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675 Old Country Road, Westbury, NY 11590
516-279-6700 • ATHALERLAW.com

Andrew M. Thaler

Member
athaler@athalerlaw.com

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ANDREW M. THALER

Andrew Thaler is founding Member of the Thaler Law Firm. With over 35 years of experience in the bankruptcy and insolvency field, his practice focuses on a wide spectrum of matters including representation of debtors, creditors, trustees and creditor committees in commercial Chapter 11 and 7 cases, consumers in Chapter 7 and 13 cases, and various situated parties in complex bankruptcy litigation and insolvency matters including service businesses, manufacturing and retail companies, and financial institutions. As a federally appointed Panel 7 Bankruptcy Trustee for the United States Bankruptcy Court for the Eastern District of New York since 1990, Andrew has presided over approximately twenty thousand bankruptcy cases. In addition to his bankruptcy practice, he also serves as a Mediator/Neutral for the United States Bankruptcy Court, Eastern District and the Mediation Panel of the Commercial Division of the Supreme Court, Nassau County. When businesses or individuals encounter financial difficulties, Andrew helps analyze the situation presented to determine the client's best course of action. His reputation for thoroughness, concern, resourcefulness, and fairness enables his clients to confidently make decisions throughout all states of their legal issue.

Andrew is active in the Nassau County Bar Association, where he has served as a member of the Board of Directors, former Dean of the Nassau Academy of Law and Chair of the Bankruptcy Law and Alternative Dispute Resolution Committees. He has lectured on bankruptcy/insolvency topics for the Nassau Academy of Law, the National Business Institute, The New York State Society of Certified Public Accountants and First American Title Insurance Company of New York. In 2011 Andrew was appointed to the New York City Bar Association's Committee on Bankruptcy & Corporate Reorganization. He is Past President (2010) of The Theodore Roosevelt American Inn of Court.

Andrew is rated "AV Preeminent" by Martindale-Hubbell, the highest level in professional excellence and since 2010 has annually been recognized by L.I. Pulse Magazine as one of the region's "Top Legal Eagles". In 2013 Andrew received the honor of being named an Access to Justice Champion through the Nassau County Bar Association.

Helen D’Eletto, Esq.

D’Eletto Law Firm PLLC
3 School Street Suite 303
Glen Cove, New York 11542
Tel: (516) 680-7833
Fax: (516) 620-0783

Helen D'Eletto is a Taxation attorney in private practice based in Glen Cove, NY. She represents small business owners, religious institutions, and nonprofit corporations in Tax Controversy, Estate Tax, and General Business Taxation issues before federal and state courts and agencies. She earned an LLM in Taxation from NYU and her JD from St. John’s University. She also holds an MBA in Accounting from Baruch College/CUNY.

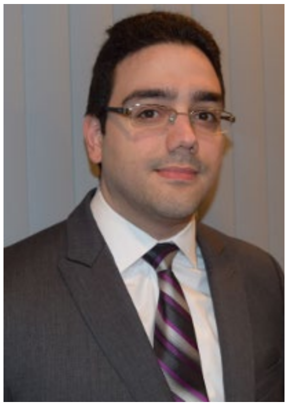
Ms. D’Eletto she has obtained multiple satisfactory outcomes for her clients in tax audits. She recently obtained a $150,000 tax reduction for a client after successfully filing an IRS audit reconsideration request. She was also admitted *Pro Hac Vice* to the Eastern District Court of Pennsylvania for a commercial litigation case and successfully defended her client resulting in the vacating of an $18 million Judgment.

Prior to opening her firm, Ms. D’Eletto was a Revenue Agent for the Internal Revenue Service. She has also worked as a Tax Analyst for companies including Ernst and Young, Salomon Brothers Inc, and Canon Inc.

Ms. D’Eletto has received a MA in Theology from St. John’s University and is currently working on a Master of Sacred Art from Pontifex University. She is also a Trustee for the Church of St Rocco’s in Glen Cove and a member of the Canon Law Society of America.

Helen D’Eletto is admitted to practice in the Courts of the State of New York, the United States Tax Court, and the Supreme Court of the United States.

SPIROS AVRAMIDIS



Spiros Avramidis is an in-house corporate attorney at NewtekOne, Inc., a publicly traded financial holding company. In that position, Mr. Avramidis identifies, counsels, and advises the various business divisions on legal and business risks related to business and industry as a whole and to individual transactions, including reviewing and drafting a wide range of commercial and other contracts, such as asset-back lending agreements, technology related master service agreements and statements of work, reseller and referral agreements, employee separation agreements, and non-disclosure agreements; advising on commercial law, privacy law, general corporate matters, mergers and acquisitions, and general employee law.

Prior to joining NewtekOne, Inc., Mr. Avramidis was an associate at Thaler Law Firm PLLC where he engaged in many aspects of bankruptcy, including chapter 7 trustee representation, chapter 7 and 11 debtor representation, chapter 7 and 11 creditor representation, and prosecuting and defending adversary proceedings.

Thomas A. O'Rourke
Bodner & O'Rourke, L.L.P.
425 Broadhollow Rd.
Melville, N. Y. 11747
631-249-7500
TORourke@bodnerorourke.com

Thomas A. O'Rourke is a founding partner of the firm Bodner & O'Rourke. Mr. O'Rourke's practice involves all areas of patent, trademark and copyright law. For over thirty years he has been registered to practice before the United States Patent & Trademark Office. Mr. O'Rourke has counseled clients regarding the procurement and enforcement of patents, trademarks, copyrights and trade secrets in a variety of technologies including mechanical, and computer technology. In addition, his practice involves domestic and international technology transfer, acquisition and licensing. He is a member of the bar of the States of New York and California. He has also been admitted to numerous Federal District Courts and Courts of Appeal across the country including, the Court of Appeals for the Federal Circuit.

Mr. O'Rourke has been a member of the Board of Directors of the New York Intellectual Property Law Association. Mr. O'Rourke is Co-Chairman of the Suffolk County Bar Association's Committee on Intellectual Property Law and has been a member of the Advisory Board of the Licensing Journal. He has lectured on Intellectual Property Law at numerous Continuing Legal Education programs, including programs presented by the American Bar Association, the Connecticut Intellectual Property Law Association and the Suffolk County Bar Association. He was also the Editor of the New York Intellectual Property Law Association Bulletin and the author of numerous articles on patents, trademarks and copyrights for the New York Intellectual Property Law

Association. Mr. O'Rourke has also authored monthly articles on intellectual property law licensing, which have appeared in the Licensing Journal. Mr. O'Rourke has also been named as a Super Lawyer.

Mr. O'Rourke has a B.S. degree in Chemistry from Fordham University and obtained his J.D. degree from St. John's University School of Law, where he was a member of the Law Review.

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Marc Brunengraber

Benjamin Cardozo School of Law, New York, New York
Juris Doctor, June 1996
1996 ABA/Cardozo Client Counseling Competition Champion

Binghamton University, State University of New York
B.A., June 1993

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Mr. Brunengraber is a Partner at CLMC and is admitted to the New York State bar since 1997, as well as to the federal bar through the Eastern and Southern Districts of New York.

Mr. Brunengraber brings over twenty-five years of experience representing, advising and counseling clients in various areas of law, in both transactional and litigation settings, including commercial, contract and business law; commercial and residential real estate; estate planning, and administration and probate matters. Mr. Brunengraber drafts and reviews contracts for a broad range of business owners, drafts and reviews partnership, shareholder and operating agreements, handles business buy/sell agreements from inception through closing, drafts and reviews commercial and residential leases, handles commercial and residential real estate closings and refinances, represents, drafts documents for, and handles closings for private lenders, handles the prosecution and defense of commercial and contract litigation, represents landlords and tenants in all phases of landlord-tenant disputes, handles probate and administration proceedings, drafts and oversees wills and trusts, enforces the terms of cooperative proprietary leases and by-laws, enforces the terms of condominium and HOA declarations, by-laws and covenants, handles land use disputes, and attends client board, shareholder and member meetings as required.

Mr. Brunengraber is a noted landlord-tenant attorney, focusing on both commercial and residential matters throughout Nassau and Suffolk counties, and handling commercial matters in the New York City boroughs. He is counsel to the profession in various landlord-tenant matters. Further, he has extensive experience representing boards of directors and managers of cooperatives, condominiums and homeowners associations, as well as their managing agencies. He has served as regulatory counsel to various federally chartered credit unions and also serves as a commercial arbitrator to Arbitration Services, Inc.

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<u>R E S U M E</u>

S. ROBERT KROLL, ESQ.
25 Merrick Avenue, 2nd floor Merrick, New York 11566
(516) 378-3051

EDUCATION

B.A. Degree, Hofstra College, Hempstead, New York; June, 1955
LLB Degree, Brooklyn Law School, Brooklyn, New York; June, 1958
Participation in programs of continuing legal education as required to maintain good standing status.

PROFESSIONAL CREDENTIALS

Admitted to the Bar, New York State, Appellate Division, Second Department, December, 1958 Term
Admitted to practice Law in Florida, 1982
Admitted to practice in the following Federal Courts: United States District Courts for the Eastern, Southern and Northern Districts of New York, Circuit Court of Appeals for the Second Circuit and the United States Supreme Court
Member of the following professional organizations:

Bar Association of Nassau County, Inc.
New York State Bar Association
Nassau Lawyers Association
Jewish Lawyers Association
Member, Theodore Roosevelt American Inn of Court

PROFESSION

General practice of law since admission to the bar
March, 1969 to 1982 - partner in the firm of Medowar & Kroll, Esqs.
Former Arbitrator for the program presently administered in Nassau County (District Court litigation as well as a volunteer arbitrator in Small Claims); have participated therein as a sole arbitrator as well as on panel of three arbitrators.

GOVERNMENTAL AND PUBLIC SERVICE

June, 2011 to present: appointed by Governor Andrew Cuomo to the MTA Inspector General Management Advisory Board; serve without compensation
March, 1993 to December 1998: District Counsel to New York State Senator James J. Lack (Second Senatorial District)
In November, 1988: appointed by the Governor, appointment ratified by the Senate, and served for a term as a member of the New York State Public Transportation Safety Board; term expired April 30, 1993; served without compensation.
June, 1983 to November, 1988: on the staff of New York State Senator Norman J. Levy, Eighth Senatorial District, as aide and counsel.

ACTIVITIES, POLITICAL

Republican Committeeman, Nassau County, 19th Ad, 49th Ed, 1982 to 2004
Past Vice President, Merrick Republican Club
Past treasurer for various political candidates
Currently treasurer for Receiver of Taxes, Town of Hempstead- Donald Clavin.

ACTIVITIES, PROFESSIONAL AND COMMUNITY

Merrick Chamber of Commerce - Past Director
Bar Association of Nassau County - Past Director, Board of Directors; Past Chair of Community Relations and Public Education Committee, Past Chair the Real Property Committee, Past Vice-chair of District Court Committee
New York State Bar Association - Member
Nassau Lawyers Association - Member
Jewish Lawyers Association - Member
Merrick Jewish Centre - Past President and Director
Sunrise-Laurelton Lodge # 1069, F & A.M (Now Spartan Lodge) (Masons) – Past Master
Rotary Club of Merrick-Bellmore - Past President
Kiwanis Club of Merrick – Member
Rapport - Past Director
W.C. Mepham Alumni Association - Member and Former Counsel

RELATED EXPERIENCE

A. Research, assistance and suggestions to Hon. Douglas F. Young, author of YOUNG'S UNIFORM CIVIL, CITY AND DISTRICT COURTS PRACTICE, published in 1965

B. Participation as a principal speaker, Bar Association of Nassau County, program on the subject FROM THEORY TO PRACTICE, REAL ESTATE TRANSACTIONS**,** October 8, 1997.

C. Participation as a principal speaker, Bar Association of Nassau County, program 10/30/69 and 11/1/69, subject: CREDITOR, DEBTORS AND BANKRUPTS.

D. Formerly Arbitrator, District Court, both for regular civil cases and as a volunteer for Small Claims and landlord-tenant mediator. Participated in panel, mandated course for District Court Arbitrators, jointly sponsored by the District Court Committee and Academy of Law.

PREVIOUS VOLUNTEER OR PRO BONO PARTICIPATION

A. Volunteer arbitrator, Nassau County Small Claims
B. Volunteer services, Nassau-Suffolk Law Services Committee, Landlord Tenant,Nassau County District Court
C. Volunteer mediator, Landlord-Tenant cases Nassau County District Court
D. Volunteer, Hofstra Law School, Veteran's Law Clinic
E. Volunteer, New York State Bar Association Lawyer Referral & Information

Service

Eric H. Gruber, Esq.

Syracuse University College of Law,
J.D., 1986
Honors
Syracuse Law Review Editor;
Exceptional Editor's Award

State University of New York at Albany,
B.A. 1983

Mr. Gruber is a CLMC partner and heads the firm's Litigation Department. Over the last 36 years, Mr. Gruber has developed a diversified commercial, corporate and transactional practice representing public and private companies and individuals over a range of practice areas from litigation and dispute resolution to transactional and corporate matters.

