HYPOTHETICAL

Overpriced Teen Furniture ("OTF") is a publicly-traded five-year old chain of 25 retail stores located primarily on the east coast. The 25 retail stores are located in large suburban malls, with good-to-excellent locations near the mall anchors. Generally, the lease terms are from ten to fifteen years with two five-year options. The leases are either slightly below market or are at market rates during the initial terms of the lease.

In addition to the 25 stores, OTF has an option to lease five additional stores in new (not yet built) suburban malls. Again, these stores again are in excellent locations and the options for the leases are below market rates for these malls.

OTF has a $25 million line of credit with its bank secured by substantially all of the assets of the business, including leasehold mortgages.

OTF has paid substantial dividends to its shareholders over the past eight quarters.

Unfortunately, due to the fickle teen furniture market, existing store sales began sinking in the last year. Despite sinking sales in the existing stores, the company opened two new stores in existing malls (bringing the total to 27 retail stores). Although sales in the two new stores have been exceedingly strong, the existing store sales have continued to sink. Accordingly, OTF has gone on an aggressive new store campaign with plans to open ten new stores in the current year.

Seeing the writing on the wall, and after reviewing the financial covenants, OTF's bank declares a default under its loan documents. OTF then restates its earnings for the past two years.

As a result of its restated earnings, OTF's Board of Directors terminates the CEO; however, all other Board members and officers continue their employment. The new CEO and the Board file a petition for relief under chapter 11 on the 3rd day of the month.

The debtor indicates to the court that it will continue to operate during its reorganization and/or liquidation. The debtor does not pay rent for the month that it filed, but pays all subsequent postpetition rent.

After six months of operating under chapter 11 relief, the debtor decides to liquidate its assets.

QUESTIONS

1. What options are available to the debtor if it wants to conduct going out of business sales from the lease locations?

    a. Does it matter if the sale will be conducted 210 days after the order for relief?

2. What options are available to the debtor if it wants to assume and assign leases as part of a plan of reorganization or liquidation?

3. What options are available to the landlord if it wants to regain control over the leased premises?

4. Can the debtor assume and assign the lease options?

5. Does the debtor have to assume or reject the lease options prior to the period specified in § 365(d)(4)?

6. Does the secured creditor's leasehold mortgage affect the rights of the debtor or landlord under § 376(d)(4)?

7. Is the United States Trustee required under § 1104(e) to move for the appointment of a trustee if he/she believes that the debtor's former CEO engaged in fraud in the initial statement of the debtor's financials?

a. Under § 1104(e), is any other party authorized to bring this motion? Can the United States Trustee assign this motion to a committee?

b. When in the case is the United States Trustee required to bring this motion?

c. Can a party-in-interest bring the motion under § 1104(a) if the CEO who was responsible for the alleged fraud is no longer current management?

HORNBOOK

I. LEASE ISSUES

The rejection of executory contracts under the Bankruptcy Code has its roots in the principal that a bankruptcy trustee may renounce title to an abandoned property which is burdensome to the estate. *See Sunflower Oil Co. v. Wilson*, 142 U.S. 313 (1891). It was generally agreed that with respect to executory contracts, the trustee had the power to the either assume or renounce the executory contract as the trustee deemed in the best interest of the estate. This option to assume or renounce was not only a privilege, but a duty to ascertain within a reasonable period of time whether there was a potential asset in the lease for the estate. This concept to assume or reject executory contracts and unexpired leases is currently contained in § 365 of the Bankruptcy Code.

It is axiomatic that reorganization in bankruptcy is, by its very nature, designed to give a business some time to reorganize. Thus, for example, retail businesses often wish to wait through a business cycle before assuming all or some of their obligations to their landlords.

The Bankruptcy Code, prior to the recent amendments, codified in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act") provided that leases may be assumed or rejected within 60 days after the filing of a petition. 11 U.S.C. § 365(d). Under the former Bankruptcy Code, the court was permitted to extend this deadline, and the reality was that the deadline was often extended for periods substantially exceeding the initial 60-day period. These extensions often lasted for many months and, especially in large cases, may have delayed for years the landlord's ability to exercise its right.

