishes procedures for WorldCom's acceptance or rejection of the test results. Finally, Section 7.05 of the IRU Agreement requires Cambrian to provide network maps and drawings showing the route and identifying the fibers and related network circuitry that comprise the WorldCom Fibers and permit their use. Section 7.05 provides in full as follows:

> 7.05 Network Maps and Drawings. Cambrian shall provide WorldCom with network maps and drawings of the WorldCom Fibers and the applicable portions of the Cambrian System Route within thirty (30) days of the Acceptance Date and will contain the following information:
>
> > (a) Route Description Maps: The Maps will contain a geographical depiction of the segment(s) containing the WorldCom Fibers, provided in the form of electronic mapping utilizing such electronic medium as Delorme, MapInfo, Streets & Trips, or other compatible software presentation. The depiction in the Maps will identify each building with interconnection to the specific fibers being provided to the [sic] WorldCom and show any fiber cross-connect at Cambrian Node building.
> >
> > (b) Fiber Drawings: The fiber level drawings of the dark fiber network will provide conduit information, fiber assignment numbers around ring on each WorldCom lateral into WorldCom sites, and at the Cambrian Node, drawings and documents which include FDP WorldCom fiber port assignments, splice points in manholes providing access to WorldCom building, associated Cambrian manhole nomenclatures, Cambrian to WorldCom circuit ID's (to aid in identifying Segments within the fiber cable system), fiber mileage, and lateral or backbone fiber type.
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> Defined Mileage will be fiber distances via OTDR traces between a POP or Transmission Site and the next contiguous POP or Transmission Site.
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> Fiber type will be provided on the AutoCad block diagram. The Maps will identify the type of fiber (for example, Single mode, LEAF, NDSF, MetroCor, or SMF-LS) in each segment. The Maps will be provided electronically in MapInfo or Streets & Trips or

Hard copy from AutoCad. Hard copy format of route maps and first level detail drawings can also be provided in AutoCad. Drawings will be in both block/line format.

11. The Maintenance Agreement requires Cambrian to provide maintenance services with respect to the WorldCom Fibers for the Term. Maintenance Agreement §§ 2.01, 3.01. The Maintenance Agreement further requires Cambrian to operate and maintain a network operation and control center ("NOCC") during the Term. *Id.* § 3.02. Cambrian presently services the Baltimore MAN, and other parts of Cambrian's network, from its NOCC located in Washington, D.C.

12. Under the Maintenance Agreement, WorldCom was required to pay a one-time fee in the amount of $216,000. Maintenance Agreement § 4.01. Such fee was to cover services to be provided by Cambrian throughout the duration of the 20-year Term. *Id.*

Subsequent Events

13. Subsequent to the execution of the Agreement, Cambrian performed certain test procedures in accordance with Article 7.02 and Exhibit C of the IRU Agreement. Cambrian tested all of its 144 fibers along the Baltimore MAN for proper specifications and standards. Cambrian did not at that time identify which of the fibers along the Baltimore MAN would be assigned to WorldCom.

14. Promptly following the execution of the Agreement, Cambrian sent a Notice of Completion (as the term is defined in the IRU Agreement) to WorldCom. WorldCom requested additional test data. Thereafter, Cambrian retested the system and provided the data to WorldCom. At the time these tests were conducted, Cambrian had not identified which of the 144 optical fibers would be assigned to WorldCom.

15. On or about June 11, 2002, WorldCom delivered a Notice of Acceptance as required under Article 7.04 of the Agreement. The Notice of Acceptance merely served as the

affirmation that the fibers along the Baltimore MAN met industry standards and the specifications set out in Exhibit C to the Agreement. The Notice of Acceptance did not identify any specific optical fiber as the "WorldCom Fibers." Nor did the Notice of Acceptance constitute an acceptance of possession of any fibers. Rather, as provided in the IRU Agreement, the Notice of Acceptance merely acknowledged that the fibers met the applicable technical specifications.

16. On or about June 14, 2002, Cambrian submitted an invoice for the payment of the IRU Fee and the Maintenance Fee. The total amount of the invoice was $791,000.

17. On July 21, 2002, WorldCom filed a voluntary petition under chapter 11 of title 11 of the United States Code, 11 U.S.C. § 101, et seq. (the "Bankruptcy Code") commencing this Case No. 02-13533, in the United States Bankruptcy Court for the Southern District of New York.

18. On September 19, 2002, WorldCom wire transferred payment to Cambrian in the amount of $791,000 ("WorldCom Payment").

19. On September 20, 2002 (the "Petition Date"), Cambrian and its sole member, Cambrian Holdings LLC ("Holdings") filed voluntary petitions under chapter 11 of the Bankruptcy Code in the Virginia Court. Pursuant to sections 1107(a) and 1108 of the Bankruptcy Code, Cambrian and Holdings continue to operate their businesses and manage their affairs as debtors in possession.

20. At no time has Cambrian identified which of the 144 optical fibers in the Baltimore MAN would be assigned to WorldCom. Nor has Cambrian provided to WorldCom any of the maps, drawings or technical data specified in Section 7.05 of the IRU Agreement. Moreover, Cambrian has not taken action to connect WorldCom to the Baltimore MAN. As set

forth in Cambrian's Rejection Motion, many of the conditions set forth in the Agreement were never satisfied and therefore the Agreement remains executory, subject to assumption or rejection by the Cambrian bankruptcy estate. *See* Stay Motion Exhibit E.

21. On February 12, 2003, Cambrian filed its Motion for Approval of Sale of Substantially all of the Debtor's Assets Free and Clear of Liens, Claims and Encumbrances and to Approve Conditional Assumption and Assignment of Leases and Executory Contracts ("Sale Motion") and set the Sale Motion for hearing on March 24, 2003.

22. On February 13, 2003, Cambrian filed the Rejection Motion and scheduled it to be heard, in conjunction with the Sale Motion, on March 24, 2003.

23. On March 5, 2003, WorldCom's counsel informed Cambrian regarding its belief that the filing of the Rejection Motion was an act to "obtain possession of" or "exercise control over" property of the WorldCom estate in violation section 362 of the Bankruptcy Code. *See* Stay Motion Exhibit F.

24. On March 10, 2003, Cambrian responded to WorldCom's letter, rebutting WorldCom's arguments of stay violation. *See* Stay Motion Exhibit G.

25. In an attempt to impede the hearing on the Sale Motion, WorldCom filed the Stay Motion and initially sought an expedited hearing on the matter to be set for March 18, 2003. After consultation between the parties, Cambrian agreed to continue its Rejection Motion until April 22, 2003 and WorldCom agreed to proceed with its Stay Motion on April 8, 2003.

26. At the hearing on March 24, 2003, the Virginia Court approved the Sale Motion.

27. An order approving the Sale Motion was entered on March 28, 2003 ("Sale Order"), a copy of which is attached hereto as Exhibit A. The Sale Order has a specific provision regarding WorldCom which states:

> [Cambrian] shall not assume or assign the IRU Agreement, undated, between [Cambrian] and MCI Worldcom Network Services, Inc. ("WorldCom") (the "WorldCom IRU Agreement") pursuant to this Order. [Cambrian] and WorldCom reserve their respective rights with respect to the WorldCom IRU Agreement. This Order shall not negate, impair or prejudice in any way the rights, claims or interests of WorldCom under the WorldCom IRU Agreement, nor constitute a sale free and clear of any such rights, claims or interests. Nor shall this Order or the sale of assets approved pursuant to this Order impose any obligations on Buyer with respect to the WorldCom IRU Agreement or the indefeasible right of use of fibers allegedly given to WorldCom under the WorldCom IRU Agreement. The rights of all parties are reserved for further determination.

See Exhibit A, ¶ 32.

ARGUMENT

A. *The Rejection of an Executory Contract is not a violation of the Automatic Stay*

28. WorldCom argues that "Cambrian's Motion violates § 362(a)(3) because it is an attempt to obtain possession of or exercise control over" its property interest in the fibers. Stay Motion ¶ 27. Section 362(a) states "a petition filed under section 301, 302 or 303 . . . operates as a stay, applicable to all entities, of . . . (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C § 362(a)(3). By the filing of the Rejection Motion, Cambrian did not act in violation of the provisions of section 362 and the Stay Motion should be denied.

29. The Bankruptcy Code provides that "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). The decision to assume or reject a contract must be approved by the court. *See, e.g.*, *In re Thinking Machs Corp.*, 67 F.3d 1021, 1025 (1st Cir. 1995)("court approval is a condition precedent to the effectiveness of a trustee's rejection of a [contract]…"; *see also* 3 Collier on Bankruptcy ¶ 365.03.

30. Section 157(b)(1) of title 28 of the United States Code provides, "[b]ankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11…and may enter appropriate orders and judgments…" 28 U.SC. § 157(b)(1). Proceedings to assume or reject executory contracts or unexpired leases are core proceedings within the bankruptcy court's jurisdiction. *See In re Texaco Inc.*, 77 B.R. 433 (Bankr. S.D.N.Y. 1987) ("[t]here is no question that proceedings to assume or reject executory contracts or unexpired leases are matters concerning the administration of the estate within the meaning of 28 U.S.C. § 157(b)(2)(A) and are core proceedings."); *see also In re Taylor,* 91 B.R. 302, 313 (Bankr. D.N.J. 1988) (assumption or rejection of services contract is a core proceeding and "certainly deals with the administration of the estate"); *Harley Hotels, Inc. v. Rain's International Ltd.,* 57 B.R. 773 (M.D. Pa. 1985); *In re Nexus Communications, Inc.*, 55 B.R. 596 (Bankr. E.D.N.C. 1985); *In re Republic Oil Corporation*, 51 B.R. 355, 358 (Bankr. W.D. Wis. 1985); *In re Turbowind, Inc.*, 42 B.R. 579, 583 (Bankr. S.D. Cal. 1984).

31. The underlying authority relied upon by WorldCom involve instances where parties attempted to terminate executory contracts with a Debtor. Rejection is not termination. As the Bankruptcy Code unequivocally provides "rejection of an executory contract or unexpired lease constitutes a breach of such contract or lease." 11 U.S.C. § 365(g). Rejection and breach are not the same thing as termination. *In re Park,* 275 B.R. 253, 254-56 (Bankr. E.D. Va. 2002) ("rejection . . . is not a species of avoidance: that is, it does not eliminate the estate's liability. Rather, rejection simply constitutes breach of the lease or contract . . . "); *see In re Austin Dev. Co.*, 19 F.3d 1077 (5th Cir.), *cert. denied*, 513 U.S. 874 (1994) ("the terms rejection, breach and termination are used differently, but not inconsistently or interchangeably, as some courts have suggested."); *In re Garfinkle*, 577 F.2d 901 (5th Cir. 1978) (rejection of a lease does not destroy

the leasehold estate); *In re Picnic 'N Chicken, Inc.*, 58 B.R. 523 (Bankr. S.D. Cal. 1986)(adopting approach that "rejection of a lease does not have the conclusive effect of terminating it"); *In re Tri-Glied, Ltd.,* 179 B.R. 1014 (Bankr. E.D.N.Y. 1995); *In re The Drexel Burnham Lambert Group,* 138 B.R. 687, 703 (Bankr. S.D.N.Y. 1992) ("rejection merely frees the estate from the obligation to perform; it does not make the contract disappear."); *In re Lavigne*, 114 F.3d 379 (2nd Cir. 1997) ("[r]ejection is not the power to release, revoke, repudiate, void, avoid, cancel or terminate or even to breach contract obligations. Rather, rejection is a bankruptcy estate's election to decline a contract of lease asset. It is a decision not to assume"); *see also In re Grand Union Company*, 266 B.R. 621, 627 (Bankr. D.N.J. 2001); *In re Klein*, 218 B.R. 787, 790 (Bankr. W.D. Pa. 1998); *In re Columbia Gas Sys., Inc.,* 50 F.3d 233, 239 (3rd Cir. 1995); *In re Modern Textile, Inc.,* 900 F.2d 1184 (8th Cir. 1990). As noted in Collier on Bankruptcy, "if rejection of a lease [or contract] worked [as] a termination, it would be difficult to justify granting the party to the contract or lease a damage claim for such rejection…" 3 Collier on Bankruptcy ¶ 365.09[3].

32. A breach of contract by a nonparty debtor is not an act "to obtain possession of the property of the estate or of property from the estate or to exercise control over the property of the estate." 11 U.S.C. § 362(a)(3). Breach of contract by itself is not a violation of the stay. *See, e.g., In re APF Co.*, 274 B.R. 408, 417-418 (Bankr. D. Del. 2001), *citing* David G. Epstein et al., Bankruptcy, § 3.14 at 174 (West 1992) ("Nothing is lost by failing to stay breach of contract. The cause of action for the breach belongs to the estate. It can remedy the wrong by any appropriate means as in any other action for breach of a contract, including the recovery of . . . damages . . . "); *see also In re Golden Distributors, Ltd.,* 122 B.R. 15, 19 (Bankr. S.D.N.Y. 1990)(breach of employment contracts and continued solicitation of the debtor's customers in

violation of the contract was not "conduct … to obtain possession or control of property of the estate.")

33. WorldCom cites a single case for its novel proposition that the filing of a motion to reject an executory contract is a violation of the automatic stay. *See* Stay Motion ¶ 39, *citing In re Harbour House Operating Corp.*, 26 B.R. 324, 326 (D. Mass. 1982). *In re Harbour* has nothing to do with the issue. The only reference to the automatic stay in the *Harbour* opinion was the Court's observation in its statement of facts, in which the court observed that the counterparty to a contract filed its own bankruptcy and that the motion to reject was stayed. One of the parties thereafter sought relief to litigate in state court. The court did not discuss, much less decide, the legal effect of the stay on a motion to reject. The court's passing reference to the rejection motion barely even rises to the level of dictum. The *Harbour* decision was published in 1982. No published decision has cited to *Harbour* as authority for the position that a motion to reject an executory contract is stayed by the bankruptcy of the non-debtor party.

34. By filing the Rejection Motion, Cambrian did not act in violation of the WorldCom stay. Furthermore, if the Virginia Court approves the Rejection Motion, Cambrian will be in breach of the Agreement, not in violation of the stay, and WorldCom can pursue its legal rights accordingly.

B. ***This court should not determine the merits of the Rejection Motion***

35. As stated above, Cambrian filed a motion to reject the Agreement with the Virginia Court. This matter is set for hearing on April 22, 2003. This Court need not address the issue of the merits of the Rejection Motion. The proper venue for these issues is the Virginia Court.

36. Generally, when two courts have concurrent jurisdiction over a matter, the first court requested to adjudicate the matter will have priority to consider the case. *Orthmann v. Apple River Campground, Inc.*, 765 F.2d 119, 121 (8th Cir. 1985) (courts follow a "first to file" rule).

37. WorldCom seeks to litigate an issue already set for hearing in the Virginia Court. The Rejection Motion was filed first, all the relevant parties are before the Virginia Court, and the Virginia Court can provide complete relief. The Stay Motion is an indirect way for WorldCom to have this Court decide the Rejection Motion. WorldCom should be "given an equal start in the race to the courthouse, not a head start." *See Kerotest Mfg. Co. v. C-O-Two Fire Equipment Co.,* 342 U.S. 180, 185 (1952); *see also West Gulf Maritime Association v. ILA Deep Sea Local 24*, 751 F.2d 721, 728 (5th Cir. 1985)("federal courts long have recognized that the principle of comity requires federal district courts -- courts of coordinate jurisdiction and equal rank -- to exercise care to avoid interference with each other's affairs."), *cert. denied*, 474 U.S. 874 (1985); *First City Nat'l Bank and Trust Co. v. Simmons*, 878 F.2d 76, 79 (2d Cir. 1989)("Where there are two competing lawsuits, the first suit should have priority, absent the showing of balance of convenience…or…special circumstances…giving priority to the second.")

38. The Virginia Court has already approved the fast track sale of substantially all of Cambrian's assets. Cambrian is in the process of winding down its business. The Sale Motion was filed on February 12, 2003 and was originally scheduled for hearing on March 24, 2003. WorldCom first contacted Cambrian regarding this matter on March 5, 2003. WorldCom advised Cambrian that it intended to seek emergency relief from this Court on March 18, 2003 to resolve the applicability of the stay.

39. Cambrian did not agree to continue the hearing on the Rejection Motion. Cambrian agreed to the continuation rather than force the parties to act on an emergency basis. However, WorldCom has taken the opportunity to try to obtain a determination on the merits of the Rejection Motion.

40. The Rejection Motion, and related characterization of the Agreement, should be decided solely by the Virginia Court. This Court's refusal to address the characterization issue will effectively promote uniformity, discourage forum shopping, conserve the debtors' and creditors' resources and facilitate the efficient and speedy resolution of the Cambrian and WorldCom bankruptcy cases.

C. *The Agreement is an Executory Contract*

41. As noted above, there is no reported decision regarding the exact characterization of an IRU agreement.[1] Although WorldCom suggests that the language in the IRU Agreement purports to be non-executory, such an *ipso facto* clause is not controlling. *Richard Royce Collection Ltd. v. New York City Shoes, Inc. (In re New York City Shoes)*, 84 B.R. 947, 960 (Bankr. E.D. Pa. 1988)(assertion that the license agreement was non-executory was not enough: "[the trademark licensing agreement] certainly appears to fit… the classic 'executory contract' definition of a contract that has not been fully performed on both sides"). The controlling authority is the reality of the transaction.

42. The Bankruptcy Code does not define "executory contract." However, the legislative history to Section 365 refers to the term executory contract as including "contracts on which performance remains due to some extent on both sides." *H.R. Rep. No. 595*, 95th Cong.,

[1] Commentary suggests that the unsettled legal status of IRUs may remain despite their significant role in telecommunications bankruptcies because of the dual relationship that many in the industry enjoy as both purchaser and seller of IRUs. Gold, Matthew J., "*Global Crossing and the Use of IRUs: Unsettled Questions on Their Legal Status*," The Bankruptcy Strategist, Vol. 19, No. 6, Pg. 5 (April 2002).

1st Sess. 347 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6303. Some courts have interpreted Section 365 to apply to contracts substantially unperformed "that the failure of either to complete performance would constitute a material breach excusing performance of the other." *See Sharon Steel Corp. v. National Fuel Gas Distrib. Corp.,* 872 F.2d 36, 39 (3rd Cir. 1989), *quoting* Vern Countryman, *Executory Contracts in Bankruptcy*: Part 1, 57 Minn. L. Rev. 439, 460 (1973); *See also In re C & S Grain Co.,* 47 F.3d 233 (7th Cir. 1995); *Commercial Union Ins. Co. v. Texscan Corp. (In re Texscan Corp.),* 976 F.2d 1269 (9th Cir. 1992). Still other courts have expanded their definition of executory contracts to include contracts where "the debtor has unperformed duties that the trustee may elect to perform or breach, depending on which will result in the best value for the estate." 3 COLLIER ON BANKRUPTCY 365.02[1][a] (Lawrence P. King ed., 15th ed.), *citing In re Marten Bros. Toolmakers, Inc*., 796 F.2d 1435 (11th Cir. 1986); *Stipes v. General Dev. Corp. (In re General Dev. Corp.)*, 177 B.R. 1000 (S.D. Fla. 1995); *Cohen v. Drexel Burnham Lambert Group, Inc.(In re Drexel Burnham Lambert Group, Inc.)*, 138 B.R. 687 (Bankr. S.D.N.Y. 1992).

43. While WorldCom attempts to focus on language that obviates the consequences of an executory contract being rejected in bankruptcy, the IRU Agreement confers upon both Cambrian and WorldCom continuing obligations. Despite the argument by WorldCom that it owns the fibers, the ongoing nature of the obligations of both parties under the Agreement renders it executory. *See, e.g., In re HQ Global Holdings, Inc.,* 2003 Bankr. Lexis 146 (Bankr. D. Del. 2003)("essence of the Agreements was the Debtors' affirmative grant to the Franchisees of the **right to use**")(emphasis added); *see also Lubrizol Enterprises, Inc v. Richmond Metal Finishers, Inc.,* 756 F.2d 1043 (4th Cir. 1985).

44. Although at times rejection may result in adverse consequences, Congress clearly provided for the rejection of executory contracts. *See Lubrizol* at 1048 ("[a]wareness of Congress of those consequences is indeed accorded to union members under collective bargaining contracts…and to lessees of real property")(citations omitted). In *Lubrizol*, the Debtor sought to reject a nonexclusive license to utilize a metal coating process technology. The court evaluated the continued obligations under both parties including to provide notice and forbearance. The fourth circuit rejected the lower court's characterization that the agreement was effectively a sale of property because of the "limited nature of the interest conveyed." *Id.* at 1046.[2] The court reversed the lower court's ruling that the contract was not executory despite the purported grant of the license.

45. Section 365(n) of the Bankruptcy Code was enacted to correct certain adverse consequences of the *Lubrizol* decision. However, Congress specifically limited the protections under section 365(n). *See In re HQ Global Holdings, Inc.* at 16 ("since Bankruptcy Code does not include trademarks in its protected class of intellectual property, Lubrizol controls"). No such protections were afforded to purchasers of IRUs.

46. WorldCom argues that it met its obligations of payment and the grant of the fibers is complete. WorldCom continues to have, *inter alia*, the following obligations under the IRU Agreement:

- WorldCom must give 48 hours notice before any access to the fibers; § 8.03
- WorldCom must make requests to Cambrian for any work, including, splicing of the WorldCom fibers or the installation of the handholes or other access points; § 8.02
- WorldCom cannot interfere with the use of the Cambrian System Route; § 9.01

[2] The court found that the license agreement was most analogous to a lease and stated "Congress expressly made leases subject to rejection under § 365 in order to 'preclude any uncertainty as to whether a lease is an executory contract'" *Id.* (citations omitted)

- WorldCom must continue to maintain all authorizations through the term of the Agreement; § 6.02
- The failure by WorldCom to maintain its authorizations is an event of default; § 6.02
- WorldCom must timely pay a pro rata share of taxes; § 13.03
- WorldCom must indemnify Cambrian for certain tax assessment protests; § 13.04
- WorldCom must maintain its required insurance through the term of the Agreement; §§ 14.03 and 17.01
- WorldCom must notify Cambrian of any impending damage or loss to the Cambrian System Route; § 14.04
- WorldCom must cooperate with Cambrian regarding authorizations and requirements of governmental authorities; § 14.05
- WorldCom must indemnify Cambrian for various restricted acts, including, among others, negligence or misconduct; § 15.01
- WorldCom must continue to keep the terms of the IRU Agreement confidential; § 21.01

47. Because both WorldCom and Cambrian have continuing obligations, the Agreement between Cambrian and WorldCom is executory, subject to assumption or rejection by Cambrian.

i. The Agreement is a contract for services

48. The IRU Agreement requires that Cambrian provide to WorldCom the exclusive right of use of certain fibers along its network. These type of transactions are referred to as "sale" of network capacity transactions. The fibers are an intangible measure of network capacity. The IRU Agreement sets forth that the fibers must comply with certain industry specifications, including capacity requirements. *See* IRU Agreement § 7.01 and Exhibit C. The substance of the IRU Agreement is that Cambrian maintain the Baltimore MAN, including all regulatory approvals, franchises, permits, orders, consents and rights-of-way (collectively the "Authorizations") and deliver a certain level of prospective capacity thorough the fiber conduits. The purchase of certain fibers would be meaningless without Cambrian's continued maintenance of the Authorizations and provision of support.

49. The IRU Agreement purports to grant certain fibers identified on Exhibit B of the IRU Agreement. However, Exhibit B identifies nothing more than a specific number of fibers and describes in detail the Baltimore MAN. This description cannot meet any reasonable test of identification.[3] Further, regardless of the adequacy of identification, the necessity of the services to be performed by Cambrian (namely maintaining its network) render the entire contract service related.

50. The IRU Agreement provides that the laws of the State of New York govern. Bankruptcy courts have recognized that "Congress has left to state law the determination of the nature of property rights in the assets of a bankruptcy estate." *Butner v. United States*, 440 U.S. 48 (1979).

51. Under New York law, the provision of services does not constitute a sale of the components used to provide such services. *See Mounting & Finishing Company, Inc.*, 294 N.Y. 104, 107, 60 N.E.2d 825, 826 (1945) (manufacturing of advertising displays is not sale of paper, glue, wood, fibre board, etc. that compose the display, but rather sale of service); s*ee also Matter of Mendoza F.D. Works v. Taylor*, 272 N.Y. 275, 279, 5 N.E.2d 818 (1936)(dyer did not resell dye stuffs and chemicals but performed work on the property of others); *Milau Assoc. Inc. v. North Ave. Dev. Corp.*, 42 N.Y.2d 482, 486, 368 N.E.2d 1247 (1977)(sale of goods remedies would not apply to contract that requires the assembly of materials and construction of article).

[3] The testimony of Mr. John M. Morrissey, deputy Chief Accountant for the United States Securities and Exchange Commission is persuasive on the characterization of IRUs. Mr. Morrissey testified before Congress concerning telecommunications accounting issues in response to the SEC's investigation of Global Crossing Ltd. Mr. Morrissey noted that providers of network capacity characterize IRUs as arrangements for the provision of services if the "network capacity contract does not convey to the purchaser the right to use specific identifiable assets." *See Testimony before Subcommittee on Oversight and Investigations Committee on Financial Services* (March 21, 2002), a copy of which is attached hereto as Exhibit B. Mr. Morrissey defined specific identifiable assets as "a specific fiber or wavelength of light within a fiber-optic cable network, along with the conduit through which that cable passes, the land on which the conduit rests, and a specific component of the telecommunications equipment at each end of the cable necessary to transmit data over the network." *Id.*

Milau Assoc. involved a suit for, among other causes, a breach of an implied warranty of fitness against the general contractor who built a warehouse where an underground pipe connecting a sprinkler system burst. *Id.* at 484. In finding that the agreement for the construction of the warehouse was mainly service oriented and no cause for implied warranty of fitness could be maintained, the Court stated that "the parties contemplated the workmanlike performance of a construction service." *Id.* at 488. The Court noted that the substance of the agreement was "no more than a series of performance undertakings, plans, schedules and specifications for the incorporation of the specialized system." *Id.* at 487, 488.

52. The substance of the IRU Agreement is in Cambrian's construction and maintenance of its telecommunications network, namely the Baltimore MAN, and selling prospective capacity along that network. Exhibit B to the IRU Agreement identifies the location of the Baltimore MAN, while Exhibit C provides for the capacity and industry specifications for the fibers. WorldCom purchased an amount of prospective network capacity located along the Baltimore MAN as represented by six undetermined fibers. The fibers and, more importantly the delivery of prospective capacity along the Baltimore MAN, were a service provided by Cambrian.

53. By its own admission, WorldCom states that "the value of the fibers is that they are physically embedded in an existing network, and WorldCom paid for the right to use them as they are." *See* Stay Motion ¶ 31. The value is in the network, operated and maintained by Cambrian. WorldCom acknowledges that the purchase was for use of the Cambrian services (or network) and not the physical fibers.

