AMERICAN BANKRUPTCY INSTITUTE

2017 Southeast Bankruptcy Workshop

# The Retail Business Is Booming (in Bankruptcy)

CONCURRENT SESSION


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2017

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## Hypothetical Retail Debtor

- 50 year operating history
- $750 million of revenue on 450 stores, with 25% of revenue coming from ecommerce sales ($562.5 million in stores and $187.5 million in online sales)
    - All stores are leased with mall-based landlords. Average store size is 5,000 sq. ft.
    - The Company owns a fee simple interest in the headquarters building and its distribution/fulfillment center. Combined appraised value if occupied of $40 million. Have gotten sale leaseback offers in the past for $40 million at an 8% cap rate.
- Publicly-held, 30% by sponsor that took the business public and 70% by institutional and retail customers
- Capital Structure:
    - $200 million asset based revolver with a nationally-recognized bank that has a large presence financing retailers. Typical borrowing base with fluctuating advance rates throughout the year based on seasonality. Typical structure with a 10% of facility "block" and other common availability reserves. Blanket lien on all assets except real estate. Average outstanding balance over the course of the year is $65 million.
    - $25 million in mortgage debt secured solely by the two parcels of real estate (headquarters and distribution center). Over-secured relative to appraised value.
    - $100 million second lien note secured by all assets except real estate, but has a security interest in the equity of the entities that hold the company's real estate, providing a synthetic second lien.
    - $100 million of trade payables, 50% from domestic sources and 50% from foreign sources
- Other Assets:
    - No material brand equity for the name of the store chain
    - $100 million of Net Operating Losses (NOLs)
- Rent:
    - Paying approximately $110 million in annual rent (~15% of total sales and 19.5% of in-store sales), while market comps are closer to 12% of in-store sales
        - Implies market rent for the entire store network should be closer to $67.5 million.
- EBITDA:
    - $30 million today
- Valuation:
    - Based on trading multiples in the market today as of June 2017, the business is worth approximately 4.0x-4.5x EBITDA.
    - Liquidation of the entire chain would result in a full repayment to the ABL lender, a full recovery to the mortgage lender and a partial repayment for the second lien lender
    - Suggests that the second lien lender is the fulcrum security

- Events Leading to Bankruptcy
    - Longtime successful retailer that over the last several years has seen their primary market become a very competitively crowded space with new entrants.
        - Newer entrants enjoy younger leases (with less time for escalation) and were predominantly entered into after the great recession, giving a material advantage to the newer entrants on their overall rent burden. New entrants also have been quicker to move into mobile applications and have greater penetration in ecommerce.
    - Sponsor purchased business during the recession and then took the company public in 2014. Sponsor still retains a 30% stake in the business and three of seven board seats. Sponsor has continued to sell stock as the share price has declined, as they earned their targeted return at the IPO.
    - Business has been losing money the last two years. Same store sales were -7% in 2016 after a -9% in 2015. The Company seems to be stabilizing at a -2% SSS for 2017.
    - Liquidity has gotten tight as losses have mounted. Vendors are pressuring the company for shorter terms, cash on delivery and/or cash in advance, further pressuring liquidity.
    - Sponsor has signaled that they are unwilling to inject fresh capital
    - Second lien lender has signaled that it is willing to sponsor a plan, and would inject capital sufficient to fund a 50% recovery to trade creditors that execute a qualified vendor agreement whereby the vendor agrees to provide normalized terms during the bankruptcy case and for two years post-emergence. The second lien lender's plan support is also subject to:
        - Substantial rent concessions to approach market rates and with smaller future escalators
        - Closing and liquidation of up to 150 stores (subject to landlord negotiations) that are in low-traffic malls and are losing money
- Company has engaged
    - Bankruptcy counsel
    - Financial Advisor
    - Investment Banker
    - Lease Consultant
- Pre-filing activities
    - Financial Advisor – engaging with the trade to manage relationships; monitoring liquidity, DIP budgeting
    - Investment Banker – negotiating a plan support agreement with the second lien lender, arranging and marketing DIP financing
    - Bankruptcy Counsel – preparation for a Chapter 11 filing, negotiating plan support agreement, finalizing DIP credit agreement
    - Company solicits proposals for liquidation of the 150 stores to be closed

## Hypothetical Retail Debtor Issues for Discussion

### Prepetition Issues and Strategies

The second lien lender has signaled that they are willing to sponsor a plan, but the Company must obtain substantial rent concessions to approach market rates and smaller future escalators. What does the Company need to provide its landlords in order to support its request for lease concessions? What are the landlords' main considerations in determining whether it will agree to the concessions?

The vendors are pressuring the Company for shorter terms, cash on delivery and/or cash in advance, which is further pressuring liquidity. What does the Company need to provide its vendors in order for them to provide terms both inside chapter 11 and then subsequent to emergence?

The Company has identified 150 stores to be closed. Should the Company attempt to liquidate and close these stores on their own or should they engage a professional liquidator? If they decide to engage a liquidator, should they be retained prior to filing chapter 11 or wait and engage them after the filing?

### First Day Issues

The Company seeks relief under chapter 11 and files several first day motions seeking authority to: continue customer programs, pay critical and foreign vendors, continue selling consigned goods, and establish procedures for transfers of equity securities and trading in claims against the estate.

In the customer program motion, the Company requests authority to honor prepetition gift cards postpetition and to continue selling gift cards. The critical vendor motion seeks authority to pay vendors that the Company deems critical, but does not identify the vendors or cap the total amount to be spent. Similarly, the foreign vendor motion seeks to pay unidentified foreign vendors in an unspecified amount. A large unsecured creditor objects to this relief. How should the Court rule?

In exchange for continuing to sell consigned goods, the Company proposed to grant the consignment vendor a replacement lien with the same validity and priority as its existing lien, if any, so long as the consignment vendor had a valid, enforceable, non-avoidable and perfected security interest. Any lien, however, was subject to any claims and defenses of the debtors or other lienholders, including the secured lenders. The Company also proposed to deposit proceeds from sales of the consigned goods into a segregated account, but the proceeds could not be remitted to the consignment vendors without the consent of the secured lenders because these proceeds were the secured lenders' cash collateral. The consignment vendors objected and the secured lenders filed a reservation of rights. How does the Court rule?

Your client is an equity holder and receives a copy of the interim order approving the motion to establish procedures for transfers of equity securities. Your client calls you and wants to know what this motion means and why the Court granted it.

GOB Sale Issues

The Company intends to reorganize. How does the Company ensure that the going out of business sales at the 60 underperforming stores will not confuse the consumer or the investor market that a going concern outcome is still viable?

The Company retained a liquidator and filed a motion to approve GOB sale procedures, including signage, store hours, and brining in additional inventory. Several landlords objected to the procedures arguing that they violate various lease provisions. How does the Court rule?

Postpetition Issues

The majority of the Company's rent payments are due on the fifteenth of the month. Is there any benefit to the Company filing for bankruptcy on the thirtieth of the month?

Up against the 210-day limit, the Company filed a motion to assume certain its non-residential real property leases, which the Court approved. Approximately three months later, the Company filed a motion to assign some of its leases to a third-party buyer. Several of the landlords objected on the grounds that the deadline had passed. How does the Court rule?

Plan Issues

The Company's plan seeks broad third party releases. The U.S. Trustee objects and argues that non-consensual third party releases are not allowed. How does the Court rule?

## Supporting Materials for Hypothetical Retail Debtor Discussion

### TREATMENT OF GIFT CARDS IN BANKRUPTCY[1]

- Status of pre-petition claims. Courts disagree on the status of the claims of pre-petition gift card holders. Compare In re City Sports, Inc. et al., 554 B.R. 329, 334-35 (Bankr. D. Del. 2016) (disagreeing with WW Warehouse, and finding that unredeemed, pre-petition gift cards are not entitled to priority under 11 U.S.C. § 507(a)(7) because they are not "deposits"); with In re WW Warehouse, 313 B.R. 588 (Bankr. D. Del. 2004) (unredeemed, pre-petition gift card claims were consumer deposits entitled to priority under § 507(a)(7)).
- Regardless of the status of claims of gift card holders, some courts have authorized debtors to continue to honor pre-petition gift cards post-petition, recognizing that it fosters good will with the customer base and aids in reorganization. See e.g., In re Skin Sense, Inc., 2017 Bankr. LEXIS 307 (Bankr. E.D.N.C. Feb. 3, 2017); In re The Wet Seal Inc., et al., Case No. 15-10081-CSS, Dkt. 53 (interim) and 95 (final) (Bankr. D. Del. Jan. 16 and 20, 2015); In re Southern Season, Inc., Case No. 16-80559 C-11, Dkt. 50 (Bankr. M.D.N.C. July 6, 2016) (interim order).
    - In Southern Season, due to the perceived benefit to the value of the reorganization estate, all constituencies consented to the continued honoring of gift cards on an interim basis, including the pre-petition and debtor in possession lenders with liens on inventory and accounts.
- Some courts place limits on post-petition redemption of pre-petition gift cards. See In re Sports Authority Holdings, Inc. et al., Case No. 16-10527-MFW, Dkt. 2081 at 22, ¶ 26 (Bankr. D. Del. May 24, 2016) (requiring sale agent in going out of business sale to accept certain gift cards for the first 34 days of the sale, and requiring debtors to reimburse agent for the amount of redeemed gift cards, subject to further limitations); and In re The Sharper Image Corp., Case No. 08-10322-KG, Dkt. 189 (Bankr. D. Del. Mar. 7, 2008) (allowing redemption on the condition that customers spend twice the amount redeemed).
- Continued sale of gift cards post-petition – Courts have allowed the continued sale of gift cards post-petition. See e.g., In re Quicksilver, Inc. et al., Case No. 15-11880, Dkt. 65 (Bankr. D. Del. Sept. 10, 2015). This sale of a gift cards post-petition creates cost of administration claims in favor of the buyer. See Skin Sense, Case No. 16-05626-5-JNC, at 9-10 (noting that consumer buyers of post-petition gift cards become unknowing debtor-in-possession lenders). None of the typical constituencies in the case (other than the United States Trustee or the Bankruptcy Administrator) have an incentive to seek protection of these small post-petition lenders.
- Protections for post-petition buyers. In Skin Sense, the court required the debtor to segregate 85% of the proceeds from the sale of post-petition gift cards for the benefit of the purchasers. Only after the consumer redeemed the gift card was the debtor permitted access to the full proceeds of that gift card. Id. at 10-11 (citing In re Hancock Fabrics, et al., Case No. 16-10296-BLS, Dkt. 49 (Bankr. D. Del. Feb. 3, 2016) (requiring debtor to develop procedure to differentiate between gift cards sold pre-petition and post-petition). In limiting the debtor's immediate access to only 15% of the proceeds from post-petition gift card sales, the court in Skin Sense noted the difference between small retailers with "limited access to capital" and larger cases in which courts had permitted unrestricted use of the proceeds from post-petition