An experienced litigator and accomplished trial attorney, Mr. Gruber has crafted the legal strategy for a broad range of civil cases and arbitrations. Mr. Gruber has represented plaintiffs and defendants in various matters across a spectrum of substantive areas, including commercial disputes, business torts, partnership disputes and dissolutions, real estate, construction, creditors' rights including bankruptcy and general business law in the federal and state trial and appellate courts and before various arbitration panels.

On the transactional side, Mr. Gruber routinely counsels individuals and legal entities in their business and real estate matters including mergers, acquisitions, dispositions and general business counseling including the negotiation and preparation of shareholders agreements, operating agreements, partnership agreements, independent contractor agreements and other various agreements. Mr. Gruber has extensive experience in real estate and commercial finance having negotiated and drafted sophisticated mortgage and finance agreements. Mr. Gruber also has experience in asset-based lending and other areas of commercial finance, including bankruptcy matters, workouts, and turn-around situations. Mr. Gruber has represented various business entities in connection with the acquisition and sale of businesses and assets. Mr. Gruber has also represented landlords, managing agents and businesses in connection with the structuring and negotiation of commercial real estate leases, as well as litigation that has arisen out of, or in connection with, such transactions.

Mr. Gruber has lectured for various professional groups and organizations including the Nassau Academy of Law on points of legal procedure and litigation.

Mr. Gruber is admitted to the United States Court of Appeals for the Second Circuit, the United States District Court for the Southern and Eastern Districts of New York, and all the Courts of the State of New York.

Mr. Gruber is a Member of the New York State Bar Association and the Nassau County Bar Association. He is also a member of the Executive Board of the Theodore Roosevelt American Inns of Court and a Past President of B’nai B’rith’s Banking and Finance Unit.

By Edward P. Yankelunas

For many generations, the corporation has been a key feature of the American enterprise system. By treating the corporation as a distinct entity separate and apart from its owner, the law has encouraged the innovation, entrepreneurship and industry that were the underpinnings of America's Industrial Revolution. Along with perpetual existence and transferability of ownership, the law permits a business to be incorporated for the very purpose of allowing the business owner to escape personal liability. Thus, ordinarily, the separate personalities of corporations and their owners "cannot be disregarded."[1] However, when the privilege to operate a business in the corporate form is abused, New York courts have disregarded the separate legal existence of the corporation and its owner and have pierced the corporate veil to hold business owners liable for the conduct and debts of the corporation.

Piercing the Veil Between the Corporation and Its Owner

As reflected by Judge Benjamin Cardozo's 1926 opinion in *Berkey v. Third Avenue Railway Co.*,[2] "general rules of agency" were then considered the basis for imposing personal liability on business owners for the "perversion of the privilege to do business in a corporate form."[3] Under that analysis, "whenever anyone uses control of the corporation to further his own rather than the corporation's business, he will be liable for the corporation's acts 'upon the principle of *respondeat superior* applicable even where the agent is a natural person.'"[4] Over time, the instrumentality rule developed in New York as the most "practical and effectively applicable theory for breaking down corporate immunity where equity requires . . . to circumvent fraud or other legal wrong."[5] Under the instrumentality rule, the issue is whether the business owner has completely dominated the business and used the corporation as an instrumentality to do the owner's personal business. If that question is answered in the affirmative and the owner's conduct has harmed a third party – typically a creditor – the court may conclude that the corporation is the owner's alter ego, that neither the corporation nor the business owner has a separate personality, and may hold the owner responsible for the acts and debts of the corporation. As the Third Department aptly stated in *Rohmer Associates v. Rohmer*, where a "corporate entity has been so dominated by an individual . . . and its separate entity so ignored that it primarily transacts the dominator's business instead of its own and can be called the other's alter ego, the corporate form may be disregarded to achieve an equitable result."[6] That reasoning has been applied in New York to pierce the veil of limited liability companies.[7] Notably, as the New York Court of Appeals emphasized in *Morris v. State Department of Taxation & Finance*, "[w]hile complete domination of the corporation is the key to piercing the corporate veil, especially when the owners use the corporation as a mere device to further their personal rather than corporate business . . . such domination, standing alone, is not enough; some showing of a wrongful or unjust act toward [a third party] is required."[8]

Such action presupposes that the dominated corporate entity has an underlying obligation or liability to the party asking the court to pierce the corporate veil. A request for such a ruling is not an independent cause of action.[9] Moreover, although preponderance of the evidence is the applicable standard of proof – not clear and convincing evidence[10] – due to the long-standing reluctance of New York courts to disregard the corporate form, the party asking the court to use the court's equitable powers to pierce the corporate veil bears a "heavy burden"[11] of showing the requisite domination and resulting inequitable consequences. That showing should include demonstrating a "causal relationship" between misuse of the corporate form and harm suffered by the party asking the court to pierce the veil.[12]

An evaluation of a claim that the corporate form should be disregarded under the alter ego doctrine is a case-specific analysis that is "equitable in nature" and dependent on the "attendant facts and equities."[13] No one factor is dispositive. The following factors are typically relied upon by the courts in New York to hold a business owner responsible for the debts and conduct of the entity dominated by the owner:[14]

- The owner shuttles funds in and out of personal and corporate bank accounts.
- The owner uses corporate funds and property for personal purposes and obligations.
- The corporation or limited liability company (LLC) is under-capitalized.
- There is a lack of corporate formalities (i.e., issuance of stock, election of directors, keeping corporate records, etc.).
- Common office space and telephone numbers are used by the corporation or LLC and the individual business owner.
- There is an overlap in ownership, officers, directors and personnel.

Proof of Fraud Is Relevant, but Not Essential

Significantly, it is not necessary to plead or prove fraud in order to pierce the corporate veil in New York. In fact, as the U.S. Court of Appeals for the Second Circuit ruled in *Passalacqua Builders, Inc. v. Resnick Developers South Inc. et al.*, it would be error for a court to instruct a jury "that plaintiffs were required to prove fraud" to pierce the corporate veil, stressing that "New York law . . . permits the corporate form to be disregarded where excessive control alone causes the complained of loss."[15] According to the court, the "critical question is whether the corporation is [a] 'shell' being used by the [business owners] to advance their own purely personal rather than corporate ends."[16]

Nevertheless, even if not essential, proof of fraud is certainly relevant.[17] Indeed, being able to show fraud can only help the party seeking to pierce the corporate veil because facts demonstrating fraud will increase the likelihood that the court will use its equitable powers to disregard the corporate form. Such showings would include the classic "indicia of fraud" – that is, the transfer of corporate funds between family members initiated by the dominating business owner, the owner retaining control of the funds after the transfer and the lack of consideration for the transfer.[18] For example, in *Colonial Surety Co. v. Lakeview Advisors, LLC*, the judgment debtor formed a limited liability company of which he was the manager and sole principal. In affirming the "reverse-piercing" of the LLC, the Fourth Department noted that the debtor not only used the LLC's funds for personal expenses but also used the LLC's funds to "make payments to his wife in lieu of his salary."[19]

Another fraud-based argument that has persuaded New York courts to pierce the corporate veil is "constructive fraud," which consists of the transfer of corporate assets without consideration in order to put assets beyond the reach of creditors. In *EAC of New York v. Capri 400, Inc.*,[20] the petitioner in that CPLR Article 52 proceeding sought to enforce a judgment against a corporation that had sold a restaurant business to the petitioner. The contract provided that the corporate seller hold a mortgage for $350,000 on the real estate involved in the transaction. However, at closing the mortgage was executed in favor of the corporation's owner, who then kept most of the sale proceeds, allegedly in payment of a loan owed to him by the corporation. The owner also claimed that he was entitled to a "dividend distribution" from the corporation in the amount of $346,000, which justified the assignment to him of the $350,000 mortgage. When the petitioner sought to pierce the corporate veil and enforce its judgment against the corporation's owner, the owner conceded his domination of the corporation. This turned the court's attention to whether the owner utilized his domination and control to perpetrate a "fraud or wrong against petitioners which resulted in their injury." Holding that the owner had engaged in a "constructive fraud" that injured the petitioner, the Third Department said:

> Here, the wrongful act consisted of a fraudulent transfer of corporate assets by [the owner], as director and officer of the corporations, to himself, as an individual. Even without proof of intent to defraud, constructive fraud may be shown where the debtor transfers assets without fair consideration and the debtor becomes insolvent. . . . [The owner's] transfer of all corporate assets – namely the mortgage – from [the corporation] to himself cannot be considered a conveyance in good faith, as it rendered the corporation insolvent at the expense of [the corporation's] creditors, namely petitioners.[21]

Piercing the Veil Between Corporations

The alter ego doctrine has also been applied in New York to pierce the veil between corporations when affiliate or subsidiary corporations are used by a dominating parent corporation to engage in wrongful conduct. As stated by the U.S. District Court for the Southern District of New York in *Trabucco v. Intesa Sanpaolo, S.p.A*,

> [u]nder New York Law, one corporation is considered to be mere alter ego when it "has been so dominated by . . . another corporation . . . and its separate identity so disregarded, that it primarily transacted the dominator's business rather than its own." . . . Then, the dominating corporation will be held liable for the actions of its subsidiary . . . Alter ego cases typically involve the determination of "which corporate parties may be cast in damages for the breach" of a contract. . . . In this analysis, control is the key.[22]

the policyholder-plaintiffs alleged that after obtaining approval from the New York State Superintendent of Insurance to restructure an insurance corporation and its related subsidiaries and affiliates, the corporate parent allegedly stripped approximately $5 billion in cash and securities from the subsidiary insurance company for no consideration in violation of the N.Y. Debtor and Creditor Law and the parent's common law duties. Concluding that the policyholders' "complaint adequately states a claim for abuse of the corporate form that may support a declaration piercing the corporate veil of the [subsidiary insurance company]," the Court of Appeals reinstated the policyholders' claims that the parent "abused its control of its wholly-owned subsidiary . . . by causing it to engage in harmful transactions that now shield billions of dollars in assets from plaintiffs and expose them to significant liability."[26]

Constructive fraud consists of the transfer of corporate assets without consideration in order to put assets beyond the reach of creditors.

The following are factors considered by the courts in New York in determining whether the alter ego doctrine should be used to pierce the veil between corporate entities.[23] Again, no one factor is dispositive and "all need not be present to support a finding of alter ego status":[24]

- the absence of corporate formalities such as issuance of stock, election of directors, etc.;
- inadequate capitalization;
- whether funds are put in and taken out of the corporation for personal rather than corporate purposes;
- overlap in ownership, officers, directors and personnel;
- common office space, address and telephone number for the corporate entities;
- the amount of business discretion displayed by the allegedly dominated corporation;
- whether the related corporations deal with the dominated corporation at arm's-length;
- whether the corporations are treated as independent profit centers;
- the payment or guarantee of debts of the dominated corporation by other corporations in the corporate group;
- whether the dominating corporation in question uses property owned by the dominated corporation as if it were its own.

The N.Y. Court of Appeals was called upon to pierce the veil between corporations in *ABM AMRO Bank N.V. v. MBIA Inc.*,[25] a case resulting from the deterioration of the world financial markets that began in 2007. There,

Likewise, in *Last Time Beverage Corp. v. F&V Distribution Co., LLC*, the plaintiff-judgment creditor obtained a judgment against a limited liability company (LLC) relative to various soft drink distribution agreements. It sought to pierce the LLC's corporate veil to hold a related corporation responsible for the judgment on the grounds that the LLC and the corporation were controlled by the same owner. The proof presented to the court showed that the LLC and the alter ego corporation had overlapping ownership, officers and personnel, that both entities used the same office space, that the LLC was undercapitalized without a "substantial loan" from the related corporation, and that both entities failed to observe corporate record-keeping formalities. The Second Department upheld the ruling of a referee that the LLC and the corporation were "jointly and severally liable" under the agreements at issue and that the LLC and the corporation "were alter egos of [their owner] and, accordingly, of one another."[27]

Similarly, in *N.Y. District Council of Carpenters Pension Fund v. Perimeter Interiors Inc.*, a union asserted a claim for ERISA contributions. Both the corporation that employed union carpenters and a related non-union corporation were dominated by the same individual owner. The non-union corporation never signed the relevant union collective bargaining agreement (CBA). The court noted the existence of evidence satisfying certain of the corporation-to-corporation alter ego factors listed above, such as common employees and commingled funds. As for wrongful conduct, the court found the business owner secretly used the non-union corporation to receive and distribute wages covered by the CBA for which ERISA contributions were payable. After finding that both the union and non-union corporations were "alter egos of one another," the court concluded that the non-union corporation was just as obligated as the union corporation under the CBA to pay the required contributions.[28]

Reverse Piercing

Courts traditionally pierce the corporate veil to hold a controlling shareholder personally liable for a corporate debt. However, where the business entity and its controlling owner are alter egos, under the reverse-piercing doctrine the "piercing flows in the opposite direction and makes the corporation liable for the debt of the [owner]."[29] As long as the required showing is made, "[t]he direction of the piercing [traditional or reverse] is immaterial."[30] "In both situations there is a disregard of the corporate form, and the controlling shareholders [or business owners] are treated as alter egos of the corporation and vice versa."[31] In effect, since the business owner and the corporation are alter egos, they are merely two sides of the same coin.