54. Pursuant to Section 365(a) of the Bankruptcy, Cambrian may reject a contract for services. *See In re James Taylor*, 913 F.2d 102 (3rd Cir. 1990)(Section 365(a) permits the trustee

to reject executory personal service contracts); *see also All Blacks B.V., et al. v. Gruntruck et al.*, 199 B.R. 970 (W.D. Wash. 1996). Cambrian in its sound business judgment finds no useful purpose for assumption of the contract. Any claim that WorldCom may have with respect to rejection will be like other claims of general unsecured creditors and dealt with in the reorganization plan.

ii. The Agreement is not severable

55. As clearly stated by WorldCom "the severability provision does not preclude the operation of basic executory contract doctrine." Stay Motion ¶ 33. Basic executory contract doctrine provides that: (i) the conditions (i.e., delivery of the network maps, drawings showing the route and identification of the fibers and related network circuitry that comprise the WorldCom Fibers) were material and never completed rendering the IRU Agreement non-severable; (ii) even if delivery of the fibers occurred, the IRU Agreement taken as a whole, remains non-severable and executory; and (iii) the IRU Agreement and Maintenance Agreement are interdependent integrated documents rendering them together one executory Agreement.

56. First, WorldCom takes the position that the severable language of the Agreement should be given full effect and that the delivery of the maps was "immaterial." *Id.* This however flies in the face of basic tenets of contract law interpretation. Cambrian and WorldCom are sophisticated parties and clearly drafted the granting language and severability of the IRU to be contingent upon the delivery of, among other things, network maps and drawings showing the route and identifying the fibers and related network circuitry that comprise the WorldCom Fibers and permit their use. IRU Agreement § 7.05. As noted above, these conditions were never met and were material to the grant of the fibers and therefore the Agreement never became severable.

57. Second, WorldCom argues that the grant and transfer of the six fibers is complete. Stay Motion ¶ 29. This is wishful thinking. WorldCom cannot identify the specific fibers that supposedly were assigned to WorldCom or the points of connection to these fibers.

58. Moreover, absent Cambrian's cooperation, WorldCom cannot connect any fibers to the Cambrian System Route. *See* Stay Motion Exhibit A (IRU Agreement ¶ 8.02)("[a]ny work required to connect the WorldCom fibers to the central offices…including, without limitation, splicing of the WorldCom Fibers or the installation of handholes or other access points along the Cambrian System Route, shall be undertaken only by Cambrian at WorldCom's request.")

59. If indeed this were a severable agreement, then Cambrian would be entitled to reject its remaining obligations under the IRU Agreement. By its own admission, WorldCom acknowledges that "the value of the fibers is that they are physically embedded in an existing network, and WorldCom paid for the right to use them as they are." *See* Stay Motion ¶ 31. Cambrian's continued operation of its network is fundamental to the use of the fibers. If Cambrian does not connect WorldCom to its network and maintain the network, the fibers have no practical use. This demonstrates that Cambrian's continued operation is the substance of the Agreement.

60. A severable contract includes "two or more promises which can be acted on separately such that the failure to perform one promise does not necessarily put the promisor in breach of the entire agreement" *Black's Law Dictionary* 1373-74. (6th ed. 1990). Simply stated, if Cambrian does not grant fibers to WorldCom, the connection, maintenance, delivery of maps, drawings and various other obligations are moot. Likewise, if Cambrian does not connect WorldCom to its network and maintain its network then the fibers are useless. Failure by

Cambrian to act in either situation would be a material breach of the entire IRU Agreement. These obligations are materially dependent.

61. Furthermore, when read as a whole, the IRU Agreement, akin to a license agreement for the exclusive right to use, provides that "WorldCom shall not interfere with, or materially or adversely affect the use by any other Person of the Cambrian System and/or any electronic or optronic equipment used by such Person in connection therewith." WorldCom's continued obligation to forbear from taking action adverse to Cambrian preserves the executory nature of the Agreement. *See In re HQ Global Holdings, Inc.*, 2003 Bankr. Lexis 146 (Bankr. D. Del. 2003)("agreement to forbear from using…is an ongoing material obligation . . ."), *citing Lubrizol Enterprises, Inc v. Richmond Metal Finishers, Inc.,* 756 F.2d 1043 (4th Cir. 1985)("core obligation of forbearance in licensing to others made the contract executory").

62. If WorldCom were to interfere in any way with the Cambrian System Route, it would be in material breach of the Agreement and hence, even if, as WorldCom argues, "delivery" of the fibers occurred, the IRU Agreement read as whole remains executory, subject to the assumption or rejection by Cambrian.

63. Third, the IRU Agreement and Maintenance Agreement are integrated documents rendering the entire Agreement executory. The Maintenance Agreement demonstrates the dependency on the IRU Agreement:

- the opening recitals make specific reference to the IRU Agreement;
- definitions section incorporates all capitalized terms from IRU Agreement; § 1.01
- term of agreement commences on the "IRU Effective Date"; § 2.01
- "[i]n the event the IRU Agreement is terminated for any reason, [the Maintenance Agreement][] shall also terminate"; § 2.01
- insurance requirements of IRU Agreement are "incorporated herein by reference" § 7.01.

64. Under New York Law, agreements executed "contemporaneously by the same parties, for the same purpose, and in the course of the same transaction" should be read as one integrated transaction, even "despite facially absolute language" to the contrary. *Pieco, Inc. v. Atlantic Computer Systems, Inc. (In re Atlantic Computer Systems, Inc.)*, 173 B.R. 844 (S.D.N.Y. 1994), *quoting Carvel Corp. v. Diversified Management Group*, 930 F.2d 228, 233 (2nd Cir. 1991).

65. The Maintenance and IRU Agreements were entered into contemporaneously, involve the same parties, are for the same purpose and course of transaction in WorldCom's use of Cambrian's network. The Maintenance Agreement by its very terms clause cannot exist without the IRU Agreement. *See* Maintenance Agreement § 7.01.

66. Taken in their entirety the IRU Agreement and Maintenance Agreement are one Agreement and without question, the Maintenance Agreement requires continued, ongoing services by Cambrian.

67. The IRU Agreement read together with the Maintenance Agreement is one executory contract, subject to the assumption or rejection by Cambrian, and this Court should permit Cambrian to proceed in the Virginia Court with its Rejection Motion.

iii. No closing or delivery has occurred

68. The issue of whether an IRU agreement can ever become non-executory remains an open issue. No court has published an opinion resolving the character of IRU agreements or the proper treatment of such agreements under Section 365 of the Bankruptcy Code. Although the character of IRUs remains an unsettled question, this open issue need not be resolved. It is abundantly clear that even if IRU agreements can be considered as providing for a conveyance of

a property interest, under the facts of this case, no conveyance occurred. Consequently, the IRU Agreement remains executory.

69. As discussed above, by its terms, the IRU Agreement becomes non-executory, "upon the parties' performance of their respective obligations under Articles II, IV and VII" of the IRU Agreement. IRU Agreement § 25.03.

70. Section 7.05 – part of Article VII of the IRU Agreement – imposes significant and specific obligations on Cambrian. It requires Cambrian to provide maps and drawings that identify, among other things, the conduit information, the fiber assignment numbers, the fiber port assignments and splice points. These items together are critical to identifying which of the 144 optical fibers in the Baltimore MAN constitute the "WorldCom Fibers." Without these items, "delivery" of the WorldCom Fibers could not occur. Since Cambrian did not provide the maps and drawings, Cambrian did not complete its obligations under Article VII of the IRU Agreement. Thus, according to the terms of the IRU Agreement itself, the requirements for the IRU to have become "non-executory" did not occur.

71. Furthermore, under Section 4.01– part of Article IV of the IRU Agreement – the grant of the IRU purportedly would be complete "upon payment of the IRU Fee and *delivery* of the WorldCom Fibers." (Emphasis added.) Cambrian never delivered the fibers. Cambrian did not connect WorldCom to the Baltimore MAN. WorldCom has never used the Baltimore MAN. That delivery never occurred is evident from the simple fact that if Cambrian takes no further action, the "WorldCom Fibers" are and will remain useless to WorldCom.[4] No delivery or closing of the IRU Agreement occurred and therefore the Agreement remains executory.

[4] The IRU Agreement unequivocally states that "Cambrian shall control all activities concerning access to the Cambrian System Route, including the WorldCom Fibers." IRU Agreement § 8.01. In addition, any work requiring connection, splicing or installation of the WorldCom fibers or

WHEREFORE, Cambrian respectfully requests an entry of an order (i) denying the Stay Motion; and (iii) granting such other and further relief as this court deems proper and just.

Dated: April 3, 2003

Respectfully submitted,

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handholes or other access shall be undertaken only by Cambrian. *Id*. § 8.02. WorldCom may gain access to the WorldCom Fibers only upon ***request*** and, if required by Cambrian, the presence of a Cambrian employee. *Id*. § 8.03.

IN THE (RED)® THE BUSINESS BANKRUPTCY BLOG

Published By Robert L. Eisenbach III of Cooley LLP

Assignments For The Benefit Of Creditors: Simple As ABC?

By Bob Eisenbach on March 16, 2008

Companies in financial trouble are often forced to liquidate their assets to pay creditors. While a Chapter 11 bankruptcy sometimes makes the most sense, other times a Chapter 7 bankruptcy is required, and in still other situations a corporate dissolution may be best. This post examines another of the options, the assignment for the benefit of creditors, commonly known as an "ABC."

A Few Caveats. It's important to remember that determining which path an insolvent company should take depends on the specific facts and circumstances involved. As in many areas of the law, one size most definitely does not fit all for financially troubled companies. With those caveats in mind, let's consider one scenario sometimes seen when a venture-backed or other investor-funded company runs out of money.

One Scenario. After a number of rounds of investment, the investors of a privately held corporation have decided not to put in more money to fund the company's operations. The company will be out of cash within a few months and borrowing from the company's lender is no longer an option. The accounts payable list is growing (and aging) and some creditors have started to demand payment. A sale of the business may be possible, however, and a term sheet from a potential buyer is anticipated soon. The company's real property lease will expire in nine months, but it's possible that a buyer might want to take over the lease.

- A Chapter 11 bankruptcy filing is problematic because there is insufficient cash to fund operations going forward, no significant revenues are being generated, and debtor in possession financing seems highly unlikely unless the buyer itself would make a loan.
- The board prefers to avoid a Chapter 7 bankruptcy because it's concerned that a bankruptcy trustee, unfamiliar with the company's technology, would not be able to generate the best recovery for creditors.

The ABC Option. In many states, another option that may be available to companies in financial trouble is an assignment for the benefit of creditors (or "general assignment for the benefit of creditors" as it is sometimes called). The ABC is an insolvency proceeding governed by state law rather than federal bankruptcy law.

California ABCs. In California, where ABCs have been done for years, the primary governing law is found in California Code of Civil Procedure sections 493.010 to 493.060 and sections 1800 to 1802, among other provisions of California law. California Code of Civil Procedure section 1802 sets forth, in remarkably brief terms, the main procedural requirements for a company (or individual) making, and an assignee accepting, a general

assignment for the benefit of creditors:

> 1802. (a) In any general assignment for the benefit of creditors, as defined in Section 493.010, the assignee shall, within 30 days after the assignment has been accepted in writing, give written notice of the assignment to the assignor's creditors, equityholders, and other parties in interest as set forth on the list provided by the assignor pursuant to subdivision (c).
>
> (b) In the notice given pursuant to subdivision (a), the assignee shall establish a date by which creditors must file their claims to be able to share in the distribution of proceeds of the liquidation of the assignor's assets. That date shall be not less than 150 days and not greater than 180 days after the date of the first giving of the written notice to creditors and parties in interest.
>
> (c) The assignor shall provide to the assignee at the time of the making of the assignment a list of creditors, equityholders, and other parties in interest, signed under penalty of perjury, which shall include the names, addresses, cities, states, and ZIP Codes for each person together with the amount of that person's anticipated claim in the assignment proceedings.

In California, the company and the assignee enter into a formal "Assignment Agreement." The company must also provide the assignee with a list of creditors, equityholders, and other interested parties (names, addresses, and claim amounts). The assignee is required to give notice to creditors of the assignment, setting a bar date for filing claims with the assignee that is between five to six months later.

ABCs In Other States. Many other states have ABC statutes although in practice they have been used to varying degrees. For example, ABCs have been more common in California than in states on the East Coast, but important exceptions exist. Delaware corporations can generally avail themselves of Delaware's voluntary assignment statutes, and its procedures have both similarities and important differences from the approach taken in California. Scott Riddle of the Georgia Bankruptcy Law Blog has an interesting post discussing ABC's under Georgia law. Florida is another state in which ABCs are done under specific statutory procedures. For an excellent book that has information on how ABCs are conducted in various states, see Geoffrey Berman's General Assignments for the Benefit of Creditors: The ABCs of ABCs, published by the American Bankruptcy Institute.

Important Features Of ABCs. A full analysis of how ABCs function in a particular state and how one might affect a specific company requires legal advice from insolvency counsel. The following highlights some (but by no means all) of the key features of ABCs:

- Court Filing Issue. In California, making an ABC does not require a public court filing. Some other states, however, do require a court filing to initiate or complete an ABC.
- Select The Assignee. Unlike a Chapter 7 bankruptcy trustee, who is randomly appointed from those on an approved panel, a corporation making an assignment is generally able to choose the assignee.
- Shareholder Approval. Most corporations require both board and shareholder approval for an ABC because it involves the transfer to the assignee of substantially all of the corporation's assets. This makes ABCs impractical for most publicly held corporations.
- Liquidator As Fiduciary. The assignee is a fiduciary to the creditors and is typically a professional liquidator.

- Assignee Fees. The fees charged by assignees often involve an upfront payment and a percentage based on the assets liquidated.
- No Automatic Stay. In many states, including California, an ABC does not give rise to an automatic stay like bankruptcy, although an assignee can often block judgment creditors from attaching assets.
- Event Of Default. The making of a general assignment for the benefit of creditors is typically a default under most contracts. As a result, contracts may be terminated upon the assignment under an *ipso facto* clause.
- Proof Of Claim. For creditors, an ABC process generally involves the submission to the assignee of a proof of claim by a stated deadline or bar date, similar to bankruptcy. (Click on the link for an example of an ABC proof of claim form.)
- Employee Priority. Employee and other claim priorities are governed by state law and may involve different amounts than apply under the Bankruptcy Code. In California, for example, the employee wage and salary priority is $4,300, not the $10,950 amount currently in force under the Bankruptcy Code.
- 20 Day Goods. Generally, ABC statutes do not have a provision similar to that under Bankruptcy Code Section 503(b)(9), which gives an administrative claim priority to vendors who sold goods in the ordinary course of business to a debtor during the 20 days before a bankruptcy filing. As a result, these vendors may recover less in an ABC than in a bankruptcy case, subject to assertion of their reclamation rights.
- Landlord Claim. Unlike bankruptcy, there generally is no cap imposed on a landlord's claim for breach of a real property lease in an ABC.
- Sale Of Assets. In many states, including California, sales by the assignee of the company's assets are completed as a private transaction without approval of a court. However, unlike a bankruptcy Section 363 sale, there is usually no ability to sell assets "free and clear" of liens and security interests without the consent or full payoff of lienholders. Likewise, leases or executory contracts cannot be assigned without required consents from the other contracting party.
- Avoidance Actions. Most states allow assignees to pursue preferences and fraudulent transfers. However, the U.S. Court of Appeals for the Ninth Circuit has held that the Bankruptcy Code pre-empts California's preference statute, California Code of Civil Procedure section 1800. Nevertheless, to date the California state courts have refused to follow the Ninth Circuit's decision and still permit assignees to sue for preferences in California state court. In February 2008, a Delaware state court followed the California state court decisions, refusing either to follow the Ninth Circuit position or to hold that the California preference statute was pre-empted by the Bankruptcy Code. The Delaware court was required to apply California's ABC preference statute because the avoidance action arose out of an earlier California ABC.

The Scenario Revisited. With this overview in mind, let's return to our company in distress.

- The prospect of a term sheet from a potential buyer may influence whether our hypothetical company should choose an ABC or another approach. Some buyers will refuse to purchase assets outside of a Chapter 11 bankruptcy or a Chapter 7 case. Others are comfortable with the ABC process and believe it provides an added level of protection from fraudulent transfer claims compared to purchasing the assets directly from the insolvent company. Depending on the value to be generated by a sale, these considerations may lead the company to select one approach over the other available options.
- In states like California where no court approval is required for a sale, the ABC can also mean a much faster closing — often within a day or two of the ABC itself provided that the assignee has had time to perform due diligence on the sale and any alternatives — instead of the more typical 30-60 days required for bankruptcy court approval of a Section 363 sale. Given the speed at which they can be done, in the right situation an ABC can permit a "going concern" sale to be achieved.
- Secured creditors with liens against the assets to be sold will either need to be paid off through the sale or will have to consent to release their liens; forced "free and clear" sales generally are not possible in an ABC.
- If the buyer decides to take the real property lease, the landlord will need to consent to the lease

assignment. Unlike bankruptcy, the ABC process generally cannot force a landlord or other third party to accept assignment of a lease or executory contract.

- If the buyer decides not to take the lease, or no sale occurs, the fact that only nine months remains on the lease means that this company would not benefit from bankruptcy's cap on landlord claims. If the company's lease had years remaining, and if the landlord were unwilling to agree to a lease termination approximating the result under bankruptcy's landlord claim cap, the company would need to consider whether a bankruptcy filing was necessary to avoid substantial dilution to other unsecured creditor claims that a large, uncapped landlord claim would produce in an ABC.
- If the potential buyer walks away, the assignee would be responsible for determining whether a sale of all or a part of the assets was still possible. In any event, assets would be liquidated by the assignee to the extent feasible and any proceeds would be distributed to creditors in order of their priority through the ABC's claims process.
- While other options are available and should be explored, an ABC may make sense for this company depending upon the buyer's views, the value to creditors and other constituencies that a sale would produce, and a clear-eyed assessment of alternative insolvency methods.

Conclusion. When weighing all of the relevant issues, an insolvent company's management and board would be well-served to seek the advice of counsel and other insolvency professionals as early as possible in the process. The old song may say that ABC is as "easy as 1-2-3," but assessing whether an assignment for the benefit of creditors is best for an insolvent company involves the analysis of a myriad of complex factors.

ABL ADVISOR
SERVING ASSET-BASED LENDING DECISION MAKERS

Chapter 11 Reform: Proposed 'Adequate Protection' Recommendation Hurts Retailers

By: Daniel P. Wilansky
Date: Apr 06, 2015 @ 07:00 AM

In December 2014, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 released its recommendations for amendment to the current Bankruptcy Code. If implemented, these recommendations would deeply impact secured lenders and their borrowers. Secured lenders' concerns include limitations on, among other things, rolling up prepetition debt, liens on avoidance actions, and milestones in DIP financing agreements. While the bankruptcy bar has provided publications summarizing these concerns at a high level, it is now useful to examine individual recommendations more closely. This article addresses the effect of one recommendation – the standard to be used in the calculation of adequate protection – on secured lending to retailers. As further explained below, if enacted, the Commission's recommendation would severely disrupt the secured lending market in general, but may be even more problematic for borrowers in the retail space. Secured lenders would ultimately adapt to the new environment by underwriting loans that offer reduced incremental liquidity, higher pricing, and more restrictive structure.

Background

The ABI Commission's recommendations include a new standard for calculating adequate protection at the commencement of a bankruptcy case. Specifically, the Commission recommends that the adequate protection required to safeguard a secured creditor's interest be determined based on the "foreclosure value" of the collateral, defined as the net amount a secured creditor would realize upon a "hypothetical, commercially reasonable foreclosure sale of the secured creditor's collateral under applicable non-bankruptcy law." This method of calculation marks a departure from current practice. Although the Bankruptcy Code does not currently provide a specific standard, many courts apply standards such as "going concern value," "reorganization value," or "market value." These standards are generally much higher than "foreclosure value."

The new "foreclosure value" standard would disrupt the secured credit market, allowing debtors to more easily establish the adequate protection needed to access a secured lender's cash collateral or to obtain post-petition financing with liens that are *pari passu* with, or senior to, a secured lender's existing liens. The Commission's other recommendations do not mitigate this risk. For example, the proposal that a secured creditor should ultimately receive "reorganization value" for purposes of distributions would be of little help to a secured lender whose cash collateral and senior liens have already been diluted. After competing liens attach to the same asset, proceeds of the collateral may still be distributed at "reorganization value" – but now this value will be sliced apart and distributed among multiple creditors.

Lending to Retailers

The Commission's adequate protection framework would be especially troublesome for retailers. These companies often have a capital structure that includes asset-based loans, in which inventory and other assets are pledged as collateral. Lenders carefully structure these loans so that collateral value always exceeds amounts outstanding. In the context of inventory, collateral value generally means "net orderly liquidation value" (NOLV). This value assumes that inventory is sold in a going-out-of-business (GOB) sale overseen by a bankruptcy court, instead of through a foreclosure sale under state law. GOB sales generate significantly better recoveries than foreclosure sales. In a GOB sale, liquidators seek to maximize recovery by selling as much inventory as possible through the retail channel. Liquidators are experts at using the retailer's existing store base to drive sales. Only after the benefits of this channel are exhausted will liquidators look to sell inventory to wholesalers and other potential buyers. In contrast, lenders pursuing a

foreclosure remedy would need to seize inventory and sell primarily through alternate channels. While this framework may be sufficient for wholesalers, it ignores the obvious channel for liquidating a retailer's inventory. A market for appraisals of retail inventory at "foreclosure value" does not even exist. For these reasons, a world in which adequate protection is calculated at "foreclosure value" would be disruptive to secured lenders and the retailers who borrower from them.

Continued on Page 2...

The analysis becomes even more troubling in the context of other financing offered to retailers. For example, retailers often supplement their asset-based loans with secured cash-flow loans for additional liquidity. Lenders who provide both asset-based loans and secured cash flow loans typically take blanket security interests in all assets of the borrower. The total leverage (asset-based loans plus cash-flow loans) is generally limited by a metric that proxies for the "going concern value" of the company (e.g. multiple of EBITDA). Absent negotiated cure rights, an Event of Default is triggered when leverage exceeds "going concern value." This structure makes sense from an underwriting perspective, as the lender's exit in a downside scenario involves selling the company as a whole. However, this logic must be reevaluated in a world where adequate protection is calculated at "foreclosure value."

Market Reaction

If the adequate protection recommendation is implemented, it is not difficult to predict the lending market's reaction. Secured lenders would underwrite loans that provide less incremental liquidity, as advances would be tied to "foreclosure value" of collateral. In the asset-based lending context, even if initial advances are tied to other metrics (e.g. NOLV), lenders would still take protective measures in the event of a downside scenario. These measures include implementing additional borrowing base reserves or reducing advance rates on inventory. Cash flow loans would also provide less incremental liquidity, with total leverage likely tied to metrics other than proxies for "going concern value." In addition to liquidity constraints, new loans would have higher pricing and more restrictive structure, especially in the beginning stages of this new regime. Restrictive structures may include unfettered discretion (instead of commercially reasonable discretion) to alter advance rates or borrowing base reserves. Lenders may also impose higher availability blocks or other means of suppressing liquidity.

Importantly, while the Commission's recommendations are certainly not lender friendly, it is not lenders who will suffer the most under this framework. Lenders will find ways to operate in most environments, taking protective measures as to liquidity, pricing, and structure. However, retailers in distress or turnaround mode will not enjoy the same fate. The liquidity runway needed to turn around a retail business will be cut short. As a result, retailers will face more bankruptcies, restructurings, and liquidations – and these events will arise sooner than under the existing bankruptcy framework. Borrowers operating on the razor's edge, who previously could have executed a turnaround plan, will incur the increased costs (and other unpleasantness) associated with these events. Admittedly, the adequate protection proposal would make it easier for new lenders to provide DIP financing. However, this new DIP financing – coupled with an existing loan tied to "foreclosure value" – would not create more liquidity than under the existing framework. Lenders are only willing to advance against collateral up to an asset's projected recoverable value. Having multiple lenders involved in financing a debtor does not change this rule. If anything, bankruptcy cases would become longer and more expensive as a result – priming DIP financings are not for the faint of heart.

The Commission's recommendations were intended to benefit debtors but ignored the fact that markets are dynamic. Industry participants react to changes in law, and this is especially true in a banking or lending environment. If the adequate protection recommendation is implemented, secured lenders' focus on capital preservation will remain unchanged – but borrowers, especially retailers, will ultimately bear the brunt of the proposal's unintended consequences.

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Debtor and Debtor-in-Possession

UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

SANTA ANA DIVISION

In re EASY LIFE FURNITURE INC., a California corporation, Debtor.	Case No.: 14-12713-CB Chapter 11 **DEBTOR'S MOTION TO DISMISS CHAPTER 11 CASE** Date: March 4, 2015 Time: 10:00 a.m. Judge: Hon. Catherine Bauer Place: Ronald Reagan Federal Building and Courthouse 411 West Fourth Street Courtroom 5D Santa Ana, CA 92701-4593

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INTRODUCTION

Easy Life Furniture Inc., debtor and debtor-in-possession herein ("Debtor") hereby moves for an order dismissing this chapter 11 bankruptcy case and providing for related relief, including: (a) a provision that all orders entered in this bankruptcy case shall remain in full force and effect following the dismissal; (b) a provision authorizing the payment of certain priority claims with estate assets; and (c) a provision for the revesting of estate assets, including the remainder of the deposit from Elavon, in the Debtor and for the distribution of said assets to the Debtor's priority creditors. The statutory predicates for the relief requested are Bankruptcy Code sections 305(a) and 1112(b). This Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334, and this is a core proceeding under 28 U.S.C. § 157(b)(2)(A), (B), and (O).

This Motion requests Court approval of an orderly dismissal process sometimes referred to as a "structured dismissal." Generally speaking, this Motion requests this Court to dismiss the case and approve the distribution of estate assets to creditors at the time and in the manner set forth in the "Dismissal Procedures" described herein. Such a structured dismissal is appropriate in this case, where the assets of the Debtor's estate are significantly less than the total amount of allowed priority unsecured claims against it. The priority claims in this exceed $4 million, whereas the Debtor, after liquidating its assets and paying certain administrative priority claims, possesses only approximately $1.3 million. Thus, a speedy and cost-efficient exit to this bankruptcy case is needed in order to avoid further diminution of estate assets and a concomitant decrease in the distributions to holders of priority unsecured claims. This case cannot bear the expense of a chapter 11 plan process, and the Debtor can administer the estate's limited assets much more efficiently and cheaply than a chapter 7 trustee, who would add an additional layer of fees, commissions, and delay to the liquidation effort that is unwarranted under the circumstances. Importantly, the Debtor has discussed the structured dismissal proposed herein with both the Committee and the United States Trustee. The Committee is

supportive of the process as being in the best interests of the Debtor's creditors, and the United States Trustee has not indicated any objection to the concept.

This Motion is based on the discussion below, the supporting declaration of Jimmy Hsieh, the Notice filed concurrently herewith, and such other arguments and evidence that may be submitted prior to or at the hearing on this Motion.

II.

FACTUAL BACKGROUND

A. General Background.

On May 1, 2014 (the "Petition Date"), the Debtor commenced this Bankruptcy Case by filing a voluntary petition under chapter 11 of the Bankruptcy Code. The Debtor remains in possession of its assets and affairs as a debtor in possession under Bankruptcy Code section 1107. No trustee or examiner has been appointed. An official committee of unsecured creditors (the "Committee") was appointed by the Office of the United States Trustee on May 15, 2014.

The Debtor formerly operated a family-owned furniture retail chain headquartered in Buena Park, California, with locations throughout Southern California. The Debtor sold furniture to the consumer marketplace through the operation of its retail stores. On the Petition Date, the Debtor had 14 retail locations.