[1] The panel would like to thank The Honorable Benjamin Kahn and Sarah Boehm for preparing these materials.

gift card sales. Id. at 11. The court set the immediate availability at 15% of the proceeds based on evidence that amount historically remained unredeemed. Id. at 4 n.2.

## STUB RENT ISSUES

- Stub rent is the amount due to a landlord for the period of use and occupancy between the petition date and the first postpetition rent payment date.
- If full rent is due on the fifteenth of the month and the debtor files on the thirtieth of the month, courts are split as to whether rent for the stub period will be treated as a prepetition claim or an administrative expense payable pursuant to section 365(d)(3) of the Bankruptcy Code.
- The Third, Sixth, and Eighth Circuits have adopted the "billing date" approach, which is the date the rent becomes due and payable. If that date is prior to the petition date, the entire amount will be treated as a prepetition claim because the right to payment accrued in its entirety on the due date. See In re Oreck Corp., 506 B.R. 500, 507 (Bankr. M.D. Tenn. 2014) (adopting the "billing date approach"); In re Koenig Sporting Goods, Inc., 203 F.3d 986 (6th Cir. 2000); In re Montgomery Ward Holding Corp., 268 F.3d 205, 212 (3d Cir. 2001).
    - What if the lease requires one rent payment per year, due on January 1 and the tenant files January 10?
        - In circuits that do not pro rate and while perhaps more inequitable or contentious, courts have recognized that this would not change the outcome above. See Oreck, 506 B.R. at 506 n.10 (acknowledging that any strategic behavior this causes "can be constrained by forethought and careful drafting") (quoting Montgomery Ward, 268 F.3d at 212).
- The Second, Fourth, and Ninth Circuits, however, have adopted the "proration" or "accrual" approach, which prorates the rent and requires that the postpetition portion of that month's rent be paid. See In re Leather Factory Inc., 475 B.R. 710 (Bankr. C.D. Cal. 2012) (prorating rent); In re Circuit City Stores, Inc., 447 B.R. 475 (Bankr. E.D. Va. 2009) (same).

## ASSUMPTION AND REJECTION STRATEGIES

- Section 365(d)(4) requires debtors to assume or reject executory contracts and unexpired leases of nonresidential real property within 120 days of the petition date, subject to a 90 extension upon prior written consent of the lessors.
- In In re Eastman Kodak Co., 495 B.R. 618 (Bankr. S.D.N.Y. 2013), Kodak assumed a lease within the 210-day limit, and the order granting the assumption expressly preserved Kodak's rights to "assign any of the Assumed Leases pursuant to, and in accordance with, the requirements of section 365 of the Bankruptcy Code."
    - Lessor ITT neither objected to the motion nor the court order approving it. One year later, Kodak filed a motion to assign the lease to another party as part of an asset sale agreement, to which ITT objected.
    - ITT argued that a nonconsensual assignment must occur simultaneously with, not after, assumption of the lease – and thus cannot occur outside the 210-day period of § 365(d)(4).
    - According to ITT, the use of the present tense of the verb "to assume" in section 365(f)(2), authorizing assignment only if "the trustee assumes such contract or lease" leads to the inference that assignment must take place at the time of the assumption.

- The Court disagreed with ITT and held that Kodak could assign the lease. The words of the statute do not require simultaneous assumption and assignment. Section 365(d)(4) does not contain a deadline to assign a contract.
  - Does this interpretation of the Bankruptcy Code to permit the assignment of a previously assumed commercial lease outside the deadline for assumption reasonably balance the goal of providing protection to landlords and the goal of maximizing the value of a debtor's estate?

**THIRD PARTY INJUNCTIONS – INCLUDING INJUNCTIONS PROTECTING NON-DEBTORS**

## I. Non-plan, Preliminary Injunctions

- Extensions of the automatic stay
- '[T]here are cases [under 362(a)(1)] where a bankruptcy court may properly stay proceedings against non-bankrupt co-defendants.'" A.H. Robbins Co. v. Piccinin (In re A. H. Robbins Co.), 788 F.2d 994, 999 (4th Cir. 1986). In order to extend the automatic stay, there must be unusual circumstances. These unusual circumstances arise when there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the the third-party defendant will in effect be a judgment or finding against the debtor. Id.; but see Credit Alliance Corp. v. Williams, 851 F.2d 119, 121-22 (4th Cir. 1988) (distinguishing Piccinin, and finding that guarantor not protected by the automatic stay where there was nothing unusual about the guarantee relationship); Matter of Lockard, 884 F.2d 1171, 1179 (9th Cir. 1989) (declining to adopt Piccinin's unusual circumstances extension of the automatic stay for protection of other primarily liable entities).
- Is there such a thing as extension of the automatic stay? Or is it simply a distinction between: (1) the stay applies under the unusual circumstances of the case because the action against the third party constitutes a de facto action against the debtor; (2) that the court may issue an injunction under section 105(a) that can be co-extensive with the protection of the stay; or (3) a combination of the two? See In re Excel Innovations, Inc., 502 F.3d 1086, 1096 (9th Cir. 2007) (BAP erred when it treated the "unusual circumstances" doctrine to extend the automatic stay and the usual preliminary injunction standard as separate and distinct bases for affirming the stay; "[t]hat is error, because the 'unusual circumstances' doctrine does not negate the traditional preliminary injunction standard"). The court further explained:

  > As we have noted, stays under the doctrine, "although referred to as extensions of the automatic stay, were in fact injunctions issued by the bankruptcy court after hearing and the establishment of unusual need to take this action to protect the administration of the bankruptcy estate."

  Id.; see also In re Chicora Life Center, LC, 553 B.R. 61, 64-65 (Bankr. D.S.C. 2016) (drawing a distinction between the extraordinary circumstances required in order to extend the automatic stay under Piccinin and the required showing for a similar stay under section 105(a), and stating, "[a]fter further review of the order in Piccinin and its progeny, it appears that the establishment of 'unusual circumstances' is not required under Fourth Circuit precedent to stay third-party litigation under § 105"); cf. Piccinin, 786 F.2d at 1002-03 (finding that "[t]he statutory power of the bankruptcy court to stay actions involving the debtor or its property is not, however, limited to section 362(a)(1) and (a)(3)," but section 105 also provides such authority).
- Injunctions under 11 U.S.C. § 105