Reverse-piercing has also been applied between corporations to hold a subsidiary liable for the debts of its parent. While applying veil piercing in that context may not be common or traditional, as Judge Learned Hand wrote in 1929 in *Kingston Dry Dock Co. v. Lake Champlain Transportation Co.*, "it would be too much to say that a subsidiary can never be liable for a transaction done in the name of a parent."[32] Under recent cases applying New York law, the courts have held that a creditor may "reach the subsidiary through its parent, or in other words, to collapse . . . the parent, into . . . the subsidiary."[33] Guided by the same "rules that govern straight veil piercing," using reverse piercing a court may "hold a subsidiary liable for the debts of its parent."[34]

The court's description of reverse piercing among corporate entities in *Miramax Film Corp. v. Abraham et al.* is instructive. Noting that reverse piercing the veil of a dominated business entity to impose liability on the dominating entity may be "rare" but "appropriate in cases where the alter ego is being used as a 'screen' for the dominating entity," the U.S. District Court for the Southern District of New York stated:

> If it is found that a shell corporation was used by a dominating entity as a means to commit a fraud or other wrongful act against a plaintiff, then the legal fiction of corporate separateness vanishes, and the dominating entity and the shell corporation are deemed a single unit. This would render the assets of the dominating entity and the shell corporation to be deemed one and the same.[35]

Put another way, since the dominating parent corporation and the dominated subsidiary are alter egos of each other, and since piercing between alter egos flows in both directions, the subsidiary is liable for the debts and conduct of the parent, just as the parent is held liable for the debts and conduct of the subsidiary.

Substance Over Form

Moreover, in reviewing a request to pierce the corporate veil under the alter ego theory, New York courts will not place form over substance.[36] The accounting treatment of a transaction is not dispositive. A court will not permit accounting mechanisms to trump the facts and to be improperly used to shield assets from creditors, or to otherwise engage in wrongful conduct. Rather, the focus is not on the accounting treatment of a transaction, but on the reality of the actual conduct of the dominating business owner or corporation, and whether the conduct is fraudulent or inequitable and has caused harm.

Consider the following example: A judgment debtor is the owner of a business that he controls; the owner uses funds deposited in the corporate bank account for purely personal purposes and transfers corporate funds from that bank account to his wife for no consideration. In opposing the judgment creditor's claim that the corporation and the owner are merely alter egos, the business owner relies on financial statements and tax returns showing that his use of corporate funds for personal purposes, as well as the transfer of corporate funds to his wife, are treated as distributions of corporate earnings to the owner. Further assume, however, that in order to evade his judgment creditor, the owner never takes possession of the alleged corporate distributions by depositing the funds in his personal bank account. Focusing on the reality that the owner never had possession of the alleged distributions of income, which enabled him to evade his personal judgment creditor, a New York court will likely reject the judgment debtor's accounting explanation and hold that the owner and corporation are alter egos of each other and will pierce the veil of the corporation to prevent the owner from using the corporation to frustrate the rights of the judgment creditor.

Conclusion

With a certain literary flair, the U.S. Court of Appeals for the Second Circuit stated in *Brunswick Corp. v. Waxman* that the law in New York relative to piercing the corporate veil "is hardly as clear as a mountain lake in springtime."[37] One reason for this statement is that equity is not an exact science. Considered "impossible to define completely," equity has been described as a means to ameliorate "harsh or otherwise undesirable effects resulting from a strict application of any particular rule of law."[38] In the context of corporations, a strict application of the law would leave a court without the ability to fashion a remedy when the corporate form is used to evade a judgment or some other obligation, or is otherwise abused at the expense of a third party. Fortunately, however, settled notions of equity provide New York courts with the power to pierce the corporate veil in order to strike the proper balance between the laudable policy behind the legal fiction of the separate identity of a corporation and its owner, and the "need to protect those who deal with the corporation."[39] Although the burden of convincing a court to pierce the corporate veil is heavy, if that burden is satisfied by the "attendant facts and equities," New York courts have not hesitated to disregard the fiction of corporate separateness in order to achieve a fair and just result. ■

1. *Port Chester Elec. Constr. Corp. v. Atlas et al.*, 40 N.Y.2d 652, 656 (1976).

2. 244 N.Y. 84, 95 (1926).

3. *Id.*

4. *Walkovszky v. Carlton*, 18 N.Y.2d 414, 417 (1966) (quoting *Rapid Tr. Subway Constr. Co. v. City of N.Y.*, 259 N.Y. 472, 488 (1932)).

5. *Lowendahl v. Baltimore & Ohio R.R. Co.*, 247 A.D. 144, 156 (1st Dep't), *aff'd*, 272 N.Y. 360 (1936); *see also Brunswick Corp. v. Waxman*, 459 F. Supp. 1222, 1229 (E.D.N.Y. 1978), *aff'd*, 599 F.2d 34 (2d Cir. 1979).

6. 36 A.D.3d 990, 991 (3d Dep't 2007).

7. *Last Time Beverage Corp. v. F&V Distrib. Co., LLC*, 98 A.D.3d 947 (2d Dep't 2012); *Grammas v. Lockwood Assoc., LLC*, 95 A.D.3d 1073 (2d Dep't 2012); *Colonial Sur. Co. v. Lakeview Advisors, LLC*, 93 A.D.3d 1253 (4th Dep't 2012).

8. 82 N.Y.2d 135, 141–42 (1993).

9. *First Keystone Consultants, Inc. v. Schlesinger Elec. Contractors*, 871 F. Supp. 2d 103, 124 (E.D.N.Y. 2012); *Robinson v. Day*, 103 A.D.3d 584, 588 (1st Dep't 2013).

10. *Rotella v. Derner*, 283 A.D.2d 1026 (4th Dep't 2001).

11. *TNS Holdings Inc. v. MKI Sec. Corp.*, 92 N.Y.2d 335, 339 (1998).

12. *Giordano v. Thompson*, 438 F. Supp. 2d 35, 48 (E.D.N.Y. 2005).

13. *Morris v. State of N.Y. Dep't of Taxation & Fin.*, 82 N.Y.2d 135, 141 (1993).

14. *Miramax Film Corp. v. Abraham, et al.*, 2003 U.S. Dist. LEXIS 21346 at *22–23 (S.D.N.Y. 2003); *Millennium Constr., LLC v. Loupolover*, 44 A.D.3d 1016, 1017 (2d Dep't 2007); *John John, LLC v. Exit 63 Dev., LLC*, 35 A.D.3d 540, 541 (2d Dep't 2006).

15. 933 F.2d 131, 141 (2d Cir. 1991).

16. *Id.* at 138.

17. *Julien J. Studley, Inc. v. Lefrak*, 48 N.Y.2d 954 (1979); *Rotella*, 283 A.D.2d 1026.

18. *FDIC v. Conte*, 204 A.D.2d 845, 846 (3d Dep't 1994).

19. 93 A.D.3d 1253, 1255 (4th Dep't 2012).

20. 49 A.D.3d 1006 (3d Dep't 2008).

21. *Id.* at 1007 (internal citations omitted).

22. 695 F. Supp. 2d 98, 107 (S.D.N.Y. 2010).

23. *Passalacqua Builders, Inc.*, 933 F.2d at 139.

24. *N.Y. Dist. Council of Carpenters Pension Fund v. Perimeter Interiors, Inc.*, 657 F. Supp. 2d 410, 421 (S.D.N.Y. 2009) (quoting *C.E.K. Indus. Mech. Contractors, Inc. v. N.L.R.B.*, 921 F.2d 350, 354 (1st Cir. 1990)).

25. 17 N.Y.3d 208 (2011).

26. *Id.* at 229.

27. 98 A.D.3d 947, 950–51 (2d Dep't 2012).

28. 657 F. Supp. 2d 410, 421–22 (S.D.N.Y. 2009).

29. *Sweeney, Cohn, Stahl & Vaccaro v. Kane*, 6 A.D.3d 72, 75 (2d Dep't 2004).

30. *State of N.Y. v. Easton*, 169 Misc. 2d 282, 290 (Sup. Ct., Albany Co. 1995).

31. *Sweeney, Cohn, Stahl & Vaccaro*, 6 A.D.3d at 76.

32. 31 F.2d 265, 267 (2d Cir. 1929).

33. *Sec. Investor Prot. Corp. v. Stratton Oakmont, Inc.*, 234 B.R. 293, 320 (S.D.N.Y. 1999).

34. *Id.* at 321.

35. 2003 WL 22832384, *10 (S.D.N.Y. Nov. 25, 2003) (citations omitted).

36. *Wajilam Exports (Singapore) PTE. LTD v. ATL Shipping Ltd. et al.*, 475 F. Supp. 2d 275, 282 (S.D.N.Y. 2006); *Vebeliunas v. Babitt*, 2002 U.S. Dist. LEXIS 1271, *29 (S.D.N.Y. 2002).

37. 599 F.2d 34, 35 (2d Cir. 1979).

38. 55 N.Y. Jur. 2d, Equity, § 1, p. 423 (1986).

39. *Passalacqua Builders, Inc.*, 933 F.2d at 139.

ABN AMRO Bank, N.V. v. MBIA Inc.

17 N.Y.3d 208 (N.Y. 2011) · 2011 N.Y. Slip Op. 5542 · 928 N.Y.S.2d 647 · 952 N.E.2d 463
Decided Jun 28, 2011

No. 124.

Argued May 31, 2011.

Decided June 28, 2011

APPEAL from an order of the Appellate Division of the Supreme Court in the First Judicial Department, entered January 11, 2011. The Appellate Division, with two Justices dissenting, (1) reversed, on the law, three orders of the Supreme Court, New York County (James A. Yates, J.; op 26 Misc 3d 1223[A], 2010 NY Slip Op 50238[U]), which had denied defendants' motion to dismiss the complaint; (2) granted the motion; and (3) dismissed the complaint.

209 *ABN AMRO Bank, N.V. v MBIA Inc.*, 81 AD3d 237, modified. *209

Sullivan Cromwell LLP, New York City (*Robert J. Giuffra, Jr., Michael T. Tomaino, Jr., Brian T. Frawley, Julia M. Jordan, William H. Wagener* and *Jonathan C. Shapiro* of counsel), *Skadden, Arps, Slate, Meagher Flom LLP (Jay B. Kasner, Scott D. Musoff* and *George A. Zimmerman* of counsel), *Mayer Brown LLP (Jean-Marie L. Atamian* of counsel), *Schulte Roth Zabel LLP (Alan R. Glickman* of counsel), *Hughes Hubbard Reed LLP (Michael Luskin* and *Robb W. Patryk* of counsel), and *Bracewell Giuliani LLP (Rachel B. Goldman* of counsel), for appellants. I. The Appellate Division majority erred in holding that the Superintendent of Insurance's private letter approvals, issued without notice and a hearing, bar plaintiffs' Debtor and Creditor Law and common-law claims. (*Capital Tel. Co. v Pattersonville Tel. Co.*, 56 NY2d 11; *Abiele Contr. v New York City School Constr. Auth.*, 91 NY2d 1; *Matter of Van Wie v Kirk*, 244 AD2d 13; *Friedman v State of New York*, 24 NY2d 528; *Burden v Graves*, 23 AD3d 421; *David v Biondo*, 92 NY2d 318; *McGettigan v New York Cent. R.R. Co.*, 268 NY 66; *Levine v Tolchin*, 239 AD2d 279; *Fiala v Metropolitan Life Ins. Co.*, 6 AD3d 320; *In re MetLife Demutualization Litig.*, 689 F Supp 2d 297.) II. Under settled law, the Appellate Division majority erred in holding that plaintiffs must bring their challenge to MBIA's fraudulent "transformation" exclusively in a CPLR article 78 proceeding. (*Koerner v State of NY, Pilgrim Psychiatric Ctr.*, 62 NY2d 442; *May v State of New York*, 86 AD2d 898; *Capital Tel. Co. v Patter sonville Tel. Co.*, 56 NY2d 11; *Richards v Kaskel*, 32 NY2d 524; *Dacus v Spin-Nes Realty Constr. Co.*, 22 NY2d 427; *Greyhound Leasing Fin. Corp. v Joiner City Unit*, 444 F2d 439; *Matter of City of New York [Grand Lafayette Props. LLC*], 6 NY3d 540; *Sohn v Calderon*, 78 NY2d 755; *Matter of Lewis Tree Serv. v Fire Dept. of City of N.Y.*, 66 NY2d 667; *Travelers Indem. Co. v State of New York*, 33 AD2d 127, 28 NY2d 561.) III. In any event, this Court should reverse, because the Appellate Division majority impermissibly considered — and found — disputed "facts" outside the "four corners" of the complaint. (*Travelers Indem. Co. v State of New York*, 33 AD2d 127; *People v Coventry First LLC*, 13 NY3d
212 108; *Capital Tel. Co. v Pattersonville Tel.* *212 *Co.*, 56 NY2d 11; *Tango v Tulevech*, 61 NY2d 34; *United States Gypsum Co. v Indiana Gas Co., Inc.*, 350 F3d 623; *Matter of Charles H. Greenthal Co. v Lefkowitz*, 32 NY2d 457; *Leon v Martinez*, 84 NY2d 83; *Walker v City of New York*, 46 AD3d 278; *Matter of Granwell*, 20 NY2d