B. Orderly Liquidation Effort and Assets of the Estate.

As reflected in the first day motions and first day declaration of Mr. Hsieh (Dkt. No. 8), this case was a liquidation from the start. The case was filed to implement an orderly liquidation strategy designed to maximize the value of the Debtor's assets for the benefit of the its creditors, while limiting the Debtor's ongoing administrative expenses. The ground rules for this effort were set out in the Debtor's first day motions that were approved by this Court. Among other things, this Court approved the Debtor's motions to reject all of its retail leases, to conduct going out of business sales at its retail locations, to complete certain pre-petition deliveries to customers, and to pay certain priority employee claims. (See, Dkt. Nos. 39, 40, 41, 52, 69, 74).

The final piece of liquidation of the Debtor's assets occurred when the Debtor held an auction in this Court on July 2, 2014 to sell its remaining assets, and then moved out of its leased warehouse and headquarters through the stipulated rejection of that lease effective July 31, 2014. (See, Dkt. Nos. 184, 185, 186, 193). The Debtor no longer maintains any operations of any kind.

The Debtor now holds approximately $1,308,281.28 in cash in its bank accounts. The Debtor may have additional funds coming in from a deposit maintained with Elavon, Inc. ("Elavon"), its credit card processor. At one time, this deposit was approximately $450,000, but it has been reduced by the application of credit card chargebacks and fees against it. Elavon is not contractually obligated to turn the remainder of the deposit over to the Debtor until nine months after the cessation of the Debtor's business, which would be on approximately April 1, 2015. Elavon has taken the position that this period should be longer, and the Debtor is currently in a dispute with Elavon over that issue. The Debtor received an accounting of the deposit held at Elavon on December 9, 2014 which reflected that the balance of the deposit was $389,093.84.

The Debtor also understands that the Committee performed a preference analysis and made the decision that there were no preference claims worth filing, a position with which the Debtor agrees.

C. Claims Against the Estate.

The bar date in this Bankruptcy Case to file proofs of claim for non-governmental entities passed on July 20, 2014. The bar date for governmental claims passed on November 1, 2014. Thus, the universe of claims is known, as is the universe of the Debtor's assets.

The amount of priority unsecured claims against the Debtor far exceed the amount of cash, such that the only claims that will receive any payment in this case are priority claims. Following is a description of such claims, in order of priority.

First, there are claims with administrative priority under Bankruptcy Code section 507(a)(2), that have not yet been paid. The Debtor recently received approval to

pay $243,996.32 in claims with administrative priority under Bankruptcy Code section 503(b)(9). (See, Dkt. No. 300). Those claims are in the process of being paid and are not reflected in the below chart. The administrative claims that are reflected below consist of the fees and costs sought in the concurrently filed final fee applications, and a couple of additional post-petition administrative claims described below. The administrative claims consisting of professional fees are subject to the review and approval of the Court at the hearing on the final fee applications, which is anticipated to be held on the same date and time as the hearing on this Motion.

In addition, a reserve would need to be created for the following administrative expenses not yet incurred: (i) the salary of Easy Life's sole officer and director, Jimmy Hsieh; (ii) U.S. Trustee fees; and (iii) the cost of storage of the Debtor's books and records for a reasonable period post-dismissal, and cleaning and disposing of said records. These reserves are reflected on Chart 1 below, as is a general contingency reserve of $50,000 in case further administrative claims arise that are currently unexpected. The reserves may be held in the Debtor's own account, in an escrow account, in a client trust account at Sheppard Mullin, or in another fashion in the Debtor's reasonable discretion.

Chart 1: Outstanding Administrative Claims and Reserves

Claimant Name	Claim No.	Priority Amount
Sheppard Mullin Richter & Hampton LLP (Debtor's Counsel)	N/A	$ 52,923.92[1]
Contingency Reserve	N/A	$ 50,000.00
Pachulski Stang Ziehl & Jones LLP (Committee's Counsel)	N/A	$ 21,971.04
Sherwood Partners, Inc. (Debtor's Financial Advisor)	N/A	$ 15,959.06[2]
Lodgen, Lacher, Golditch, Sardi, Saunders & Howard LLP (Debtor's Accountants)	N/A	$ 12,545.48
Jimmy Hsieh Salary Reserve	N/A	$ 7,500.00
U.S. Trustee Fee Reserve	N/A	$ 6,500.00

[1] Net of Sheppard's remaining retainer of $52,034.69.

[2] Net of amounts already paid to Sherwood through the exhaustion of its retainer and the filing of monthly fee notices.

Aetna	N/A[3]	$	2,269.44
Reserve for Storage Costs, Cleaning and Disposing of Records	N/A	$	2,041.00
	Total Outstanding Administrative Claims and Reserves 507(a)(2)	***$***	***171,709.94***

There are also three remaining wage and benefit claims that have priority under Bankruptcy Code sections 507(a)(4) and (a)(5). They are as follows:

Chart 2: Wage and Benefit Claims

Claimant Name	**Claim No.**	**Allowed Priority Amount**	
Aetna	N/A	$	2,269.44
Nancy Perlman	38	$	1,255.50
Richard Sperandio	25	$	546.31
	Total Priority Under 507(a)(4) and (a)(5)	***$***	***4,071.25***

The next group of priority claims consists of customer deposit claims which are afforded priority under Bankruptcy Code section 507(a)(7) up to the amount of $2,775 for each individual. The Debtor's amended schedules in this case (Dkt. No. 83) included an Exhibit 1 to Schedule E which set forth all the claims having priority under Bankruptcy Code section 507(a)(7) on the Petition Date. On the Petition Date, these priority claims totaled approximately $684,942.00. Since then, however, the Debtor continued to make deliveries to customers who had made deposits with the Court's approval. As a result, the amount of claims with priority under Bankruptcy Code section 507(a)(7) has shrunk dramatically, to $42,456.56. Attached to this Motion is Chart 3, which lists those individuals who still have priority customer deposit claims under Bankruptcy Code section 507(a)(7).

Finally, the last group of priority unsecured claims consist of priority unsecured tax claims under Bankruptcy Code section 507(a)(8). This consists primarily of the claim filed

[3] Aetna presented the Debtor with a claim of $4,538.88 based on the funding of certain employee benefits. The Debtor has agreed to give Aetna an allowed administrative claim of half that amount, or $2,269.44, and an allowed priority claim under 507(a)(5) for the remaining $2,269.44. The Debtor seeks approval of this stipulation as part of this Motion.

by the Board of Equalization, though there are a few smaller tax claims outstanding as well.

Chart 4: Priority Tax Claimants

Claimant Name	Claim No.	Allowed Priority Amount
State Board of Equalization	1	$ 3,754,273.89
County of Orange	82	$ 17,815.53
Internal Revenue Service	N/A[4]	$ 10,298.23
Internal Revenue Service	43	$ 1,586.21
City of Los Angeles, Office of Finance	81	$ 351.25
	Total Priority Under 507(a)(8)	***$ 3,784,325.11***

D. Proposed Dismissal Procedures.

In connection with the proposed dismissal of this chapter 11 case, the Debtor proposes the following procedures (the "Dismissal Procedures"), for which it seeks approval in this Motion.

1. Payment of Claims and Funding of Reserves.

Thus, the total amount of priority claims to be paid and reserves to be funded are as follows:

Chart 5: Waterfall of Payments by Priority Level

Priority Level	Claimants	Amount of Allowed Claims and Reserves	Amount of Distributions	Percentage Distributions
Outstanding Administrative Expenses and Reserves – 507(a)(2)	See Chart 1	$171,709.94	$171,709.94	100%
Wages and Benefits – 507(a)(4) and (a)(5)	See Chart 2	$4,071.25	$4,071.25	100%
Customer Deposits –	See Chart 3	$42,456.56	$42,456.56	100%

[4] The Debtor owed $18,021.90 in additional unemployment tax to the IRS due to its being in California, a non-credit reduction state. These amounts were owed for the 2014 calendar year. The Debtor had employees for seven months of the year, and therefore accrued unemployment tax for seven months of the year. Of those seven months, three months (May, June, July) were post-petition, and four months (January, February, March, April) were pre-petition. The Debtor has thus already paid 3/7 of the total amount, or $7,723.67, as a post-petition administrative claim incurred in the ordinary course. The Debtor will pay 4/7 of the total amount, or $10,298.23, as a pre-petition priority claim under Bankruptcy Code section 507(a)(8).

507(a)(7)				
Taxes – 507(a)(8)	See Chart 4	$3,784,325.11	$1,090,043.53	28.8%
General Unsecured Claims	N/A	$0	$0	0%
	TOTAL	***$ 4,002,562.86***	***$ 1,308,281.28***	

As reflected above, all of the priority claims except for the priority tax claims will be paid in full. The priority tax claims exceed the amount of the remaining available funds in the estate and so will receive a pro rata distribution of approximately 28.8%.[5] Because the amount of priority claims in the case exceeds the amount of cash available in the estate, there will be no distribution to general unsecured claims.

2. Distribution of Reserved Funds.

To the extent amounts reserved for administrative expenses in Chart 1 exceed the actual amount of administrative expenses incurred, the additional amounts would be paid pro rata to the holders of priority tax claims under Bankruptcy Code section 507(a)(8).

3. Distribution of Additional Funds Received by Debtor.

Any additional funds received by the Debtor following the dismissal of this bankruptcy case, including without limitation the remaining deposit with Elavon, would be paid pro rata to the holders of the priority tax claims listed in Chart 4, until the priority tax claims are paid in full. In the unlikely event that the amount of funds received by the Debtor following the dismissal of this case were sufficient to pay the priority tax claims in Chart 4 in full, leaving an excess to be distributed to holders of allowed general unsecured claims, the Debtor will move to reopen this bankruptcy case and seek further instruction from this Court.

4. Orders To Remain Effective.

The dismissal order shall provide that orders entered in the case shall remain in full force and effect despite the dismissal, including without limitation the orders approving the

[5] Note that in addition to the pro rata distribution received by all priority tax claimants, the claim of the Board of Equalization will also receive funds pledged to the Board of Equalization which are currently maintained in a certificate of deposit at Cathay Bank. The Debtor understands that the balance of the certificate of deposit is currently approximately $51,891.82.

first day motions and stipulations with the Debtor's landlords regarding the rejection of the Debtor's leases.

III.

ARGUMENT

A. This Court May Dismiss this Case Without Cause.

Bankruptcy Code section 305(a)(1) provides that "[t]he court, after notice and a hearing, may dismiss a case under this title … at any time if – (1) the interests of creditors and the debtor would be better served by such dismissal…" No "cause" is required for the dismissal of a case under Section 305(a); one merely needs to establish that dismissal is in the best interests of creditors. Here, as discussed below, dismissal is clearly in the best interests of creditors.

B. Alternatively, this Court May Dismiss the Case for Cause.

Bankruptcy Code section 1112(b) allows a court to dismiss a case for cause. The section provides in relevant part that:

> the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause unless the court determines that the appointment under section 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate.

11 U.S.C. § 1112(b)(1).

Bankruptcy courts have broad discretion to determine whether cause exists, and once it is found, the court must then dismiss the case, convert the case to chapter 7, or appoint a trustee or examiner. *See, e.g., In re Products Int'l Co.*, 395 B.R. 101, 107 (Bankr. D. Ariz. 2008); *In re YBA Nineteen, LLC*, 505 B.R. 289, 302 (S.D. Cal. 2014); *In re Bronson*, 2013 WL 2350791 at *7 (9th Cir. B.A.P. 2013). [6]

[6] Section 1112(b)(2) provides an exception to 1112(b)(1) – that is, it provides that a court may not convert or dismiss a case – where certain unusual circumstances exist. The unusual circumstances identified are two: (i) a plan will be confirmed within a reasonable time; or (ii) cause is based on an act or omission for which there is reasonable justification and which may be cured within a

Section 1112(b)(4) sets forth a non-exhaustive list of examples of "cause." The very first example listed is: "(A) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation." 11 U.S.C. § 1112(b)(4). In addition, courts have found cause to exist for dismissal when the primary purpose of the bankruptcy case has been achieved. *See, e.g., In re MELP, Ltd.*, 143 B.R. 890, 893 (Bankr. E.D. Mo. 1992) ("In this case MELP came into bankruptcy court seeking protection of the automatic stay to enable it to reorder its affairs and make peace with its creditors. This purpose has been successfully achieved.").

Here, the primary purpose of the bankruptcy has been achieved, in that the orderly liquidation has been completed. The Debtor's assets have been reduced to cash and its liabilities have been minimized. However, since the priority claims exceed the amount of cash available, any avenue other than dismissal would involve a significant waste of resources that would unnecessarily diminish the return to priority tax claimants. Likewise, keeping the case in chapter 11 any longer would only cause unnecessary administrative claims to accrue, especially if an effort were made to confirm a plan. Dismissal of the case according to the proposed Distribution Procedures above is the best alternative under the facts and circumstances of this case, where costs need to be minimized in order to preserve as many assets as possible for distribution to priority tax claimants.

Notably, the proposed Dismissal Procedures strictly implement the absolute priority rule, paying priority creditors in the waterfall set forth in Chart 5 above according to the priorities established in Bankruptcy Code section 507(a). There is nothing odd or unusual about the Dismissal Procedures that suggests they would need to be part of a chapter 11 plan. Rather, the straight-forward application of the priorities of Section 507(a) adopted in the Dismissal Procedures is tailor made for a structured dismissal.

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reasonable period of time. *See*, 11 U.S.C. § 1112(b)(2). Neither unusual circumstance is present here because no plan can be confirmed within a reasonable time in this case, and cause is not based on any particular act or omission.

Courts have recognized dismissals, and in particular structured dismissals, to be appropriate and in the best interests of creditors in similar circumstances. *See, e.g., In re Buffet Partners, L.P.,* 2014 WL 3735804 *3 (Bankr. N.D. Tex. July 28, 2014) (approving a structured dismissal where other options of conversion or plan confirmation "would add significant and unnecessary time and expense," noting that "there is not much in the way of assets left to administered," and that the "the economic value of the Debtor in this case will be served by dismissing the case, rather than converting it"); *In re Rodeo Creek Gold Inc*., Case No. 13-50301 (Bankr. D. Nev., Order entered July 12, 2013 as Docket No. 608) (approving a structured dismissal that paid assigned claims to a trust, created a trust fund, among other things); *In re William M. Lansdale*, 8:09-bk-22982-ES (Bankr. C.D. Cal. Order entered March 4, 2010) (Smith, J.) (dismissing case following settlement subject to payment of claims, professional fees, and U.S. Trustees, among other things).

This Court should follow suit and issue an order dismissing this case and approving the Dismissal Procedures, so that the economic value of the Debtor's estate can be preserved for the benefit of creditors to the maximum extent possible.

IV.

CONCLUSION

For the reasons stated above, the Debtor requests that this Court issue an order dismissing this chapter 11 case, approving the Dismissal Procedures, and providing related relief.

Dated: February 11, 2015 SHEPPARD, MULLIN, RICHTER & HAMPTON LLP

By */s/ Michael Lauter*
MICHAEL LAUTER

Attorneys for Easy Life Furniture Inc.,
Debtor and Debtor-in-Possession

Chart 3

Customer Deposit Priority Claims - 11 U.S.C. § 507(a)(7)

Last Name	First Name	Total Deposit	Allowed Claim
Acosta/Flores	Guadalupe & Jessica	$267.03	$267.03
Alcazar	Joanne	$200.00	$200.00
Allen	Regenia	$100.00	$100.00
Arias	Ingrid	$196.19	$196.19
Arige	Eswar	$356.39	$356.39
Arige	Eswar	$1,501.18	$1,501.18
Austin	Norma	$100.00	$100.00
Austin	Kevin	$141.69	$141.69
Avdeef	Arlene	$144.00	$144.00
Baghdasarian	Anita	$1,050.00	$1,050.00
Barajas	Jose/Veronica	$350.00	$350.00
Barcelos	Margarent	$100.00	$100.00
Barragan	Bertha	$1,089.99	$1,089.99
Bartley	Erica	$277.19	$277.19
Blade	Farica	$65.00	$65.00
Blunt	Belma	$500.00	$500.00
Boghouzian	Joura	$204.36	$204.36
Brown	Tameeka	$200.00	$200.00
Brown	Jovan/Jasmine	$40.00	$40.00
Brugh	Charles	$272.48	$272.48
Burton	Julia	$20.00	$20.00
Camacho	Rachel	$210.00	$210.00
Campbell	Lisa & Darrin	$40.00	$40.00
Castro	Nora	$40.00	$40.00
Chavez	Gabriela	$65.00	$65.00
Chovan	Michael	$40.00	$40.00
Cisneros	Martha	$100.00	$100.00
Corral	Adel	$1,073.62	$1,073.62
Davis	Carl	$198.72	$198.72
Davis	George	$120.00	$120.00
Davis	George	$48.00	$48.00
Deady	Jan	$140.00	$140.00
Dixon	Lloyd	$149.00	$149.00
Donis	Myner	$14.40	$14.40
Dreger	Roger / Cathy	$200.00	$200.00
Duarte	Rosie	$150.00	$150.00
Duate	Maribel	$100.00	$100.00
Engineer	Massarrat	$258.49	$258.49
Faria	Wagner	$200.00	$200.00
Fermoselle	Deya	$1,781.96	$1,781.96
Fink	Jason	$67.99	$67.99
Gamboa	Martin	$75.00	$75.00
Goel	Mahesh	$362.78	$362.78

Last Name	First Name	Total Deposit	Allowed Claim
Griffin	Daniel	$269.99	$269.99
Guerrero	Marrlene/Eno	$55.00	$55.00
Holz	Albert & Nancy	$1,727.63	$1,727.63
Houston	Erby	$191.89	$191.89
Infante	Israel J.	$400.00	$400.00
Jackson	Robin	$110.00	$110.00
Jiriicek	David	$674.98	$674.98
Jones	Denise	$500.00	$500.00
Keranen	Karl	$120.00	$120.00
Khanjyan	Yurik	$653.99	$653.99
Kim	Eunyoung/ Young Tae	$100.00	$100.00
Kimble	Abire	$647.99	$647.99
Klavs	Nicolle	$20.00	$20.00
Lepe	Leticia	$290.89	$290.89
Lepe	Leticia	$36.00	$36.00
Lewis	Cheyenne Petrakos	$4,861.23	$2,775.00
Lewis	Cheyenne Petrakos	$653.99	$653.99
Luna	Jerry	$1,318.86	$1,318.86
Macaseno	Tesse	$988.18	$988.18
Mack	Barbara	$939.00	$939.00
Manrique	Fabiola	$100.00	$100.00
Mao	Jianjun	$453.61	$453.61
Markosyan	Silva	$54.00	$54.00
Masood	Tessa/Abid	$100.00	$100.00
Mccarthy	James	$1,090.77	$1,090.77
Merritt	Cheryl	$180.00	$180.00
Mohamed	Abdifatah	$140.00	$140.00
Moncada	Merced	$84.00	$84.00
Moody	Floyd	$300.00	$300.00
Moore	John	$126.34	$126.34
Morino	Jenna	$100.00	$100.00
Nieto	Yolanda	$250.19	$250.19
Ogbechi	Brenda	$20.00	$20.00
Olenich	Igor	$196.19	$196.19
Palacios	Susana	$200.00	$200.00
Park	June	$100.00	$100.00
Pham	Angela	$1,090.77	$1,090.77
Phillips	Bryan	$298.08	$298.08
Rahimi	Amir	$161.99	$161.99
Ramirez	Constance	$541.17	$541.17
Ramirez	Eduardo	$16.20	$16.20
Rincon	Darlene	$30.00	$30.00
Rodriguez	Elizabeth	$300.00	$300.00
Rodriguez	Samuel	$500.00	$500.00
Rodriguez	Patricia	$182.79	$182.79
Romero	Rosalie	$20.00	$20.00
Romo	Victoria	$1,226.87	$1,226.87
Ross	Iuni Or Faamanatu	$360.00	$360.00
Ruiz	Socorro	$337.95	$337.95

Last Name	First Name	Total Deposit	Allowed Claim
Sanders	Barbara	$302.00	$302.00
Santana	Alfred	$69.60	$69.60
Sanyal	Arpita	$50.00	$50.00
Saqebi	Mariam	$35.09	$35.09
Scandrick	Zanavia	$200.00	$200.00
Smith	Patrice	$200.00	$200.00
Snipes	Nelson	$440.00	$440.00
Sohrt	Mike	$186.19	$186.19
Stratton	Justin	$97.58	$97.58
Sylvester	John	$1,085.72	$1,085.72
Taylor	Mark	$200.00	$200.00
Thomas	Traci	$33.60	$33.60
Townsend	Janine	$140.00	$140.00
Tran	Kim	$863.99	$863.99
Turner	Thomas	$430.53	$430.53
Vasquez	Jose	$457.78	$457.78
Vazquez	Sofia	$120.00	$120.00
Vazquez	Azucena	$120.00	$120.00
Ventress	Jim	$137.33	$137.33
Washington	Kevin	$711.60	$711.60
Weems	Margo	$105.00	$105.00
Williams	Joyce	$520.00	$520.00
Williams	Lori	$510.00	$510.00
Wilson	Darryl	$520.00	$520.00
Wyson	Marla	$200.00	$200.00
Yong	Jee	$955.78	$955.78
Yudico	Stephanie	$120.00	$120.00
	TOTALS	***$43,542.79***	***$42,456.56***

GIFTING MECHANISMS USED IN BANKRUPTCY CASES

Generally, the "gifting" concept allows a senior class to share its distribution or property with a junior class or certain members thereof, notwithstanding the hierarchical priority scheme established under the Bankruptcy Code. More recent cases in the Second and Third Circuits have made it more difficult for debtors, secured creditors, creditors' committees and other parties in interest to obtain approval of gifting plans at least in those jurisdictions. As a result, gifting through other mechanisms or a combination of mechanisms, including through Rule 9019 settlements outside of a plan, section 363 sales and stipulated case dismissals, may become more commonly used, although such mechanisms themselves raise some questions.

I. Gifting in a Chapter 11 Plan

A. In General

A gifting plan is a plan in which a senior class of creditors allows a portion of its recovery under the plan to go to a junior class of creditors or equity holders or a subset thereof. A carve-out plan is a gifting plan in which a secured party (typically, an undersecured creditor with a blanket lien in most or substantially all of the debtor's assets) offers the gift out of the recovery it would otherwise receive in direct satisfaction of its security interest. Generally, the purpose of a gifting plan is to gain support of the plan from other creditors and/or equity holders, whose cooperation, including voting for the plan, is strategically important to plan confirmation. A sampling of gifting plan cases, as well as cases involving other gifting mechanisms, is provided in Attachment 1.

Typically, gifting plans have been objected to on various grounds, including that it violates Bankruptcy Code section 1129(b)(1). Specifically, gifting to a junior class before all classes senior to it have been paid in full may, arguably, violate the absolutely priority rule (section 1129(b)(2)(B)(ii)); selective gifting plans which provide a gift to a subset of creditors or equity holders of a certain priority level may violate the Bankruptcy Code's prohibition against unfair discrimination among creditors (section 1129(b)(1)). However, if no class votes (or is deemed to vote) against the proposed plan, then section 1129(b) issues (the unfair discrimination and absolute priority rules) do not come into play.

> The gifting doctrine, at least as implemented through a plan, has been severely limited in the Second and Third Circuits by virtue of the *DBSD* and *Armstrong* decisions, respectively. *In re DBSD N Am., Inc.,* 634 F.3d 79 (2d Cir. 2011) ("The Code extends the absolute priority rule to 'any property,' …, not 'any property not covered by a senior creditor's lien.' The Code focuses entirely on who 'receive[s]' or 'retain[s] the property 'under the plan … not on who *would* receive it under a liquidation plan. And it applies the rule to any distribution 'under the plan' on account of a junior interest … regardless of whether the distribution could have been made outside the plan, and regardless of whether other reasons might support the distribution in addition to the junior interest."); *In re Armstrong World Indus., Inc.,* 432 F.3d 507 (3d Cir. 2005) (prior cases do "not stand for the unconditional proposition that creditors are generally free to do whatever they wish with the bankruptcy proceeds they receive"). As a result, at least in the Second and Third Circuits,

a plan which proposes to skip a senior class and pay distributions to a more junior class will face very serious obstacles in plan confirmation if the senior class votes against the plan. Nonetheless, debtors, secured creditors, and especially creditors' committees -depending on the particular circumstances of the bankruptcy case- may continue to push for gifting plans, given, in many cases, unsecured creditors would not otherwise receive any meaningful recovery where the debtor's assets are fully liened up and the secured lender is undersecured. It is unclear whether bankruptcy courts, more broadly, will apply *DBSD* and *Armstrong* to preclude the application of the gifting doctrine in chapter 11 cases where the gift is implemented in pre-plan settlements, section 363 sales, cash collateral / financing orders, and under other non-plan circumstances, although as reflected in Attachment 1 there are examples of cases permitting gifting in such other contexts.

B. Consensual Plans

Notwithstanding the foregoing, consensual gift plans should remain viable even in the Second and Third Circuits. As noted above, the cram down provisions of section 1129(b)(2) are triggered only when a plan proponent seeks to confirm a plan over the objection of a dissenting class. Thus, depending on the circumstances of the case, the plan proponent and/or senior creditors could focus on negotiations with representatives of the skipped class to see if some other concessions could be made in exchange.

Plan proponents sometimes seek to incentivize a skipped class to accept the plan by providing that certain distributions will be provided to such class if it accepts the plan, and that little or no distributions will be provided if the class rejects. Such incentives have been called "deathtrap" provisions, which may be approved in some jurisdictions. *See, e.g., In re Drexel Burnham Lambert Group*, 138 B.R. 714, 717 (Bankr. S.D. N.Y. 1992) ("[W]e have no conceptual problem with senior interests offering to junior interests an inducement to consent to the Plan and waive whatever rights they have…. [W]e find no statutory provision that proscribes such discrimination [against classes that vote against a plan]."); *In re Adelphia Comms. Corp.*, 368 B.R. 140, 275 (Bankr. S.D. N.Y. 2007) ("I see no Absolute-Priority Rule objection to the so-called 'deathtrap provision' requiring equity holders to vote in favor of the Plan or forfeit their distributions under it. Because the … [i]nterests at issue will have only speculative value on the Effective Date, and because a 'carrot and stick' provision … is wholly permissible, the … [contrary] argument fails."). *But see, e.g., In re MCorp Fin. Inc*., 137 B.R. 219, 236 (Bankr. S.D. Tex. 1992) ("Debtors have included in their plans a provision authorizing some possible payout to equity (MCorp classes 15, 16, 17) upon a favorable vote by Class 15 (Shearson), but none to these three classes upon a negative vote by Class 15…. There is no authority in the Bankruptcy Code for discriminating against classes who vote against a plan of reorganization…. The court finds that this MCorp Plan provision results in the plan's not being fair and equitable. Further, this provision also results in unfair discrimination."). Alternatively, another option could be for the debtor and secured creditor to divide up the consideration that might have gone to a single class or subset of creditors and structure a plan to provide some sort of gift to all impaired classes (*i.e*., dividing up the limited gift in more pieces).

C. "New Value" Plan

The Second Circuit in *DBSD* did not address whether a gift to equity holders from a senior creditor is permissible even if an unsecured creditor class rejects the plan, if the plan proponent can demonstrate that the equity holder did indeed provide "new value" to the debtor. *DBSD*, 634 F.3d at 97 (noting in this case, "old owners [were] to receive new ownership without contributing any new value"). The Third Circuit in *Armstrong* acknowledged the possibility of such transfers being properly in exchange for new value, but there, the court concluded that distributions would be given to equity holders on account of their status as interest holders. *Armstrong*, 432 F.3d at 515-16.