- Though section 105(a) does not give the bankruptcy court carte blanche—the court cannot for example, take an action prohibited by another provision of the Bankruptcy Code, Law v. Seigel,--- U.S. ---, 134 S. Ct. 1188, 1194, 188 L.Ed.2d 146 (2014); In re Kmart Corp., 359 F.3d 866, 871 (7th Cir. 2004)—it grants the extensive equitable powers that bankruptcy courts need in order to be able to perform their statutory duties.
- "The question that the bankruptcy judge and the district judge failed to address because of their cramped interpretation of section 105(a) is whether the injunction sought by CEOC is likely to enhance the prospects for a successful reorganization . . . . If it is, and its denial will thus endanger the success of the bankruptcy proceedings, the grant of the injunction would in the language of section 105(a), be 'appropriate to carry out the provisions' of the Bankruptcy Code, since successful resolution of disputes arising in bankruptcy proceedings is one of the Code's central objectives." In re Caesars Entertainment Operating Co., Inc., 808 F.3d 1186, 1188-89 (7th Cir. 2015) (although finding that the bankruptcy court had authority to issue the injunction, the court remanded for the bankruptcy court to determine whether an injunction was warranted under the facts of the case).
    - On remand, Judge Goldgar held that, if third-party litigation would "defeat or impair" the bankruptcy court's jurisdiction over the case before it, the debtor only must show a likelihood of a successful reorganization and that the injunction would serve the public interest in order to obtain a third-party injunction under section 105(a). There is no need to show irreparable harm or an inadequate remedy at law. In re Caesars Entertainment Operating Co., Inc., 561 B.R. 441, 450 (Bankr. N.D. Ill. 2016) (citing Fisher v. Apostolou, 155 F.3d 876, 882 (1998) (concluding that any finding by the court that the traditional four elements required to support an injunction were met "was an unnecessary exercise . . . since 'a bankruptcy court can enjoin proceedings in other courts when it is satisfied that such proceedings would defeat or impair its jurisdiction over the case before it'" (quoting In re L&S Industries, Inc., 989 F.2d 929, 932 (7th Cir. 1993)). Cf., Chicora Life Center, 553 B.R. at 66 (without the injunction, the debtor would not obtain funding for its reorganization, and this is irreparable harm; citing In re Brier Creek Corp. Ctr. Assocs. Ltd., 486 B.R. 681, 695 (Bankr. E.D.N.C. 2013)).
    - Judge Goldgar further determined that "the relevant public interest is the interest in successful reorganizations, since reorganizations preserve value for creditors and ultimately the public." Caesars, 561 B.R. at 453 (citing Gander Partners LLC v. Harris Bank, N.A. (In re Gander Partners), 432 B.R. 781, 789 (Bankr. N.D. Ill. 2010)).
- Other courts have applied four elements when considering whether to issue preliminary injunctions under § 105. See e.g. In re Bailey Ridge Partners, LLC, Bankr. Case No. 17-00033, 2017 WL 2126794, *7 (Bankr. N.D. Iowa May 16, 2017) (considering: (1) whether there is a likelihood of successful reorganization; (2) whether there is imminent irreparable harm to the estate in the absence of an injunction; (3) whether the balance of the harms tips in favor of the moving party; and (4) whether the public interest weighs in favor of an injunction; citing, inter alia, Nevada Power Co. v. Calpine Corp. (In re Calpine Corp.), 365 B.R. 401, 409 (S.D.N.Y. 2007); and granting temporary injunction where third-party creditor was fully secured and allowing guarantor and third-party suits to proceed would interfere with principals' ability to reorganize, among other facts considered by the court).

- Side note on mandatory vs. prohibitory injunctions:

> A preliminary injunction may be characterized as being either prohibitory or mandatory. Here, Plaintiffs assert that the preliminary injunction they seek is prohibitory while Defendants claim it is mandatory, which "in any circumstance is disfavored." Taylor v. Freeman, 34 F.3d 266, 270 n.2 (4th Cir. 1994). Whereas mandatory injunctions alter the status quo, prohibitory injunctions "aim to maintain the status quo and prevent irreparable harm while a lawsuit remains pending." Pashby, 709 F.3d at 319. We have defined the status quo for this purpose to be "the last uncontested status between the parties which preceded the controversy." Id. at 320 (internal quotations marks and citation omitted). "To be sure, it is sometimes necessary to require a party who has recently disturbed the status quo to reverse its actions, but . . .[s]such an injunction restores, rather than disturbs, the status quo ante." Aggarao v. MOL Ship Mgmt. Co., 675 F.3d 355, 378 (4th Cir. 2012) (internal quotation marks and citation omitted).
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> League of Women Voters of N. Carolina v. North Carolina, 769 F.3d 224, 235-36 (4th Cir. 2014).

## II. Plan Injunctions

- Rule 3016(c) – "If a plan provides for an injunction against conduct not otherwise enjoined under the Code, the plan and disclosure statement shall describe in specific and conspicuous language (bold, italic, or underlined text) all acts to be enjoined and identify the entities that would be subject to the injunction."
- Rule 2002(c)(3)—Notice of hearing on confirmation shall "include in conspicuous language (bold, italic, or underlined text) a statement that the plan proposes an injunction; . . . describe briefly the nature of the injunction; and . . . identify the entities that would be subject to the injunction."
- Rule 3017(f) – "If a plan provides for an injunction against conduct not otherwise enjoined under the Code and an entity that would be subject to the injunction is not a creditor or equity security holder, at the hearing held under Rule 3017(a), the court shall consider procedures for providing the entity with . . . at least 28 days' notice of the time fixed for filing objections and the hearing on confirmation of the plan containing the information in Rule 2002(c)(3); and . . . to the extent feasible, a copy of the plan and disclosure statement."
- At a minimum, the bankruptcy court must have "related to" subject matter jurisdiction over the third party claims proposed to be released under a plan. See In re Combustion Eng'g, Inc., 391 F.3d 190, 224, 233 (3d Cir. 2005) (a chapter 11 plan could not permanently enjoin third-party claims because it did not have "related to" jurisdiction over the claims).
- Standards for non-debtor releases in plans. Non-debtor releases in plans "should be granted cautiously and infrequently." Behrmann v. National Heritage Foundation, 663 F.3d 704, 712 (4th Cir. 2011) (citing Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Commc'ns, Inc.), 416 F.3d 136, 142 (2d Cir. 2005)). Other circuits have similarly allowed and limited non-debtor releases in plans. See Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648, 657-58 (6th Cir. 2002); and Gillman v. Cont'l Airlines (In re Cont'l Airlines), 203 F.3d 203, 212-13 (3d Cir. 2000)); but see Resorts Intn'l Inc. v. Lowenschuss, 67 F.3d 1394, 1401 (9th Cir. 1995) (third-party plan injunctions are prohibited because "§ 524(e) precludes bankruptcy courts from discharging

the liabilities of non-debtors"); Landsing Diversified Props.-II v. First Nat'l Bank and Trust Co. of Tulsa (In re Real Estate Fund, Inc.), 922 F.3d 592, 600-02 (10th Cir. 1990) (per curiam) (although temporary stay of actions against non-debtor third party during the bankruptcy proceeding may be permissible to facilitate the reorganization process, "the stay may not be extended post-confirmation in the form of a permanent injunction that effectively relieves the nondebtor from its own liability to the creditor").

- Factors Considered
    - (1) Identity of interest between the debtor and third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) the non-debtor has contributed substantial assets to the reorganization; (3) the injunction is essential to the reorganization, namely the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) the impacted class or classes has overwhelmingly voted to accept the plan; (5) the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) the plan provides an opportunity for those claimants who choose not to settle to recover in full; and (7) the bankruptcy court made a record of specific factual findings supporting its conclusions. Dow Corning, 280 F.3d at 658. See also In re Railworks Corp., 345 B.R. 529, 536 (Bankr. D. Md. 2006) (citing Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d 973 (1st Cir. 1995), in which the court gathered cases considering the following factors: (1) injunctive relief is essential to the formulation and confirmation of a plan of reorganization; (2) overwhelming creditor approval of the plan; (3) the plan contemplates full payment of all creditor claims; and (4) the plan provides for payment of substantially all of the claims affected by the injunction); and Behrmann, 663 F.3d at 712 (finding the Dow Corning and Railworks factors "instructive" and "so commend[ing] them to a bankruptcy court when considering whether to approve nondebtor releases as part of a plan of reorganization").
- The bankruptcy court must make specific FACTUAL findings supporting these conclusions. See Behrmann, 663 F.3d at 712-13 (reversing the bankruptcy court because, although the bankruptcy court had found that the release provisions: (1) were essential to the reorganization; (2) were an essential means of implementing the plan; (3) were an integral element of the transactions contemplated by the plan; (4) conferred a material benefit on the estate and creditors; (5) were important to the plan's overall objectives; and (6) were consistent with applicable provisions of the Bankruptcy Code, the court made no specific factual findings of why these conclusions were correct).
- Where the third-party claims to be enjoined/released are Stern-type claims over which the bankruptcy court cannot enter final judgments without consent, the United States District Court for the District of Delaware recently has held that the bankruptcy court lacks constitutional authority to enter a confirmation order containing a plan injunction permanently enjoining such claims. Opt-Out Lenders v. Millennium Lab Holdings II, Inc. (In re Millennium Lab Holdings II, LLC), Bankr. Case No. 15-12284-LSS, Civ. No. 16-110-LPS, 2017 WL 1032992 (D. Del. March 17, 2017). In that case, the district court remanded for the bankruptcy court to determine whether it had constitutional authority to enter final orders with respect to the enjoined claims. Id. at *14.