The 2005 Act leveled -- or even tilted -- the playing field considerably. Landlords argue that the effect is to simply level the field, while other creditors and debtors are much less happy with the change. The legislative intent, however, was made clear in Senator Hatch's statements regarding the amendments to § 365(d):

> This legislation, like the conference report in the last two congresses, acts to curb this abuse. It imposes a firm deadline on a retail debtor's decision

> to assume or reject the lease. It permits a Bankruptcy Trustee to assume or reject a lease on a date which is the earlier of the date of confirmation of a plan or the date which is 120 days after the date of the order for relief. A further extension of time may be granted within the 120 day period, for an additional 90 days, for cause, upon motion of the Trustee or lessor. Any subsequent extension can only be granted by the Judge upon the prior written consent of the lessor, either by the lessor's motion for an extension, or by motion of the Trustee, provided that the Trustee had the prior written approval of the lessor. This is important. We are limiting the bankruptcy judge's discretion to grant extensions of the time for the retail debtor to decide whether to assume or reject the lease after a maximum possible period of 210 days from the date of the entry of the order for relief. Beyond the maximum period, there is no authority of the Judge to grant further time unless the lessor has agreed in writing to the extension.

It is clear from the congressional language that the intent of Congress in amending § 365(d) was to take any discretion away from the court and to mandate that the trustee make his decision whether to assume or reject a non-residential lease within a maximum time period of 210 days. This change will give landlords more certainty about their ability to relet the property and if the lease is assumed, a more prompt cure. In addition, a certain stream of postpetition rent debtors will be placed in the dilemma of rejecting a lease (and giving up a lease hold) or assuming it (and incurring the potential administrative expense claim for rent) well before the sales results of the holiday season have occurred, for example, or before the profitability of a location or their prospects of reorganization are known.

II. APPOINTMENT OF A TRUSTEE

While the 2005 Act slightly changed the general standard to be applied by the court in determining whether to appoint a trustee, it took a bigger step by requiring that the United States Trustee move for the appointment of a chapter 11 trustee "if there are reasonable grounds to suspect that the current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtors chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting." 11 U.S.C. § 1104(e).

The "reasonable grounds to suspect" trigger requires the United States Trustee to file a motion to appoint a trustee which may lead to increased litigation costs, a diversion of manpower and business disruption in the early stages of many cases where financial reporting has been or has alleged to have been deficient. Many public companies in chapter 11 have restated their financials, are the subject of investigations or are involved in investor/bondholder lawsuits alleging security law violations in connection with their public reporting. Thus, the new subsection raises many questions about its implementation.

Courts will be called upon to answer questions such as: (i) is the mere existence of these lawsuits or investigations a reasonable ground to suspect actual fraud and, if so, how many?; (ii) which members of the debtor's governing body must have been involved?; (iii) more fundamentally, does the involvement of a single member of the board taint the debtor, or does this subsection require a few (or even a majority) of the members to be involved?; and (iv) if the court does hold a "mini trial" with respect to the trustee's motion, what is the effect of this trial, and is it to be given *res judicata* or collateral estoppel effect? These are all questions which need answers.

Notwithstanding this change, the United States Trustee may still make a motion at any time, whether or not required under this new subsection. It would seem, therefore, that this provision is most likely put into play when a party-in-interest wants to supplant management, forcing the United States. Trustee to seek appointment of a trustee. If the United States. Trustee refuses to file the motion, a party-in-interest may file a motion seeking to compel the United States. Trustee to do so. It seems clear that a party-in-interest may prefer that the United States Trustee bring this motion and bear the cost of any investigation and expense for the motion. Further, the "reasonable grounds to suspect" standard seems to be lower than the pre-amendment substantive grounds for appointment of a trustee.

The effect of this amendment is yet to be seen, but it will certainly put new pressures upon the business, the board of directors and CEOs involved in public companies. While turnaround companies and workout firms may become the beneficiaries of this section, the likely increased cost may reduce any substantial recoveries to the debtor's stakeholders.