The new value exception to the absolute priority rule (discussed by the U.S. Supreme Court in *Bank of America NT & SA v. 203 N. LaSalle Street P'ship*, 526 U.S. 434 (1999)), if still viable, may allow a junior class to receive distributions under a plan on account of the new value, rather than receiving distributions "on account of their claims or interests." Whether what amounts to a gifting arrangement can pass muster under a new value argument seems somewhat doubtful since the equity holder must give a substantial contribution in exchange. *See, e.g., In re OCA, Inc.,* 357 B.R. 72 (Bankr. E.D. La. 2006) (rejecting new value argument in support of plan where secured creditor would gift participation rights to equity holders, while unsecured creditors would not be paid in full with interest; among other reasons: "The only immediate contribution provided for by the plan is that the equity holders will support the plan and will issue a press release to that effect. Even if the court accepts for a moment the plan proponents' argument that the support of the equity holders is necessary for a successful reorganization, that is only one of the requirements of the exception. The record is devoid of any evidence that this support is equivalent to new capital, that it is 'money's worth,' and certainly no evidence as to the value, either now, on the effective date, or in the future of the stock in the reorganized debtor that these certain equity holders would have a right to purchase."); *DBSD*, 634 F.3d at 97 ("Given that the Supreme Court [in strictly applying new value doctrine] has hesitated to allow old owners to receive new ownership interests even when contributing new value, it is doubtful the Court would allow old owners to receive new ownership without contributing any new value, as in this case.").

D. Gifting Supported by Business/Other Compelling Reasons

In the plan context, some plan proponents have justified the gifting mechanism on the basis, among other grounds, that singling out certain unsecured creditors for preferential treatment was supported by business reasons such as the need for the reorganized debtor's continued relations with the selected, important creditors. *See, e.g., In re Union Fin. Services Group*, 303 B.R. 390, 423 (Bankr. E.D. Mo. 2003) ("There is no unfair discrimination in a Plan provision that allows the Senior Secured Lenders and the DIP Lenders voluntarily to assign to unsecured creditors cash collateral proceeds that otherwise would rightfully belong to the secured creditors, particularly in the context of a reorganization where continued relations with those unsecured creditors are important to future business of the reorganized Debtors."); *In re Journal Register Co.*, 407 B.R. 520, 534 (Bankr. S.D. N.Y. 2009) ("[T]he 'gift' is necessary to ensure the goodwill of trade creditors essential to the Debtors' postconfirmation survival. The goal of the 'gift' is in accordance with the overriding purpose of chapter 11 that

going concern value be preserved or enhanced."). *Compare with, e.g., In re Snyders Drug Stores, Inc.,* 307 B.R. 889 (Bankr. N.D. Ohio 2004) (plan unfairly discriminated against landlords with rejection claims in favor of certain other unsecured creditors; there was no evidence suggesting that the favored classes would refuse to deal with reorganized debtor absent preferential payments, and thus, the plan was not "reasonably tailored to foster only those relationships that [were] critical to the success of the reorganized debtor"). Potentially, more plan proponents may attempt to frame gifting mechanisms in such and other creative ways, although a bankruptcy court may be wary of such framing to be just an artifice to favor creditors who may be supportive of the plan.

II. Settlements Outside of a Plan

As noted, the unfair discrimination and absolute priority rules under section 1129(b)(2) are implicated only in a cramdown plan context, and thus, use of the gifting outside of a plan and as part of a settlement agreement, approved under Bankruptcy Rule 9019, should potentially be a viable alternative in many cases. Most bankruptcy courts apply the multi-factor test for settlements discussed in the U.S. Supreme Court's decision in *Protective Comm. For Indep. Stockholders of TMTTrailer Ferry, Inc. v. Anderson,* 390 U.S. 414 (1968), or other similar factors. Thus, arguably, approval of gifting through a pre-plan settlement should be subject to a more deferential Rule 9019 standard, instead of more stringent plan confirmation requirements.

The Second Circuit applied the *TMT Trailer* factors in *In re Iridium Operating LLC,* 478 F.3d 452 (2d Cir. 2007), but concluded that the most important factor, and often, the dispositive factor, for a bankruptcy court to consider when determining whether a settlement is fair and equitable is whether the settlement's distribution scheme complies with the priority scheme under the Bankruptcy Code. The *Iridium* court did suggest that if there is only a minor divergence from the Code's priority scheme and the other *TMT Trailer* factors weigh heavily in favor of the settlement, then it is possible, in the Second Circuit, to have a pre-plan gifting settlement approved. The Second Circuit in *DBSD* specifically did not address whether a secured creditor can enter into a private agreement outside of a plan with a junior class in order to provide such class with a gift of its property. While this option may be available, it has obstacles. For example, in many cases, there may be too many key junior creditors, thus it would not be feasible for a secured creditor to enter into numerous private agreements outside of a plan. Second, a private agreement between a secured creditor and a junior creditor will likely need to be fully disclosed to the Court, opening that up to scrutiny and also possibly incentivizing other junior creditors to seek concessions as well.

The case law in some other jurisdictions such as the Third Circuit appears more favorable towards gifts incorporated into a pre-plan settlement. *See, e.g., In re LCI Holding Co., Inc.,* Case No. 12-13319 (KG) (Bankr. D. Del. 2013) (order (docket no. 690) approving settlement among creditors' committee with purchaser and secured lenders, whereby, among other things, purchaser would gift millions of dollars for benefit of unsecured creditors; committee argued that non-estate property was at issue, and thus the proposed gifting was proper under *TSIC* and *World Health Alternatives*); *World Health Alternatives*, 344 B.R. 291 (finding that absolute priority rule does not apply outside of plan context, carve-out for

unsecured creditors was with non-estate property, and that such carve-outs are permissible; applying 9019 four-factors test). *But see, e.g., In re AWECO, Inc*., 725 F.2d 293 (5th Cir. 1984) ("a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payments will be respected as to objecting senior creditors"). If Third Circuit cases such as *World Health Alternatives* and *TSIC* are viewed as a trend in the case law, there may be more attempts to seek approval of pre-plan settlements invoking the gifting doctrine. Often, it may be helpful to narrowly tailor the scope of a gifting settlement and minimize the "bells and whistles" to also avoid arguments that the settlement constitutes a *sub rosa* plan. *See, e.g., Iridium*, 478 F.3d at 467 ("[T]he bankruptcy court did not err in concluding that the settlement of the dispute of the liens and other property had a proper business justification and was 'a step towards possible confirmation of a plan of reorganization and not an evasion of the plan confirmation process.'"). *See generally In re Louise's Inc*., 211 B.R. 798 (D. Del. 1997) (court would not approve "plan of reorganization disguised as a Rule 9019 compromise").

III. Gifting in the Sale Context

Junior creditors may attempt to receive a recovery from a purchaser of the debtor's assets and seek approval of such arrangement on the basis that the property to fund the gift belongs to the gifting party, instead of the bankruptcy estate. *See, e.g., In re TSIC, Inc.*, 393 B.R. 71 (Bankr. D. Del. 2008) (committee negotiated deal with stalking horse bidder / ultimate successful bidder for debtor's assets in a section 363 sale process, whereby buyer agreed to fund trust account for the benefit of unsecured creditors in exchange for committee's acquiescence to sale; after approval of sale, the settlement was approved largely based on rationale that non-estate property would be used to pay unsecured creditors regardless of the absolute priority rule); *In re LCI Holding Co., Inc.,* Case No. 12-13319 (KG) (Bankr. D. Del. 2013) (orders, docket no. 617, 690) (court approved 363 sale, as part of which purchaser –an entity formed by debtors' secured lenders– agreed to fund carve-outs for the payment of debtors' and committee's professionals and case wind-down expenses; debtors, committee and other interested parties argued that ample basis existed for 363 approval, and escrowed carve-outs were not property of the estate and purchaser was free to distribute such property as it saw fit; subsequently, committee entered into 9019 settlement with purchaser and secured lenders, whereby, among other things, purchaser would provide $2 million payment for the benefit of unsecured noteholders and $1.5 million for the benefit of other general unsecured creditors; court approved committee's motion over US Trustee's and United States' objections).[1] The absolute priority rule codified in section 1129(b) is not directly applicable to section 363 sales; instead, sales of the debtor's assets outside of the ordinary course are subject to

[1] At least as a leveraging point, it can also perhaps be argued to a secured creditor and the bankruptcy court that some sort of gifting by the secured creditor should be required to pass muster under section 363. That is, if all value from a section 363 sale would basically go to the secured creditor, then, arguably, in some cases depending on the circumstances, there would really be no valid business justification from the estate's perspective to pursue the sale. *See In re Fremont Battery Co*., 73 B.R. 277, 279 (Bankr. N.D. Ohio 1987) (no sound business purpose to approve 363 sale since sale would not benefit unsecured creditors; "the proceeds from the proposed sale would, at most, benefit one creditor only"); *In re Encore Healthcare Assoc.*, 312 B.R. 52, 57 (Bankr. E.D. Pa. 2004) ("Here the proposed sale not only generates funds solely for the secured creditor which could realize the value of its collateral by foreclosing and selling the assets itself but more significantly advances no purpose of a Chapter 11 proceeding.").

a more flexible business judgment standard. *See generally In re Trans World Airlines, Inc*., 2001 WL 1820326, *11 (Bankr. D. Del. 2001) ("The purpose of a § 363 sale is to maximize benefits to the debtor's entire estate. Where a sale results in disparate treatment of similarly situated creditors the sale may appear to be at the expense of individual creditor constituencies. However, if the sale is in the best interests of the estate it follows that the entire estate suffers in the absence of the sale."); *In re General Motors Corp*., 407 B.R. 463 (Bankr. S.D.N.Y. 2009) ("neither section 1123(b)(4) nor any other section of the Code trumps or limits section 363").

Notwithstanding the foregoing, gifting in connection with or through section 363 sales may face objections on other grounds, including that the sale may constitute a *sub rosa* plan. *See generally Pension Benefit Guaranty Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.),* 700 F.2d 935 (5th Cir. 1983). *See, e.g., In re On-Site Sourcing, LLC*, 412 B.R. 817 (Bankr. E.D. Va. 2009) (court approved section 363 sale of debtor's assets to secured lender but ordered removal of gift provision (including a gift of $132,000 to an unsecured creditors trust), holding, among other things, such provision and related release provisions would constitute a *sub rosa* plan and approval thereof would deprive administrative and priority creditors of rights under sections 1129, among other plan related provisions).

To sidestep such issues, another possibility may be for debtors and committees to negotiate with potential buyers to assume certain unsecured claims as part of the asset purchase agreement. Indeed, in various cases, purchasers have assumed certain unsecured liabilities without much controversy -- the rationale being that the purchaser is free to select claims it wishes to pay or otherwise assume as part of the sale.

IV. Stipulated Dismissal, Conversion and Stay Relief

Other possible contexts in which to implement a gifting mechanism include:

(i) The debtor and committee consent to a secured creditor obtaining relief from the automatic stay to thereafter effect a gift to junior creditors. Whether this is a practical alternative in many cases is unclear. What provisions should go into such a stipulated stay relief order? If the secured creditor obtains relief from stay but then decides not to go forward with gifting distributions to other creditors, what is the remedy and who seeks such remedy? What happens to unliquidated and disputed unsecured claims, and what if there are many unsecured claims to be addressed/resolved? Perhaps, a gift could be obtained from the secured creditor prior to and in exchange for subsequent stay relief (*see, e.g., In re CFM U.S. Corp*., Case No. 08-10668 (KJC) (Bankr. D. Del. 2009) ((order, docket no. 1097) in exchange for gifted funds from secured creditor, secured creditor was, among other things, granted relief from automatic stay to foreclose upon, recover from, and setoff against its collateral and proceeds thereof, subject to terms of parties' stipulation)), but then that arrangement/settlement must be vetted by the bankruptcy court as well.

(ii) The debtor and committee stipulate to conversion to chapter 7. As chapter 7 does not include the rigid absolute priority rule, there is less statutory support for a

prohibition on gifting in a chapter 7 liquidation. *See DBSD*, 634 F.3d at 97. Further, the distribution scheme of section 726 and the priorities of section 507 do not come into play until all valid liens are satisfied. *In re SPM Mfg. Corp.,* 984 F.2d 1305, 1311 (1st Cir. 1993). Both sections apply only to distributions of property of the estate and do not govern the rights of creditors to transfer or receive non-estate property, thus, arguably, giving creditors more flexibility/discretion to distribute or share their recoveries. However, conversion to chapter 7 has its disadvantages. For example, the chapter 7 trustee must get up to speed and incur more administrative expenses and charge its fees (thus potentially reducing the ultimate payout for unsecured creditors), and the trustee may consider pursuing avoidance actions or other causes of action, which may not be cost-effective or worthwhile overall based on all the circumstances and may delay recoveries for many creditors. Other questions arise such as: Bankruptcy Rule 3002 establishes a bar date for filing proofs of claim in a chapter 7 case. How does that impact the beneficiaries of a general unsecured creditor (GUC) trust established by the stipulated conversion order (assuming such a trust is set up as part of the conversion)? How would a GUC trust work in the chapter 7 setting, with a chapter 7 trustee? If a GUC trust with a trustee is not set up (instead just escrowed accounts are established), is the chapter 7 trustee authorized to distribute the account funds if they are non-estate property?

(iii) The debtor, committee and secured creditor obtain a stipulated dismissal order. A structured dismissal of a chapter 11 case frequently entails a dismissal of the case, along with a grant of authority to the estate fiduciaries to make a distribution to creditors using a carve-out or non-estate property of the secured lender. In a standard case dismissal, there would be the question as to who has standing to enforce a gifting arrangement outside of the bankruptcy case and where/how the agreement would be enforced, but often in stipulated dismissal arrangements, the bankruptcy court retains jurisdiction to hear matters related to orders entered in the chapter 11 case and prior orders are expressly preserved. Often, structured dismissals also have other bells and whistles such as releases for the secured creditor in exchange for the funding of recoveries to other creditors and truncated claim administration procedures. Given the precedents (some of which are described in Attachment 1), this may be the most pragmatic alternative in many cases.

Structured dismissals may occur in various circumstances, including cases where the debtor's assets have been sold in the chapter 11 case but the debtor is administratively insolvent or potentially administratively insolvent, but does not have the means to fund the confirmation process, and in such case, the debtor may propose to pay a distribution – funded by the secured creditor's property- to general unsecured creditors, although higher priority claims may not be paid in full, and cases where the debtor has sold its assets and potentially could confirm a chapter 11 liquidating plan, but the proponents believe a structured dismissal is most appropriate to maximize the payout to unsecured creditors. In some cases, a committee pursuing possible claims against a secured creditor reaches a settlement with the creditor and the debtor, and obtains approval thereof under Rule 9019, which settlement establishes the exit strategy of the case (*e.g.*, a stipulated dismissal) and a liquidating trust or other mechanism to distribute the secured creditor's proceeds to other creditors.

A stipulated dismissal arrangement could increase the funds available for distribution to creditors other than the secured lenders, while reducing the administrative burden and costs (costs in connection with a chapter 11 liquidating plan or a chapter 7 liquidation) by closing cases more quickly and efficiently. On the other hand, in some cases, arguably, structured dismissals may sidestep important bankruptcy safeguards that are part of the traditional chapter 11 liquidating plan and chapter 7 conversion options, although, as noted, bells and whistles can be added to a stipulated dismissal order and prior notice thereof could be provided to all creditors and parties in interest. However, it could be argued that structured dismissals with extensive bells and whistles may amount to an impermissible *sub rosa* plan. *See, e.g., In re BT Tires Group Holding, LLC*, Case No. 09-11173 (CSS) (Bankr. D. Del. 2009) (US Trustee's objection to debtors'/committee's motion for stipulated dismissal providing for, *inter alia*, a GUC trust on basis that structured dismissal would be "a bare bones chapter 11 liquidating plan designed to get these cases closed without following the requirements of the Code" (docket no. 334); debtors were apparently administratively solvent; motion was ultimately denied without prejudice, and debtors later filed and got confirmed a liquidating plan).

V. Cash Collateral / DIP Financing Context

It is rather common practice for secured creditors to allow estate professionals a "carve-out" of their secured lien in a cash collateral or DIP financing order. Among other things, such carve-outs incentivize counsel and other professionals to continue to work in the debtor's case so as to maximize value for the bankruptcy estate, and consequently the value of the secured creditor's collateral.

In some cases, debtors, creditors' committees and secured lenders have negotiated, and courts have allowed, carve-outs to be used more broadly for purposes such as funding the payment of general unsecured creditors. Often times, however, additional measures will have to be taken to further implement the carve-outs provided for in the financing order, such as a subsequent settlement which, for example, authorizes the further distribution of the funds to unsecured creditors. *See, e.g., In re Wickes Holdings LLC*, Case No. 08-10212 (KJC) (Bankr. D. Del. March 28, 2008) (docket no. 513; final cash collateral/DIP order providing for carve-out of certain monies (proceeds of collateral) for funding a general unsecured claim trust account to be used to pay unsecured creditors pursuant to further orders; note that stipulated dismissal order was subsequently entered further implementing GUC trust).

VI. Committee's Fiduciary Duties

In negotiating, approving or otherwise dealing with gifting arrangements –whether in a plan or as part of a sale or other mechanism discussed herein– a creditors' committee will have to be cognizant of its fiduciary duties. The committee has a fiduciary duty to general unsecured creditors generally, and attendant thereto, a duty to maximize the recovery from the estate's assets for the benefit of such creditors. *See generally TSIC*, 393 B.R. at 78 (committee owes duty "to the class it represents *viz*., the general unsecured creditors of Debtor"). To reach that goal, it may be appropriate or reasonable for a creditors' committee to push for a gifting

arrangement, particularly where the secured creditors appear to be undersecured and without a settlement, unsecured creditors would very likely receive little or no residual value. *See, e.g., id.* (given the committee's fiduciary duty to unsecured creditors, "The Court is satisfied that the Committee's actions in achieving the Settlement [resulting in a trust for the benefit of unsecured creditors] were proper."); *World Health Alternatives*, 344 B.R. at 303 (case law acknowledging that creditors' committee owes duty to general unsecured creditors "recogniz[es] the implicit conflict of interest between general unsecured creditors and priority creditors"). *But see Iridium*, 478 F.3d at 466 ("The Committee has a fiduciary duty to maximize their recovery of the Estate's assets…. If in pursuit of that duty, it reaches a settlement that in some way impairs the rule of priorities, it must come before the bankruptcy court with specific and credible grounds to justify that deviation and the court must carefully articulate its reasons for approval of the agreement. That has not happened here.").

In some cases, that a gifting arrangement is the most viable alternative before a creditors' committee may be a black-and-white matter, although in other cases, what the committee should strive for may be a murkier situation. In any event, it is likely that the reviewing bankruptcy court would carefully scrutinize any gifting arrangement and the committee's role. *See, e.g., Iridium*, 478 F.3d at 466.

THE GARNER DOCTRINE

The Fifth Circuit in *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970), relying on trust law principles and other rationales, held that upon a showing of good cause, shareholders suing derivatively (in that case, against the corporation's directors/officers for fraud, securities law violations, and other counts) could override the corporation's attorney-client privilege.[2] Plaintiffs sought to depose the attorney who had represented the corporation at the time the questionable activities took place, and the production of various documents was also sought. The court held, where the corporation is in a suit against its shareholders on charges of acting inimically to shareholders' interests, protection of those interests, as well as those of the corporation and of the public, requires that the availability of the privilege be subject to the right of the stockholders to show cause why it should not be invoked in the particular instance. The court addressed this issue in a particularized context: where the party asserting the privilege is an entity which acts wholly or partly in the interests of others, and it is these others who seek access to the privileged communications; corporate management does not manage for itself but instead, has duties owed to shareholders.

The *Garner* court applied a test balancing the shareholders' needs for information against the corporation's need for confidentiality, setting forth a non-exclusive list of factors to be considered in determining whether shareholders have shown good cause: (i) the number of shareholders involved and the percentage of stock they represent; (ii) the bona fides of the shareholders; (iii) the nature of their claim and whether it is obviously colorable; (iv) the necessity or desirability of obtaining the information and its availability from other sources; (v) whether the alleged misconduct of the corporation was criminal, illegal but not criminal, or of doubtful legality; (vi) whether the communications related to past or to prospective actions; (vii) whether the communication is of advice concerning the litigation itself; (viii) whether the shareholders are "blindly fishing"; and (ix) the risk of revealing trade secrets or other confidential information that the corporation has an interest in keeping confidential for independent reasons.

The *Garner* doctrine (also referred to as the "fiduciary exception" to the attorney-client privilege by some courts) has been applied by various courts, and has been broadened by some courts to apply to various situations other than shareholder derivative actions – primarily on the basis that the attorney-client privilege should not be a shield when the adversary is one to whom a special duty is/was owed. *See, e.g., Grimes v. DSC Comm. Corp.*, 724 A.2d 561, 568 (Del. Ch. 1998) ("Delaware courts follow the approach outlined in *Garner*."); *Deutsch v. Cogan*, 580 A.2d 100 (Del. Ch. 1990) (extending *Garner* to situation where cashed-out minority shareholders of a subsidiary sought to abrogate attorney-client privilege of parent company's controlling shareholder in dispute over merger transaction that minority shareholders claimed was not fair); *Stenovich v. Wachtell, Lipton, Rosen & Katz*, 195 Misc.2d 99, 756 N.Y.S.2d 367 (N.Y. Sup. Ct. 2003); *Quintel Corp., N.V. v. Citibank, N.A.,* 567 F.Supp. 1357 (S.D.N.Y. 1983) (defendant bank acting as fiduciary for plaintiff in real estate transaction); *In re Teleglobe Communications*

[2] Most courts have held that the *Garner* doctrine does not apply to attorney work product. *See, e.g., Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, 244 F.R.D. 412, 423 (N.D. Ill. 2006) (citations omitted).

Corp., 493 F.3d 345 (3d Cir. 2007) (explaining that *Garner* may potentially be applicable in suit by debtors against controlling shareholder of debtors' corporate parent because once subsidiary became insolvent, its fiduciaries owed duty to subsidiaries' creditors, not its shareholders; remanded for further proceedings); *Geissal v. Moore Med. Corp*., 192 F.R.D. 620 (E.D. Mo. 2000) (ERISA plan administrators and beneficiaries); *In re Braniff, Inc*., 153 B.R. 941 (Bankr. M.D. Fla. 1993) (*Garner* doctrine could potentially have been extended to suit by debtor and creditors' committee against former officers/directors of debtor in respect to defendants' request for privileged documents; defendants, however, failed to show good cause); *RMED International, Inc. v. Sloan's Supermarkets, Inc*., 2003 U.S. Dist. LEXIS 71 (S.D.N.Y. Jan. 6, 2003) (*Garner* doctrine extended to federal securities class action). *But see, e.g., In re The Celotex Corp.*, 196 B.R. 596, 600 n.3 (Bankr. M.D. Fla. 1996) (without much explanation, not applying *Garner* to suit by certain creditors' committees for the benefit of debtor against certain insiders; "These types of shareholder derivative actions [as in *Garner*] are clearly distinguishable from the case at bar."); *Weil v. Investment/Indicators Research & Management, Inc*., 647 F.2d 18 (9th Cir. 1981) (refusing to apply *Garner* in direct shareholder action; "The *Garner* plaintiffs sought damages from other defendants on behalf of the corporation, whereas [plaintiff] seeks to recover damages from the corporation for herself and the members of the proposed class. *Garner*'s holding and policy rationales simply do not apply here.").

The *Garner* doctrine has been extended by some courts to committee's actions on behalf of the bankruptcy estate against the debtor. *See, e.g., Official Comm. of Asbestos Claimants of G-I Holding, Inc. v. Heyman* ("*G-I Holding*"), 342 B.R. 416, 425 (S.D.N.Y. 2006) (*Garner* doctrine applied in suit (alleging spin-off of debtor's subsidiary was fraudulent transfer and debtor's former CEO breached fiduciary duty owed to debtor and caused debtor to breach its fiduciary duty to creditors) brought by asbestos claimants committee (expressly authorized by the bankruptcy court to sue on behalf of the bankruptcy estate); "Because the *Garner* fiduciary exception has been extended to plaintiffs analogous to the Committee …, it is appropriate to apply the *Garner* exception and require [debtor] to produce its documents withheld on the basis of the attorney-client privilege."). *But see, e.g., Celotex*, 196 B.R. at 600 n.3.

Arguments can be made that the *Garner* doctrine should be applicable to such situations where a statutory committee, acting on behalf of or for the benefit of the estate, should be able to abrogate the debtor's attorney-client privilege in suits/proceedings against the debtor and/or its directors, officers and other insiders, because it is, in large measure, a stand-in for the estate. *See, e.g., G-I Holding*, 342 B.R. at 424 ("Here, the Committee contends that it represents G-I's entire bankruptcy estate because it seeks as successor to G-I corporate entity to enhance that estate by setting aside the [allegedly improper] transfers …, and because it is the beneficiary of the fiduciary duties owed by G-I's management, including [the defendant former CEO]."). *But see In re SPM Mfg. Corp.,* 984 F.2d 1305, 1315 (1st Cir. 1993) (creditors' committee is not a fiduciary for the debtor or estate as a whole, but instead for general unsecured creditors only; citations omitted). Or, the committee represents a material constituency (unsecured creditors) to which the applicable debtor's fiduciaries owed duties prepetition. That is, the *Garner* doctrine should be applied at least in situations where the suit involves acts/omissions and claims during the period the debtor was insolvent, and thus the focus of the directors'/officers' fiduciary duties had shifted so as to include the consideration of the entire corporate enterprise, including the interests of creditors. *See North American Catholic Educational Programming Foundation,*

Inc., v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) (upon insolvency, a company's creditors can prosecute derivative claims on behalf of company against directors for breach of fiduciary duty); *Teleglobe*, 493 F.3d 345 (*Garner* may potentially be applicable in suit by debtors against controlling shareholder because once subsidiary became insolvent, its fiduciaries owed duty to subsidiaries' creditors, not its shareholders).

On the other hand, the "good cause" test is arguably uncertain and unpredictable and, if extended to situations beyond shareholder derivative actions, may threaten to materially erode the corporate attorney-client privilege. *See generally Shirvani v. Capital Investing Corp*., 112 F.R.D. 389 (D. Conn. 1986) (refusing to apply *Garner* in securities fraud action; "clear-cut analysis and consistent application [of the 'good cause' test] remain elusive"; "a hasty resort to *Garner* concepts will confuse who corporate counsel's clients realistically are, and ignore the genuine need of management in the ordinary course for confidential communications and advice"; shareholders have "adequate disclosure rights under long-established limits to the attorney-client privilege in cases of demonstrable wrongdoing" such as when the communication furthered criminal or fraudulent conduct).

More specifically, in the bankruptcy context, the debtor in possession and the creditors' committee are distinct entities, and situations may arise where, while each claims it is acting for the best interest of the estate, the debtor and the creditors' committee may be on opposite sides of a dispute; and indeed in some cases it may be more beneficial overall to the estate if the subject communication remain privileged. Moreover, if the *Garner* doctrine were to be broadly applied in the bankruptcy context, properly privileged communications may be chilled between a financially distressed company and its counsel -both prepetition and postpetition. In short, broader application of *Garner* to bankruptcy cases could hinder corporate decision-making and communication prepetition and postpetition, to the detriment of the company and the bankruptcy estate.