## III. Settlement Injunctions and Releases

- The Eleventh Circuit has held that bankruptcy courts have legal authority to enter orders barring non-settling defendants from asserting claims of contribution and indemnity against a co-defendant who settles with the estate representative. See Munford v. Munfor, Inc. (In re Munford), 97 F.3d 449, 454 (11th Cir. 1996) (settlement with chapter 11 debtor in possession). In Munford, the Eleventh Circuit established "related to" jurisdiction over the third-party claims (and therefore authority to issue the release and injunction) because the bar order was made a condition to the settlement. Id. at 454. The Sixth and Fifth Circuit have taken a more restrictive approach, and required that the outcome of the barred actions must have an effect on the bankruptcy estate in order for "related to" jurisdiction to exist. See Papas v. Buchwald Capital Advisors, LLC (In re Greektown Holdings, LLC), 728 F.3d 567, 578 (6th Cir. 2013) (citing Feld v. Zale Corporation (Matter of Zale Corporation), 62 F.3d 746 (5th Cir. 1995)).
- Standards for third party bar orders and releases in settlements:
    - Any bar order must be fair and equitable. "In making such a determination, courts consider the interrelatedness of the claims that the bar order precludes, the likelihood of nonsettling defendants to prevail on the barred claim, the complexity of the litigation, and the likelihood of depletion of the resources of the settling defendants." Munford, 97 F.3d at 455. See also, In re Fundamental Long Term Care, Inc., 515 B.R. 352, 359 (Bankr. M.D. Fla. 2014) (finding that bar order must be fair and equitable *to the parties being enjoined*, and where settlement would result in exposure of non-settling defendants of up to $1 billion without corresponding benefit, proposed settlement and bar order was not fair and equitable).
    - Factors to consider when determining whether the bar order should be approved include: (1) the non-debtor third-party claims which will be barred are interrelated to the estate's claims; (2) the parties opposed to the bar order have not presented sufficient evidence of the strength and existence of their claims against the beneficiary of the bar order; (3) the estate's litigation against the beneficiary of the bar order is complex; (4) the continued litigation by the estate and other parties against the beneficiary will deplete resources otherwise available to the estate and its creditors. See In re Jiangbo Pharmaceuticals, Inc., 520 B.R. 316, 323 (Bankr. S.D. Fla. 2014) (citing Munford).

# WHEN FAILING RETAIL TURNS TO BANKRUPTCY TO MAXIMIZE VALUE: GOING OUT OF BUSINESS SALES AND THE IMPLICATIONS OF STATE LAW, LEASE PROVISIONS, AND CONSIGNMENT INVENTORY[1]

## Introduction

A common method of facilitating liquidation for a retailer with multiple locations is a "going-out-of-business" sale. A going-out-of-business ("GOB") sale allows a debtor to sell off merchandise at some or all of its underperforming stores, while keeping the profitable (if any) stores up and running. The sale of assets in the chapter 11 bankruptcy context helps to streamline this process, allowing the debtor to focus on maintaining profitable locations instead of using resources to sell the assets through its own sale process. Moreover, the sales are typically conducted by liquidators who will pay more for inventory in liquidation because they are able to run the GOB sales in the debtor's stores, potentially despite lease provisions to the contrary and state or local restrictions. These same liquidators may even augment the debtor's inventory with their own inventory to draw more customers into the stores, maximizing returns. Given the alternatives it is no wonder retailers considering a large scale multi-location liquidation elect to do so through the bankruptcy courts.

As a matter of practice, GOB sale arise in bankruptcy cases in two contexts. First, as a first day motion debtors sometimes seek to assume a pre-petition consulting agreement with a liquidator that will facilitate the sale of the inventory and furniture, fixtures and equipment ("FF&E") at a retailers various locations. These sales are presented as first day motions because the GOB sales are to be conducted at locations that are not part of a viable or reorganized debtor. Simply put, these locations are a drain on the going concern and value will be maximized if the inventory and other property at these locations is liquidated promptly.

Second, debtors often seek to sell all or substantially all of their assets through sales pursuant to 363(b) of the Bankruptcy Code. Where no going concern buyers ultimately surface through the sale process or going concern buyers do not submit adequate offers to purchase the assets, liquidators are generally the successful bidders in connection with such sales. In such a circumstance, the debtor generally enters into an agency agreement with the liquidators that allows the liquidators to sell the inventory and the FF&E at the locations where the debtors are currently operating (which generally consists of malls and other leaseholds).

## GOB Sale Process

GOB sales are governed by section 363 of the Bankruptcy Code which provides that a "trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." A GOB sale motion will often by filed in the first few days of the bankruptcy case's initiation, and it is in the debtor's best interest to begin planning *prior to* the petition date to streamline the process. Pre-petition consultants are often hired to assess which locations should be closed to align with broader goals to maximize value. In deciding on a list of stores to close, companies will consider factors such as individual store profitability, recent sales

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trends, geographic market where the store is located, and potential to realize negotiated rent reductions with specific landlords.[2]

GOB sales often occur within a short time period after the petition date because of restrictions imposed by the Bankruptcy Code and pre-petition lenders. The time frame to complete a GOB sale is condensed because the Bankruptcy Code places a limit on how long a debtor has to assume or reject executory contracts and unexpired leases. Under Section 365(d)(4)(B)(i) of the Code, a debtor has 120 days to decide whether to assume or reject an executory contract or unexpired lease. This period may only be extended once for cause on a motion by the debtor for an additional 90 days.[3] After that, an extension concerning the decision on an unexpired lease will only be allowed with landlord approval. That means that if the debtor is unable to assume its leases, it has at most 210 days to conduct an entire GOB sale. Aware of this restricted time frame, pre-petition lenders will often mandate prompt GOB.

GOB sale motions generally include proposed procedures for conducting the sale. In the Motion, the debtor generally identified which stores the sales will take place, how long the sale will continue, and what level of advertising will occur. For advertising, the debtor generally explains in detail what kind of advertising will occur and the exact language that is going to be used. Furthermore, large companies with many locations often opt to hire a liquidating consultant or agent to oversee the process who must also be approved by the court.

For a GOB sale motion to be approved, a debtor must also demonstrate a legitimate business justification to initiate a GOB sale outside the ordinary course of business, and must establish one of the required elements of section 363(f) to sell assets free and clear of liens and claims.

Authority to Initiate a GOB Sale

A debtor seeking to initiate a GOB sale must provide the court with an articulated business reason to justify the sale. The debtor will generally be forced to show that the failing locations have no hope of reorganization and that the GOB sale is the best opportunity for the business to preserve value for creditors and other interested parties. Merely showing that the debtor is losing money will likely not be sufficient to justify a GOB sale.

For example, in *Stephen Industries, Inc. v. McClung*,[4] the court granted the debtor's motion to sell the assets in a radio station outside the ordinary course of business because the station was no longer making a profit and the owner could no longer meet its payroll and other operating expenses.[5] If the radio station stopped operating, then it would lose its FCC licenses. In this case, approving the

[2] *See, e.g.*, *In re Payless Holdings LLC, et al,* No. 17-42267, at 4* (Bankr. E.D. Miss. Apr. 5, 2017) (explaining to the bankruptcy court why certain stores should be closed).

[3] *See In re Ernst Home Center, Inc. and EDC, Inc.*, 209 B.R. 974, 980 (Bankr. W.D. Wash. 1997) (listing as examples of factors courts consider in deciding whether cause exists to extend time to assume or reject contracts: whether lease is primary asset of debtor, lessor has a reversionary interest in the building built by the debtor, debtor has had time to intelligently appraise its financial situation, lessor continues to receive rent, an extension will damage lessor beyond compensation available under Bankruptcy Code, case is exceptionally complex, or any other factors bearing on whether debtor has had a reasonable time to decide what to do.)

[4] 789 F.2d. 386, 390 (1986).

[5] *Id*.

sale was in the best interests of all parties.[6] The Second Circuit affirmed the bankruptcy court's approval of an asset sale in *The Official Committee of Unsecured Creditors of LTV Aerospace & Defense Co. v. The LTV Corp (In re Chateaugay Corp.)*,[7] where it found that waiting would risk diminishing the ultimate value to be received from the assets, whereas an immediate sale would protect all creditors. The court noted that a judge may consider all factors, including potential tax benefits, the immediate need to maximize the assets value, how close a plan is to completion and the percentage of assets to be sold.[8]

Based on this reasoning, a debtor has a greater chance of gaining approval for a GOB sale at a specific location if evidence suggests that waiting would irreparably diminish the eventual return on the assets to the detriment of other creditors.

Approval to Sell Assets Free and Clear of Liens

One of the primary benefits of selling assets under section 363 is the ability to sell the assets free and clear of any liens or claims under Section 363(f).[9] However, to do so a debtor must establish either that applicable non-bankruptcy law permits such a sale, the entity consents, the sale price of the property is greater than the aggregate value of all liens on the property, the interest is in bona fide dispute, or the entity could be compelled in a legal or equitable proceeding to accept money satisfaction for the interest.[10] Companies conducting a GOB sale will often be able to gain the consent of the lienholder because the GOB sale likely represents the best opportunity to maximize value.[11] However, lenders will often require extra protection for their consent such as conditions on how the final proceeds will be used.[12]

To further facilitate a proposed GOB sale, a debtor will ask the court to waive a debtor's compliance with state or local laws concerning GOB sales and any provisions contained in the debtor's lease restricting the ability to conduct such a sale. However, courts are split as to how far the bankruptcy court can go in overriding non-bankruptcy law and lessor rights.

## Regulatory Restrictions on GOB Sales

GOB Sales are powerful tools for businesses and have the ability to entice large numbers of consumers. With this in mind, many states have enacted rules governing how GOB sales may be conducted to ensure that consumers are not mislead by deceptive practices. Furthermore, GOB sales may implicate general consumer protection laws or other generally applicable regulations. Where a GOB sale plan contravenes a valid law, local and state governments will often intervene to try and impede the process.

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[6] *Id*.

[7] 973 F.2d 141, 145 (2d Cir. 1992).

[8] *Id*. at 144.

[9] *See* 11 U.S.C. § 363(f): "The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate."

[10] *See* 11 U.S.C. § 363(f)(1-5).