91; *Securities Exch. Commn. v First Jersey Sec, Inc.*, 101 F3d 1450.) IY The Appellate Division majority erred in dismissing plaintiffs' well-pleaded claim for breach of the implied covenant of good faith and fair dealing. (*Dalton v Educational Testing Sew.*, 87 NY2d 384; *New York Univ. v Continental Ins. Co.*, 87 NY2d 308; *Bank of China v Chan*, 937 F2d 780; *Gross v Empire Healthchoice Assur, Inc.*, 16 Misc 3d 1112[A], 2007 NY Slip Op 51390[U]; *Chase Manhattan Bank, N.A. v Keystone Distribs., Inc.*, 873 F Supp 808; *EBC I, Inc. v Goldman Sachs Co.*, 7 AD3d 418; *Randall-Smith v 43rd St. Estates Corp.*, 17 NY2d 99.) V The Appellate Division majority erred in dismissing plaintiffs' well-pleaded veil-piercing claim. (*Matter of Morris v New York State Dept. of Taxation Fin.*, 82 NY2d 135; *First Bank of Ams. v Motor Car Funding*, 257 AD2d 287; *Serio v Ardra Ins. Co.*, 304 AD2d 362; *Grad v Roberts*, 14 NY2d 70; *Matter of EAC of NY, Inc. v Capri 400, Inc.*, 49 AD3d 1006; *Rebh v Rotterdam Ventures*, 252 AD2d 609; *Chase Manhattan Bank [N.A.] v 264 Water St. Assoc., 11A* AD2d 504; *Prodell v State of New York*, 211 AD2d 966; *Associated Indem. Corp. v Fairchild Indus., Inc.*, 961 F2d 32; *Klostermann v Cuomo*, 61 NY2d 525.)

Kasowitz, Benson, Torres Friedman, LLP, New York City (*Marc E. Kasowitz, Daniel R. Benson, Albert S. Mishaan, Kenneth R. David, Seth A. Moskowitz* and *Sarmad M. Khojasteh* of counsel), for respondents. I. The Appellate Division correctly dismissed the complaint as an impermissible collateral attack on the New York State Insurance Department's decision. (*Matter of City of New York [Grand Lafayette Props. LLC]*, 6 NY3d 540; *Matter of Foy v Schechter*, 1 NY2d 604; *Buffalo State Line R.R. Co. v Supervisors of Erie County*, 48 NY 93; *United States Trust Co. of NY v Mayor of City of N.Y.*, 144 NY 488; *City of New York v Aetna Cas. Sur. Co.*, 264 AD2d 304; *Eslick v Blue Cross of W. N.Y.*, 159 AD2d 940; *Matter of Lewis Tree Serv. v Fire Dept. of City of N.Y.*, 66 NY2d 667; *Matter of Corrigan v Joseph*, 304 NY 172; *Fiala v Metropolitan Life Ins. Co.*, 6 AD3d 320; *Steen v Quaker State Corp.*, 12 AD3d 989.) II. The plaintiff banks cannot refute that the Appellate Division correctly dismissed their plenary action as an impermissible collateral attack. (*Abiele Contr. v New*
213 *York City School Constr. Auth.*, 91 NY2d 1; *Matter of R.W. Granger Sons v Comptroller of* *213 *State of N.Y.*, 220 AD2d 945; *Matter of Hertz v Rozzi*, 148 AD2d 535; *People ex rel. Piatt v Wemple*, 117 NY 136, 140 US 694; *Travelers Indem. Co. v Orange Rockland Utils., Inc.*, 73 AD3d 576; *Capital Tel. Co. v Pattersonville Tel. Co.*, 56 NY2d 11; *Fransen v Conoco, Inc.*, 64 F3d 1481, 516 US 1166; *Matter of Van Wie v Kirk*, 244 AD2d 13; *Friedman v State of New York*, 24 NY2d 528; *Burden v Graves*, 23 AD3d 421.) III. The Appellate Division properly dismissed the plaintiff banks' claims as a matter of law. (*Matter of Feiner v New York State Off. of Real Prop. Servs.*, 25 AD3d 1005; *Kadison v Long Is. Sav. Bank*, 225 AD2d 523; *C N Camera Elecs. v Farmore Realty*, 178 AD2d 310; *Fiala v Metropolitan Life Ins. Co.*, 6 AD3d 320; *Steen v Quaker State Corp.*, 12 AD3d 989; *Brawer v Johnson*, 231 AD2d 664; *Matter of East NY Sav. Bank Depositors Litig.*, 145 Misc 2d 620; *Craft v Florida Fed. Sav. Loan Assn.*, 786 F2d 1546; *Harr v Prudential Fed. Sav. Loan Assn.*, 557 F2d 751; *Wright v Prudential Ins. Co. of Am.*, 285 F Supp 2d 515.) IV The dismissal of the plaintiff banks' plenary claims is in no way unconstitutional. (*Board of Regents of State Colleges v Roth*, 408 US 564; *Duke Power Co. v Carolina Environmental Study Group, Inc.*, 438 US 59; *Lovell v One Bancorp*, 818 F Supp 412; *Baraka v McGreevey*, 481 F3d 187, 552 US 1021; *Gibbes v Zimmerman*, 290 US 326; *Crane v Hahlo*, 258 US 142; *Martz v Incorporated Vil. of Val. Stream*, 22 F3d 26; *Walentas v Lipper*, 862 F2d 414; *S D Maintenance Co., Inc. v Goldin*, 844 F2d 962; *Ganci v New York City Tr. Auth.*, 420 F Supp 2d 190.) V The Appellate Division correctly dismissed the plaintiff banks' claims for failure to state a cause of action. (*Lamphear v State of New York*, 91 AD2d 791; *Rowe v Great Atl. Pac. Tea Co.*, 46 NY2d 62; *Vermont Teddy Bear Co. v 538 Madison Realty Co.*, 1 NY3d 470; *DL Holdings v Goldman Co.*, 287 AD2d 65; *NPS, LLC v Ambac Assur. Corp.*, 706 F Supp 2d 162; *Water Works Bd. of City of Birmingham v Ambac Fin. Group, Inc.*, 718 F Supp 2d 1317; *Allapattah Servs., Inc. v Exxon Corp.*, 61 F Supp 2d 1300, 333 F3d 1248; *National Union Fire Ins. Co. of Pittsburgh, Pa. v Xerox Corp.*, 25 AD3d 309; *Bank of China v Chan*, 937 F2d 780.) VI. The plaintiff banks'

request for leave to replead their complaint should be denied. (*Bingham v New York City Tr. Auth.*, 99 NY2d 355; *Prichard v 164 Ludlow Corp.*, 49 AD3d 408; *Minihane v Weissman*, 226 AD2d 152; *Matter of Grimm v State of NY. Div. of Hous. Community Renewal Off of Rent Admin.*, 15 NY3d 358.)

Eric T. Schneiderman, Attorney General, New York City (*Steven C. Wu, Barbara D. Underwood* and *Richard*
214 *Dearing* of *214 counsel), for Superintendent of Insurance, amicus curiae, I. The Superintendent of Insurance's approval of insurer transactions may not be collaterally attacked in a plenary fraudulent conveyance action. (*Matter of Guardian Life Ins. Co. of Am. v Bohlinger*, 308 NY 174; *Matter of City of New York [Grand Lafayette Props. LLC*], 6 NY3d 540; *Connors v Amax Coal Co., Inc.*, 858 F2d 1226; *Flacke v Onondaga Landfill Sys.*, 69 NY2d 355; *Breen v Cunard Lines S. S. Co.*, 33 NY2d 508; *Matter of New York Pub. Interest Research Group v New York State Dept. of Ins.*, 66 NY2d 444; *Matter of Cohen v Board of Appeals of Vil. of Saddle Rock*, 100 NY2d 395; *Milwaukee v Illinois*, 451 US 304; *Matter of Knickerbocker Agency [Holz*], 4 NY2d 245; *Matter of Lawyers Tit. Guar. Co.*, 254 App Div 491.) II. The plaintiff banks' arguments are meritless. (*Fransen v Conoco, Inc.*, 64 F3d 1481; *Abiele Contr. v New York City School Constr. Auth.*, 91 NY2d 1; *Whitney Nat. Bank in Jefferson Parish v Bank of New Orleans Trust Co.*, 379 US 411; *Matter of Evans v Monaghan*, 306 NY 312; *Matter of Venes v Community School Bd. of Dist. 26*, 43 NY2d 520; *Capital Tel. Co. v Pattersonville Tel. Co.*, 56 NY2d 11; *People v Grasso*, 11 NY3d 64; *Milwaukee v Illinois*, 451 US 304; *Richards v Kaskel*, 32 NY2d 524; *Matter of Charles H. Greenthal Co. v Lefkowitz*, 32 NY2d 457.)

New York Civil Liberties Union Foundation, New York City (*Andrew L. Kalloch* and *Taylor Pendergrass* of counsel), for New York Civil Liberties Union and others, amici curiae. I. It is a violation of due process to preclude a litigant from asserting claims on the basis of a prior proceeding to which the litigant was not a party. (*Hansberry v Lee*, 311 US 32; *Pennoyer v Neff* 95 US 714; *Gramatan Home Invs. Corp. v Lopez*, 46 NY2d 481; *Whitley v Klauber*, 51 NY2d 555; *Parklane Hosiery Co. v Shore*, 439 US 322; *Matter of People v Applied Card Sys., Inc.*, 11 NY3d 105; *Bigelow v Old Dominion Copper Mining Smelting Co.*, 225 US 111; *Hannah v Larche*, 363 US 420; *Ohio Bell Telephone Co. v Public Util. Comm'n of Ohio*, 301 US 292; *Morgan v United States*, 304 US 1.) II. The Insurance Department's decision cannot preclude the assertion of common-law rights and causes of action, which must be preserved in the absence of explicit derogation by the Legislature. (*Jamison v Encarnacion*, 281 US 635; *Isbrandtsen Co. v Johnson*, 343 US 779; *Kirke La Shelle Co. v Armstrong Co.*, 263 NY 79; *United States v Rodgers*, 461 US 677; *Imbler v Pachtman*, 424 US 409; *United States v Sanges*, 144 US 310; *Commodity Futures Trading Comm'n v Schor*, 478 US 833; *Briscoe v LaHue*, 460
215 US 325; *Nixon v Fitzgerald*, 457 US 731; *Scheuer v Rhodes*, 416 US 232.) *215 *Patrick J. Borchers*, Omaha, Nebraska, pro se and *Arthur R. Miller*, New York City, pro se, amici curiae. I. The Superintendent of Insurance's determination was not entitled to preclusive effect. (*Allied Chem. v Niagara Mohawk Power Corp.*, 72 NY2d 271; *United States v Utah Constr. Mining Co.*, 384 US 394; *Matter of Josey v Goord*, 9 NY3d 386.) II. No issue fatal to the plaintiffs' fraudulent conveyance causes of action was conclusively decided. (*Capital Tel. Co. v Pattersonville Tel. Co.*, 56 NY2d 11.) III. Plaintiffs were strangers to the Superintendent of Insurance's determination and thus cannot be adversely bound. (*B. R. DeWitt, Inc. v Hall*, 19 NY2d 141; *Capital Tel. Co. v Pattersonville Tel. Co.*, 56 NY2d 11; *Estate of Schneider v Fin-mann*, 15 NY3d 306; *Phillips Petroleum Co. v Shutts*, 472 US 797; *Martin v Wilks*, 490 US 755; *Taylor v Sturgell*, 553 US 880; *Richards v Jefferson County*, 517 US 793; *Amchem Products, Inc. v Windsor*, 521 US 591; *Hansberry v Lee*, 311 US 32; *Matter of Pell v Board of Educ. of Union Free School Dist. No. 1 of Towns of Scarsdale Mamaroneck, Westchester County*, 34 NY2d 222.)