ATTACHMENT 1

SAMPLE GIFTING CASES

Jurisdiction	Case Name	Gifting Mechanism	Approved?	Summary
FIRST CIRCUIT	*Official Unsecured Creditors' Committee v. Stern (In re SPM Mfg. Corp.),* 984 F.2d 1305 (1st Cir. 1993)	Pre-Plan Settlement	Y	Creditors' committee and secured creditor reached agreement to share proceeds of sale or other disposition of debtor's assets. Debtor's assets were sold under section 363, and case was converted to chapter 7. Secured creditor and committee filed motion to require delivery of sale proceeds, portion of which would be distributed per the prior agreement to general unsecured creditors ahead of priority tax creditors. "[T]he distribution scheme of section 726 (and, by implication, the priorities of section 507) does not come into play until all valid liens on the property are satisfied…. Because [bank]'s secured claim absorbed all of SPM's assets, there was nothing left for any other creditor in this case…. The Code does not govern the rights of creditors to transfer or receive nonestate property…. [C]reditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors." (internal citations omitted)
SECOND CIRCUIT	*In re DBSD N Am., Inc.,* 634 F.3d 79 (2d Cir. 2011)	Gifting Plan	N	Plan provided that holders of the second lien, who were undersecured, would "gift" part of their distribution in the form of new shares/warrants to a class of equity holders, although general unsecured creditors would receive stock for far less than their claims. Strictly interpreting the Bankruptcy Code, the Second Circuit found that this carve out gift, because it would be done under the plan and on account of the equity holders' existing equity position, violated the absolute priority rule and overturned the plan confirmation. It is a violation of the absolute priority rule if a junior party (i) receives property, (ii) under a plan, (iii) on account of its claim or interest over the dissenting vote of an intermediate class that has not been paid in full. "The Code extends the absolute priority rule to 'any property,' 11 U.S.C. § 1129(b)(2)(B)(ii), not 'any property not covered by a senior creditor's lien.' The Code focuses entirely on who 'receive[s]' or 'retain[s] the property 'under the plan … not on who *would* receive it under a liquidation plan. And it applies the rule to any distribution 'under the plan' on account of a junior interest … regardless of whether the distribution could have been made outside the plan, and regardless of whether other reasons might support the distribution in addition to the junior interest."
	In re Iridium Operating LLC, 478 F.3d 452 (2d Cir. 2007)	Pre-Plan Settlement	N (remanded)	Creditors' committee and secured creditors reached an agreement under which the committee would not challenge lenders' liens in exchange for a gift that would fund litigation against Motorola, an administrative claimant and the former parent of the debtor, and portions of any monies recovered from pending litigation with Motorola would be distributed to a litigation trust for the benefit of unsecured creditors and

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Jurisdiction	Case Name	Gifting Mechanism	Approved?	Summary
				therefore, would bypass administrative claims held by the parent. The Second Circuit noted that the *SPM* case was a chapter 7 case but stopped short of holding that *SPM* did not apply in chapter 11 cases. The Second Circuit refused to establish a *per se* rule prohibiting gifting under a pre-plan settlement, but established a high bar for allowing gifting in the settlement context. "[W]hether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and equitable' under Rule 9019. The court must be certain that parties to a settlement have not employed a settlement as a means to avoid the priority strictures of the Bankruptcy Code. In the Chapter 11 context, whether a settlement's distribution plan complies with the Bankruptcy Code's priority scheme will often be the dispositive factor. However, where the remaining factors weigh heavily in favor of approving a settlement, the bankruptcy court, in its discretion, could endorse a settlement that does not comply in some minor respects with the priority rule if the parties to the settlement justify, and the reviewing court clearly articulates the reasons for approving, a settlement that deviates from the priority rule." Remanded because "[t]he record does not explain, however, the Settlement's distribution of residual ILLLC funds to the Committee in violation of the absolute priority rule, and we will not speculate as to what reasons the Committee or the Lenders may offer for this deviation."
	In re Journal Register Co., 407 B.R. 520 (Bankr. S.D.N.Y. 2009)	Gifting Plan	Y	Confirmed chapter 11 plan provided an additional, selective gift from undersecured lender class to a subset of the unsecured creditor class (trade creditors). The absolute priority rule was not implicated because the intermediate class was paid in full. The Code's prohibition against unfair discrimination was implicated because the gift (made out of an account deemed not to be property of the debtors) was only available to a subset of general unsecured creditors (who would also have to give postpetition releases to the lenders). Court reasoned that there was no principle preventing the secured lenders from making this type of gift completely outside the plan and that on these facts, there was nothing inappropriate about making the distributions in the plan context ("the provisions of the Plan relating to the Trade Account Distribution are immaterial and do not cause it to be an inappropriate distribution 'under the Plan'").

Jurisdiction	Case Name	Gifting Mechanism	Approved?	Summary
	In re Harvey Electronics, Inc., Case No. 07-14051 (Bankr. S.D. N.Y. 2008) (motions, docket no. 95, 161; orders, docket nos. 106, 177)	Stipulated Dismissal, with earlier 9019 Settlement	Y	9019 settlement among debtor, committee and secured creditor was reached and approved, pursuant to which the secured creditor agreed to have GOB sale proceeds fund a GUC trust in exchange for a release. Dismissal later approved, providing for, among other things, committee's counsel to make certain distributions from GUC trust to unsecured creditors after dismissal; survival of all prior orders; and court's retention of jurisdiction in respect to implementation of any orders of the court. Because of the lower than expected sale proceeds, it does not appear that all administrative and priority creditors were paid in full.
	In re Levitz Home Furnishings, Inc., Case No. 05-45189 (Bankr. S.D. N.Y. 2008) (motion, docket nos. 1134; orders, docket nos. 514. 1167)	Stipulated Dismissal, with earlier 363 Sale Order	Y	Debtors, committee, and DIP lenders (one of which was the purchaser of debtors' assets) agreed to, as part of the section 363 sale order, the funding of a GUC trust with monies that would have otherwise gone to the DIP lenders (through the APA or otherwise). Subsequently, debtors and committee filed joint motion for dismissal of case and procedures for claims resolution and distribution of GUC trust funds to unsecured creditors; there were insufficient funds to pay off remaining DIP financing claims and thus no plan could be confirmed. Dismissal order entered , providing for GUC trustee to pay any UST fees and court's retention of jurisdiction in respect to final fee applications.
THIRD CIRCUIT	*In re Armstrong World Indus., Inc.* 432 F.3d 507 (3d Cir. 2005)	Gifting Plan	N	Proposed plan sought to gift new warrants to Class 12 equity holders, while senior classes of unsecured creditors were not being paid in full. The plan was designed such that if the Class 6 general unsecured creditors voted to reject the plan, the warrants would instead go to Class 7, comprised of certain tort claims, which would then automatically waive receipt of the warrants which would instead go to Class 12. The Third Circuit upheld the district court's decision to deny confirmation, reasoning that the *SPM*, *MCorp* and *Genesis Health* line of cases does "not stand for the unconditional proposition that creditors are generally free to do whatever they wish with the bankruptcy proceeds they receive. Creditors must also be guided by the statutory prohibitions of the absolute priority rule …." The *Armstrong* court distinguished the foregoing line of cases; in *Armstrong*, the gift was clearly property of the estate and not a carve-out of a secured creditor's distribution.
	In re LCI Holding Co., Inc., Case No. 12-13319 (KG) (Bankr. D. Del. 2013) (orders, docket no. 617, 690)	363 Sale & 9019 Settlement	Y	(1) Court approved 363 sale, as part of which the purchaser –an entity formed by the debtors' secured lenders– agreed to fund carve-outs for the payment of the debtors' and committee's professionals and case wind-down expenses. The US Trustee objected that, among other thing, the escrowed carve-outs should be shared with all administrative claimants and the case should be converted or dismissed. The debtors, committee and other interested parties argued that ample basis existed for 363 approval, and the escrowed carve-outs were not property of the estate and the purchaser was free to distribute such property as it saw fit, citing, for example, *TSIC*

Jurisdiction	Case Name	Gifting Mechanism	Approved?	Summary
				and *World Health Alternatives*. The sale order provided, among other things, the escrowed funds "shall not constitute property of the Debtors' estates." (2) Subsequent to the sale order, the committee entered into a 9019 settlement with the purchaser and secured lenders, whereby, among other things, purchaser would effectively release avoidance actions against unsecured creditors (purchased assets under the APA), and purchaser would provide a $2 million payment for the benefit of unsecured noteholders and $1.5 million for the benefit of other general unsecured creditors, as well as additional funds for Committee's professional fees; the secured lenders would subordinate their deficiency claims and waive any recovery from the $1.5 million fund. Committee argued that, again, non-estate property was at issue, and thus the proposed gifting was proper under *TSIC* and *World Health Alternatives*. The court approved the committee's motion over the US Trustee's and United States' objections.
	In re Nacirema Industries, Inc., Case No. 11-12339 (RG) (Bankr. D.N.J. 2012) (motion, docket no. 442; order, docket no. 464)	Stipulated Dismissal	Y	Following approval of section 363 sales, debtor and creditors' committee filed a joint motion for entry of a structured dismissal order and order authorizing sale of debtor's remaining assets to underesecured secured lender. Structured dismissal order included the following terms: (i) remaining assets sold to bank via credit bid and carve-outs; (ii) additional carve-out was approved and debtor was authorized to distribute money to pay tax claims and counsel fees in scheduled payments; (iii) other allowed claimholders (attached as exhibit and further supplemented by order) to receive pro rata distribution (no other creditors to receive any distribution); (iv) bank, debtor, committee and their counsel received full releases (with no exclusion for gross negligence and willful misconduct); (v) debtor authorized to abandon property; (vi) releases and other orders would survive dismissal and court would retain jurisdiction.
	In re Washington Mut., Inc., 442 B.R. 314 (Bankr. D. Del. 2011)	Gifting Plan	Y (but plan not confirmed for other reasons)	Disadvantaged class of holders of trust preferred shares objected to the plan on grounds that it provided for discriminatory treatment within the class of preferred shareholders, specifically that a certain subset of preferred shareholders (*i.e*., the REIT holders) received additional consideration from the secured creditor if they consented to a release of the secured creditor. The court found that to the extent that the REIT holders received more than other preferred shareholders, they received it directly from the secured creditor in exchange for a release. Citing *SPM* and *World Health Alternatives,* the court noted that a "secured creditor's gift to a junior creditor did not violate the absolute priority rule since the property belongs to the secured creditor and not the estate.'" Plan not confirmed for other reasons.

Jurisdiction	Case Name	Gifting Mechanism	Approved?	Summary
	In re G.I. Joe's Holding Corp., Case No. 09-10713 (KG) (Bankr. D. Del. 2011) (orders, docket nos. 753, 773 & 804))	Stipulated Dismissal, with earlier 9019 Settlement	Y	Following approval of section 363 sales, debtors, creditors' committee, and undersecured prepetition lenders entered into a global settlement. Debtors and committee filed a joint 9019 motion seeking approval of the settlement, as well as entry of a structured dismissal order. The motion was granted, and three orders ultimately entered. The first order approved the settlement and contained provisions similar to those in a structured dismissal order, including (i) prepetition lenders were released from prepetition and postpetition conduct, except for the obligations under the settlement, (ii) certain cash held by debtors was to be returned to lenders, and (iii) streamlined disbursement, claim objection/reconciliation and dismissal procedures, including payments to administrative claimants and for unsecured creditors out of a GUC trust (with an estimated 1% payout for GUCs), to be implemented prior to the dismissal of the case, were approved. Subsequently the court entered a supplemental settlement order authorizing, among other things, the scheduled creditor payments, and finally, the court entered a basic structured dismissal order providing that, notwithstanding section 349, all orders of the court would survive dismissal and the court would retain jurisdiction over all matters relating to the implementation of said orders.
	In re KB Toys, Inc., Case No. 08-13269 (Bankr. D. Del. 2010) (order on settlement, docket no. 914; dismissal order, docket no. 993)	Stipulated Dismissal, with 9019 Settlement	Y	Debtors initially moved for approval of GOB sales and use of cash collateral of undersecured lenders, and the creditors' committee objected. Parties reached a settlement and the GOB sales proceeded. Debtors and committee jointly moved under sections 349 and 1112(b) and Rule 9019 to approve a stipulation between debtors, committee and lenders, and streamlined procedures for reconciliation, resolution and allowance of stub rent and 503(b)(9) claims and the making of distributions to holders of those claims (generally, other than professional fee claims and UST fees, other priority and unsecured claimants would receive no distribution). Among other things, lenders agreed to a 506(c) surcharge for postpetition rent, and to contribute additional funding (including from sale proceeds) for the payment of 503(b)(9) claims and stub rent claims (approximately 57% and 75% recoveries, respectively), in exchange for, *inter alia*, releases of claims against the lenders. Parties argued that structured dismissal was preferable to a chapter 7 conversion because of greater recovery to creditors under the 9019 settlement and release of avoidance actions against creditors thereunder, which they would not otherwise receive. Court approved settlement and case was subsequently dismissed on certification of counsel after all resolved claims paid; court retained jurisdiction over all matters related to any order entered in the chapter 11 case.

Jurisdiction	Case Name	Gifting Mechanism	Approved?	Summary
	In re CFM U.S. Corp., Case No. 08-10668 (KJC) (Bankr. D. Del. 2009/2010) (motion, docket no. 1017; orders, docket nos. 1097, 1282)	Stipulated Dismissal, with earlier 9019 Settlement including Stay Relief	Modified	9019 settlement was reached among debtors, committee and undersecured creditor, whereby, among other things, committee's action against creditor was dismissed, mutual releases were given, and secured creditor agreed to have its cash collateral fund an account for benefit of general unsecured creditors, 503(b)(9) claimants and the committee's professionals. Citing *Armstrong*, US Trustee and IRS objected, arguing, among other things, the proposed gifting would violate the absolute priority rule by leaving other administrative and priority creditors unpaid, and the settlement constituted a *sub rosa* plan. Ultimately, debtors, committee and secured creditor agreed to a "Disbursing Agreement" pursuant to which payments would be made out of the gifted funds in accordance with Code's priority scheme. In exchange for gifted funds from secured creditor, secured creditor was also granted relief from automatic stay to foreclose upon, recover from, and setoff against its collateral and proceeds thereof, subject to terms of parties' stipulation. Subsequently, all claims were resolved and a final accounting was filed. Case dismissal was granted, providing for, among other things, survival of certain prior orders and court's retention of jurisdiction.
	In re NPPI Holdings, Inc., Case No. 09-11547 (PJW) (Bankr. D. Del. 2009) (motion, docket nos. 521, 526; orders, docket nos. 319, 568, 576, 612, 789)	Pre-plan Settlements, with related Conversion	N (modified)	Pursuant to prior settlements/stipulations (one approved under Rule 9019 and another approved without express reference to Rule 9019), certain secured lenders agreed to gift funding to a GUC trust. Subsequently, in connection with the debtors' conversion motion, the creditors' committee filed a motion seeking to establish the GUC trust, approval of the trust agreement, and approval of certain exculpation/releases. The GUC trust would proceed post-conversion and make distributions to unsecured creditors, while the chapter 7 trustee would address other case matters. The US Trustee objected to the GUC trust motion, arguing that it was a disguised plan bypassing chapter 11 plan requirements (including the payment in full of administrative/priority claims), it improperly sought estate representative designation for the GUC trustee, and it sought improper third party releases. Based on the court's stated inclination at the hearing to deny the GUC trust motion, the committee requested alternative relief to have it exist for a limited period subsequent to the conversion motion. The court denied the GUC trust motion, but granted the conversion motion. Under the court's order, in the chapter 7 proceeding, the committee –labeled as a "post-conversion committee"– would remain; however, the chapter 7 trustee's rights were reserved to assert that the escrowed GUC funds constituted property of the estate for distribution to all creditors, and not just general unsecured creditors. Ultimately, the post-conversion committee and chapter 7 trustee entered into a stipulation, deeming the escrowed funds to be contributed to the estates and after the transfer of these funds to the chapter 7 trustee, the trustee could use the funds in accordance with the priority scheme under section 726.

Jurisdiction	Case Name	Gifting Mechanism	Approved?	Summary
	In re TSIC, Inc., 393 B.R. 71 (Bankr. D. Del. 2008)	9019 Settlement, after 363 Sale	Y	After approval of the sale of debtor's assets to a third party stalking horse bidder, the court approved a Rule 9019 settlement in which the purchaser agreed with the creditors' committee to fund a trust account for the exclusive benefit of general unsecured creditors, in exchange for the committee not impeding the sale. The court stated: "Regardless of how one analyzes *Armstrong*, it is beyond cavil that *Armstrong* did not address a payment of property that did not belong to the estate by a non-creditor here the [purchaser], to a junior class outside of a plan of confirmation…. The [purchaser]'s funds are not proceeds from a secured creditor's lien, do not belong to the estate, and will not become part of the estate even if the Court does not approve the Settlement." Case is not a true gifting case in that a third party was providing value that would not otherwise have gone to it, like a secured creditor situation.
	In re World Health Alts., Inc. 344 B.R. 291 (Bankr. D. Del. 2006)	9019 Settlement	Y	Settlement agreement provided that secured creditor would carve out a payment for the benefit of the unsecured creditors (ahead of priority creditors) in exchange for creditors' committee not pursuing objection to sale motion and for release by estate. The U.S. Trustee objected to the settlement on the grounds that, among other things, the committee was not authorized to compromise estate claims at the expense of priority creditors. According to the court, "the payout to general unsecured creditors is a carve out of the secured creditor's lien and not estate property. I believe the Bankruptcy Code does not prohibit this arrangement and reported cases so hold…. [Further] Section 1129(b)(2)(B) and the absolute priority rule … are not implicated here because the settlement does not arise in the context of a plan of reorganization." The court distinguished *Armstrong*, further stating that *Armstrong* adopted reasoning that acknowledged the propriety of this type of ordinary carve out.
	In re Genesis Health Ventures Inc., 266 B.R. 591 (Bankr. D. Del. 2001)	Gifting Plan	Y	Chapter 11 plan confirmed in which undersecured lenders gifted portions of their recovery (new common stock and new warrants) to some, but not all, unsecured creditor classes and to certain key management employees. The court found that the plan did not run afoul of the unfair discrimination rule or the absolute priority rule because, *inter alia*, the objecting parties were to get at least as much as they would have in the absence of gifting. "[E]ven if the … Senior Lenders … receive all of the debt and equity distributed under the debtor's plan, the claims of the Senior Lenders would not be satisfied in full. The Senior Lenders have agreed to share the distributions that they would otherwise be entitled to only with [certain] classes …, and have chosen to omit [certain] claimants from the agreement. Notwithstanding the resulting difference in the treatment of [such] claimants from the treatment of unsecured claimants otherwise, there is no impediment to the agreement."

Jurisdiction	Case Name	Gifting Mechanism	Approved?	Summary
FOURTH CIRCUIT	*In re On-Site Sourcing, LLC*, 412 B.R. 817 (Bankr. E.D. Va. 2009)	363 Sale	N (modified)	Court approved section 363 sale of debtor's assets to secured lender but ordered removal of gift provision (including a gift of $132,000 to an unsecured creditors trust), holding, among other things, such provision and related release provisions would constitute a *sub rosa* plan and approval thereof would deprive administrative and priority creditors of rights under sections 1129, among other plan related provisions. "In fact, the proceeds from the sale of property of the estate are property of the estate…. [Further] [t]he general unsecured creditors trust provision is contrary to the scheme of distribution envisioned in both a chapter 7 and chapter 11 liquidation."
FIFTH CIRCUIT	*In re Bag Liquidation, Ltd*., Case No. 08-32096 (Bankr. N.D. Tex. 2009) (motions, docket nos. 287 & 672; orders, docket nos. 660, 688)	Stipulated Dismissal (with earlier 9019 settlement)	Y	After debtors' sale of substantially all their assets, court approved structured dismissal upon debtors' and committee's joint motion, including approval of payment of administrative claims, UST fees, and unsecured claims (an expected 2.1% recovery) as scheduled by debtor. Secured creditor had previously agreed to reduce claim and such claim was previously paid; as part of prior 9019 settlement, lender agreed to fund a GUC trust from proceeds of its collateral in exchange for release. Final fee application order entered after the effective date of case dismissal.
	In re OCA, Inc., 357 B.R. 72 (Bankr. E.D. La. 2006)	Gifting Plan	N	Senior secured creditor waived its right to receive new common stock in favor of existing equity holders for agreeing not to raise objections to the plan. The plan, however, failed to provide for any interest for general unsecured claims, and thus they would not be paid in full. Approving of the Third Circuit's Armstrong decision, the court held the plan violated the absolute priority rule. "Although this court agrees with the proposition that a creditor receiving a distribution from an estate may do whatever it likes with the money it receives *after* distribution, the court finds it troublesome when the creditor purports to share with other creditors or equity, over the objection of an intermediate class, through the mechanism of a plan in a Chapter 11 that this court is called upon to confirm." Court also rejected new value argument.
	In re Sentry Operating Co., 264 B.R. 850 (Bankr. S.D. Tex. 2001)	Gifting Plan	N	The plan discriminated unfairly between two classes of unsecured creditors where it provided for a disproportionate payout (using undersecured creditor's cash collateral) in favor of trade creditors over other unsecured creditors. "Creditors with claims of equal rank are entitled to equal distribution…. To accept [lender]'s argument that a secured lender can, without any reference to fairness, decide which creditors get paid and how much …, is to reject the historical foundation of equity receiverships and to read the section 1129(b) requirements out of the Code." The court distinguished the facts from *MCorp* because purportedly the issue there did not involve payments under a plan, but rather an approval of a settlement (albeit through confirmation of a plan). The court explained that a plan may be presumptively

Jurisdiction	Case Name	Gifting Mechanism	Approved?	Summary
				subject to denial on the basis of unfair discrimination even though it provides fair and equitable treatment for all classes when there is (i) a dissenting class; (ii) another class of same priority; and (iii) a difference in the plan's treatment in either (a) a materially lower percentage recovery for the dissenting class, or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution. This presumption of denial based on different recoveries can be overcome by showing that: (1) a lower recovery for the dissenting class is consistent with the results that would obtain outside of bankruptcy, or (2) a greater recovery for the other class is offset by contributions from that class to the reorganization.
	In re MCorp Fin., Inc., 160 B.R. 941 (S.D. Tex. 1993)	Gifting Plan	Y	Chapter 11 plan confirmed in which senior unsecured bondholders bypassed junior bondholders to convey a gift to a class comprised of the FDIC in order to settle ongoing litigation between debtor and FDIC. "[T]he FDIC is paid by the [senior bondholders] out of their higher-priority share. The [senior bondholders] may share their proceeds with creditors junior to the [junior bondholders], as long as the [junior bondholders] continue to receive as [sic] least as much as what they would without the sharing."
SIXTH CIRCUIT	*In re Dawahare's of Lexington, LLC*, Case No. 08-51381 (JMS) (Bankr. E.D. Ky. 2008) (motions, docket nos. 192, 304; orders, docket nos. 224, 316)	Stipulated Dismissal, with earlier 9019 settlement	Y	9019 settlement was reached by debtor, committee and lender, whereby, among other things, lender allowed cash collateral to fund a GUC account and avoidance actions against unsecured creditors were waived, while claims against lender were waived and committee agreed to withdraw sale objection and conversion motion. Pursuant to the settlement's terms, dismissal of case was later granted, which included provisions for all case orders to survive dismissal; release by creditors of estate, debtor's counsel, committee and its counsel; exculpation for debtor, committee and its professionals and employees; and court's retention of jurisdiction with respect to dismissal and distribution orders.
	In re Snyders Drug Stores, Inc., 307 B.R. 889 (Bankr. N.D. Ohio 2004)	Gifting Plan	N	Under proposed plan, secured creditor agreed to allow funds to be used to pay reclamation claimants and trade/other creditors with whom reorganized debtor hoped to continue business relations. Court held the plan unfairly discriminated against landlords holding lease rejection claims. "The distribution specifically includes recoveries from preserved litigation claims, including avoidance actions. This is property of the estates…. The distribution must, therefore, be made in accordance with the bankruptcy code." Among other things, there was no evidence suggesting that the favored classes would refuse to deal with reorganized debtor absent preferential payments. As such, the plan was not "reasonably tailored to foster only those relationships that [were] critical to the success of the reorganized debtor."

Jurisdiction	Case Name	Gifting Mechanism	Approved?	Summary
SEVENTH CIRCUIT	*In re Holly Marine Towing Inc*., 669 F.3d 796 (7th Cir. 2012)	9019 Settlement	Y	In this chapter 7 case, court approved settlement whereby nondebtor parties (debtor's principals) who had alleged competing interests in real property, with the debtor, agreed to give portion of sale proceeds they had received to fund payment to debtor's attorneys. "The record reflects a careful consideration by the bankruptcy court of all the competing interests involved in the sale of the Ewing property. Holly Marine was not the only party to claim an ownership interest; Headland and Dawson also had competing claims to that property which surfaced as part of the marital dissolution. And the $65,000 payout to Bauch was taken from both Dawson's and Headland's individual $229,126.09 interest in the Ewing property…. Because the funds paid to Bauch were never assets of the estate, the priority scheme simply does not apply."
EIGHTH CIRCUIT	*In re Union Fin. Services Group, Inc*., 303 B.R. 390 (Bankr. E.D. Mo. 2003)	Gifting Plan	Y	Citing *SPM* and other cases, court approved payment of critical business claims, allowed utilities claims and *de minimis* claims that would be made from funds earmarked and assigned by the senior secured lenders and DIP lenders; this was a matter of separate negotiation and contract between and among the senior secured lenders and those parties. "There is no unfair discrimination in a Plan provision that allows the Senior Secured Lenders and the DIP Lenders voluntarily to assign to unsecured creditors cash collateral proceeds that otherwise would rightfully belong to the secured creditors, particularly in the context of a reorganization where continued relations with those unsecured creditors are important to future business of the reorganized Debtors."
NINTH CIRCUIT	*In re Protocol Servs., Inc.,* 2005 Bankr. LEXIS 3191 (Bankr. S.D. Cal. Dec. 23, 2005)	Gifting Plan	Y	The plan proposed to distribute equity in the reorganized debtor: 58% to senior secured lender and remainder to unsecured noteholders. Secured lender's lien was secured by substantially all of the debtors' assets. Relying on *SPM,* the court found that the secured lender had a right to agree to a carve-out from the collateral securing its lien. Thus, the plan distributions to the unsecured noteholders were proper.

Commentary:

The Supreme Court's held 6-3 that lawyers may not be compensated for successfully defending fee applications. According to Justice Thomas, Section 330 does not explicitly abrogate the American Rule, which evidently has the same status as a statute.

High Court Denies Compensation for Defending Fees in Bankruptcy

The U.S. Supreme Court ruled that attorneys can't be paid for defending their fee requests in a bankruptcy case because the Bankruptcy Code ``does not explicitly overrule the American Rule," which requires each side to pay its own lawyers.

Writing for himself and four other justices, Justice Clarence Thomas said on June 15 the American Rule is a ``bedrock principle" to be employed ``unless a statute or contract provides otherwise."

Justice Sonia Sotomayor reached the same result in a short concurring opinion, saying there is no ``textual" support for shifting the burden of fees to the bankrupt company.

Justice Stephen G. Breyer dissented, in an opinion joined by Justices Ruth Bader Ginsburg and Elena Kagan.

The dissenters criticized the majority for requiring the statute to explicitly overrule the American Rule. They said an earlier high court decision on fee shifting had no such requirement.