CASE SUMMARIES

In re Marvel Entertainment Group, 140 F.3d 463 (3d Cir. 1998)

The debtor-in-possession was a comic book publisher that had filed a chapter 11 bankruptcy and continued to operate as a debtor-in-possession. Appellant partnerships, which had assumed control of the debtor-in-possession following its bankruptcy, contested the appointment of a trustee in the debtor-in-possession's action against creditor holding companies. The district court appointed a trustee. On appeal, the court held that the district court had properly exercised its discretion in appointing a trustee under §§ 1104(a)(1) or (a)(2) of the Bankruptcy Code because "cause" justifying appointment included the acrimony that existed between the debtor-in-possession and creditors and because the trustee's appointment was in the best interests of the parties and the bankruptcy estate.

The court reasoned that although the language of § 1104(a)(1) does not promulgate an exclusive list of causes for which a trustee must be appointed, it does provide that a trustee shall be appointed for cause, including fraud, dishonesty, incompetence, or gross mismanagement or similar cause. The court found that that because an unhealthy conflict of interest was manifest in the "deep-seeded conflict and animosity" between the controlled debtor and the lenders and in the lack of confidence all creditors had in the appellant partnerships interests' ability to act as fiduciaries, the district court did not depart from the proper exercise of discretion when it determined sufficient cause existed under § 1104(a)(1) to appoint a neutral trustee to facilitate reorganization.

*In re Sharon Steel Corp***.,** 871 F.2d 1217 (3d Cir. 1989)

The debtor filed a voluntary petition for reorganization. The debtor's management, appellants, remained in control of the corporation's operations as debtor-in-possession until the committee became dissatisfied and petitioned the bankruptcy court for appointment of a trustee pursuant to § 1104 of the Bankruptcy Code. Because early negotiations for a stipulation providing for independent management seemed promising, the court delayed appointment. When

negotiations floundered, the court entered an order appointing a trustee. A joint motion to vacate the appointment, which included a stipulation purporting to be the agreement of the parties, was denied. The court held that the appointment of a trustee was not an abuse of discretion because § 1104(a)(2) created a flexible standard to appoint a trustee. Since the stipulation was undated and included many elapsed conditions and unexecuted provisions, it clearly represented an agreement under negotiation. Furthermore, the appointment of the chapter 11 trustee was not an abuse of discretion where there was evidence of systematic siphoning of the debtor's assets to other companies under common control on the eve of bankruptcy and continuing postpetition mismanagement.

The court noted that the appointment of a trustee is mandatory upon a determination of cause, but also that "a determination of cause . . . is within the discretion of the court finding 'cause' due to [the] debtor-in-possession's gross mismanagement of [the] estate and internal conflicts of interest." The court found that "deep seeded conflict and animosity between a debtor and its creditors" is at the heart of this bankruptcy case, thus "the selection of a plan, whatever its details, is in the best interests of all parties, and the best way to achieve that result is to appoint a trustee." The "cause" therefore was due to the debtor-in-possession's gross mismanagement of the estate and internal conflicts of interest.

In re Ionosphere Clubs, Inc., 113 B.R. 164 (Bankr. S.D.N.Y. 1990)

The debtors filed a voluntary bankruptcy petition under chapter 11 of the Bankruptcy Code. After the debtors filed, they continued to operate their businesses as debtors-in-possession. However, the creditors moved to appoint a chapter 11 trustee to replace the debtors-in-possession in order to enhance the value of the estate and proceed toward a viable reorganization. The issue for the court was whether a trustee should be appointed. The court looked at the following factors to determine whether to appoint a trustee: the trustworthiness of debtors, the debtors-in-possession's past and present performance and prospects, the confidence of creditors in present management, and the benefits derived by the appointment, balanced against the cost of the appointment.

In this case, the debtors' inability to formulate a business plan and the enormous operating losses sustained by the estate mandated the court to appoint a trustee for cause under § 1104 of the Bankruptcy Code. The court found clear and convincing evidence which mandated the appointment of a trustee to replace the debtors-in-possession.