[11] *See Payless*, No. 17-42267 at 17 ("The debtors anticipate that, to the extent there are liens on the Store Closure Assets, all holders of liens will consent to the sales because they provide the most effective, efficient, and time-sensitive approach to realizing proceeds for, among other things, the repayment amounts due to such parties."); *In re Hancock Fabrics, Inc., et al., a Delaware Corp*., No. 16-10296-BLS, 35-36 (Bankr. D. Del. Feb. 02, 2016) ("Debtors' senior secured lenders and Noteholders have expressly consented to the Sale Transaction.").

[12] *Hancock*, No. 16-10296-BLS at 36.

However, the bankruptcy court has the authority under the Supremacy Clause of the Constitution to preempt state laws that conflict with the underlying scheme of the Bankruptcy Code. Constitutional authority is vested in Congress "[t]o establish…Uniform Laws on the subject of bankruptcies throughout the United States." U.S. Const., art. I, § 8, cl. 4. Accordingly, Federal law may supersede state law either where Congress expressly preempts state law in the wording of a statute, or state law may be impliedly preempted where an inference may reasonably be made that the state law will impede the effectiveness of the federal scheme.

The court in *Baker & Drake, Inc. v. Public Service Commission of Nevada*[13] outlined the four types of implied preemption that may apply to bankruptcy law. Federal law may impliedly preempt state law where the federal scheme is sufficiently comprehensive to allow the inference that Congress left "no room" for state regulation, the federal interest is "so dominant" as to preclude state laws on the same subject, complying with both sets of laws would be a physical impossibility, or the state law stands as an obstacle to the accomplishment and execution of the full objectives and purposes of the federal scheme.[14] The court reasoned that the first three will generally not apply to bankruptcy since the federal Bankruptcy Code and state law often coexist.[15]

Therefore, a debtor seeking to have a state law preempted might argue that the law undermines the overall goals of the Bankruptcy Code to maximize the value of estate assets and facilitate efficient resolution of the case. For example, in *In re Shenango Group, Inc.*[16], the bankruptcy court waived a debtor's obligation to follow a state law, finding that the state law undermined the distribution scheme envisioned by the Bankruptcy Code.[17] In that case, a state wage law would have required officers of a bankrupt company to pay missed vacation and retirement benefits to employees. However, compelling the officers to pay these benefits would have allowed the employees to recover from both the employees and the company in contravention of the intent of the federal scheme.[18]

Furthermore, a court deciding whether to preempt a state statute has the discretion to consider whether the waiver will accrue a benefit to the estate that outweighs any compromise of protection to the consuming public. For example, in *In re Crawford Furniture Manufacturing Corp.*,[19] the bankruptcy court held that the benefits that would accrue from waiving a state law regarding the length of a GOB sale outweighed the benefit that customers would receive from strict adherence to the statute.[20] The debtor in that case agreed to procedures designed to protect prospective customers, so the risk of harm to consumers was minimal.[21]

While bankruptcy courts have wide discretion to advance the interests of federal bankruptcy law through preemption, dissenting parties still have avenues for objection. In particular, some courts have held that 28 USC § 959(b) provides an independent limit on a debtor's ability to ignore state laws, and a limit on preemption has also been created for laws regarding public health or safety. Considering the fact that GOB sales may be used to exploit customers, stricter compliance may be

[13] 35 F.3d. 1348 (9th Cir. 1994)
[14] *Id*. at 1353.
[15] *Id*.
[16] 186 B.R. 623 (Bankr. W.D. Pa. 1995)
[17] *Id*. at 629.
[18] *Id*.
[19] 460 B.R. 586 (Bankr. W.D.N.Y. 2011).
[20] *Id*. at 591.
[21] *Id*. at 592.

required for state laws regarding advertising, the augmentation of inventory at failing stores, and the duration of a GOB sale. When the debtor seeks to override these requirements, oftentimes competing interests are resolved through agreements among the parties.

### 1. Interaction between the Bankruptcy Code and 28 USC § 959(b) in the GOB Sale Context

Under 28 USC § 959(b), a trustee and a debtor-in-possession must manage property according to the valid laws of the state in which the property is located. Governments have often argued that 28 USC § 959(b) prohibits a court from approving a GOB sale that does not comply with applicable state laws. However, only a minority of courts have concluded that a debtor must comply with regulations that apply to GOB sales outside of bankruptcy. For example, in *In re White Crane Trading Co. Inc.*,[22] the court held that section 959 limits the authority of a debtor to circumvent state deceptive trade practice laws during a GOB sale and stands for the proposition that a trustee must carry out his duties in conformity with state law.[23] The court noted that GOB sales pose significant risks to the public because of "widely understood opportunities for exploitation of the gullible."[24]

Conversely, the majority of courts have held that 28 USC § 959(b) does not apply to liquidation sales, but only to the situation of the debtor seeking to continue running the business. The court in *Walker v. Maury County*[25] makes a compelling argument that the language of Section 959(b) evinces a statutory intent for the section to apply only when the business is being operated.[26] Section (a) states that debtors in possession may be sued for acts "in carrying on the business" and section (b) states that a debtor "shall manage and operate the property" according to the laws of the state.[27] Taken together, the two sections do not appear to apply to a situation in which assets are being liquidated.[28] Following this reasoning, the Walker court declined to use 28 USC § 959(b) as a limit on the court's ability in a liquidation to preempt a local zoning regulation.[29]

Courts have also looked to the purpose of the statute in declining to apply 28 USC § 959(b) to liquidations. In passing the statute, Congress sought to negate the idea that a debtor-in-possession could ignore the laws of the state of operation affecting the conduct of the business committed to its charge. See, e.g., *Mo. Dept. of Natural Res. v. Valley Steel Prods. Co. (In re Valley Steel Prods. Co.)*, 157 B.R. 442, 448 (Bankr. E.D. Mo. 1993), quoting *Palmer v. Webster & Atlas Nat'l Bank*, 312 U.S. 156 (1941). According to the Seventh Circuit, strictly applying 28 USC § 959(b) to liquidation sales would not serve the purposes that Congress intended because a trustee or debtor in a liquidation is not operating the business but rather only has to retain the status quo and keep the assets intact.[30]

### 2. Exception to Preemption for Laws regarding health and safety

[22] 170 B.R. 694 (Bankr. E.D. Cal. 1994).
[23] *Id*. at 702-703.
[24] *Id*.
[25] 91 B.R. 190 (Bankr. S.D. Ga. 1998).
[26] *Id*. at 196.
[27] 28 USC § 959.
[28] 91 B.R. 190, 196.
[29] *Id*.
[30] *S.E.C. v. Wealth Mgmt. LLC*, 628 F.3d 323, 334 (7th Cir. 2010).

The Supreme Court has held that the Bankruptcy Code may not preempt a state statute that is "reasonably designed to protect the public health or safety from identified hazards."[31] In *Midlantic National Bank v. New Jersey Dep. of Environmental Protection*, the bankruptcy court had allowed the debtor to abandon a toxic waste site to save money in contravention of a New Jersey regulation, but the Supreme Court reversed, reasoning that Congress did not intend for the Bankruptcy Code to preempt all state laws.[32] The *Midlantic* court noted that "Congress has repeatedly expressed its legislative determination that the trustee is not to have carte blanche in ignoring non-bankruptcy law" and "the efforts of the trustee…must yield to the governmental interest in public health and safety."[33]

Subsequent courts have followed this reasoning, declining to waive a debtor's obligation to adhere to a state statute that is reasonably tailored to protect public safety. In *Baker & Drake, Inc. v. Pub. Serv. Comm'n of Nev. (In re Baker & Drake, Inc.)*,[34] for example, the 9th Ciruit refused to allow a cab company to treat their drivers as independent contractors during a reorganization when Nevada law required treating them as full employees, because the law was designed toward public safety by ensuring that the company be responsible for any liability in the case of an accident.[35]

### 3. Advertising

Many states have passed consumer protection laws designed to prevent companies from advertising GOB sales when the company is *not* in bankruptcy. Such sales can lead to excellent returns for the company, but there are concerns that they may also lead to customer confusion, so-called deceptive advertising, and can hurt the public image of a shopping area. Because of the dangers posed to the public by false advertising, courts often require more strict compliance with local GOB advertising requirements. The court may even pose sanctions where a debtor has sought to exploit the bankruptcy system to escape consumer protection laws. In *In re Int'l Oriental Rug Ctr., Inc.*,[36] a debtor advertised a liquidation sale, even though he had filed a petition for reorganization. The court imposed sanctions on the debtor for indicating to the court in a motion in bad faith that the company would not be holding a liquidation sale.[37] Advertising that conflicts with state laws is often approved by the court.

### 4. Augmentation of Inventory in Failing Stores

In addition, state laws typically limit the amount and nature of the goods that the retailer can add it to is current merchandise specifically for the GOB sale. The impetus for these laws is twofold, though the basic premise is that augmentation is misleading to the consumer. First, the new merchandise may not be the same quality that consumers expect of the retailer, which can be misleading to customers who have come to purchase the same items previously sold by the store. Second, it is counter-intuitive for a store that is winding down its operations to sell newly acquired merchandise. Adding new merchandise is what stores that are operational do in the normal course of business. Plus, having a larger inventory can actually delay the completion of the closing if

[31] *Midlantic National Bank v. New Jersey Dep. of Environmental Protection*, 474 U.S. 494, 507 (1986).
[32] *Id*. at 505.
[33] *Id*. at 502.
[34] 35 F.3d 1348 (9th Cir. 1994).
[35] *Id*. at 1353.
[36] 165 B.R. 436 (Bankr. N.D. Ill. 1994)
[37] *Id*. at 438.