The appeal arose from the Chapter 11 reorganization of Asarco LLC. Two Texas firms represented the company in successfully prosecuting a fraudulent-transfer suit worth $7 billion to $10 billion against the metal producer's Mexican owner, Grupo Mexico SAB. As a result of the victory, all creditors were paid in full.

Base Compensation

The bankruptcy judge awarded $113 million in fees to Houston-based Baker Botts LLP and $7 million to Corpus Christi-based Jordan, Hyden, Womble, Culbreth & Holzer PC as their base compensation.

The bankruptcy court also granted bonuses of $4.1 million and $125,000 to the firms and gave them $5 million and $15,000, respectively, in reimbursement for successfully defending their fee requests from attack by Grupo Mexico.

That money, like their other fees, would come from the Asarco bankruptcy estate.

The U.S. Court of Appeals in New Orleans ruled categorically in April 2014 that bankruptcy lawyers can never be paid for defending their fee requests unless opposition was mounted in bad faith. Thomas upheld that result.

Thomas cited Section 330(a)(1) of the Bankruptcy Code, which allows ``reasonable compensation for actual and necessary" expenses. He said that provision ``neither specifically nor explicitly authorizes courts to shift the costs" from one side to the other.

'Disinterested Service'

The dissenters said the statute does allow fee shifting on the theory that defense of compensation is among the underlying services that bankruptcy courts are allowed to pay. Thomas said time spent defending fees was not a ``disinterested service" performed in the administration of the bankruptcy.

The government side with the law firms, contending that defense fees must be paid so compensation for other services isn't diluted.

During oral argument in February, Sotomayor observed on two occasions that defending fees benefits only the lawyer, not the bankrupt estate. Kagan tipped her hand by saying defense costs are merely one aspect of what's a ``reasonable" fee permitted by Section 330 of the Bankruptcy Code. Similarly,

Ginsburg said she saw no difference between seeking fees in the first place and defending fees later.

Scalia said at oral argument that a law firm that sues for its fees outside of bankruptcy pays its own costs of collection under the American Rule.

The case is Baker Botts LLP v. Asarco LLC, 14-103, U.S. Supreme Court (Washington).

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FREQUENTLY ASKED QUESTIONS (FAQS) – PROFESSIONAL COMPENSATION

The United States Trustee Program is prohibited from providing legal advice to private individuals. These questions and answers relate to general circumstances involving bankruptcy.

Questions

1. After *ASARCO*, will the USTP object to defense fees incurred after an objection has been filed in court?
2. Will the USTP rely on *ASARCO* to object to fees incurred in preparing a fee application?
3. After *ASARCO*, will the USTP object to defense fees incurred negotiating or explaining fee applications *before an objection is filed in court?*
4. Will the USTP object to professionals seeking a pre-approved term of employment that permits the payment of fees-on-fees otherwise disallowed by *ASARCO*?
5. Will the USTP object if a professional seeks a higher rate or enhanced compensation, *i.e.*, a bankruptcy premium, than that charged for comparable non-bankruptcy engagements based on the purported risk of non-payment for future fee litigation and resulting dilution of its bankruptcy compensation?
6. How will the USTP handle pending cases with requests for fees incurred in defending fee applications?
7. Will the USTP continue to object to billing for the preparation of invoices submitted in support of a fee application?
8. Will the USTP object to non-legal professionals seeking the reimbursement of legal fees for defending objections to fee applications?

Answers

1. **After *ASARCO*, will the USTP object to defense fees incurred after an objection has been filed in court?**

   A: Yes. The Supreme Court ruled that attorneys' fees for defending objections to applications for compensation ("defense fees" or "fees-on-fees") are *per se* prohibited because section 330 does not expressly alter the American Rule against fee shifting. *See generally Baker Botts LLP v. ASARCO LLC*, 135 S. Ct. 2158, 2167 (2015). Although the U.S. Trustee Fee Guidelines for Attorneys in Larger Chapter 11 cases ("LCFG") state that billing the estate for defending fee applications is "generally inappropriate" unless the defense fees fall "within a judicial exception applicable within the [judicial] district," LCFG, B.2.g., there are no applicable judicial exceptions after *ASARCO*.

2. **Will the USTP rely on *ASARCO* to object to fees incurred in preparing a fee application?**

   A: No. The Court in *ASARCO* did not disallow reasonable compensation for preparing a fee application and noted that "preparation of a fee application is best understood as a 'servic[e] rendered' to the estate administrator under § 330(a)(1)." 135 S. Ct. at 2167. Thus, reasonable charges for preparing interim and final fee applications are compensable because section 330(a)(1) allows them, and section 330(a)(6) requires that the compensation for the fee application be reasonable in relation to the level and skill required to prepare it. *See* also LCFG, B.2.f. (preparation of a fee application is not required for lawyers practicing in areas other than bankruptcy as a condition to getting paid).

3. **After *ASARCO*, will the USTP object to defense fees incurred negotiating or explaining fee applications *before an objection is filed in court?***

   A: Generally no, but it depends on the facts and circumstances of each case. Work that is an extension of fee application preparation will not generally be objectionable. Thus, good faith

communications and negotiations regarding a well-prepared fee application may be considered an extension of fee application preparation. But patently poor and deficient fee applications that elicit extensive inquiries or negotiations and require extensive amendment may not be considered part of the fee application preparation. For example, fees related to repeated billing errors, such as vague descriptions or block-billing, will draw an objection. In the absence of further court guidance post-*ASARCO*, the USTP will consider many factors in determining whether such defense fees appear to be for the professional's benefit or for the client's and, therefore, objectionable or not. The USTP's goal is to apply *ASARCO* faithfully, while encouraging sound billing practices and professional cooperation and compliance short of litigation, where possible.

4. **Will the USTP object to professionals seeking a pre-approved term of employment that permits the payment of fees-on-fees otherwise disallowed by *ASARCO*?**

   A: Yes. Professionals' employment and compensation rights in bankruptcy arise by statute. *ASARCO's* analysis is relevant to all Bankruptcy Code sections dealing with employment and compensation. First, section 328 permits a professional to seek court approval for any reasonable terms and conditions of employment. But section 328, like section 330, does not contain explicit statutory authority for deviating from the American Rule against fee-shifting. Second, section 328 terms must both relate to the scope of the professional's employment and be reasonable. Paying fees-on-fees is neither a term of employment nor is it reasonable for the estate to pay for work that is not a client service. Third, section 330(a)(1) governs the award of compensation, subject to sections 326, 328, and 329, and *ASARCO* expressly precludes an award of fees-on-fees under section 330(a)(1). (A section 330 award is what gives the professional an administrative claim against estate assets under section 503(b)(2)).

   In addition, estate-paid professionals cannot by consent or contract create an exception to pay what the Code does not allow. *See In re Lehman Bros. Holdings, Inc.*, 508 B.R. 283, 294 (S.D.N.Y. 2014). The Code, through sections 326-331 and 503, regulates both professional compensation and administrative expenses paid from the estate in a comprehensive way that parties are not free to rewrite. *See id.* Thus, fees cannot be shifted by a contract that violates a statute, and the USTP will generally object to efforts to pay fees-on-fees in circumvention of *ASARCO*.

5. **Will the USTP object if a professional seeks a higher rate or enhanced compensation, *i.e.*, a bankruptcy premium, than that charged for comparable non-bankruptcy engagements based on the purported risk of non-payment for future fee litigation and resulting dilution of its bankruptcy compensation?**

   A: Yes. The Court in *ASARCO* considered—and rejected—the idea of bankruptcy premiums or enhancements based on the risk of "dilution." "In our legal system, no attorneys, regardless of whether they practice in bankruptcy, are entitled to receive fees for fee-defense litigation absent express statutory authorization. Requiring bankruptcy attorneys to pay for the defense of their fees thus will not result in any disparity between bankruptcy and nonbankruptcy lawyers." *ASARCO*, 135 S. Ct. at 2168. This analysis is consistent with section 330(a)(3)'s standard that a bankruptcy practitioner's reasonable compensation is what is customary and comparable to a non-bankruptcy practitioner's, i.e., market rates and billing practices. See 11 U.S.C. § 330 (a)(3)(F). To the extent the Fifth Circuit suggested otherwise in its earlier *ASARCO* decision, 751 F.2d 291 (5th Cir. 2014), the Supreme Court disagreed.

   Moreover, dilution risk is minimal. *ASARCO* is an exceedingly rare case for many reasons. First, *ASARCO* involved the very unusual circumstance where management of the reorganized debtor was again controlled by the parent upon confirmation. Post-confirmation management was uniquely motivated to be hostile to debtor's bankruptcy counsel because bankruptcy counsel had represented the debtor in obtaining an extraordinarily large judgment against the parent during the bankruptcy—and any reduction in fees would have been a dollar-for-dollar economic benefit to the parent. Second, the

fee defense costs were $5 million, reflecting again the very unusual nature of the case. Third, in many cases, the USTP is the only party that objects to a fee application. *See In re Busy Beaver Building Centers, Inc.*, 19 F.3d 833 (3rd Cir. 1994). Finally, because an objecting party must pay its own attorneys' fees to pursue fee objections, this should discourage frivolous objections. And to the extent there are bad faith or frivolous fee objections, the Court noted that a bankruptcy professional can avail itself of Rule 9011 sanctions. 135 S. Ct. at 2168, n.4.

6. **How will the USTP handle pending cases with requests for fees incurred in defending fee applications?**

   A: Any newly filed interim application and any final application containing a request for defense fees *for the first time* should be reviewed under the standards discussed above. That is, if the fees-on-fees resulted from fee litigation, an objection is generally appropriate. If no fee objection was ever filed, then whether the fees-on-fees are objectionable depends on the facts and circumstances of the case.

   If fees-on-fees have been previously awarded on an interim application that would have been disallowed under *ASARCO's* ruling, the USTP should determine whether an objection at the final application stage is advisable based on controlling law within the jurisdiction.

7. **Will the USTP continue to object to billing for the preparation of invoices submitted in support of a fee application?**

   A: Yes. There is no statutory authorization to shift fees for preparing invoices (as opposed to fee applications) to the estate, and the Court in *ASARCO* did not rule otherwise.

   As explained in the LCFG, "routine billing activities . . . typically are not compensable outside of bankruptcy. Most are not compensable because professionals do not charge a client for preparing invoices, even if detailed. Reasonable charges for preparing interim and final fee applications, however, are compensable, because the preparation of a fee application is not required for lawyers practicing in areas other than bankruptcy as a condition to getting paid." LCFG, B.2.f. This rationale applies to all cases, including those not subject to the LCFG.

8. **Will the USTP object to non-legal professionals seeking the reimbursement of legal fees for defending objections to fee applications?**

   A: Yes, using standards analogous to those discussed above that apply to attorneys seeking compensation for fee defense work. Regardless of whether the fee defense request is made by a legal or financial professional, the result must be the same based on *ASARCO*: A professional's legal fees for litigating fee objections cannot be paid. Non-lawyer professionals, such as financial advisors, are entitled to no better and no worse treatment than lawyers with respect to legal fees for defending objections to fee applications in a bankruptcy case.

   Because legal fees for defending fee application objections cannot be paid as compensation under section 330(a)(1)(A), those same legal fees cannot be reimbursed as expenses under section 330(a)(1)(B). Section 330(a)(1)(B) allows the award of "necessary" expenses. But those expenses must relate and be incident to the work for which the professional can be compensated under section 330(a)(1)(A). Otherwise, in *ASARCO*, Baker Botts need only have retained outside counsel to defend its fee applications and expensed the legal fees for reimbursement rather than seek compensation for them.

Updated September 25, 2015

AMERICAN BANKRUPTCY INSTITUTE

Structured Dismissals: A New Way Out

- The Third Circuit in Jevic describes structured dismissals as "simply dismissals that are preceded by other orders of the bankruptcy court . . . that remain in effect after dismissal."
  - Such orders may address or approve:
    - Settlement agreements;
    - Distributions of estate assets (particularly sale proceeds);
    - Third-party release provisions;
    - Carve-out "gift" trusts for lower priority creditors;
    - Survival of court orders after dismissal; and
    - Retention of the court's jurisdiction over the case after dismissal

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Structured Dismissals: A Solution?

- Structured dismissals are increasingly common due in large part to the rise in section 363 sales of substantially all assets.
  - Particularly so when the liquidating debtor has *de minimis* funds to distribute to creditors
    - Structured dismissals facilitate negotiation and settlement where otherwise the case might spiral into costly liquidation
- Considered a "less worse" alternative to outright dismissal:
  - Structured dismissals can provide for a structured settlement where
    - (1) a Chapter 7 conversion would be unduly expensive/litigious, and
    - (2) a liquidating plan would be impractical, such as when the debtor is administratively insolvent
- Structured dismissals can provide junior creditors with limited recovery in situations where, if the case were converted to Chapter 7, they would recover nothing. (*See, e.g.,* Jevic)

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Structured Dismissals: Authorized Under the Code?

- Under section 305(a) the court may dismiss a case, after notice and a hearing, if "the interests of creditors and the debtor would be better served by such dismissal."
- Courts may dismiss cases "for cause" upon a motion from a party in interest under section 1112(b).
  - "For cause" for purposes of this subsection includes:
    - (A) "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation" and
    - (M) "inability to effectuate substantial consummation of a confirmed plan"
- Courts also rely on section 105, which affords courts broad discretion to issue any order "necessary or appropriate to carry out the provisions of this title," for support in ordering structured dismissals.
- While the Code does not expressly authorize structured dismissals, the Third Circuit in Jevic noted that section 349 explicitly authorizes courts to alter the effect of dismissal "for cause."
- Some courts and commentators, including the ABI Reform Commission, however, are disconcerted by the lack of an express statutory mandate. They are concerned that structured dismissals could be used to "short-circuit" certain protections the Code affords creditors such as the absolute priority rule and the disclosure/soliciting provisions of confirmation.

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Leading Case: Jevic

- In 2006, a subsidiary of Sun Capital Partners ("Sun") acquired Jevic Transportation, Inc. ("Jevic"), a New Jersey trucking company, in a leveraged buyout. CIT Group ("CIT") led the financing.
- On May 19, 2008, Jevic ceased operations and notified its employees that they were being terminated. The company filed for Chapter 11 in Delaware the next day.
  - Jevic owed approximately $53 million to Sun and CIT, which both held first-priority liens on substantially all of Jevic's assets.
- Two adversary proceedings were filed during the pendency of the case:
  - (1) Former Jevic truck drivers (the "Drivers") filed a class action against Jevic and Sun alleging violations of the Worker Adjustment and Retraining Notification Act, which require sixty day written notice before termination.
    - The bankruptcy court ruled that Jevic (but not Sun) was subject to a claim of $12.4 million, $8.3 million of which could be classified as employee wage claims afforded special priority under section 507(a)(4).
  - (2) The Official Committee of Unsecured Creditors (the "Committee") brought a fraudulent conveyance action against Sun and CIT on behalf of the estate.

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Leading Case: Jevic

- In March 2012, Jevic, CIT, Sun, the Committee and the Drivers met to discuss a possible settlement of the fraudulent conveyance action.
  - At the time, Jevic's assets had been reduced to only $1.7 million in cash, all of which was subject to Sun's first-priority lien.
- Jevic, CIT, Sun, and the Committee (but not the Drivers) negotiated a settlement pursuant to which:
  - the settling parties would provide mutual releases and the fraudulent conveyance action would be dismissed;
  - CIT would pay $2 million to cover the company's and Committee's legal fees and administrative expenses;
  - Sun would assign its first-priority lien to a trust, which would pay tax and administrative claimants first and general unsecured creditors second on a *pro rata* basis; and
  - Jevic's Chapter 11 case would be dismissed.
- The settlement did not include any provision or consideration for the Drivers.

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Leading Case: Jevic

- The Drivers and the U.S. Trustee objected to the settlement agreement, arguing that because the settlement excluded the Drivers but made distributions to unsecured creditors it violated the absolute priority rule.
- The U.S. Trustee also contended that structured dismissals are not permitted under the Bankruptcy Code.
- The Bankruptcy Court overruled both objections and approved the settlement.
  - The court acknowledged that the Code does not expressly authorize structured dismissals, but found that the relief was justified by dint of the "dire circumstances" present in the case.
    - There was "no prospect of a confirmable Chapter 11 plan" and conversion to Chapter 7 was not a viable option because the trustee would lack the resources necessary to fund the case.
  - The court rejected the Trustee's and Drivers' argument that the court could not approve the settlement because it violated the absolute priority rule, explaining that the Code's priority scheme does not extend to settlements.

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Leading Case: Jevic

- The Drivers and U.S. Trustee appealed to the District Court, which affirmed the Bankruptcy Court's decision. The Drivers and U.S. Trustee appealed to the Third Circuit.
- The Third Circuit addressed two issues: (1) whether a structured dismissal is permissible under the Bankruptcy Code; and (2) if so, whether a settlement in the context of a structured dismissal must follow the absolute priority rule.
  - As to (1), the Third Circuit explained that while section 349 "contemplates that dismissal will typically reinstate[] the pre-petition state of affairs … it also explicitly authorizes the bankruptcy court to alter the effect of dismissal 'for cause'—in other words, the Code does not strictly require dismissal of a Chapter 11 case to be a hard reset."
    - The Third Circuit highlighted that even the Drivers acknowledged that both a liquidating plan and Chapter 7 were not viable options.
  - Accordingly, it held, "absent a showing that the structured dismissal has been contrived to evade the procedural protections of the plan confirmation or conversion process, a bankruptcy court has discretion" to order a structured dismissal.
  - As to (2), the Third Circuit adopted the Second Circuit's Iridium standard, a multi-factored approach in which the most important factor is that a settlement be "fair and equitable" but under which a noncompliant settlement could be approved if "the remaining factors weighed heavily in favor" of approving a settlement.

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Recent Case: Endeavour

- Endeavour Operating Corporation, an oil-and-gas company, filed for Chapter 11 protection in October 2014. The company planned a debt-for-equity swap with noteholders that would reduce their liabilities by 50%
- But in February, as the company was nearing confirmation of its prearranged plan, it requested a delay to reassess its assumptions in light of plummeting oil prices.
- The company then undertook a series of asset sales, leading into September, when it sought an order for a structured dismissal over the objections of unsecured creditors.
- At the September 2015 hearing regarding the proposed structured dismissal, the court expressed its reluctance to order a structured dismissal over the objections of the unsecured creditors, noting that structured dismissals are "almost exclusively" consensual transactions.
- But in October, upon learning that the company had struck a deal with the unsecured creditors that would allow them to recover $3.2 million from the estate, the court agreed to approve the structured dismissal, dubbing it "an exercise in pain allocation."

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Questions

- Would / should a court ever order a structured dismissal over the objections of a junior creditor when that creditor contends conversion to Chapter 7 is feasible?
  - What if the objection appeared to be a holdout strategy (i.e., there was no chance at recovery in Chapter 7)?
- Is a structured dismissal necessarily an exit route of last resort? Or could negotiated, consensual structured dismissals take the place of Chapter 7 liquidations even where conversion is practicable?
- Would / should a court ever propose a structured dismissal in lieu of a traditional, outright dismissal? (Section 105 would appear to allow for it.) Or should this exit strategy be proposed only by parties in interest?

(d) QUESTIONS/JUDGES INPUT:

- Would / should a court ever order a structured dismissal over the objections of a junior creditor when that creditor contends conversion to Chapter 7 is feasible?
- What if the objection appeared to be a holdout strategy (i.e., there was no chance at recovery in Chapter 7)?
- Is a structured dismissal necessarily an exit route of last resort? Or could negotiated, consensual structured dismissals take the place of Chapter 7 liquidations even where conversion is practicable?
- Would / should a court ever propose a structured dismissal in lieu of a traditional, outright dismissal? (Section 105 would appear to allow for it. Or should this exit strategy be proposed only by parties in interest?
- ABI Commission's views on structured dismissals.
- ABI Task Force input
- Show of hands if you think the framework of the Jevic settlement is a good approach to exiting a case? Is it permissible under the Code?

4. Other Creative Exit Strategies **(S. Levine)**

(a) Overview of alternative Exit Strategies

(b) ICL Holding Case: background, facts and ruling

(e) QUESTIONS/JUDGES INPUT:

- What structure or structuring tips might help defeat an objection?
- Did it help in ICL that the objector was the IRS as opposed to multiple objectors or perhaps more sympathetic objectors (employees, other administrative creditors - like those extending post-petition credit or services)?

5. Combined Plans & Disclosure Statements & Other Exits **(J. Hagle)**

(a) Overview of alternative Exit Strategies

(b) Corinthian Colleges Case: background, facts and ruling

(c) QUESTIONS/JUDGES INPUT:

- How much of a statutory stretch do you think it is to apply Section 1125(f) to large chapter 11 cases? Do you think this was what Congress intended?
- What kind of cases/situations lend themselves best to exit via a combined plan and disclosure statement? Do you think there is a distinction between liquidating/asset sale exits vs. restructurings?
- What do you see as the risks associated with going the combined plan/disclosure statement route? In your experience, have you ever seen the attempt fail, i.e. sent the parties back to the drawing board to start the disclosure process over again?
- What do you see as the benefit from the combined plan/disclosure statement approach.

6. Proposed Local Rule 3017-2 **(D.Pacitti/Judges)**

(a) Overview of the Rule

(b) QUESTIONS/JUDGES INPUT:

- Show of hands if you think the new proposed rule is a good idea.
- Should the rule be expanded to non- 363 sale cases?

***In re ICL Holding Company, Inc.*, No. 14-2709, 2015 WL 5315604 (3d Cir. Sept. 14, 2015), *aff'g sub nom United States v. LCI Holding Co., Inc.*, Nos. 13-924 (SLR), 13-1188 (SLR), 2014 WL 975145 (D. Del. March 10, 2014)**

- The Third Circuit found that the District Court and Bankruptcy Court did not err when it approved a sale of substantially all of the assets of ICL Holding Company, Inc. and its affiliated debtors (the "*Debtors*") and a settlement between the purchaser (the Debtors' prepetition senior lender), the official committee of unsecured creditors, and the Debtors that provided that following and as part of the senior secured lender's credit bid it directly paid through an escrow, among other things, certain professional fees and expenses of professionals and (b) the senior lender also paid for a distribution to allowed general unsecured claims.
- The court further permitted the senior lender, who was paying directly and therefore did not have to follow the waterfall required by the Bankruptcy Code to not pay an administrative expense claim asserted by the Internal Revenue Service (the "*IRS*") from those creditors entitled to share in the escrowed funds.

The Stay Request

- The IRS sought a stay of the sale closing, Arguably not to avoid the sale itself but to avoid the distribution of the cash proceeds paid by the lenders to the professionals or unsecured creditors without payment of its claim.
- The request for the stay was denied.
- The transaction closed and the senior lenders paid the settlement funding into escrow to pay (a) unsecured creditors and (b) professionals and certain wind down case costs.

The Appeal

- Following the denial of the stay, the IRS appealed the sale order itself permitting the payments to other creditors, but not to the IRS, arguing that the treatment favored creditors with an equal or lesser priority under the Bankruptcy Code's distribution scheme.

Procedurally Moot – Not

- The Third Circuit held that the appeal was neither constitutionally, statutorily, nor equitably moot.
  - Not Constitutionally Moot:
    - The Third Circuit found the IRS' $24 million administrative claim will go unpaid if the distributional terms of the escrowed funds are left undisturbed.
    - Though the prospect of recovery might be remote, the appeal is not constitutionally moot, and the Third Circuit had jurisdiction to consider whether the IRS was entitled to a portion of the sale proceeds paid in cash.
  - Not Statutorily Moot:
    - The Third Circuit did not view section 363(m) as a bar to review because the IRS was not seeking to claw back a sale from a good-faith purchaser but only to re-allocate funds paid to third-parties.
  - Not Equitably Moot:
    - The Court did not find equitable mootness applicable to the appeal as the issues did not involve confirmation of a plan of reorganization.
    - Further absent the settlement the unsecured creditors would have received nothing so even though they now lost the right to object to the sale the loss of the right to object did not create a compelling argument here.

Secured Creditors Direct Gifting Is Good!

- On the merits, the Third Circuit found the sale and settlement were properly approved by the Bankruptcy Court.
  - The IRS made two substantive arguments:
    - that the escrowed funds and settlement money were proceeds paid to obtain debtor assets, and thus qualify as estate property that should have been paid out according to the Bankruptcy Code's creditor-payment scheme, and
    - that equally ranked creditors must receive equal payouts and lower ranked creditors may not be paid until higher ranking creditors are paid in full.

Secured Creditors May Pay Unsecured Creditors Directly

- The Third Circuit determined that although it is true that the secured lenders paid cash to resolve objections to the sale, the money never made it into the estate nor was it paid at the debtors' direction.
- Instead the secured lender group, using that group's own funds, made payments to unsecured creditors - so the money paid never qualified as estate property.
  - Looking to *In re TSIC*, 393 B.R. 71 (Bankr. D. Del. 2008), the Third Circuit determined here that debtor estate assets were not set aside for unsecured creditors in violation of the Bankruptcy Code priority scheme,
  - Rather lender funds paid by the purchaser directly and not from lien proceeds were used to fund the settlement and those funds never became an time estate assets,
  - Therefore the settlement funds did not become part of its estate even as a pass-through

Direct Gifting To Professionals And Winding Down Is Good Too

- Similarly, with regard to the funds used to pay professionals fees and certain wind down expenses, the Third Circuit held that these too were direct lender payments, and not payments from the debtor estates.
  - The difference between a carve-out from the lenders' collateral and a direct payment of its own funds is that the purchaser made a credit bid and took back, purchased, its collateral.
  - The professional fees and wind down settlement payments were made with the lenders own money "to facilitate . . . a smooth . . . transfer of the assets from the debtors' estates to [the secured lenders]" by resolving objections to that transfer. Bankruptcy Court June 11, 2013 Hr'g Tr. 23:9–13.
  - To assure that no funds reached the debtors' estate, the secured lenders agreed to pay cash for services and expenses through escrow arrangements.

Getting Around What Might Look Like Contrary Law

- Interestingly, the Third Circuit distinguished *In re DBSD North America, Inc.*, 634 F.3d 79 (2d Cir. 2011), by noting that the issue there was whether, under a plan of reorganization, an "undersecured . . . [creditor] entitled to the full residual value of the debtor [was] free to 'gift' some of that value" to a shareholder of the debtor. *Id.* at 94.
  - The Second Circuit Court held that "secured creditors could have demanded a plan in which they received all of the reorganized corporation, but, having chosen not to, they may not surrender part of the value of the estate for distribution to the stockholder as a gift," *id.* at 99 (internal quotation marks omitted).
  - The Third Circuit noted that the Second Circuit did not address the issue of whether a lender can distribute *non*-estate assets directly to a lower-ranked creditor and, thus, permitted that to happen here.

THE DISAPPEARANCE OF RETAIL REORGANIZATIONS UNDER THE AMENDED SECTION 365(d)(4)

Lawrence C. Gottlieb
Cooley LLP

"Circuit City, Eddie Bauer, Boscov's, Borders, and Beyond:
Is Chapter 11 Bankruptcy Working for Retailers?"