Simpson Thacher Bartlett LLP, New York City (*David W Ichel, Barry R. Ostrager, Joseph M. McLaughlin, Patrick T Shilling* and *Daniel J. Stujenske* of counsel), for Aurelius Capital Master Ltd. and others, amici curiae. I. The MBIA defendants cannot satisfy the elements of collateral estoppel. (*Staatsburg Water Co. v Staatsburg Fire Dist.*, 72 NY2d 147; *Capital Tel. Co. v Pattersonville Tel. Co.*, 56 NY2d 11; *Leon v Martinez*, 84 NY2d 83; *Pattison v Pattison*, 301 NY 65; *Mills v Everest Reins. Co.*, 410 F Supp 2d 243; *Baker v Muraski*, 61 AD3d 1373; *Dalton v Educational Testing Serv.*, 87 NY2d 384; *FCNB Spiegel v Dimmick*, 163 Misc 2d 152; *Bauer v Planning Bd. of Vil. of Scarsdale*, 159 AD2d 532; *J. A. Preston Corp. v Fabrication Enters.*, 68 NY2d 397.) II. Even if there were a "collateral attack doctrine" apart from collateral estoppel, it could not bar plaintiffs' claims. (*Capital Tel. Co. v Pattersonville Tel. Co.*, 56 NY2d 11; *Fiala v Metropolitan Life Ins. Co.*, 6 AD3d 320; *Richards v Kaskel*, 32 NY2d 524; *Belco Petroleum Corp. v AIG Oil Rig*, 164 AD2d 583; *McGee v Lepow*, 82 AD2d 746, 54 NY2d 1027; *Matter of East NY. Sav. Bank Depositors Litig.*, 145 Misc 2d 620, *aff'd sub nom. Wechsler v Murray*, 162 AD2d 251; *Brawer v Johnson*, 231 AD2d 664; *Matter of Empire Blue Cross Blue Shield Customer Litig.*, 164 Misc 2d 350, *aff'd sub nom. Minihane v Weissman*, 226 AD2d 152; *Steen v Quaker State Corp.*, 12 AD3d 989; *Academic Health Professionals Ins. Assn. v M.Q. of NY., Inc.*, 30 AD3d
216 165, 7 NY3d 895.) III. Precluding claims on the *216 basis of private agency determinations would be bad public policy. (*Staatsburg Water Co. v Staatsburg Fire Dist.*, 72 NY2d 147; *David v Biondo*, 92 NY2d 318.)

concur with Judge CIPARICK; Judge READ dissents in a separate opinion in which Judge GRAFFEO concurs.

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OPINION OF THE COURT

CIPARICK, J.

In this dispute between MBIA Insurance Corporation (MBIA Insurance) and certain of its policyholders, the principal question presented is whether the 2009 restructuring of MBIA Insurance and its related subsidiaries and affiliates authorized by the Superintendent of the New York State Insurance Department (the Superintendent) precludes these policyholders from asserting claims against MBIA Insurance under the Debtor and Creditor Law and the common law. We hold that the Superintendent's approval of such restructuring pursuant to his authority under the Insurance Law does not bar the policyholders from bringing these claims.

I.

This appeal has its origins in the unraveling of the world's financial markets that began in 2007. As described in the complaint, plaintiffs are a group of unrelated banking and financial services institutions that hold financial guarantee insurance policies issued by defendant MBIA Insurance on their structured-finance products. In May 2009, they commenced this action against defendants MBIA Insurance, MBIA Inc., and MBIA Insurance Corp. of Illinois (MBIA Illinois) following the Superintendent's February 2009 approval of their application for restructuring. Plaintiffs contend that the restructuring constituted a fraudulent conveyance, which left MBIA Insurance undercapitalized and unable to meet its obligations under the terms of their policies.

Prior to the restructuring, MBIA Inc., a publicly-traded Connecticut-based corporation, provided financial guarantee insurance and other forms of credit protection to its customers worldwide. It conducted this business through its wholly-owned subsidiary, MBIA Insurance, a New York-based corporation. MBIA Illinois, an essentially-dormant, Illinois-domiciled corporation, was a wholly-owned subsidiary of MBIA Insurance.

As a monoline insurer, MBIA Insurance "exclusively wrote financial guarantee insurance policies and did not offer property, casualty, life, disability or other forms of insurance." Under the terms of its policies, MBIA
217 Insurance promised to pay its *217 policyholders if an obligor on a covered instrument defaulted. Historically, MBIA Insurance had underwritten policies that covered municipal bonds and other types of securities issued by governmental entities. However, in response to market trends, MBIA started offering guarantee insurance related to structured-finance products. Structured-finance products, which include mortgage-backed securities, are "obligations payable from or tied to the performance of pools of assets." Notably, by the end of 2008, MBIA Insurance had a portfolio of policies with a face amount of $786.7 billion. Approximately one third of MBIA Insurance's portfolio consisted of structured-finance policies ($233 billion in face amount); the remaining two thirds consisted of municipal bond policies ($553.7 billion in face amount).

Beginning in 2007 and continuing through 2008, the health of the real estate market deteriorated. In turn, the risks associated with certain financial products tied to real estate, such as structured-finance products, increased concomitantly. Not surprisingly, MBIA Insurance's exposure to liability with respect to its structured-finance policy portfolio grew exponentially as the real estate market crumbled during this period.

In 2008, MBIA Inc. responded to this crisis in a number of ways. On February 25, 2008, it publicly "announced] that it would establish `separate legal operating entities for MBIA's public, structured, and asset management businesses' within five years." At the same time, MBIA Inc. suspended the issuance of new structured-finance guarantee policies. In May 2008, MBIA Inc. also considered infusing $900 million of its own cash into its subsidiaries "in order to `support MBIA Insurance[`s] triple-A ratings and existing and future policyholders.' "Despite these efforts to curb the negative effects of the downturn in the real estate market, in early June 2008, both Moody's Investors Service, Inc. (Moody's) and Standard Poor's Rating Services downgraded MBIA Insurance's creditworthiness. MBIA Inc., as a result, opted not to invest its own cash into its subsidiaries, but instead decided to pursue its plan to segregate its municipal bond portfolio from its structured-finance portfolio, which it feared was turning toxic.

Under the Insurance Law, many aspects of this plan required approval or nondisapproval by the Superintendent. To that end, on December 5, 2008, MBIA Insurance, on behalf of itself and the other defendants, submitted an ex parte application to the Superintendent, detailing a series of proposed transactions
218 that *218 would effectuate their desired goals. MBIA Insurance supplemented and amended its application several times in the ensuing two months. Defendants requested approval of the following transactions in order to separate their two sets of portfolios. First, MBIA Insurance would declare and distribute a $1,147 billion dividend to MBIA Inc. Second, MBIA Insurance would redeem and retire roughly one third of its capital stock from MBIA Inc. and in exchange would give MBIA Inc. approximately $938 million more in cash and securities, as well as all of the issued and outstanding stock of MBIA Illinois. Third, MBIA Inc. would transfer the cash it received from the dividend distribution and the cash, securities and MBIA Illinois stock it received in connection with the stock redemption to MuniCo Holdings Inc. (MuniCo), a wholly-owned subsidiary of MBIA Inc. Fourth, MuniCo would capitalize MBIA Illinois, no longer a subsidiary of MBIA Insurance, by contributing $2,085 billion it received in these asset transfers.

Finally, following the capitalization of MBIA Illinois, MBIA Insurance further proposed that it and MBIA Illinois would enter into a series of transactions pursuant to which MBIA Illinois would "reinsure, on a cut-through basis, those financial guaranty insurance policies sold or reinsured by MBIA [Insurance]." Such an arrangement would allow the municipal bond policyholders to submit claims directly to MBIA Illinois as well as MBIA Insurance. In exchange, MBIA Insurance would remit about $3.66 billion to MBIA Illinois, most of which represented "the net unearned premium reserve . . . associated with" the municipal bond policies.

By letter dated February 17, 2009, the Superintendent granted each of the approvals requested by MBIA Insurance (the Transformation). The approval letter stated that the Transformation was fair to structured-finance policyholders, noting that MBIA Insurance would "continue to *pay* all valid claims in a timely fashion." No notice or opportunity to be heard was given to the policyholders.

Specifically, the Superintendent approved the proposed dividend payment made by MBIA Insurance to MBIA Inc. under Insurance Law § 4105 (a), which requires a determination that MBIA Insurance would "retain sufficient surplus to support its obligations and writings." Next, the Superintendent approved the proposed stock redemption, concluding under Insurance Law § 1411 (d) that it was "reasonable and equitable." Finally,
219 with respect to the proposed reinsurance transaction, the *219 Superintendent did not disapprove, concluding that it comported with statutory factors enunciated in Insurance Law §§ 1308, 1505 and 6906. In his letter, the Superintendent stressed a number of times that his approvals and nondisapprovals were based on "the representations contained in the [amplication [by MBIA Insurance] and its supporting submissions, and in reliance on the truth of those representations and submissions."

Following the Superintendent's issuance of its approval/nondisapproval letter, defendants consummated the Transformation, which was given retroactive effect to January 1, 2009. The very next day, MBIA Inc. publicly announced that it had succeeded in segregating its municipal bond policy portfolio from its structured-finance policy portfolio by restructuring its principal insurance subsidiary, MBIA Insurance. MBIA Inc.'s chief executive officer emphasized in a letter to shareholders that the Transformation provided the holding company "with much needed clean capacity for new municipal bond business."

On February 18, 2009, the Superintendent issued his own public statement, announcing that he had overseen "a transformation of [MBIA Insurance] that effectively splits that company in two, dividing its assets and liabilities between two highly capitalized insurance companies." Despite the Superintendent's public endorsement of the restructuring, Moody's further downgraded MBIA Insurance's credit rating to B3, six steps below investment grade and three steps above "junk." One of the primary reasons Moody's cited for its downgrade of MBIA Insurance was the "substantial reduction in claims-paying resources relative to the remaining higher-risk exposures in its insured portfolio, given the removal of capital, and the transfer of unearned premium reserves associated with the ceding of its municipal portfolio to MBIA Illinois."

In May 2009, plaintiffs commenced this action in Supreme Court alleging fraudulent conveyances under New York's Debtor and Creditor Law, breach of contract, abuse of the corporate form, and unjust enrichment. "[A]midst an ongoing financial crisis," plaintiffs allege that

> "[i]n an unlawful attempt to escape MBIA Insurance's coverage obligations to [p]laintiffs and other policyholders, [defendants executed a series of fraudulent conveyances, in breach of MBIA Insurance's
> 220 contracts, to transfer MBIA Insurance assets into MBIA Illinois — an entity that [d]efendants *220 structured to be free from liabilities or other obligations to [p]laintiffs."

Plaintiffs specifically allege that "[defendants [fraudulently] stripped approximately $5 billion in cash and securities out of MBIA Insurance" and that MBIA Insurance received no consideration for the assets it transferred. They further allege that the fraudulent conveyances have exposed them to potentially billions of dollars in losses since MBIA Insurance is now woefully undercapitalized and insolvent. Moreover, plaintiffs allege that MBIA Inc. abused the corporate form by causing MBIA Insurance to engage in these unfair transactions in order to shield assets away from plaintiffs. Plaintiffs seek to set aside the allegedly fraudulent transfer or, in the alternative, a declaration that defendants shall be jointly and severally liable to plaintiffs under plaintiffs' insurance policies, or an award of damages.

Defendants moved to dismiss the complaint on June 9, 2009. Their principal basis for dismissal is that plaintiffs' claims in this plenary proceeding are impermissible "collateral attacks" on the Superintendent's approval of the Transformation, which can only be challenged in a CPLR article 78 proceeding. Defendants also contend that the complaint fails to state cognizable causes of action.

On June 15, 2009 — six days after defendants moved to dismiss the complaint and within the four-month statute of limitations period — plaintiffs separately filed an article 78 proceeding in Supreme Court, assigned to the same Justice handling the plenary action, challenging the Superintendent's 2009 approval/nondisapproval of the Transformation. Plaintiffs assert in that proceeding that the Superintendent acted arbitrarily and capriciously and abused his discretion. For relief, plaintiffs seek an annulment of the Superintendent's determination and a declaration that the transactions approved by the Superintendent in connection with the Transformation are null and void. The article 78 proceeding remains pending while the parties conduct discovery.

In a written decision, Supreme Court denied defendants' motion seeking dismissal of the complaint (*ABN Amro Bank N.V. v MBIA Inc.*, 26 Misc 3d 1223[A], 2010 NY Slip Op 50238[U] [Sup Ct, NY County 2010]). The court rejected defendants' "collateral attack" argument, noting that plaintiffs were not seeking a 221 determination from the court that the Superintendent incorrectly applied New York's Insurance Law *221 (2010 NY Slip Op 50238[U] at *16). Rather, Supreme Court held, the "mere fact that there was earlier approval of the . . . restructuring by the Insurance Department does not immunize defendants from subsequent statutory and common law claims" (*id.* at *13). In so holding, the court observed that "[t]he Superintendent was not called upon to examine whether defendants intended to defraud policyholders" (*id.* at *15). Supreme Court then evaluated the legal sufficiency of the complaint and found that plaintiffs adequately pleaded causes of action under the Debtor and Creditor Law (*see id.* at *18). It also concluded that plaintiffs adequately stated claims for breach of contract premised on a breach of the implied covenant of good faith and fair dealing, abuse of the corporate form allowing for a declaratory judgment piercing the corporate veil of MBIA Insurance, and unjust enrichment (*see id.* at * 18-19).