"everything must go." Thus, limits on adding merchandise can actually be seen as limits to the allowed duration of a GOB sale, discussed more fully below.

Courts have ruled differently on whether a debtor must comply with state laws that prohibit the augmentation of pre-existing inventory. In *In re Crawford Furniture Mfg. Corp.*,[38] a chapter 11 debtor sought authority to sell its remaining inventory along with a non-debtor entity's inventory through a GOB sale free of New York's restrictions that prohibited such augmentation. The *Crawford* Court examined its discretion to waive state restrictions (including requirements for licenses, observing time limitations, and bulk sales laws) and determined it would only exercise that authority if the proposed sale was reasonably designed to fulfill the legitimate goal of liquidating estate property, which the Court determined it was.[39] In reaching that decision, the Court was cognizant that it "must always exercise [its] discretion reasonably and through careful accommodation of the goals and purposes of the [Bankruptcy Code]" while "balance[ing] competing concerns: on the one hand, the goal of bankruptcy to maximize a recovery of value for creditors, and on the other hand, the desire of the state to protect the consuming public."[40] Accordingly, the Court had to resolve four critical issues: (1) whether the proposed sale was designed primarily to market estate property and not as subterfuge to evade state laws regarding sale of unrelated merchandise; (2) whether the proposed sale complied with non-waivable requirements of valid laws of the state in which property was situated or attempted too broadly to disregard such restrictions; (3) whether, with respect to those restrictions for which state law allowed a waiver, any such a waiver would accrue benefit to the estate that outweighed any compromises of protection to consuming public; and (4) whether the parties proposed transparent procedures that were reasonably designed not to mislead purchasers, creditors and other interested parties.[41]

The debtor, a furniture manufacturer, contended that its proposed going-out-of-business sale if conducted outside the strict constraints of state law would not impair concerns of consumer protection, and that the sale would appropriately maximize value for distribution to creditors.[42] The bankruptcy court held that, with appropriate limitations, the debtor's going-out-of-business sale outside the confines of state law was appropriate.[43] While there was a need to augment the debtor's inventory to offer an attractive combination of merchandise, the sale properly limited consigned merchandise to appropriate type, quantity, and value to insure the marketing of merchandise similar to what the debtor previously offered for sale (for example, offering mattresses to go with the manufacturer's wood frame beds).[44] Further, the sale was primarily designed to market estate property rather than to evade state laws, the debtor agreed to continue to be bound by other state and local laws regulating public health, welfare, and safety, and the sale utilized transparent procedures which were reasonably designed to avoid misleading purchasers, such as using appropriate sale tags.[45]

Conversely, in *In re Willis Furniture Co.*,[46] the bankruptcy court declined to approve certain advertising devices that the debtor sought to use in connection with a proposed GOB sale, which

[38] 460 B.R. 586 (Bankr. W.D.N.Y. Dec. 5, 2011).
[39] *Id*. at 591.
[40] *Id*. at.
[41] *Id*. at 591-92.
[42] *Id*. at 588.
[43] *Id*. at 592.
[44] *Id*. at 591.
[45] *Id*. at 592.
[46] 148 B.R. 691 (Bankr. D. Mass. Dec. 22, 1992).

included selling inventory of the liquidation company in addition to its own inventory under the auspices of a bankruptcy liquidation.[47] At the time of filing its Chapter 11 case, the debtor sought permission to hold a GOB sale that it would advertise as a "bankruptcy sale" in conjunction with a liquidator. The bankruptcy court denied the motion as well as two amended versions thereof. The court granted the third motion, placing substantial conditions on the sale, and denied a motion for reconsideration. The debtor unsuccessfully appealed the denial to the district court and the Court of Appeals, which rejected the debtor's claim that the court's refusal to allow it to advertise the event as a "Chapter 11 Bankruptcy Sale" violated the debtor's First Amendment rights. After remand, the debtor again sought the court's approval for two advertising devices for use in connection with the sale. The court denied the motion and went so far as to find it sanctionable as being directly contrary to the appellate court's order. It found that to refer to the sale as a "debtor's Chapter 11 sale" when inventory was being furnished on a consignment basis by a solvent company *not* under Chapter 11 pressures to raise funds was misleading, because the proposed sale was little more than a device for the liquidator to sell its own merchandise.[48]

**4. Duration of GOB Sales**

Another area in which states regulate the GOB sale process is the duration of such a sale. Consumers are so enticed by the magic words, "clearance", "store-closing sale" and the like that without these limitations, retailers could easily be persuaded to hold a perpetual "going out of business" sales, which may arguably lead to unfair competition with other stores who are not labeling their sales as such.

As discussed above, the court in *Crawford* applied a balancing test in deciding whether it was reasonable to extend a GOB sale past what was allowed under state law.[49] The court weighed the benefit to the estate against any compromise to consumer protection. The company demonstrated that it would enhance the asset recovery of the estate if the GOB was extended through the holiday season, while the adoption of procedures by the company ensured that any damage to consumers would only be minimal.[50] In particular, the debtor adopted a series of disclosure requirements to protect prospective customers. Therefore, a debtor seeking to extend a GOB past what is legally permitted may have to demonstrate to the court how a longer sale will benefit the estate.

**Lease Restrictions on GOB Sales**

The ability of a debtor to complete a GOB sale will often conflict with provisions in leases that prohibit closure sales. Landlords fear that extended GOB sales will undermine the image and reputation of the premises and may arguably give the debtor an unfair advantage over other nearby tenants. Therefore, if a court grants a debtor the right to ignore an anti-GOB provision in a lease, the court will have infringed on the landlord's bargained for rights.

As a practical matter, courts generally override provisions in leases restricting closure sales, finding that such clauses undermine the ability of a debtor to maximize the value of its assets in a section 363 sale. In *In re Tobago Bay Trading Co.*,[51] the court allowed a debtor to conduct a liquidation sale, notwithstanding a contrary provision in a lease. The *Tobago* court reasoned that

[47] *Id*.
[48] *Id*. at 694.
[49] *Crawford*, 460 B.R. at 592.
[50] *Id*.
[51] 112 B.R. 463 (Bankr. N.D. Ga. 1990).

"where the benefit to the debtor outweighs the potential harm to the lessor, the court may exercise its equitable powers to deny enforcement of a clause that would have severe negative consequences on a Chapter 11 debtor's ability to reorganize."[52] The court pointed out that the objectors to the reorganization "have made no showing that they or other tenants will suffer substantial economic detriment as a result of the failure to enforce this…provision."[53] The potential harm in this case was substantially greater than the potential harm to the objectors and "would result in onerous and burdensome costs to an already financially stressed debtor's estate."[54]

On the other hand, because GOB sales have become such a common part of chapter 11 cases, bankruptcy courts have sought to impose some restrictions to ensure landlord rights are protected. Going back to the 1980's, the court in *In the matter of Lisbon Shops, Inc.*,[55] agreed to waive a provision in a lease prohibiting GOB sales, but placed limits on the debtor's discretion to conduct the sale. The court discussed the perceived dangers associated with GOB sales, recognizing that they may disrupt the image of the area and cause an imbalance in the planned tenant mix. However, the court reasoned that such dangers are unlikely as long as sufficient procedures were adopted. With this in mind, the court concludes that "a liquidation sale, conducted by the debtor, using its employees, from the present location, for a fixed and reasonable time, under the supervision of the Bankruptcy Court would accomplish both objectives" of debtor's benefits under federal law and lessor interest.[56] In any event, debtors often agree to reasonable provisions in leases to ensure that their GOB plan is approved.[57]

Courts have also specifically declined to enforce continuous use clauses in leases, which allow a landlord to place the lease in default if the premises are not in use for a certain period of time.[58] Such clauses protect a landlord's interests by ensuring that a lot does not remain vacant if a tenant's business fails, but bankruptcy courts have held them unenforceable as anti-assignment clauses under Section 365(f) of the Bankruptcy Code. Section 365(f) states that "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."[59] One such example is when a debtor assigns a lease but the assignee needs time to renovate, a continuous use clause may place the lease in default before the transition can happen. In such instance, the continuous use clause would be an anti-assignment provision that offends 365(f).

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[52] *Id*. at 467.

[53] *Id*.

[54] *Id*.; *see also In re Ames Dep't Stores, Inc.*, 136 B.R. 357 (Bankr. S.D.N.Y. 1992) (holding in the context of a 363 sale that "to enforce the anti-GOB sale clause of a lease would contravene overriding federal policy requiring debtor to maximize estate assets by imposing additional restraints never envisioned by Congress" and that "363(e) reserves for bankruptcy courts the discretion to condition the time, place and manner of GOB sales.").

[55] 24 B.R. 693(Bankr. E.D. Miss. 1982).

[56] *Id*. at 695.

[57] *See Payless*, No. 17-42267, Sale Guidelines at 1 (where the debtor agreed to terms stipulated in the lease in the sale guidelines to not distribute written materials and at conclusion of sale allowing landlord normal access to the premises as provided by the lease).