LAWRENCE C. GOTTLIEB[1]

> *To the extent we understand the law of corporate reorganizations as providing a collective forum in which creditors and their common debtor fashion a future for a firm that would otherwise be torn apart by financial distress, we may safely conclude that its era has come to an end.*[2]

The year was 2002, nearly three years before President George W. Bush signed into law the Bankruptcy Abuse Prevention and Consumer Act of 2005, S. 256 ("BAPCPA"), when Professors Baird and Rasmussen published this epitaph mourning the passage of chapter 11 as a means by which companies could restructure debt and emerge from bankruptcy as reorganized and rehabilitated entities. According to Baird and Rasmussen, structural changes in the U.S. economy over the preceding twenty-five years, including the national shift from a manufacturing economy to a service economy, the globalization of financial markets, and the increasing significance of intangible assets and intellectual capital, combined to leave the Chapter 11 process ill-suited for the twenty-first century.[3]

The factors cited by Baird and Rasmussen are certainly important to any macroscopic analysis of Chapter 11 reorganization, particularly in view of the significant "intangible asset" bankruptcies of Enron, WorldCom and Adelphia that dominated headlines roughly 10 years ago. But the systemic decline of Chapter 11 reorganization has also invaded the retail sector, where "hard assets" are no less prevalent today than they were in the 1990s, a time when many distressed retailers used the significant powers and protections of the Chapter 11 process to resuscitate their businesses.[4]

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[1] Lawrence C. Gottlieb is the former Chair of the Bankruptcy & Restructuring Group of Cooley LLP. The Cooley Bankruptcy & Restructuring group has played significant roles in some of the largest retail bankruptcies and out of court restructuring cases. Cooley represents and has represented official committees of unsecured creditors in such cases as Montgomery Ward, Federated Department Stores, Hancock Fabrics, Mervyn's, Eddie Bauer, Boscov's, Goody's, Gottschalks, Athlete's Foot, Footstar, The Bombay Company, Florsheim Shoes, Sharper Image, and Levitz Home Furnishings, among many others. Cooley also served as counsel to Crabtree & Evelyn, one of only a handful of retailers since the implementation of the 2005 bankruptcy amendments to emerge successfully as an unimpaired reorganized entity. Mr. Gottlieb has authored numerous published articles on various retail bankruptcy issues, including the effects of the 2005 amendments on retail reorganization. Mr. Gottlieb has also testified before the House Judiciary Committee on the effects of BAPCPA.

[2] Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN L. REV. 751, 753 (2002).

[3] *Id*.

[4] The Federated Department Stores case (*In re Federated Dep't Stores, Inc.*, Case No. 90-10130 (BP) (Bankr. S.D. Ohio 1990)) symbolizes the highly successful retail restructurings of that decade. Before its Chapter 11 case, Federated was saddled with $7.5 billion of debt after its purchase as part of a highly leveraged takeover by Canada's Campeau Corporation in 1988. Faced with a declining business and loss of confidence among its vendors, Federated filed for Chapter 11 protection in 1990, where it was forced to quickly sell various key assets, including a portion of its real estate interests. Despite these problems, Federated was able to restructure its debt and triumphantly emerge from bankruptcy as a reorganized entity in 1992 by swapping $5 billion in debt and other

Today, retailers almost invariably begin the Chapter 11 process with little hope of emerging as a standalone entity. Numerous economic factors—including capital constraints, competition from online and discount retailers, and weak consumer demand—have clearly contributed to this downward spiral (particularly during the height of the recent recession), however, to pin the disappearance of retail reorganization solely on one or more of these economic factors would be to ignore the devastation wrought by the amendment under BAPCPA's amendment to the provisions of the Bankruptcy Code concerning a debtor's deadline to assume or reject unexpired leases of nonresidential property.

Prior to BAPCPA, section 365(d)(4) of the Bankruptcy Code was a powerful tool used by retailers to downsize operations while simultaneously adding considerable value to their estate. Under the old regime, a debtor had 60 days to decide whether to assume or reject its commercial real estate leases, without the consent, and often over the objection, of its lessors. This 60-day period was subject to extension "for cause." The Bankruptcy Code placed no limit on the duration or number of extensions that could be sought, and extensions were routinely granted by courts presiding over mid-size and larger cases, where the requesting debtor was continuing to perform its lease obligations.

BAPCPA revised section 365(d)(4) to place an outside limit of 210 days on the time by which a debtor must assume or reject a commercial real estate lease. Specifically, section 365(d)(4) provides that a commercial real estate lease is deemed rejected if not assumed by the debtor by the earlier of (i) 120 days after the petition date; or (ii) confirmation of a plan. Courts are authorized to extend the 120-day period for up to an additional 90 days for cause shown. Extensions beyond 210 days—irrespective of whether the retailer operates 10 stores or 1,000 stores—are not within the discretion of the bankruptcy courts and may only be granted upon the consent of the landlord. The revisions to 365(d)(4) were designed to provide a "firm, bright line deadline" on a debtor's ability to assume or reject its leases,[5] regardless of the individualized challenges facing a debtor.

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 effort. Now, more than 7 years removed from the enactment of BAPCPA and having observed its impact on numerous retail Chapter 11 cases, I can objectively say that BAPCPA has negatively impacted a retailer's ability to meet its liquidity needs in Chapter 11 irrespective of the other factors driving a lender's decision to provide postpetition financing. As can be seen from the attached charts summarizing 25 of the largest retail bankruptcy cases since BAPCPA and 20 of the largest retail bankruptcy cases prior to BAPCPA, BAPCPA resulted in drastic changes to retail reorganization, and the vast majority of retail chapter 11 filings now end in liquidation or a quick sale under section 363 of the Bankruptcy

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liabilities for new notes and equity. Federated went on to acquire Macy's in connection with Macy's Chapter 11 case in 1994 and by 1998 Federated's debt was rated as "investment" grade by the major rating agencies.

[5] H.R. Rep. No. 109-31, pt. 1, at 86 (2005) *reprinted in* 2005 U.S.C.C.A.N. 152–53.

Code. The consequences of these changes can be dramatic: the liquidation of Circuit City and Linens 'n Things alone resulted in more than 50,000 lost jobs.

Liquidity is the lifeblood of reorganization. Absent the ability to pay certain postpetition debts as they come due, including sums owed employees, vendors, common carriers, utility providers and estate professionals to name just a few, the prospect of a retail reorganization is little more than a pipe dream. Most retailers contemplating a Chapter 11 filing have experienced sustained periods of liquidity problems and have therefore relied on the secured lending of banks and other financiers for years preceding their bankruptcy filings.[6] Consequently, at the commencement of most cases, substantially all of a retailer's assets will be subject to the prepetition liens of its lenders and may not be used or sold without their consent.

Lenders are disinclined to permit the use and disposition of their collateral and, just as important, to extend additional financing, absent a firm belief in a debtor's capacity to effectively reorganize and thereby avoid any diminution in the value of their collateral. Where a prepetition lender does not possess the requisite level of confidence in a given debtor prior to or during the Chapter 11 process, it will inevitably attempt to force a sale of the collateralized assets pursuant to section 363 of the Bankruptcy Code. Unfortunately, the revision to section 365(d)(4) of the Bankruptcy Code under BAPCPA has made it significantly more difficult for a lender to have confidence in a retail debtor's ability to reorganize in a timely manner.

From a lender's perspective, a retailer's ability to routinely obtain extensions of the lease assumption/rejection period provided three critical protections:

- First, a lender could be assured that the retailer was provided with sufficient time to analyze the value of each individual store lease before making the critical decision to assume or reject the lease.

- Second, lenders were assured that the value of a debtor's commercial lease could be monetized in the event of a failed reorganization because debtors had an indefinite period of time to assign below-market commercial leases to third parties at a premium.

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[6] The growth of the second lien lending market over the past decade has compounded these liquidity problems for distressed retailers. Not only must retailers position themselves to pay the present value of the often substantial secured claims of their senior lenders upon confirmation of a Chapter 11 plan, but many now face a relatively new and additional layer of secured debt that must also be paid in full upon emergence. Second lien lending originated in the early 1990s when the debt market stalled as a result of increased conservatism among banks and other traditional senior lenders. Second lien lenders, in contrast to mezzanine lenders, invariably play an active role in the Chapter 11 process because, in the event of a borrower default, the second lien lender can exercise its remedies (including foreclosure) against the debtor. While the second lien market has benefited distressed retailers by providing new channels of liquidity, it has also created more difficulties for those companies attempting rehabilitation in the face of both senior and second lien debt. Second lien loans have increasingly become a favorite investment vehicle of private equity firms that are judged by their internal rate of return on investments. These firms profit from generating quick returns on investment and, accordingly, are even less willing to endure the reorganization process than banks and other financial institutions.

- Third, lenders were also assured that they would be provided with enough time to conduct a "going-out-of-business" ("GOB") sale on the premises in the event a decision was subsequently made to terminate the reorganization process.

Although all three protections play important roles in a lender's decision to provide financing, it is the latter protection which is most crucial. A lender's willingness to permit the use of its collateral and/or provide pospetition financing to a retailer is in large part based on the value of the retailer's inventory at a GOB sale. Absent the ability to conduct a GOB sale from the debtor's store locations, a lender is deprived of the most commercially viable location to liquidate the collateralized inventory, and the lender's recovery may not fulfill its expectations. This issue is exacerbated for lenders because they do not have control over a debtor's decisions to assume or reject unexpired leases.

Accordingly, prepetition lenders use their substantial leverage to ensure that a retail debtor will be able to conduct a GOB sale. However, GOB sales must be planned, approved by the Bankruptcy Court (after parties in interest are provided with sufficient notice), and conducted in manner that maximizes value. All told, preparing and conducting a GOB sale takes at least 120-days in most cases. The 210-day limit set by BAPCPA therefore leaves a debtor with less than three months after the commencement of its case before GOB sales must be implemented.

As a result, most prepetition lenders now refuse to provide any more postpetition financing than necessary to fund an immediate sale or liquidation process. This is particularly problematic because retailers that file for Chapter 11 protection today increasingly have balance sheets that are encumbered by ever growing amounts of secured debt, and there is therefore virtually no ability for retailers to survive on cash collateral alone. Due to the modern retailer's capital structure, prepetition lenders have all of the bargaining power, and the result is that most postpetition financing facilities either (i) expire within the first few months of the case, (ii) include "milestones" or "trigger notices" requiring the Debtors' to follow a strict path towards liquidation or a sale, (iii) include substantial reductions in the advance rate as the case extends beyond a certain length, or (iv) employ some combination of the above. These provisions give lenders certainty that a liquidation sale will occur and be concluded before the expiration of the 210-day period provided for debtors to assume or reject leases.

Lenders are simply not willing to bear the risks associated with reorganization for fear that the retailer may lose its store leases before a GOB sale is completed. The decision not to provide reorganization financing is made by secured lenders before the debtor files for bankruptcy. This is why it is illusory for creditors or landlords to believe that they will have any influence on whether a debtor will obtain sufficient postpetition financing to conduct a reorganization.

Unsurprisingly then, retail cases filed over the past 7 years have invariably taken one of two forms: either the case is filed as a liquidation, a quick sale under Section 363 of the Bankruptcy Code, or the debtor is given a window of no more than three to four months to complete a reorganization process that history dictates takes at least three times that amount of time to accomplish. The most compelling explanation for this development is that both retailers and their lenders are acutely aware that even a full seven months in the life of a retail debtor is not a long time, particularly because most retailers and their lenders cannot judge the vitality of

the business without going through at least one Christmas season. Absent the ability to extend the assumption/rejection period beyond the 210-day limit, a debtor will often be forced into the impossible position of having to prematurely determine whether to assume or reject its commercial leases—decisions of critical importance to the ultimate success of any reorganization. Furthermore, the 210-day period does not provide a debtor sufficient time to exploit many of the tools provided by chapter 11 to assist the debtor's rehabilitation. Accordingly, even in those cases where the lender has agreed to provide financing on a preliminary, "wait-and-see" basis, such willingness has invariably been tempered, if not extinguished, by the very nature of the retail industry.

The end result is that retailers can no longer reorganize unless their prepetition lender is interested in owning the company or supporting a reorganization for some other unique reason. Appended to this testimony are charts summarizing 25 of the largest retail bankruptcy cases since BAPCPA, as well as 20 of the largest retail bankruptcies in the years preceding BAPCPA.[7] These cases demonstrate just how hobbled the chapter 11 process for retailers has become, as demonstrated by the following summary statistics:

	POST-BAPCPA	**PRE-BAPCPA**
Total number of cases analyzed:	25	20
Number of cases where plan of reorganization was approved:	3 (12%)[8]	10 (50%)
Number of cases where the debtor(s) liquidated:	12 (48%)	7 (35%)
Number of cases resolved pursuant to a 363-sale:	10 (40%)	3 (15%)
Average sale/liquidation/reorganization period:[9]	3 months	12 months

[7] The retail debtors discussed in the chart summarizing pre-BAPCPA cases (Appendix A) include: Ames Department Stores, Athlete's Foot, Bob's Stores, Bradlees I and II, Breuners Home Furnishings a/k/a Huffman Koos, Casual Male Corp., Drug Emporium, Flooring America, Footstar, Friedman's, Heilig-Meyers Company, Kmart, Loehmann's, Montgomery Wards I and II, Phar-Mor, Spiegel, Stage Stores, and Trend-Lines.

The retail debtors discussed in the chart summarizing post-BAPCPA cases (Appendix B) include: Bachrach Clothing, Blockbuster, Borders, Boscov's, Circuit City, Crabtree & Evelyn, Eddie Bauer, Finlay Enterprises, G+G Retail, Goody's, Gottschalks, Harry & David, Hub Holdings, Levitz Furniture, Linens 'n Things, Loehmann's, Movie Gallery, Musicland d/b/a Sam goody, Ritz Camera Centers, Sharper Image, Steve & Barry's, Syms/ Filene's Basement, the Bombay Company, Tweeter Home Entertainment, and United Retail Group.

[8] In each of post-BAPCPA cases that reorganized, the debtors' prepetition secured lender either accepted equity in exchange for the cancelling of its debt or was also a prepetition equity holder of the debtor.

[9] The sale/liquidation/reorganization period is the period between the commencement of the chapter 11 proceeding(s) and the date that the Court (i) approves a plan of reorganization, (ii) authorizes the sale of substantially all of the debtor's assets, or (iii) converts the case to chapter 7 or otherwise dismisses the proceedings.

	POST-BAPCPA	PRE-BAPCPA
The number of cases where the sale/liquidation/reorganization period exceeded 210 days:	0 (0%)[10]	13 (65%)
The average duration of cases where debtor(s) reorganized:	99 days	576.5 days
The average duration of cases where the debtor(s) liquidated:	93.4 days	122.3 days
The average duration of the cases resolved pursuant to a 363-sale:	81.7 days	236.7
The average recovery for general unsecured creditors (as set forth in the disclosure statements):[11]	16.3%	33.6%

For the reasons explained above, these results are entirely understandable and predictable in a post-BAPCPA world. Prior to BAPCPA, chapter 11 provided retail debtors with the time and the tools to not only address balance sheet issues, but to right-size their business and test new business plans. For example, in more than half of the pre-BAPCPA cases described in Appendix A, the debtor adjusted its retail footprint after going through a holiday season; in contrast, in the post-BAPCPA cases discussed in Appendix B, virtually no debtors were able to take similar advantage of the chapter 11 process because they were not given the time. Perhaps the past practice of providing unlimited extensions of the assumption/rejection period was unnecessary. It is clear that this practice created a substantial backlash among landlords and others that ultimately produced the truncated assumption/rejection period provided under BAPCPA. But the pendulum has swung too far. The fixing of an immutable deadline for the assumption or rejection of commercial real estate leases has dealt a knockout blow to prospective retail reorganizations.

[10] Technically, Syms/Filene's Basement emerged from bankruptcy after 302 days, but it emerged as a real estate company and all other assets were liquidated within the first 2 months of the case, so for purposes of this summary statistic it is not identified as a case with a reorganization period exceeding 210 days.

[11] For purposes of calculating the average creditor recovery, (i) where the disclosure statement did not provide a projection, the case was not included in the average, and (ii) where a disclosure statement provided a range for the projected recovery, the mid-point was used.

Appendix A to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Pre-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Bradlees Stores Inc. (95-42777) (S.D.N.Y.)	Reorganization	6/23/1995	11/18/1998[1] 1/27/1999[2]	1244 days	8–20%[3]	The "reorganization period" is calculated based on the date that Bradlees' plan was originally confirmed on November 18, 1998, even though certain landlords successfully appealed the Bankruptcy Court's decision to confirm the plan, and an amended plan was approved in January 1999. During the bankruptcy, Bradlees reduced its retail footprint from 136 stores in June 1995 to 104 in February 1999. The recovery for general unsecured creditors estimated in the disclosure statement varied for the different Debtors, but ranged between 8 and 20%.
Montgomery Ward Holding Corp (97-1409) (D. Del.)	Reorganization	7/7/1997	7/28/1999[4]	751 days	28–29%[5]	During the pendency of the reorganization, the Montgomery Wards Debtors liquidated an unprofitable subsidiary and closed 96 Montgomery Ward stores. The Montgomery Ward Debtors were also able to balance their inventory stock, dispose of unsaleable merchandise, and replace old merchandise with fresher, more saleable product through a vendor program approved by the Bankruptcy Court.

[1] *Order Confirming First Amended and Modified Plan of Reorganization for Bradlees Stores, Inc. and Affiliates Under Chapter 11 of the Bankruptcy Code* (Docket No. 3226), entered November 18, 1998.

[2] *Order Confirming Second Amended Joint Plan of Reorganization for Bradlees Stores, Inc. and Affiliates Under Chapter 11 of the Bankruptcy Code* (Docket No. 3416), entered January 27, 1999.

[3] *First Amended Disclosure Statement Pursuant to Bankruptcy Code § 1125 for Joint Plan of Reorganization of Bradlees Stores, Inc. and Affiliates Under Chapter 11 of the Bankruptcy Code* (Docket No. 3075), dated October 2, 1998.

[4] *Order Under 11 U.S.C. § 1129(a) and (b) and Fed. R. Bankr. P. 3020 Confirming First Amended Joint Plan of Reorganization of Montgomery Ward Holding Corp. And Its Debtor Subsidiaries* (Docket No. 5225), entered July 28, 1999.

[5] *First Amended Disclosure Statement with respect to First Amended Joint Plan of Reorganization of Montgomery Ward Holding Corp. and Its Debtor Subsidiaries* (Docket No. 4498), dated May 26, 1999.

Appendix A to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Pre-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Loehmann's, Inc. (99-01138) (D. Del.)	Reorganization	5/18/1999	9/06/2000[6]	477 days	53%[7]	During its chapter 11 proceeding, Loehmann's undertook substantial operational changes and closed 21 non-core stores as part of an effort to concentrate on three core markets. The Debtor first obtained authority to conduct GOB sales at 13 underperforming stores in July 1999 (auctioning the leases in October 1999), and then obtained authority to conduct additional GOB sales in April and May 2000.
Stage Stores, Inc. (00-35078) (S.D. Tex.)	Reorganization	6/1/2000	8/8/2001[8]	433 days	N/A	After filing for Chapter 11 protection, the Stage Store Debtors conducted two store closing initiatives, conducting GOB sales at 107 shortly after filing and 121 stores about six months later. General unsecured creditors were entitled to either equity or some combination of equity and cash, and the disclosure statement did not provide an estimated recovery. However, the Debtors projected a 7% recovery for trade vendors in the event of a liquidation, and stated that general unsecured trade creditors received more under the plan, indicating an expected return exceeding 7%.[9]
Flooring America, Inc. (00-68370) (N.D. Ga.)	Liquidation	6/15/2000	7/25/2000[10]	40 days	4–14%[11]	A chapter 11 trustee was appointed in January 2001, by which point the vast majority of the Debtors' assets had been liquidated.

6 *Findings of Fact, Conclusions of Law, and Order Confirming Second Amended Plan* (Docket No. 1368), entered September 6, 2000.

7 *Second Amended Disclosure Statement Accompanying Second Amended Plan of Reorganization of Loehman's, Inc. Under Chapter 11 of the Bankruptcy Code, as Modified on July 28, 2000* (Docket No. 1230).

8 *Order Confirming Third Amended Chapter 11 Plan of Reorganization of Stage Stores, Inc., Specialty Retailers, Inc. and Specialty Retailers, Inc. (NV), as Modified* (Docket No. 1650), entered August 8, 2001.

9 *Amended and Restated Disclosure Statement Under 11 U.S.C. § 1125 in Support of Third Amended Plan of Reorganization of Stage Stores, Inc., Specialty Retailers, Inc., and Specialty Retailers, Inc. (NV), As Modified* (Docket No. 1330), filed on June 6, 2001.

10 *Order Approving Store Closings, Closing Sales and Rejection of Related Unexpired Leases and Executory Contracts* (Docket No. 276), entered July 25, 2000.

11 *Disclosure Statement in Connection with Joint Chapter 11 Plan of Liquidation for Flooring America, Inc. and Related Debtor Entities Proposed by: Morton P. Levine, the Chapter 11 Trustee for Flooring America, Inc. and Related Debtor Entities, And the Official Committee of Unsecured Creditors for Flooring America, Inc. and Related Debtor Entities* (Docket No. 1983), dated December 31, 2002.

Appendix A to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Pre-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Trend-Lines, Inc. (00-15431) (Mass.)	Reorganization	8/11/2000	10/17/2001[12]	432 days	N/A	Early in the proceedings, the Debtors sought approval of an agency agreement for the liquidation of the inventory located in the Golf Day Stores and in Trend-Lines' distribution center. Subsequently, in April 2001, the Debtors liquidated their Post Tool business in the face of declining sales. The Debtors also reduced headcount and overhead, instituted management and sales programs to improve their business, and moved into a new warehouse and headquarters during the pendency of the chapter 11 cases. The distribution to unsecured creditors consisted of a cash distribution as well as shares in the reorganized Debtor, and the disclosure statement did not provide an estimated recovery.[13]
Heilig-Meyers Company (00-34533) (E.D. Va.)	Liquidation	8/16/2000	4/24/2001[14]	251 days	3.5–5%[15]	The Debtors commenced the chapter 11 proceedings operating approximately 872 stores. In September 2000, 302 Heilig-Meyers Furniture and ValueHouse stores were closed. In February 2001, 181 additional stores were closed. In the face of continuing underperformance, the Debtors decided to close the remaining 349 Heilig-Meyers Furniture stores in April 2001.

12 *Order Confirming First Amended Joint Reorganization Plan of Trend-Lines, Inc. and The Official Committee of Unsecured Creditors (Docket No. 974)*, entered on October 17, 2001.

13 *First Amended Disclosure Statement with Respect to First Amended Joint Reorganization Plan of Trend-Lines, Inc. and the Official Committee of Unsecured Creditors* (Docket No. 882), filed September 7, 2001.

14 *Order (A) Authorizing Debtors and/or their Agent to Conduct Certain Store Closing Sales Pursuant to Sections 105 and 363 of the Bankruptcy Code at Their Remaining Heilig-Meyers Store Locations; (B) Approving Certain Employee Retention Plans; and (C) Granting Ancillary Relief Related Thereto* (Docket No. 1549), entered April 24, 2001.

15 *Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code in Support of Second Amended and Restated Joint Liquidating Plan of Reorganization Proposed by Heilig-Meyers Company, Heilig-Meyers Furniture Company, Heilig-Meyers Furniture Company West, Inc., HMY Star, Inc., and Macsaver Financial Services, Inc. and The Official Committee of Unsecured Creditors* (Docket No. 6025), dated May 5, 2005.

Appendix A to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Pre-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Bradlees Inc. (00-16035) (S.D.N.Y.)	Liquidation	12/26/2000	1/4/2001[16]	8 days	12–24%[17]	Bradlees first filed for bankruptcy in June 1995 and emerged in February 1999 before filing again in late 2000 and liquidating its assets. Prior to commencing the second chapter 11 proceedings, the Debtors marketed their assets and ultimately selected a bid by liquidators, including Gordon Brothers Retail Partners LLC.
Montgomery Ward, LLC (00-4667) (D. Del.)	Liquidation	12/28/2000	1/16/2001[18]	19 days	4-100%[19]	Montgomery Ward first filed for bankruptcy in July 1997 and emerged in July 1999 before filing again in late 2000 and liquidating its assets. Recovery to general unsecured creditors depended on the outcome of litigation, and ultimately exceeded 30%.
Drug Emporium, Inc. (01-41066) (N.D. Oh.)	Reorganization	3/24/2001	9/4/2001[20]	164 days	18–23%[21]	These proceedings effectuated a prenegotiated sale of the Debtors' business to Snyder Drug Stores (which would file for bankruptcy in 2003). During the pendency of the Chapter 11, the Debtors held an auction for 50 of their underperforming stores, certain of which were sold as going concerns and certain of which were liquidated.

16 *Order Pursuant to Sections 105(a), 363(b) and 365(a) of the Bankruptcy Code and Bankruptcy Rule 6006 for Authorizing the Debtors (A) to Assume an Agency Agreement Among Gordon Brothers Retail Partners LLC, et al. and the Debtors, (B) To conduct GOB Sales, (C) To sell Assets Free and Clear of Liens and Other Interests, and (D) To Pay Severance to Terminated Employees* (Docket No. 70), entered on Jan. 4, 2001.

17 *Second Amended Disclosure Statement Relating to Third Amended Joint Plan of Liquidation of Bradlees Stores, Inc., et al., Together With the Official Committee of Unsecured Creditors Under Chapter 11 of the Bankruptcy Code* (Docket No. 972), dated November 7, 2001.

18 *Final Order (A) Authorizing Debtors to Conduct Store Closing Sales and Discontinue Operations at Stores, Distribution Centers and Other Facilities and (B) Granting Ancillary and Other Relief* (Docket No. 204), entered January 16, 2001.

19 *Third Amended Disclosure Statement to Accompany Third Amended Plan of Liquidation Filed by Official Committee of Unsecured Creditors of Montgomery Ward, LLC, et al., Under Chapter 11 of the Bankruptcy Code* (Docket No. 3257), filed May 7, 2002.

20 *Findings of Fact, Conclusions of Law and Order Confirming Chapter 11 First Amended Joint Plan of Reorganization* (Docket No. 685), entered September 4, 2001.

21 *Disclosure Statement Concerning the Debtors' First Amended Joint Plan of Reorganization* (Docket No. 450-1), dated July 25, 2001.

Appendix A to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Pre-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Casual Male Corp. (01-41404) (S.D.N.Y.)	363 Sale	5/18/2001	5/7/2002[22]	354 days	5.2%–93.1%[23]	The recoveries for general unsecured creditors projected in the disclosure statement varied per Debtor, ranging from 5.2% to 93.1%. During the pendency of these cases, the Debtors conducted GOB sales at underperforming sales under Court orders obtained in August 2001 and January 2001. In addition, the Debtors sold their "Work'n Gear" businesses as a going concern in April 2002. The remainder of the Casual Male business was sold as a going concern in May 2002 after the Debtors, the creditors' committee, and the secured lenders agreed that a stand-alone reorganization was not in the estates' best interests.
Ames Department Stores (01-42217) (S.D.N.Y.)	Liquidation	8/20/2001	8/16/2002[24]	361 days	0–1%[25]	The Ames Debtors methodically closed underperforming stores throughout the bankruptcy cases, obtaining orders in August, November, and December 2001, as well as in June 2002, to conduct GOB sales at 123 of the Debtors' store locations. In August 2002, after having failed to meet sales estimates, the Debtors, the postpetition lenders, and the official committee of unsecured creditors decided it was in the best interest of the estates to wind down operations. The Ames Department store cases are ongoing, with the Debtors filing a disclosure statement on June 17, 2013.