The Appellate Division, with two Justices dissenting in part, reversed and granted defendants' motion to dismiss the complaint (*ABN AMRO Bank, N.V. v MBIA Inc.*, 81 AD3d 237, 248 [1st Dept 2011]). The majority construed plaintiffs' complaint as a "collateral attack" on the Superintendent's authorization of the Transformation. Citing its decision in *Fiala v Metropolitan Life Ins. Co.* (6 AD3d 320 [1st Dept 2004]), the majority held that "[a] plenary action that seeks the overturn of the Superintendent's determination, or challenges matters that the determination necessarily encompasses, constitutes an impermissible indirect challenge to that determination" (81 AD3d at 246 [internal quotation marks omitted]). As a result, the majority opined that an article 78 proceeding challenging the Superintendent's determination is the only remedy available to the plaintiffs (*see id.* at 246).

The majority also held that, in any event, plaintiffs' three common-law claims failed to state causes of action. Specifically, the majority noted that plaintiffs' breach of contract and piercing of the corporate veil claims should have been dismissed on the ground that plaintiffs fail to allege a default on payments owed to them under their policies (*see id.* at 244-245). The majority found that "[p]laintiffs also fail to allege particularized statements detailing fraud or other corporate misconduct that would warrant piercing the corporate veil" (*id.* at 245). Finally, the majority concluded that plaintiffs failed to state a cause of action for unjust enrichment because they did not allege that "MBIA Insurance has conferred some benefit upon MBIA Inc. and MBIA 222 Illinois at plaintiffs' expense" (*id.* at 246). *222

The two dissenting Justices agreed with the majority that plaintiffs' unjust enrichment cause of action should have been dismissed, but would have otherwise affirmed the order of Supreme Court (*see id.* at 253 [Abdus-Salaam, J., dissenting in part]). The dissent rejected the notion that an article 78 proceeding is the sole remedy available to plaintiffs here (*see id.* at 252-253). The dissenting Justices reasoned that the Superintendent's decision did not have a preclusive effect on plaintiffs' right to assert claims against defendants because, unlike the plaintiffs in *Fiala* and the other cases cited by the majority, plaintiffs here had no "opportunity to be heard or otherwise provide input regarding the determination" (*id.* at 253).

Furthermore, the dissent concluded that plaintiffs sufficiently pleaded a cause of action for breach of contract, under a theory that defendants breached an implied covenant of good faith, where they allege that defendants "substantially reduc[ed] the likelihood that MBIA Insurance [would] be able to pay its policyholders," thereby "injuring the right of plaintiffs to receive the fruits of the contract" (*id.* at 254 [internal quotation marks and brackets omitted]). Finally, the dissent concluded that plaintiffs sufficiently pleaded their claim for a declaratory judgment and piercing of the corporate veil, observing that plaintiffs allege that MBIA Inc. abused the privilege of doing business in the corporate form by causing MBIA Insurance to make fraudulent conveyances for no value (*see id.* at 254-255).

Plaintiffs appeal as of right pursuant to CPLR 5601 (a) and we now modify.

II.

Defendants have consistently maintained that plaintiffs' plenary claims under the Debtor and Creditor Law and the common law constitute an "impermissible collateral attack" on the Superintendent's approval of the Transformation. To support their position, defendants do not argue that plaintiffs are collaterally estopped from commencing a proceeding in Supreme Court following the Superintendent's determination. Rather, defendants contend on this appeal that the Insurance Law vests the Superintendent with "exclusive original jurisdiction" to adjudicate plaintiffs' claims that may only be challenged through an article 78 proceeding. For the reasons that follow, we reject this argument.

It is fundamental that "Article VI, § 7 of the NY Constitution establishes the Supreme Court as a court of
223 `general original *223 jurisdiction in law and equity' "( *Sohn v Calderon*, 78 NY2d 755, 766, quoting NY Const. art VI, § 7 [a]). "Under this grant of authority, the Supreme Court `is competent to entertain all causes of action unless its jurisdiction has been specifically proscribed' "(*id.*, quoting *Thrasher v United States Liab. Ins. Co.*, 19 NY2d 159, 166). Indeed, "it has never been suggested that every claim or dispute arising under a legislatively created scheme may be brought to the Supreme Court for original adjudication" (*id.*). Thus, "the constitutionally protected jurisdiction of the Supreme Court does not prohibit the Legislature from conferring exclusive original jurisdiction upon an agency in connection with the administration of a statutory regulatory program" (*id.* at 767).

We applied these principles in *Sohn* and held the agency in question there, the Division of Housing and Community Renewal (DHCR), had exclusive original jurisdiction to resolve a dispute concerning a landlord's entitlement to demolish a rent-regulated building (*see id.* at 767-768). In analyzing the statute governing DHCR's authority, Administrative Code of the City of New York § 26-408, we observed that it was "beyond question that the Legislature intended" such disputes "to be adjudicated by the DHCR" (*id.* at 765-766). Thus, we concluded that the statutory scheme proscribed the landlord in that case from circumventing DHCR's authority and commencing an action in Supreme Court seeking a declaration that was within DHCR's exclusive purview (*see id.* at 767-768). We noted that the landlord, of course, could later challenge a determination made by DHCR by way of an article 78 proceeding (*see id.* at 767).

On the other hand, in *Richards v Kaskel* (32 NY2d 524), we held that section 352-e of the General Business Law, which vests the Attorney General with exclusive jurisdiction to approve a cooperative building conversion plan, did not preclude the plaintiffs, tenants of a rent-stabilized apartment complex, from commencing a private lawsuit alleging that their landlord engaged in fraudulent misconduct in connection with such a plan (*see id.* at 535). There, we observed that section 352-e authorized the Attorney General "to consider the sufficiency of the language and content of the [cooperative conversion] plan [and to determine] that the plan . . . complied with the disclosure requirements of the statute" (*id.* at 535 n 5). Given the limited scope of the Attorney General's adjudicatory authority under this section of the General Business Law, we
224 concluded that the Legislature did not "intend[] to deprive the court of its *224 traditional equitable jurisdiction to consider claims of illegality on the part of the sponsor apart from noncompliance with that provision" (*id.; see also McGee v Lepow*, 82 AD2d 746, 747 [1st Dept 1981], *appeal dismissed* 54 NY2d 1027).

In this case, defendants essentially ask us to construe the Superintendent's exclusive original jurisdiction to approve the Transformation under the relevant provisions of the Insurance Law to mean that he is also the exclusive arbiter of all private claims that may arise in connection with the Transformation — including claims that the restructuring rendered MBIA Insurance insolvent and was unfair to its policyholders. Defendants' contention, taken to its logical conclusion, would preempt plaintiffs' Debtor and Creditor Law and common-law claims. We reject this argument and conclude that there is no indication from the statutory language and structure of the Insurance Law or its legislative history that the Legislature intended to give the Superintendent such broad preemptive power (see *Matter of Zuckerman v Board of Educ. of City School Dist. of City of N.Y.*, 44 NY2d 336, 342-343 ["A]though (the Public Employment Relations Board [PERB]) has exclusive jurisdiction of labor disputes between public employers and public employees involving the right to organize and the right to negotiate in good faith, this jurisdiction does not mean that any and all disputes between such parties fall exclusively to PERB. PERB's jurisdiction encompasses only those matters specifically covered by the Taylor Law"]).

If the Legislature actually intended the Superintendent to extinguish the historic rights of policyholders to attack fraudulent transactions under the Debtor and Creditor Law or the common law, we would expect to see evidence of such intent within the statute. Moreover, we would expect that, in such a situation, affected policyholders, such as plaintiffs, would have notice and an opportunity to be heard before the Superintendent made his determinations. Here, we find no such intent in the statute.[1] Nor do we see a provision that required the Superintendent to provide notice and an opportunity to be heard to plaintiffs before he approved the
225 Transformation (*cf. Shah v* *225 *Metropolitan Life Ins. Co.*, 2003 NY Slip Op 50591[U], *26 [Sup Ct, NY County 2003] [*aff'd in part by Fiala*, 6 AD3d at 321-322] [in the context of an Insurance Law article 73 demutualization, following the required statutory notice and an opportunity to be heard by the policyholders, "(t)he (L)egislature expressly placed the determination as to whether a plan of reorganization complied with the statute and was fair and equitable to policyholders in the (exclusive jurisdiction) of the Superintendent"]).

1 We agree with the dissent that "intent may be implied from the nature of the subject matter being regulated" and that "[a] comprehensive and detailed statutory scheme may be evidence of the Legislature's intent to preempt" (dissenting op at 232, quoting *Matter of Cohen v Board of Appeals of Vil. of Saddle Rock*, 100 NY2d 395, 400 [2003] [emphasis omitted]). We disagree, however, that the Insurance Law implies such an intent here.

Defendants nonetheless look to Insurance Law § 326 (a) as a provision conferring exclusive authority on the Superintendent to adjudicate plaintiffs' private claims. Defendants' reliance on such provision, however, is entirely misplaced. That statute, as pertinent here states that "any order, regulation or decision of the [Superintendent is declared to be subject to judicial review in a proceeding under article [78] of the civil practice law and rules." A cursory reading of the plain language reveals that it does not vest the Superintendent with the power to consider causes of action such as plaintiffs'. Rather, the statute merely provides that the Superintendent's decisions — which derive from legislatively designated authority under the Insurance Law — are subject to review in an article 78 proceeding (*see Travelers Indem. Co. v State of New York*, 33 AD2d 127, 128 [3d Dept 1969], *aff'd* 28 NY2d 561 ["it is clear from the legislative history that (Insurance Law § 326) was written in its present form to insure that all and not just some of the determinations made by the (Superintendent) were reviewable by an article 78 proceeding"]). The Superintendent's determinations, however, have never included the adjudication of claims like those plaintiffs have put forward in this action. Nor can these claims be properly raised and adjudicated in an article 78 proceeding.

III.

Because we perceive no basis to conclude that the Legislature divested Supreme Court of its general jurisdiction to adjudicate plaintiffs' Debtor and Creditor Law and common-law claims, explicitly through the Insurance Law or otherwise, we next turn to the preclusive effect, if any, of the Superintendent's approval of the Transformation on this plenary action. Such an inquiry requires an analysis of administrative collateral estoppel principles. At the outset, however, we observe that defendants correctly concede that collateral estoppel does
226 not apply here. *226 While our inquiry would normally end with such a concession, a discussion is necessary here as the so-called "collateral attack doctrine" does not exist apart from the doctrines of exclusive original jurisdiction and administrative collateral estoppel principles. And there is good reason for this. The recognized doctrines, as they exist in New York, build in protections of notice and opportunity to be heard for affected constituencies.

The doctrine of collateral estoppel (or issue preclusion) is rooted in principles of fairness. It is well settled that the doctrine "may be invoked in a subsequent action or proceeding to prevent a party from relitigating an [identical] issue decided against that party in a prior adjudication" (*Staatsburg Water Co. v Staatsburg Fire Dist.*, 72 NY2d 147, 152). In *Capital Tel. Co. v Pattersonville Tel. Co.* (56 NY2d 11), we reaffirmed the principle that collateral estoppel applies to an administrative proceeding (*id.* at 17). In the context of administrative agency determinations, we have recognized that the doctrine of collateral estoppel "is applied more flexibly, and additional factors must be considered by the court" (*Allied Chem. v Niagara Mohawk Power Corp.*, 72 NY2d 271, 276). "These additional requirements are often summed up in the beguilingly simple prerequisite that the administrative decision be `quasi-judicial' in character" (*id.*, citing *Ryan v New York Tel. Co.*, 62 NY2d 494, 500).

An administrative decision is quasi-judicial in character when it is "` "rendered pursuant to the adjudicatory authority of an agency to decide cases brought before its tribunals employing procedures substantially similar to those used in a court of law" ` "(*Matter of Jason B. v Novello*, 12 NY3d 107, 113, quoting *Ryan*, 62 NY2d at 499). Thus, for collateral estoppel to be triggered, not only must the identity of the issue decided in the prior action or proceeding have been the same, but also "there must have been a full and fair opportunity to contest the decision now said to be controlling" (*Gilberg v Barbieri*, 53 NY2d 285, 291, quoting *Schwartz v Public Adm'r of County of Bronx*, 24 NY2d 65, 71; *see also Capital Tel. Co.*, 56 NY2d at 17).

Here, even assuming the issues considered by the Superintendent in approving the Transformation are identical to the issues raised by plaintiffs in their plenary action (which they are not), plaintiffs had no opportunity to contest the Superintendent's determination or, more importantly, challenge the validity of the financial
227 information provided to him by defendants *227 which formed the basis of the Superintendent's approval. The record is indisputable on this point. MBIA Insurance submitted a private application to the Superintendent. The Superintendent did not conduct public hearings or provide public notice before rendering his determination.