[58] *See, e.g.*, *In re Service Merchandise Co., Inc.*, 297 B.R. 675 (Bankr. M.D. Tenn. 2002), *In re Peaches Records and Tapes, Inc.*, 51 B.R. 583 (9th Cir. BAP 1985), *In re Goody's LLC*, No. 09–10124 CSS, 2009 WL 7812260, at *6 (Bankr. D. Del. Jan, 15 2009) (allowing a GOB sale to proceed notwithstanding any "going dark" provisions).

[59] 11 U.S.C. § 365(f).

The court in *In re Service Merchandise Co., Inc.*[60] rejected a continuous use clause as a *de facto* non-assignment clause that violated 365(f). The clause stated that "In the event that Tenant fails to operate its building on the leased premises for a continuous period of nine (9) months…Landlord shall have right…to notify tenant that it elects to purchase tenant's leasehold improvements."[61] The court reasoned that in practical reality this was merely a veiled anti-assignment clause.[62] However, courts have allowed provisions to stand that are less open-ended and do not unreasonably restrain a debtor's ability to assign the lease. For example, in *In re IT Group Inc. Co.*,[63] the court held that a right of first refusal would not hamper the debtor's ability to assign the property or recognize the full value of their interest. The court recognized a bankruptcy court's authority to retain some discretion in determining whether provisions are de facto anti-assignment clauses, but a right of first refusal is not unreasonable.[64]

**Even More Restrictions for Shopping Center Leases**

The Bankruptcy Code imposes heightened restrictions on the assumption and assignment of leases located in shopping centers.[65] Under Section 365(f)(2)(B), a debtor need only provide assurance that the assignee will perform under the lease. Recognizing that in a shopping center, a lease assignment affects not only the lessor, but could have a detrimental impact on other tenants in a shopping center, Congress placed additional restrictions on assignments of shopping center leases to the rights of both lessors and the shopping center's other tenants.[66] One thing Congress did not do is define "shopping center" so that it is clear when these additional restrictions apply. Developing a proper definition of "shopping center" has been "left to case-by-case interpretation."[67]

*Interpreting 365(b)(3)(A)*

The court in *In re Joshua Slocum Ltd.* provides a good overview of other court's interpretations of a shopping center that ultimately guided them to a finding that the lease at issue was part of a shopping center. The *Joshua Slocum* court first discussed *In re Goldblatt Brothers, Inc.*[68] In making a determination of whether the debtor's location was part of a shopping center, the Seventh Circuit in *Goldblatt* looked to several factors, including common ownership of contiguous parcels, the presence of an "anchor tenant", and joint off-street parking, but found that these factors were not determinative.[69] Rather, the court was persuaded by the *absence* of typical indicia of a shopping center, namely a master lease, fixed hours during which all stores would be open, common

[60] 297 B.R. at 693.
[61] *Id*. at 693-94.
[62] *Id*.
[63] 302 B.R. 483 (D. Del. 2003).
[64] *Id*. at 488.
[65] *See* 11 U.S.C.§ 365(b)(3), which provides in relevant part: "(3) For the purposes of paragraph (1) of this section, adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance – (A) of the source of rent and other consideration due under such lease; (B) that any percentage rent due under such lease will not decline substantially; (C) that assumption or assignment of such lease will not breach substantially any provision, such as a radius, location, use or exclusivity provision, in any other lease, financing agreement, or master agreement relating to such shopping center; and (D) that assumption or assignment of such lease will not disrupt substantially any tenant mix or balance in such shopping center."
[66] *See* S.Rep. Nos. 98-70, 98th Cong. 1st Sess. (1983).
[67] *In re Joshua Slocum Ltd.*, 922 F.2d 1081 (3d Cir. 1990) (quoting *In re Glodblatt Brothers, Inc.*, 766 F.2d 1136, 1140 (7th Cir. 1985)).
[68] 766 F.2d 1136, 1140 (7th Cir. 1985).
[69] *In re Joshua Slocum Ltd.*, 922 F.2d at 1087.

areas, and joint advertising.[70] In *905 Int'l Stores, Inc*.[71] the court also relied on "the absence of contractual interdependence among tenants" for its finding that the arrangement at issue was not part of a "shopping center". [72] *905 Int'l Stores* likewise set forth some objective criteria for determining whether a "shopping center" is at issue. "In addition to contractual interdependence among tenants, these factors include the existence of percentage rent clauses, anchor tenant clauses, joint contribution to trash and maintenance needs, contiguous groupings of stores, a tenant mix, and restrictive clauses."[73] The *Joshua Slocum* court turned to Collier's for guidance in addition to the case law (listing even more factors for consideration).

After deciding that the lease at issue was part of a "shopping center" and that the restrictions for lease assignments in shopping centers as set forth in Section 365(b)(3) applied, the *Joshua Slocum* court deferred to the Congressional purposes in enacting these restrictions when ruling that the bankruptcy court did not have authority to excise a lease provision addressing the option to terminate based on the average sales generated by the tenant.[74] The court found this lease provision affected the landlord's ability to calculate the minimum rent it could expect to receive (amounting to the "other consideration due" under the lease) and that without it, the trustee could not give adequate assurance of future performance under the lease and the landlord would not get the benefit of its bargains – something Congress was particular to protect.[75] Accordingly, the excision of the provision at issue would be in derogation of Section 365(b)(3)(A) and could not be allowed.

*Interpreting 365(b)(3)(C)*

In *Antwerp Diamond, Inc.*,[76] the bankruptcy court considered the debtors' request for what amounted to a variance of the intended use obligations of various lessees. The debtors, who operated a string of regional jewelry stores, proposed to allow their liquidator to conduct GOB sales in leased locations that had ceased operating shortly after the debtors' Chapter 11 bankruptcy filing.[77] Several of the shopping center tenants objected, alleging that the use of the since emptied spaces would be in violation of the master lease affecting other retail tenants in the shopping mall.[78] Although the debtor had not yet assumed or rejected its leases, it was clear to the court and all concerned that it intended to do so. The court found, therefore, that the debtors' proposal, which would vary the use obligations of the affected leases, was tantamount to an assignment and assumption of the debtors' rights under the leases to the asset purchaser (the liquidator) without being properly prosecuted before the bankruptcy court.[79]

The court, noting that "[o]ne of the principal legislative purposes of the 1984 shopping center amendments to § 365 was to delete the 'substantial' aspect of any harm resulting from such a 'use' modification by Debtor and, rather, require strict compliance with the 'use' provisions contained in

[70] *Id*.
[71] 57 B.R. 786 (E.D. Mo. 1985).
[72] *Id*. at 788-89.
[73] *In re Joshua Slocum Ltd.*, 922 F.2d at 1087.
[74] *Id*. at 1089-1091.
[75] *Id*. at 1091.
[76] 138 B.R. 865 (Bankr. N.D. Ohio 1992).
[77] *Id*. at 866.
[78] *Id*.
[79] *Id*. at 867-868.

the affected lease."[80] Accordingly, the court found that the attempted variance violated Section 365(b)(3)(C).

## § 363 Sales Involving Consigned Goods

Significant issues can arise in bankruptcy proceedings where a debtor attempts to liquidate consigned or purportedly consigned goods pursuant to a 363 Sale. Recent case law holds that such property may only be sold through an adversary proceeding. In *In re Whitehall Jewelers Holdings, Inc.*[81], the debtor, a national retailer of fine jewelry, attempted to sell by a 363 motion substantially all of its assets, including a certain amount of goods held under consignment agreements in which the vendors retained legal title to the consigned inventory.[82] Many of the consignment vendors objected to the sale of what they considered to be "their" property, and therefore not property of the estate subject to sale under 363.[83] The debtor argued that the dispute concerning the parties' relative interests in the consignment goods qualified as *bona fide* within the meaning of Bankruptcy Code § 363(f)(4), allowing the sale of property "free and clear of any interest in such property of an entity other than the estate, only if . . . such interest is in *bona fide* dispute."[84] In other words, arguing that the consignor's interest in the property was disputable, the debtor asserted that it could sell the property free and clear of liens. The debtor further argued that no evidence or determination of ownership was required for the court to conclude that a *bona fide* dispute existed, asserting that it was sufficient for purposes of Section 363(f)(4) that the debtor possessed Section 544(a) powers of a hypothetical judgment creditor pursuant to which the debtor might be able to avoid the ownership interests in the consigned goods, and thereby those goods could become property of the estate.[85]

The court disagreed with the debtor, holding that, if there is an "unresolved issue of whether the subject property is 'property of the estate'", then 363 cannot be utilized.[86] Instead, the court held that the debtor must first establish that the property is property of the estate, and that when there is "an unresolved issue" regarding ownership, the debtor must establish it by filing an adversary proceeding pursuant to F.R.B.P. 7001, which requires an adversary proceeding to invalidate an interest.[87]

Not every court, however, has unequivocally required an adversary proceeding to establish ownership prior to a sale under § 363. In *In re Eastman Kodak Co.*[88], the debtor tried to sell patents that were subject to ownership disputes and sought to litigate in the contested matter that it was the

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[80] *Id*. at 868.

[81] *In re Whitehall Jewelers Holdings, Inc.,* 2008 WL 2951974 (Bankr. D. Del. July 28, 2008).

[82] Selling consigned inventory is very common in this industry, and in fact the debtor had increased its consignment inventory in the years leading up to the bankruptcy filing. Both the debtor and its creditors benefitted from the consignment program because it allowed the debtor to add to the selection of goods for sale in its stores while preserving working capital for other purposes.