22 *Order Granting Motion of Debtors for (I) Authority to Sell All or Substantially All of the Assets of the Debtors' Businesses, (II) Authority to Assume and Assign Executory Contracts and Unexpired Leases Related Thereto, and Other Related Relief* (Docket No. 862), entered May 7, 2002.

23 *Disclosure Statement for Joint Plan of Liquidation of Casual Male Corp., et al., Together With the Official Committee of Unsecured Creditors Under Chapter 11 of the Bankruptcy Code* (Docket No. 1525), dated August 18, 2003.

24 *Order Pursuant to Sections 105 and 363(b), (f), (m), and (n) of the Bankruptcy Code Authorizing (i) Entry into Agency Agreement with a Joint Venture Comprised of the Nassi Group, LLC, Gordon Brothers Retail Partners LLC, and SB Capital Group LLC, (ii) Going Out of Business Sales at all the Debtors' Remaining Store Locations, and (iii) Sale of Certain Assets Free and Clear of Liens and other Interests* (Docket No. 1096), entered August 17, 2002.

25 *Debtors' Disclosure Statement for Modified First Amended Chapter 11 Plan* (Docket No. 4081), dated June 17, 2013.

Appendix A to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Pre-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Phar-Mor Inc. (01-44007) (N.D. Oh.)	363 Sale	9/24/2001	7/18/2002[26]	294 days	15–18%[27]	Phar-Mor initially filed for chapter 11 protection in 1992 in the wake of corporate mismanagement and fraud, and emerged approximately three years later in 1995. In September 2001, it entered chapter 11 again, and began liquidating its assets. The Debtors obtained approval to liquidate 65 underperforming stores on October 10, 2001. After closing these stores in November of 2001, the Debtors continued operations at 74 remaining stores, reducing overhead and attempting to solidify its position in the marketplace. In the wake of continued operating losses, however, the Debtors and the official committee of unsecured creditors determined that a sale or liquidation of the company was in the best interests of the estates. On July 18, 2002, the Debtors obtained authority to liquidate their remaining stores.

[26] *Order (A) Authorizing the Sale of Substantially all of the Debtors' Assets Free and Clear of Liens, Claims and Encumbrances; and (B) Authorizing Going-Out-of-Business Sales*, entered on July 18, 2002 (Docket No. 766).

[27] *Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code For First Amended Joint Plan of Liquidation Dated January 23, 2003 Proposed Jointly by the Debtors and the Official Committee of Unsecured creditors* (Docket No. 1495).

Appendix A to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Pre-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Kmart (02-02474) (N.D. Il.)	Reorganization	1/22/2002	4/22/2003[28]	455 days	9.7%[29]	Under the Plan, general unsecured creditors' recovery included stock in the reorganized entity as well as interests in a litigation trust, which was estimated in the Disclosure Statement to represent a 9.7% recovery. While in bankruptcy, the Debtors obtained authority to close and conduct GOB sales in 283 stores in March 2002, and, after the 2002 holiday season, the Debtors conducted another review and decided to close an additional 317 stores. During the pendency of the bankruptcy proceedings, the Kmart Debtors resolved certain government inquiries, obtained approval of a voluntary program with their vendors to return seasonal, slow-moving, unsaleable or defective merchandise, and established programs to (a) give vendors junior liens on their merchandise under certain conditions and (b) liquidate personal injury and other litigation claims, among other things.
Spiegel, Inc. (03-11540) (S.D.N.Y.)	Reorganization	3/17/2003	5/25/2005[30]	800 days	85.3–91%[31]	The Debtors' catalog business – including Spiegel Catalog and Newport News – was sold in June 2004. The Eddie Bauer businesses successfully reorganized (though Eddie Bauer would subsequently file for bankruptcy in 2009, as discussed above). In addition, during the reorganization period, the Debtors' management turned over, 21 Spiegel and Newport News outlet stores were closed, approximately 100 Eddie Bauer stores were closed (while another 11 stores were opened), excess inventory was liquidated, the workforce was reduced, and distribution operations were consolidated, among many other operational changes.

[28] *Findings of Fact, Conclusions of Law, and Order Under 11 U.S.C. Sections 1129(a) and (b) and Fed. R. Bankr. P. 3020 Confirming the First Amended Joint Plan of Reorganization of Kmart Corp. and its Affiliated Debtors and Debtors-in-Possession* (Docket No. 10,871), entered April 22, 2003.

[29] *Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession* (Docket No. 8925), dated February 25, 2003.

[30] *Findings of Fact and Conclusions of Law and Order Pursuant to 11 U.S.C. Subsection 1129(a) and Rule 3020 of the Federal Rules of Bankruptcy Procedure Confirming Modified First Amended Joint Plan of Reorganization of Affiliated Debtors and Granting Related Relief* (Docket No. 3590), entered May 25, 2005.

Appendix A to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Pre-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Bob's Stores (03-13254) (D. Del.)	363 Sale	10/22/2003	12/23/2003[32]	62 days	70%[33]	The sale of substantially all of the Debtors' assets to an affiliate of The TJX Companies was negotiated prepetition under a stalking horse asset purchase agreement, though the bid was substantially improved after an auction held during the bankruptcy proceedings. Recovery for general unsecured creditors would eventually total 98%, significantly exceeding the projection included in the disclosure statement.
Footstar, Inc. (04-22350) (S.D.N.Y.)	Reorganization	3/2/2004	1/27/2006[34]	696 days	100%	Under the plan of reorganization, Footstar was able to continue operating the footwear departments in Kmart stores until 2008, at which point Kmart would buy out the Debtors' inventory at book value. During the first few months of the bankruptcy case, the Debtors sold 353 Footaction stores to Foot Locker, Inc. as a going-concern while also liquidating 75 Footaction retail stores, 88 Just For Feet stores, and 3 Uprise retail stores.
Breuners Home Furnishings Corp. a/k/a Huffman Koos (04-12030) (D. Del.)	Liquidation	7/14/2004	7/30/2004[35]	16 days	N/A	After immediately liquidating their stores, the Debtors sought and obtained an order converting the Debtors' chapter 11 cases to cases under Chapter 7 of the Bankruptcy Code in February 2005.[36]

[31] *First Amended Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code for the First Amended Joint Plan of Reorganization of Affiliated Debtors* (Docket No. 3084), dated March 28, 2005.

[32] *Order (I) Authorizing and Approving Sale of Substantially All Assets of the Debtors Free and Clear of Liens, Claims, Encumbrances and Interest; (II) Approving Asset Purchase Agreement (As Amended and Restated); (III) Authorizing and Approving Assumption and Assignment of Executory Contracts and Unexpired Leases; and (IV) Granting Certain Related Relief* (Docket No. 355), entered December 23, 2003.

[33] *Disclosure Statement For Consolidated Joint Plan of Liquidation of the Debtors Together with the Official Committee of Unsecured Creditors Under Chapter 11 of the Bankruptcy Code, Dated May 14, 2004* (Docket No. 803).

[34] *Order Confirming Debtors' First Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, Dated December 5, 2005* (Docket No. 3267), entered on January 25, 2006.

[35] *Order (A) Authorizing the Debtors to Conduct Going Out of Business Sales Pursuant to 11 U.S.C. § 363 and (B) Approving Agency Agreement* (Docket No. 171), dated July 2, 2004.

[36] *Order Converting Case* (Docket No. 874), entered February 8, 2005.

Appendix A to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Pre-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Athlete's Foot (04-17779) (S.D.N.Y.)	Liquidation	12/07/2004	12/17/2004[37]	10 days	7–10%[38]	The Debtors ran approximately 124 Athlete's Foot stores and filed for bankruptcy to liquidate those stores. Hundreds more Athlete's Foot stores owned by franchisees continued operating.
Friedman's (05-40129) (S.D. Ga.)	Reorganization	1/14/2005	11/23/2005[39]	313 days	n/a	During the chapter 11 proceeding, the Debtors reduced their retail footprint from approximately 650 stores to approximately 480 stores. Friedman's returned to chapter 11 in 2008. The recovery for general unsecured creditors depended on the outcome of certain estate causes of action.

[37] *Order Pursuant to Sections 363, 365 and 554 of the Bankruptcy Code (A) Authorizing and Approving the Conduct of Store Closing, or Similar Themed Sales Free and Clear of All Liens, Claims and Encumbrances, (B) Approving An Agency Agreement for the Conduct of the Subject Sales as Debtor's Exclusive Agent Therefore, (C) Approving Procedures for Rejection of Leases and Abandonment of Certain Assets, and (D) Granting Other and Further Relief* (Docket No. 92), entered December 17, 2004.

[38] *Disclosure Statement for Joint Plan of Liquidation of the Debtors Together with the Official Committee of Unsecured Creditors Under Chapter 11 of the Bankruptcy Code* (Docket No. 618), dated August 8, 2005.

[39] *Findings of Fact, Conclusions of Law, and Order Under 11 U.S.C. §§ 1129(a) and (b) and Fed. R. Bankr. P. 3020 Confirming the First Amended Joint Plan of Reorganization of Freidman's, Inc. and Certain Affiliates, Debtors and Debtors-In-Possession, As Modified* (Docket No. 1338), entered on November 23, 2005.

Appendix B to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Post-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
G+G Retail (06-10152) (S.D.N.Y.)	363 sale	1/2/2006	2/17/2006[1]	46 days	50%[2]	Postpetition financing was provided to G+G Retail by the stalking horse purchaser, which did not end up as the winning bidder for the Debtor's assets.
Musicland d/b/a Sam Goody (06-10064) (S.D.N.Y.)	363 sale	1/13/2006	3/24/2006[3]	70 days	Unknown[4]	Recovery to general unsecured creditors was dependent on the outcome of certain litigation.
Bachrach Clothing (06-06525) (N.D. Ill.)	Liquidation	6/6/2006	7/10/2006[5]	34 days	Unknown	Recovery to general unsecured creditors was dependent on the outcome of certain litigation.
Tweeter Home Entertainment (07-10787) (Del.)	363 sale	6/11/2007	7/13/2007[6]	32 days	Unknown	Recovery to general unsecured creditors was dependent on the outcome of certain litigation. [7]
The Bombay Co. (No. 07-44084) (N.D. Tex.)	Liquidation	9/20/2007	10/16/2007[8]	26 days	16.4–28.9%[9]	After an auction (held within the first three weeks of the case) produced no going concern bids, Bombay liquidated its U.S. stores under a joint venture agreement with Gordon Bros. and Hilco.

1 *Order Pursuant to 11 U.S.C. §§ 105, 363 and 365 and Fed. R. Bankr. P. 2002, 2004 and 6006 Authorizing and Approving Sale of Substantially all of the Debtor's Assets to Max Rave, LLC, Free and Clear of Liens, Claims, Encumbrances and Interests* (Docket No. 236), dated Feb. 17, 2006.

2 *Disclosure Statement in Support of Plan of Liquidation of G+G Retail, Inc. under Chapter 11 of the Bankruptcy Code* (Docket No. 760), dated October 18, 2006.

3 *Order Approving Motion for Order Approving (A) Sale of Substantially All Debtors' Assets (B) Asset Purchase Agreement* (Docket No. 781), dated March 24, 2006.

4 *Disclosure Statement for First Amended Joint Plan of Liquidation of Musicland Holding Corp. and Its Affiliated Debtors* (Docket No. 1163), dated Sept. 14, 2006.

5 *Order Authorizing (1) Agency Agreement and Addendum, (2) Sale of the Debtor's Assets Free and Clear of Liens, Claims and Interests, and (3) Related Liquidation Sales* (Docket No. 126), entered July 10, 2006.

6 *Order Approving Sale of Substantially All of the Debtors' Assets Free and Clear of All Liens, Claims, Interests and Encumbrances* (Docket No. 452), entered on July 13, 2007.

7 *Disclosure Statement With Respect to Joint Plan of Liquidation of TWTR, Inc. (F/K/A Tweeter Home Entertainment Group, Inc.) and its Affiliated Debtors and Debtors in Possession* (Docket No. 2297), dated Sept. 28, 2012.

8 *Order Pursuant to Sections 363, 365 and 554 of the Bankruptcy Code (A) Authorizing and Approving the Conduct of Store Closing or Similar Themed Sales, with Such Sales to be Free and Clear of All Liens and Encumbrances, (B) Approving an Agency Agreement for the Conduct of the Subject Store Closing Sales* (Docket No. 400), entered on October 16, 2013.

Appendix B to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Post-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Levitz Furniture (07-13532) (S.D.N.Y.)	Liquidation	11/8/2007	12/4/2007[10]	26 days	Unknown	Recovery to general unsecured creditors was dependent on the outcome of certain litigation.
Sharper Image (08-10322) (Del.)	Liquidation	2/19/2008	5/30/2008[11]	101 days	*>1%*[12]	Sharper Image obtained Court authority to conduct GOB sales at 96 of its 184 stores on March 12, 2008, less than a month after the case commenced. After being unable to reorganize or find a bidder for its assets as a going concern, Sharper Image sold its remaining assets on May 30, 2008.
Linens 'n Things (08-10832) (Del.)	Liquidation	5/2/2008	10/16/2008[13]	167 days	N/A	General unsecured creditors were given a stake in a trust which was vested with certain causes of action, but little or no recovery was anticipated for general unsecured creditors. The postpetition financing facility required the Debtors to file a plan of reorganization by August 29, 2008, but the Plan was not acceptable to certain necessary parties, so the Debtors and their secured lenders agreed on a timeline for the liquidation of the remaining stores. The Debtors obtained approval to conduct going out of business sales and liquidate those stores on October 16, 2008.

9 *Disclosure Statement for First Amended Consolidated Joint Plan of Liquidation of the Debtors Together with the Official Committee of Unsecured Creditors Under Chapter 11 of the Bankruptcy Code* (Docket No. 1369), dated July 2, 2008.

10 *Order Pursuant to Sections 363, 365, and 554 of the Bankruptcy Code (A) Authorizing and Approving the Conduct of Going Out of Business, Store Closing or Similar Themed Sales, with such Sales to be Free and Clear of All Liens, Claims and Encumbrances, (B) Approving an Agreement for the Sale of Certain Assets, the Conduct of the Subject the Store Closing Sales and the Sale of Designation Rights* (Docket No. 314), entered on December 4, 2007.

11 *Order Approving Asset Purchase Agreement, Agency Agreement, Store Closing Sales, And Related Relief* (D.I. No. 763, entered on May 30, 2008.

12 *Joint Motion of the Debtor and the Official Committee of Unsecured Creditors, Pursuant to Sections 105(a), 305(a), and 1112(b) of the Bankruptcy Code, for Entry of an Order (I) Approving Procedures for (A) the Dismissal of the Debtor's Chapter 11 Case, (B) the Distribution of Certain Funds to Holders of Allowed Unsecured Claims, and (C) the Disallowance of Certain Gift Card Claims and (II) Granting Certain Related Relief* (Docket No. 2465), approved on August 13, 2012 (Docket No. 2475).

13 *Order Approving Agency Agreement, Store Closing Sales and Related Relief* (Docket No. 1861), entered October 16, 2008.

Appendix B to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Post-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Steve & Barry's (08-12579) (S.D.N.Y.)	363 Sale	07/9/2008	08/22/2008[14]	44 days	1.75–2.52%[15]	The Debtor sold substantially all of its assets to BH S&B Holdings, LLC in less than 60 days of the commencement of the bankruptcy case. Less than three months after purchasing the Steve & Barry's assets, BH S&B filed for bankruptcy, and the remaining Steve & Barry's stores were liquidated.
Boscov's (No. 08-11637) (Del.)	363 Sale	8/4/2008	11/21/2008[16]	109 days	6.4–15.74%[17]	The winning bidder was an affiliate of the prepetition owners.
Circuit City (No. 08-35653) (E.D. Va.)	Liquidation	11/10/2008	1/16/2009[18]	67 days	10–32%[19]	Auction for substantially all of the Debtors' assets held days after disappointing holiday season produced no going concern bids.
Goody's (No. 09-10124) (Del.)	Liquidation	1/13/2009	1/21/2009[20]	8 days	0.5%[21]	Goody's Jan. 13, 2009 bankruptcy filing was its second in a single year. Its predecessor company filed for bankruptcy in June 2008 and emerged four months later after closing numerous stores and restructuring its debt. In advance of its second bankruptcy filing, Goody's entered into a joint venture agreement with Hilco and Gordon Brothers to run GOB sales.

14 *Order Pursuant to Sections 105(A), 363 and 365 of the Bankruptcy Code and Bankruptcy Rules 6004, 6006 and 9014 Authorizing the Sale of Substantially All of the Debtors' Assets, Free and Clear of Liens, Claims, Encumbrances and Other Interests* (Docket No. 628), dated August 22, 2008.

15 *Disclosure Statement for Joint Plan of Liquidation Under Chapter 11 of the United States Bankruptcy Code Proposed by the Debtors and the Official Committee of Unsecured Creditors* (Docket No. 1912), dated March 4, 2008.

16 *Order Approving Asset Purchase Agreement and Authorizing the Sale of Assets of Debtors Outside the Ordinary Course of Business* (Docket No. 729), entered on 11/21/2008.

17 *Second Amended Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code of Joint Plan of BSCV, Inc. (F/K/A Boscov's, Inc.) and its Debtor Affiliates*, dated July 22, 2009 (Docket No. 1242).

18 *Order Approving Agency Agreement, Store Closing Sales and Related Relief* (Docket No. 1635), dated Jan. 16, 2009.

19 *Supplemental Disclosure with Respect to Second Amended Joint Plan of Liquidation of Circuit City Stores, Inc. and its Affiliated Debtors and Debtors in Possession and Its Official Committee of Creditors Holding General Unsecured Claims and Notice of Deadline to Object to Confirmation* (Docket No. 8253), dated August 9, 2010.

20 *Order (I) Approving Assumption of Agency Agreement* (Docket No. 122), entered January 21, 2009.

Appendix B to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Post-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Gottschalks, Inc. (No. 09-10157) (Del.)	Liquidation	1/14/2009	4/1/2009[22]	77 days	3.8–13.3%[23]	A potential going concern bidder decided at the last minute not to participate in the auction, and only liquidation bids were received.
Ritz Camera Centers (09-10617) (Del.)	363 Sale	2/22/2009	7/23/2009[24]	151 days	4–14%[25]	In 2012, the purchaser of Ritz's assets filed for bankruptcy and the company was liquidated.
Hub Holdings Corp. (No.	363 Sale	5/27/2009	7/30/2009[26]	64 days	2–4%[27]	Debtors sold certain of their Levi's, Dockers, and Anchor Blue stores on a going concern basis, while simultaneously liquidating approximately 60 stores.
Eddie Bauer (No. 09-12099) (Del.)	363 Sale	6/17/2009	7/23/2009[28]	36 days	2–17%[29,30]	Eddie Bauer continued as a going concern, but with a substantially reduced retail footprint.
Finlay Enterprises (No. 09-14873) (S.D.N.Y.)	Liquidation	8/5/2009	9/25/2009[31]	51 days	4.85%[32]	Winning bidder was Gordon Brothers with a liquidating bid. Secured claims were not paid in full, but $7 million was carved out of their collateral for the benefit of general unsecured creditors in exchange for, *inter alia*, the release of certain claims.

21 *First Amended Disclosure Statement for the Debtors' First Amended Plan of Liquidation Pursuant to Chapter 11 of the United States Bankruptcy Code Dated as of December23, 2009* (Docket No. 997).

22 *Order Approving Agency Agreement, Store Closing Sales and Related Relief* (Docket No. 349), entered April 1, 2013.

23 *Disclosure Statement for Debtor's Chapter 11 Plan of Liquidation (January 14, 2010 Modification)* (Docket No. 1353).

24 *Order Approving Sale of Substantially All of the Debtor's Assets and Granting Related Relief* (Docket No. 837), dated July 23, 2009.

25 *First Amended Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code with Respect to the First Amended Joint Plan of Liquidation Under Chapter 11 of the United States Bankruptcy Code Proposed by the Debtor and the Official Committee of Unsecured Creditors, dated March 2, 2010* (Docket No. 1373), dated March 2, 2010.

26 The Levi's and Dockers divisions were sold on June 30, 2009, while the Anchor Blue division was sold on July 30, 2009. See Docket Nos. 273, 497, and 182.

27 *Disclosure Statement for First Amended Joint Plan of Liquidation Under Chapter 11 of the Bankruptcy Code* (Docket No. 1353), dated January 6, 2011.

28 *Order (A) Approving the Sale fo the Debtors' Assets Free and Clear of all Liens, Claims, Encumbrances and Interests* (Docket No. 507), entered July 23, 2009.

29 *Disclosure Statement for the First Amended Joint Plan of Liquidation of EBHI Holdings, Inc., et al.* (Docket No. 1270), dated Jan. 26, 2013.

30 Holders of unsecured convertible notes received no distribution on account of their prepetition claim.

31 *Order Approving Agency Agreement, Store Closing Sales and Related Relief* (Docket No. 262), entered Sept. 25, 2009.

Appendix B to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Post-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Crabtree & Evelyn (09-14267) (S.D.N.Y.)	Reorganization	11/17/2009	1/13/2010[33]	57 days	45%[34]	The Debtor's prepetition secured lender, which was also the Debtor's prepetition equity holder, provided a feeless postpetition financing facility, as well as exit financing.
Movie Gallery (10-30696) (E.D. Va.)	Liquidation	2/2/2010	5/20/2010	107 days	N/A[35]	Movie Gallery emerged from its first bankruptcy proceeding in 2008. At the commencement of the second bankruptcy in February 2010, certain stores were immediately liquidated. In April of 2010, the Debtors and their creditors concluded that it was in the best interest of creditors and other parties in interest to liquidate the Debtors' remaining assets and wind-down the Debtors' affairs. On May 20, 2010, the Court entered an Order approving the liquidation of most of the Debtors' remaining assets with Great American acting as liquidator. General unsecured creditors obtained interests in a liquidating trust on account of their prepetition claims. The trust was funded with $5 million.
Blockbuster (10-14997) (S.D.N.Y.)	363 Sale	9/23/2010	4/14/2011[36]	203 days	0%	While the case is still pending, it is unlikely that there will be any distribution to creditors because the proceeds generated by the sale of the Debtors' assets did not exceed the Debtors' secured indebtedness and no assets were carved out of the secured lenders' collateral for the benefit of general unsecured creditors. Blockbuster's assets were sold to the DISH Network Corporation after an auction where the Debtors' prepetition secured lenders also bid for the Debtors' assets.

[32] *Disclosure Statement for Debtors' Modified Plan of Liquidation Under Chapter 11 of the Bankruptcy Code* (Docket No. 661), dated May 18, 2010.

[33] *Order Confirming First Amended Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, As Modified on January 12, 2010* (Docket No. 301), entered January 14, 2010.

[34] *First Amended Disclosure Statement With Respect to the Debtor's First Amended Plan of Reorganization Under Chapter 11 of the Bankruptcy Code* (Docket No. 230), dated November 17, 2009.

[35] *Disclosure Statement with Respect to Joint Plan of Liquidation of Movie Gallery Inc. and its Affiliated Debtors and Debtors in Possession* (Docket No. 1752), dated September 8, 2010.

[36] *Order Pursuant to 11 U.S.C. §§ 105(a), 363, and 365 and Fed. R. Bankr. P. 2002, 6004, 6006 and 9014 Authorizing and Approving the Sale of Debtors' Assets Free and Clear of Interests* (Docket No. 1602), entered April 14, 2011.

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Written testimony of L. Gottlieb for the ABI Commission to Study the Reform of Chapter 11

Post-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Loehmann's (10-16077) (S.D.N.Y.)	Reorganization	11/15/2010	2/9/2011[37]	86 days	7.6%[38]	Debt for equity swap accomplished with the support of certain of the Debtors' prepetition secured lenders (with a restructuring support agreement negotiated prepetition).
Borders (No. 11-10614) (S.D.N.Y.)	Liquidation	2/16/2011	7/21/2011[39]	155 Days	4–10%[40]	After an unsuccessful auction for substantially all of the Debtors' assets, Borders was liquidated by Hilco and other liquidators.
Harry & David (No. 11-10884) (Del.)	Reorganization	3/28/2011	8/29/2011[41]	154 days	10%[42,43]	Prepetition secured lender agreed to a debt for equity conversion, provided certain postpetition financing for the chapter 11 process, and made an equity contribution to the reorganized Debtors upon their emergence from bankruptcy.

[37] *Findings of Fact, Conclusions of Law and Order Confirming Debtors' Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code* (Docket No. 398), entered on February 9, 2011.

[38] *Disclosure Statement for Debtors' Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code* (Docket No 246), dated January 3, 2011.

[39] *Order Approving Agency Agreement, Store Closing Sales and Related Relief*, entered on July 21, 2011.

[40] *See Disclosure Statement for First Amended Joint Plan of Liquidation Pursuant to Chapter 11 of the Bankruptcy Code Proposed by the Debtors and the Official Committee of Unsecured Creditors* (Docket No. 2110), dated November 10, 2011.

[41] *Order Confirming the Second Amended Joint Plan of Reorganization of Harry & David Holdings, Inc. and its Debtor Subsidiaries, as Modified and Restated* (Docket No. 767), entered on August 29, 2011.

[42] *Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code for the Second Amended Joint Plan of Reorganization of Harry & David Holdings, Inc. and its Debtor Subsidiaries* (Docket No. 504), dated June 24, 2011.

[43] Certain unsecured noteholders and the Pension Benefit Guaranty Corporation were given an alternative recovery, which was estimated to be worth between 2 and 17.4% of their claim. *Id.*

Appendix B to *The Disappearance of Retail Reorganization Under the Amended Section 365(d)(4)*
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Post-BAPCPA Cases

Case Name	Disposition	Petition Date	Sale / Reorg. Date	Ch. 11 Reorg. Period	GUC Creditor Recovery	Discussion
Syms / Filene's Basement (11-13511) (Del.)	Liquidation[44]	11/2/2011	8/30/2012[45]	302 days (but all assets except owned real estate were liquidated within the first 2 months of the case)	75–100%[46]	General unsecured creditors of Syms and certain general unsecured creditors of Filene's received a distribution of 100% of their prepetition claims. Other general unsecured creditors of Filene's Basement received 75% of their allowed general unsecured claims. The distinction between the groups has to do with solvency of Syms, which held substantial real estate assets.
United Retail Group d/b/a Avenue Stores (12-10405) (S.D.N.Y.)	363 Sale	2/1/2012	4/3/2012[47]	62 days	9.2–11%[48]	Purchaser of the Debtors' assets was chosen as stalking horse bidder prepetition and received $20 million "parent contribution" from the Debtors' prepetition owner to facilitate the sale.

44 Technically, Syms/Filene's Bankruptcy did emerge from bankruptcy, but it did so as a real estate company, with no retail operations.

45 *Findings of Fact, Conclusions of Law and Order Confirming the Modified Second Amended Joint Chapter 11 Plan of Reorganization of Syms Corp. and its Subsidiaries* (Docket No. 1983), entered on August 30, 2012.

46 *Disclosure Statement with Respect to the Second Amended Joint Chapter 11 Plan of Reorganization of Syms Corp. and Its Subsidiaries* (Docket No. 1641), dated July 13, 2012.

47 *Order Authorizing the Sale of Substantially All of the Debtors' Assets Free and Clear of All Claims, Liens, Rights, Interests and Encumbrances* (Docket No. 496), entered on April 4, 2012.

48 *Debtors' Joint Plan of Liquidation Pursuant to Chapter 11 of the Bankruptcy Code* (Docket No. 619), dated June 14, 2012.