Crucially, the Superintendent accepted the truth of defendants' submissions (*cf. Shah*, 2003 NY Slip Op 50591 [U] at * 12-13, *aff'd in part by Fiala*, 6 AD3d at 321 [plenary lawsuit dismissed as a collateral attack on the Superintendent's decision to approve a demutualization of an insurance company where public hearings were held and plaintiff had notice and opportunity to be heard]). Simply put, there was nothing "quasi-judicial" about the Superintendent's approval process that ought to be binding on plaintiffs in this case (see *Staatsburg Water Co.*, 72 NY2d at 154 [even where party had an opportunity to participate in a prior proceeding, such proceeding is not quasi-judicial, and therefore not binding, where party's participation "did not necessarily amount to a full and fair opportunity to contest the determination"]).

That the Superintendent complied with lawful administrative procedure, in that the Insurance Law did not impose a requirement that he provide plaintiffs notice before issuing his determination, does not alter our analysis. To hold otherwise would infringe upon plaintiffs' constitutional right to due process. Indeed, as we stated in *Gilberg*, "[d]ue process, of course, would not permit a litigant to be bound by an adverse determination made in a prior proceeding to which he was not a party or in privity with a party" (53 NY2d at 291; *see also Phillips Petroleum Co. v Shutts*, 472 US 797, 811-812 [a party cannot be bound by a prior proceeding without "minimum procedural due process protection," including "notice plus an opportunity to be heard and participate in the litigation"]). Clearly plaintiffs here were not in privity with the Superintendent.

IV

Satisfied that the Superintendent's approval of the Transformation does not bar plaintiffs' independent plenary action, we address the sufficiency of the pleadings. Our standard of review is well familiar: "On a motion to dismiss pursuant to CPLR 3211, the pleading is to be afforded a liberal construction" (*Leon v Martinez*, 84 NY2d 83, 87; *see* CPLR 3026). Courts must "accept the facts as alleged in the complaint as true, accord plaintiffs the benefit of every possible favorable inference, and determine only whether the facts as alleged fit
228 within any cognizable legal theory" (*Leon*, 84 NY2d at 87-88). *228

We conclude that plaintiffs adequately pleaded causes of action under the Debtor and Creditor Law. Plaintiffs premise their first claim on Debtor and Creditor Law § 273, which requires them to allege that MBIA Insurance fraudulently made "conveyance[s]" that rendered it "insolvent" because it did not receive "fair consideration" for such conveyances. They base their second claim on Debtor and Creditor Law § 274, which similarly requires plaintiffs to allege that MBIA Insurance fraudulently made "conveyance[s] . . . without fair consideration," which left it with "unreasonably small capital." Debtor and Creditor Law § 276 forms the basis of plaintiffs' third cause of action. That statute requires plaintiffs to allege that defendants made conveyances and incurred obligations with the intent "to hinder, delay, or defraud either present or future creditors."

Plaintiffs, who are undoubtedly creditors of MBIA Insurance, support all of these claims by describing a series of allegedly fraudulent transactions made in bad faith by defendants after the Superintendent's approval of the Transformation, in which they ultimately assert defendants "stripped approximately $5 billion in cash and securities out of MBIA Insurance." Further, plaintiffs allege that MBIA Insurance received no consideration for the assets it transferred to MBIA Inc. As a result, plaintiffs allege that MBIA Insurance is insolvent and unable to meet its obligations under the terms of their policies. These allegations clearly support causes of action under sections 273 and 274 of the Debtor and Creditor Law. Moreover, these allegations, taken together and drawing all reasonable inferences in favor of plaintiffs, as we must at this stage of the litigation, sufficiently allege an intent on the part of defendants to defraud plaintiffs under section 276 (*see Dempster v Overview Equities*, 4 AD3d 495, 498 [2d Dept 2004]).

Turning to plaintiffs' common-law claims, we likewise conclude that plaintiffs pleaded a viable cause of action for breach of contract based upon a breach of the implied covenant of good faith. Of course, the implied covenant of good faith and fair dealing "embraces a pledge that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract" (*Dalton v Educational Testing Serv.*, 87 NY2d 384, 389 [internal quotation marks omitted]). Here, plaintiffs sufficiently allege that MBIA Insurance, by fraudulently transferring billions of dollars of its assets to MBIA Inc. for no
229 consideration, "violated the covenant by substantially reducing the likelihood *229 that [it] will be able" to meet its obligations under the terms of the insurance policies (*ABN AMRO Bank, N.V.*, 81 AD3d at 254 [Abdus-Salaam, J., dissenting in part]; *see also MBIA Ins. Corp. v Countrywide Home Loans, Inc.*, 2009 NY Slip Op 31527[U], *19 [Sup Ct, NY County 2009] [MBIA Insurance itself successfully pleaded a breach of contract cause of action premised on breach of implied covenant by alleging that defendant "unfairly shifted the risks of default and delinquencies',' to it]).[2]

2 Contrary to the dissent, plaintiffs' assertions that the allegedly fraudulent transactions rendered MBIA Insurance insolvent and unable to meet payments under the terms of the policies, as pleaded in their complaint, can very well be considered "objectively measurable deviations from specific contract provisions" (dissenting op at 235).

We further conclude that the complaint adequately states a claim for abuse of the corporate form that may support a declaration piercing the corporate veil of MBIA Insurance. As the Appellate Division dissent appropriately observed,

> "`[t]he party seeking to pierce the corporate veil must establish that the owners, through their domination, abused the privilege of doing business in the corporate form to perpetrate a wrong or injustice against that party such that a court in equity will intervene' (*Matter of Morris v New York State Dept. of Taxation Fin.*, 82 NY2d 135, 142 [1993])" (81 AD3d at 255).

In that regard, plaintiffs' allegations that MBIA Inc. abused its control of its wholly-owned subsidiary, MBIA Insurance, by causing it to engage in harmful transactions that now shield billions of dollars in assets from plaintiffs and expose them to significant liability meet this test (*cf. East Hampton Union Free School Dist. v Sandpebble Bldrs., Inc.*, 16 NY3d 775, 776 [piercing the corporate veil claim properly dismissed where plaintiff failed to allege any harm purportedly resulting from an abuse or perversion of the corporate form]).

Finally, we agree with the Appellate Division that plaintiffs' cause of action for unjust enrichment should be dismissed.

Accordingly, the order of the Appellate Division should be modified, without costs, in accordance with this opinion, and as so modified, affirmed.

READ, J. (dissenting).

Plaintiffs seek relief in this plenary action brought pursuant to the Debtor and Creditor Law and common law
230 that, if granted, would annul the decision made by *230 the Superintendent of Insurance on February 17, 2009 to approve the restructuring of MBIA Insurance Corporation (MBIA Insurance) and related subsidiaries and affiliates by unwinding the underlying transactions. Whether or not this lawsuit is called, in the coinage of the First Department, a "collateral attack" on the Superintendent's approval (81 AD3d 237, 240), the fact remains that the Legislature has confined any challenge to the propriety of the restructuring to a CPLR article 78 proceeding. This is so because the Insurance Law has preempted plaintiffs' statutory and common-law causes

of action, which are all grounded in the notion that the restructuring sanctioned by the Superintendent caused MBIA Insurance to be insufficiently capitalized to the detriment of its structured-finance policyholders. Accordingly, I respectfully dissent.

I.

New York law has historically vested the Superintendent with broad authority to regulate the insurance industry (see Insurance Law § 201 ["The superintendent shall possess the rights, powers, and duties, in connection with the business of insurance in this state, expressed or reasonably implied by this chapter or any other applicable law of this state]). As particularly relevant to this lawsuit, he is responsible for making sure that insurance companies possess sufficient reserves to pay all their claims (see Insurance Law § 1303), even in the face of "excessive losses occurring during adverse economic cycles" (*see id.* § 6903 [a] [1]).

The regulatory regime in the Insurance Law embraces both advance approval of certain transactions that may affect an insurer's viability, and post-transaction supervision of the insurer's financial condition. Further, most significant transactions between insurers in a holding company system (as happened with the restructuring) require the Superintendent's prior approval that the terms of the transaction are "fair and equitable," and his consideration of whether the transaction may "adversely affect the interests of policyholders" (*see id.* § 1505 [a] [1]; [e]). Thus, the Superintendent reviews any proposed dividend distribution exceeding certain thresholds to make certain that paying it will leave the insurer with sufficient assets to satisfy all outstanding claims (*see id.* § 4105 [a]). Similarly, he reviews proposed stock redemption plans in advance to ensure that they are
231 "reasonable and equitable" (*see id.* § 1411 [d]). *231

In addition to his prior approval of insurance transactions, the Superintendent also continually monitors domestic insurers' financial health through periodic examinations (*see id.* §§ 309-310) and reviews of insurers' annually filed financial statements and reports (*see id.* § 307). If as part of his review the Superintendent determines that an insurer lacks sufficient reserves — i.e., if it "is unable to pay its outstanding lawful obligations as they mature in the regular course of business" (*see id.* § 1309 [a]) — the Superintendent has the exclusive authority to place the insurer into specialized liquidation or rehabilitation proceedings under article 74 of the Insurance Law (*see id.* § 7402 [a], [e]). Article 74 authorizes him to avoid "[a]ny transfer of . . . the property of an insurer . . . with the intent of giving to any creditor or enabling him to obtain a greater percentage of his debt than any other creditor of the same class" (*see id.* § 7425 [a]).

The Superintendent acted to carry out his responsibilities under the Insurance Law's comprehensive regulatory regime when he approved the dividend payment and stock redemption, and did not disapprove the reinsurance transaction, the individual components of the restructuring proposed by MBIA Insurance. Although the majority notes that the Superintendent "stressed a number of times that his approvals and non-disapproval[] were based on `the representations made in the [amplication [by MBIA Insurance] and its supporting submissions, and in reliance on the truth of those representations and submissions' "(majority op at 219), he equally emphasized that his decisionmaking was informed by "the Department's examination of the MBIA Entities' financial condition prior to" the restructuring, and "the Department's analysis of the MBIA Entities' financial condition after the effectuation of the restructuring. The approval, a complex 10-page document, also imposed various conditions on MBIA Insurance and/or its related affiliates and subsidiaries. In short, the Superintendent issued the approval only after a multi-month investigation of MBIA Insurance's finances, which encompassed the review of voluminous raw financial data and the running of "super-stressed or break-the-

bank" tests by experts within the Department. He was not simply a passive recipient of information from MBIA
232 Insurance, powerless *232 to verify that company's representations and dependent on its good graces, as the majority implies.[1]

> "The Legislature may expressly state its intent to preempt, *or that intent may be implied from the nature of the subject matter being regulated as well as the scope and purpose of the state legislative scheme . . . A comprehensive and detailed statutory scheme* may be evidence of the Legislature's intent to preempt" (*Matter of Cohen v Board of Appeals of Vil. of Saddle Rock*, 100 NY2d 395, 400 [2003] [emphases added] [state law governing review of area variances preempted contrary local law]).

1 Of course, if plaintiffs believe that the Superintendent relied on inaccurate or unreliable data, they may pursue this tack in their CPLR article 78 proceeding.

As already noted, the Insurance Law vests broad powers in the Superintendent to regulate New York's insurance industry. More to the point, he is directed to ensure that precisely the kinds of transactions at issue in this case are carried out fairly and equitably, and leave the affected insurers with sufficient assets to satisfy their obligations to policyholders. The particular provisions of the "legislative scheme" relevant here, briefly described earlier, could hardly be more "comprehensive and detailed."

Concomitantly, the Superintendent considered the precise issues disputed by plaintiffs in this lawsuit when he approved the restructuring. In other words, plaintiffs' plenary action not only expressly seeks to undo the restructuring, but does so by contesting the findings underpinning the Superintendent's approval. There is essentially no daylight between the causes of action asserted by plaintiffs and the substance of the Superintendent's review.

For example, just as Debtor and Creditor Law § 274's prohibition on transfers that leave companies with "unreasonably small capital" is intended to keep companies sufficiently capitalized to "sustain operations" (*Moody v Security Pac. Bus. Credit, Inc.*, 971 F2d 1056, 1069, 1070 [3d Cir 1992]), so the Superintendent's supervision of reserves is intended to ensure that insurance companies can continue to operate by maintaining their ability to pay claims (*see* Insurance Law § 1309 [a]). Similarly, Debtor and Creditor Law § 276's prohibition on transfers that may "hinder [or] delay . . . either present or future" policyholders is essentially
233 equivalent to *233 the requirement that the Superintendent must determine that a transaction is "reasonable and equitable" (Insurance Law § 1411 [d]).