[83] The consignment vendors asserted that they held the ownership interest in the consigned goods, not the debtor and accordingly the debtor had no statutory basis to sell any of the consigned property; i.,e., the debtor had no interest in property that it could convey via a 363 sale.

[84] *Id*. at 3.

[85] *Id*. at 5.

[86] *Id*. at 7.

[87] *Id*. at 6. *See also In re Wilson*, 2011 WL 2784289, No. 11-10683 (Bankr. N. D. Cal. July 8, 2011) (requiring "litigation" to determine ownership of consigned goods prior to approving sale even though consignors admitted to not filing financing statements, but stating that "[t]he court will expedite that litigation as necessary.").

[88] *In re Eastman Kodak Co.*, 2012 WL 2255719, *1 (Bankr. S.D.N.Y. June 15, 2012).

sole owner. The court refused to litigate the ownership issue in the contested matter, stating as follows:

> Since the relief Kodak seeks is, for all intents and purposes, an action for a declaratory judgment to determine an interest in property by excluding the claimed interests of Apple and Flashpoint, the plain meaning of Rule 7001 indicates that it must be brought as an adversary proceeding, not as a contested Rule 9014 motion. Although Kodak proceeds on the premise it can obtain the relief it seeks based on this Court's ability to authorize sales under § 363, it has not cited any authority that a bankruptcy court can determine ownership of property in connection with a sale motion, and the small amount of authority on point suggests the opposite.[89]

The court in *Kodak* did, nonetheless, acknowledge that "[i]t may be appropriate in some situations" to determine ownership in a contested matter but that "[i]n this case, the issues are sufficiently complex as to require them to be asserted in the context of an adversary proceeding."[90]

The court in *Kodak* did not, however, reach the same conclusion as the court in *Whitehall Jewelers* regarding the reach of 363(f)(4). Instead, the *Kodak* court found that the "plain language" of 363(f)(4) provided for sale of property subject to another party's "interest" if the interest were subject to a legitimate dispute, and that "interest" did not just mean liens, but also meant ownership. The court in *Kodak* insightfully pointed to the use of the word "interest" in § 363(h) to show that ownership was contemplated by the drafters of the Code.[91]

The court then stated that "it would appear that Kodak could sell the disputed patents under section 363 with the proceeds to be escrowed, awaiting a determination as to whether they should be paid to Kodak, Apple, or Flashpoint."[92] Recognizing, however, the complications of this, and the threat of piecemeal litigation, the court ordered the parties to initiate an adversary proceeding.[93] The court ordered an immediate conferral of the parties to produce a schedule for an expedited adversary proceeding, and sought to assure the debtor that "the need to litigate in an adversary" would not "result in inordinate delay."[94]

While the case law does not provide much clarity, it appears the safer option for a debtor considering a 363 sale that includes consigned goods is to first file adversary proceedings to determine the rights of consignors prior to filing the proposed sale motion. Of course, in many cases, there simply is not adequate time. Alternatively, the debtor may at least seek a determination by the

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[89] *Id*. at 2 (citing to *SLW Capital, LLC v. Janica Mansaray–Ruffin (In re Mansaray–Ruffin),* 530 F.3d 230 (3d Cir. 2008)).

[90] *Id*.

[91] The court in *Kodak* also distinguished the holding in *Whitehall*, stating that "[i]t is worth noting, however, that in *Whitehall,* the debtors were seeking to sell consigned property and thus had not made even a *prima facie* showing that the property to be sold was property of the estate." *Id.* at n. 6. This opinion does not necessarily say that *Whitehall* was wrong on its facts; only that its facts were sufficiently different from the ones in front of the court. This implies of course that were there a determination of a consignment, the court in *Kodak* might have agreed to the necessity of a predicate adversary proceeding.

[92] *Id*. at 3.

[93] *Id*. at 4.

[94] *Id*. at 3.

court prior to the sale that 363(f)(4) applies to permit a sale free and clear of liens *and* competing ownership interests.

**Perfection Issues Concerning Consigned Goods**

*In re Valley Media, Inc.*[95] examined the issue of whether the proceeds of consigned goods that were sold would be available to satisfy the claims of the consignee's creditors in the absence of the consignor filing a UCC-1 financing statement.96 In Valley Media, a number of consignors had failed to file UCC-1s on property in the debtor's possession. The debtor claimed that title had passed to it pursuant to UCC § 9-319(a). In response, the consignors argued that the transaction was not a "consignment" because the debtor was "generally known by its creditors to be substantially engaged in selling the goods of others."97 If the transaction was not a consignment, under state law, the consignors would still retain title to the property and the goods would not be subject to the consignee's lender's blanket lien in inventory.98

First, the court placed the burden of proof upon the consignor, not the consignee.99 The court then stated that the consignors had to prove both prongs of the two-pronged test: (1) that the consignee is substantially engaged in selling the goods of others, and (2) that it is generally known by the creditors of the consignee that this is the case.100 The court determined that "[i]n order to be 'substantially engaged' in selling the goods of others, a merchant must not hold less than 20% of the value of its inventory on a consignment basis."101 This creates a bright line requirement capable of determination, assuming other courts follow this guideline. The court then determined that "[t]o satisfy the 'generally known' prong of the test, the [consignors] must prove that a majority of the debtor-consignee's creditors were aware that the consignee was substantially engaged in selling the goods of others*, i.e.* consignment sales."[102] This appears to be a very difficult issue to prove or

[95] 279 B.R. 105 (Bankr. D. Del. 2002).

[96] UCC § 9-102(a)(20) defines consignment as a transaction in which a person delivers goods to a merchant for the purposes of sale and (a) the merchant deals in goods of that kind under a name other than the name of the person making delivery, is not an auctioneer, and is not generally known by its creditors to be substantially engaged in selling the goods of others; (b) with respect to each delivery, the aggregate value of the goods is $1,000 or more at the time of delivery; (c) the goods are not consumer goods immediately before delivery; and (d) the transaction does not create a security interest that secured an obligation.

If a transaction qualifies as a consignment transaction under the UCC definition, the consignor needs to perfect its interest by filing a financing statement adequately describing the goods in the appropriate jurisdiction, or else risk being classified as a general unsecured creditor upon the merchant's bankruptcy filing. This is because the debtor-merchant, as a debtor-in-possession, is deemed to have the same interest in goods as a hypothetical lien creditor would, and perfection would defeat that interest.

However, in order to protect its interest against a debtor's secured creditors with a blanket lien on inventory, the consignor must perfect its interest prior to the merchant's receipt of goods, and provide these creditors with an authenticated notification that states the consignor has or expects to acquire a purchase-money security interest in inventory (pursuant to UCC § 9-103(d) which provides that a consignor has a purchase-money security interest in goods that are the subject to a consignment, which , if perfected, has priority over conflicting security interests in the same inventory under UCC § 9-324(b)). The holder of the conflicting security interest must receive this notification within five years of the consignee taking possession of the inventory at issue. It is when consignors fail to follow these procedures that litigation over consignors' interests ensues.

[97] *Id*. at 124.

[98] *Id*.

[99] *Id*.

[100] *Id*.

[101] *Id*.

[102] *Id*.

disprove, as it will depend upon the subjective knowledge of each creditor. The court clarified that a "majority" would be "determined by the number of creditors, not by the amount of creditor claims" and that "[t]estimony as to general knowledge in the industry is insufficient to prove knowledge by a majority of creditors."[103] This second requirement is often the more litigated of the two prongs, and in fact, one of the express reasons the *Whitehall* Court ordered the initiation of adversary proceedings was to give the consignors a chance to argue that the debtor failed this test and that therefore the consignors did not need a UCC-1 to perfect their title in the consigned goods.[104]

Accordingly, if consignors of goods cannot prove both of these prongs, then the transaction at issue is likely to be considered a consignment. If found to be a consignment, and the consignors do not have first priority UCC-1s, then the consignors are likely to end up as unsecured creditors because their interests may be avoidable under § 544.

Working under the assumption that an adversary proceeding is required prior to a sale of consigned property, the question arises of whether the consignors can be combined in one action or whether the debtor must file against each separately. *F.R.B.P.* 7020 provides that defendants can only be joined in a single action if there is both a common transaction or occurrence giving rise to the defendants' asserted liability and a common question of law or fact.[105] The consignment vendors in *Whitehall* likewise made the argument that the debtor would have to file a separate adversary proceeding against each vendor in order to contest the vendors' ownership interests (and legal title to) the consigned goods, basing their argument on a case decided the day before the debtor filed its petition, *SLW Capital, LLC v. Mansaray-Ruffin (In re Manasaray-Ruffin)*, 530 F.3d 230 (3d Cir. 2008). The court agreed with them, finding that this determination could not be made in a contested matter.[106]

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[103] *Id*.

[104] *Whitehall*, 2008 WL 2951974, at 6. This was the outcome of *Valley Media*: The court found the consignors did not meet both prongs of the test and since they did not perfect their interest by filing UCCs, could not assert ownership interests in the inventory.

[105] *Mosley v. General Motors Corp.*, 497 F.2d 1330, 1333 (8th Cir. 1974); *In re Conners*, 125 B.R. 611, 614 (Bankr. S.D. Cal. 1991).

[106] *Whitehall*, 2008 WL 2951974, at 7.