And in any event, the critical question is whether " *the thrust* of [plaintiffs'] complaint" goes to matters already determined by an expert agency that has been delegated the primary authority to resolve such issues (*Whitney Nat. Bank in Jefferson Parish v Bank of New Orleans Trust Co.*, 379 US 411, 417 [emphasis added]). There need not be exact correspondence. And here, "the thrust" of plaintiffs' complaint is that the re-structuring caused MBIA Insurance to be insufficiently capitalized to the detriment of its structured-finance policyholders. The Superintendent's approval of the restructuring was premised on his determination that this was not the case. Put another way, plaintiffs assert that the restructuring stripped MBIA Insurance of needed reserves whereas the Superintendent concluded that the restructuring left the insurer in sound financial condition, a prerequisite to his approval.[2]

2 The majority compares this case to *Richards v Kaskel* (32 NY2d 524, 535 n 5 [1973]); however, in *Richards*, the administrative action — the Attorney General's acceptance of a sponsor's cooperative offering plan — "[did] not constitute approval" of the plan by him (see General Business Law § 352-e [4]; *Matter of Charles H. Greenthal Co. v Lefkowitz*, 32 NY2d 457, 462 [1973] [noting that an offering plan is "filed simply for informational purposes" to enable

prospective buyers to decide whether to purchase an interest]). Moreover, the plaintiffs in *Richards* alleged specific oral misrepresentations to tenants apart from the offering plan (*see Richards v Kaskel*, 69 Misc 2d 435, 443 [Sup Ct, NY County 1972]).

The majority seems to suggest that if the Legislature "actually intended the Superintendent to extinguish the historic rights of policyholders to attack fraudulent transactions under the Debtor and Creditor Law or the common law, we would expect to see evidence of such intent within the statute"; and "we would expect that . . . affected policyholders . . . would have notice and an opportunity to be heard before the Superintendent made his determinations" (majority op at 224). As for the first proposition, we have, as already discussed, long held that preemption need not be express where the legislative regime is comprehensive and detailed. Most recently, for example, we held in *People v Grasso* (11 NY3d 64) that the Not-For-Profit Corporation Law preempted certain common-law claims pressed by the Attorney General. There was no express language in the statute to
234 this effect. And I am not *234 aware that we have ever considered the scope of an agency's notice and hearing provisions to be relevant to preemption.

II.

In my view, plaintiffs' common-law causes of action are also preempted because they are simply artfully repackaged versions of the Debtor and Creditor Law claims. In any event, these causes of action are deficient on the merits, as the Appellate Division majority correctly concluded.

The majority reinstates plaintiffs' breach of contract claim, locating the breach within the implied covenant of good faith and fair dealing because "plaintiffs sufficiently allege that MBIA Insurance, by fraudulently transferring billions of dollars in assets to MBIA Inc. for no consideration, violated the covenant by substantially reducing the likelihood that [it] will be able to meet its obligations under the terms of the insurance policies" (majority op at 228-229 [internal quotation marks omitted]). For support, the majority cites *MBIA Ins. Corp. v Countrywide Home Loans, Inc.* (2009 NY Slip Op 31527[U] [Sup Ct, NY County 2009]).

Countrywide underwrote and sold residential mortgage-backed securities and obtained financial guarantee insurance on those securities from MBIA Insurance. To get MBIA Insurance to sign on, Countrywide represented that if there was "a breach of any representation or warranty related to a mortgage loan (a `Defective Loan'), it would either cure the breach or repurchase or substitute eligible mortgage loans for the Defective Loan" (*id.* at *5). The ultimate insurance between Countrywide and MBIA Insurance, in contrast to this case, "incorporated the representations and warranties . . . and gave MBIA [Insurance] the right to rely on these representations and warranties, to enforce their terms, and to exercise remedies for any breach" (*id.* at *6).

Supreme Court rejected MBIA Insurance's generalized claims that the parties' insurance agreement included an implied promise that Countrywide would tell MBIA Insurance all about different special kinds of risk and use underwriting standards of a certain quality. But the court upheld one narrow aspect of MBIA Insurance's breach of contract claim:

> "the claim survives to the limited extent that it asserts that corrective action — such as investigating
> 235 loans which became over 30-days delinquent — would *235 have preserved MBIA[Insurance]'s benefits under the bargain, but that Countrywide Home deliberately refused to take such action in order to collect more late payment fees and service charges" (*id.* at 19).

In other words, Countrywide allegedly frustrated *specific objectives in the parties' contract.*

Here, by contrast, plaintiffs have not alleged any objectively measurable deviations from specific contract provisions. And it is undisputed that, as part of the restructuring, MBIA Illinois agreed to reinsure the $554 billion in outstanding municipal bonds issued by MBIA Insurance. As plaintiffs themselves explain, the "reinsurance gives policyholders direct claims against both the original insurer (MBIA Insurance) and the reinsurer (MBIA Illinois)." One can hardly say that MBIA Insurance derives no benefit whatsoever from the fact that one of its sister companies is now jointly liable for its entire municipal bond portfolio.

Plaintiffs also allege that the parent company abused MBIA Insurance's corporate form by shifting assets to cause insolvency and lack of present ability to meet its obligations to policyholders (although the company has, in fact, paid all claims that have become due since the restructuring). To pierce the corporate veil, plaintiff must show that "(1) the owners exercised complete domination of the corporation in respect to the transaction attacked; and (2) . . . such domination was used to commit a fraud or wrong against the plaintiff which resulted in plaintiffs injury" (*Matter of Morris v New York State Dept. of Taxation Fin.*, 82 NY2d 135, 141). We have held that "[t]hose seeking to pierce a corporate veil . . . bear a heavy burden" (*TNS Holdings v MKI Sec. Corp.*, 92 NY2d 335, 339).

In the majority's view, plaintiffs can apparently show domination of MBIA Insurance by virtue of its status as a wholly-owned subsidiary of MBIA Inc. (majority op at 229); however, "[i]t is a general principle of corporate law deeply ingrained in our economic and legal systems that a parent corporation . . . is not liable for the acts of its subsidiaries" (*United States v Bestfoods*, 524 US 51, 61). Further, the majority grounds the requisite abuse of the corporate form on the allegation that MBIA Inc. "caus[ed]" MBIA Insurance to undertake "transactions that now shield" assets from plaintiffs — in other words MBIA Inc. purportedly drained capital from its subsidiary (majority op at 229). As the Second Circuit Court of Appeals has pointed out, though, "no New York
236 authority . . . disregards *236 corporate form solely because of inadequate capitalization" (*Gartner v Snyder*, 607 F2d 582, 588 [2d Cir 1979]).

III.

The Superintendent approved MBIA Insurance's restructuring after finding that it was fair and equitable and would leave the affected insurers with sufficient assets to satisfy their obligations to policyholders, including, of course, these plaintiffs, who have persuaded the majority that the courts may nonetheless review the restructuring de novo. Having recently merged the Departments of Insurance and Banking to create a new Department of Financial Services to provide the "responsive, effective, innovative [] state banking and insurance regulation . . . necessary to operate in a global, evolving and competitive market place" (L 2011, ch 62, § 1, enacting Financial Services Law § 101-a), the Legislature may wish to consider if, as a result of today's decision, further legislation is now necessary to address the new Department's envisioned role as the arbiter of major financial transactions in these industries. Critically, it does not enhance New York's reputation as a major financial center for insurers to be put in a position where they survive our State's daunting regulatory gauntlet and gain approval for a financial transaction under the Insurance Law, yet remain vulnerable to multiple lawsuits brought in state and federal court[3] by disaffected policyholders who claim that the same transaction is fraudulent under other state statutes and common law. The regulatory agency would not be a party in these lawsuits and, after today's decision, there is no reason for such plaintiffs to bring a CPLR article 78 proceeding
237 in addition to their plenary actions.[4] It surely behooves the Legislature to make clear that *237 for which the majority discerns inadequate support in current law: the State's comprehensive financial regulatory regime preempts lawsuits under the Debtor and Creditor Law and common law seeking to upset transactions approved or directed by the Superintendent (now, the Superintendent of Financial Services), which may only be challenged in a CPLR article 78 proceeding.

3 MBIA Insurance has also been sued in the United States District Court for the Southern District of New York, and in the Delaware Court of Chancery (*see Aurelius Capital Master, Inc. v MBIA Ins. Corp.*, 695 F Supp 2d 68 [SD NY 2010] [suit by a putative class of structured-finance policyholders]; *Third Ave. Trust v MBIA Ins. Corp.*, 2009 WL 3465985, 2009 Del Ch LEXIS 186 [2009] [suit by noteholders]). The plaintiffs in these two cases press the same state statutory and common-law claims advanced by plaintiffs in this lawsuit. Multiple lawsuits in multiple jurisdictions present the obvious risk of conflicting or at least inconsistent outcomes for different policyholders of the same insurer, further undermining the certainty and stability of the Superintendent's approval.

4 Plaintiffs here did not commence their CPLR article 78 proceeding until shortly after MBIA Insurance filed its motion to dismiss. In the motion, MBIA Insurance argued that plaintiffs' action was barred as a collateral attack on the Superintendent's approval, which apparently alerted plaintiffs to the advisability of initiating a CPLR article 78 proceeding before the four-month statute of limitations expired. Other policyholders who have sued MBIA Insurance (*see* n 3 at 236) did not commence CPLR article 78 proceedings against the Superintendent.

Chief Judge LIPPMAN and Judges SMITH, PIGOTT and JONES

Order modified, etc.

238 *238

Court of Appeals of the State of New York

Morris v. Dept. of Taxation

82 N.Y.2d 135 (N.Y. 1993) · 603 N.Y.S.2d 807 · 623 N.E.2d 1157
Decided Oct 19, 1993

Argued September 7, 1993

Decided October 19, 1993

136 Appeal from the Appellate Division of the Supreme Court in the Third Judicial Department. *136

Dorsey Whitney, New York City *(Richard H. Silberberg* and *Robert G. Manson* of counsel), and *Simon, Uncyk*
137 *Borenkind,* New York City *(Eli Uncyk* of counsel), for appellant. *137 *Robert Abrams, Attorney-General,* Albany *(Lew A. Millenbach, Jerry Boone* and *Peter H. Schiff* of counsel), for New York State Department of Taxation and Finance, respondent.

HANCOCK, JR., J.

Petitioner, a New Jersey resident who maintained a rented apartment in New York, was the president of
138 Sunshine Developers, Inc. (Sunshine), a closely held corporation owned entirely *138 by his brother and his nephew. Respondent New York State Department of Taxation and Finance (the Department) assessed a compensating use tax against petitioner for two cabin cruisers purchased by the corporation outside of New York and allegedly used by him on his individual business in State waters. Although owning no stock in Sunshine, petitioner assertedly controlled the corporation and his responsibility for the tax has been upheld by disregarding the separate corporate entity under the doctrine of piercing the corporate veil. Because of his leasing a New York apartment, it has been held that petitioner, although a New Jersey resident, could not claim the nonresident's exemption from the tax *(see,* Tax Law § 1118). On his appeal, the decisive question is whether the Tax Appeals Tribunal and Appellate Division properly sustained the assessment against petitioner on the theory of piercing the corporate veil. For reasons to be explained, we conclude that, on the facts in this record, that theory should not have been applied. We, therefore, reverse.

I

The pertinent facts may be summarized from the determinations of the Administrative Law Judge of the Division of Tax Appeals and of the Tax Appeals Tribunal. Sunshine was a company with offices in New Jersey incorporated in Delaware in 1977 for the purpose of purchasing, owning, operating and leasing boats. Petitioner's brother, Robert Morris, was the majority shareholder and acted as Sunshine's secretary-treasurer; petitioner's nephew Drew, 14 years old at the time of incorporation, was the other shareholder. Robert Morris knew little about the assets or business activities of the corporation and did not participate in business decisions. As the sole board member, petitioner acted as chair and board secretary and made all corporate decisions. Petitioner had been a resident of New Jersey since 1980; from 1977 until 1984 he rented an apartment in New York City for the rare occasion when he stayed in New York overnight for business reasons.

In 1977 and in 1978 Sunshine purchased, owned, and operated at different times its primary assets, two boats ("the 1977 boat" and "the 1978 boat"), which it leased for the purpose of business entertainment to other companies owned by petitioner and Robert Morris. In October 1982, the Department assessed sales and use
139 taxes against Sunshine for the purchase and use of these boats *(see, Matter of Sunshine Developers v* *139 *Tax Commn.,* 132 A.D.2d 752, *lv denied* 70 N.Y.2d 609). On appeal, an Administrative Law Judge (ALJ), finding delivery of the boats to have occurred outside of New York, cancelled all sales tax assessments as well as the use tax on the 1977 boat, which had been used only infrequently in New York. The ALJ sustained the use tax on the 1978 boat, however. The Appellate Division upheld the tax, concluding that the 1978 boat "was seasonally moored, and therefore used, in New York. These facts support [the Department's] further conclusion that petitioners [including Sunshine] were engaged in carrying on a business in this State and, thus, not entitled to the exemption for nonresidents" *(id.,* at 754-755). The use tax assessed on the 1978 boat was paid to the Department.

The corporation subsequently sold these assets, and from June 1981 through August 1984 it purchased, owned and operated at different times two other boats ("the 1981 boat" and "the 1984 boat"). The corporation bought them following special board meetings at which petitioner, sitting as sole board member, authorized the purchases. Both boats were picked up by petitioner in North Carolina. And both boats were moored during the summer months at Montauk, New York.

In April 1985, the Department sent a notice of determination of sales and use taxes due on the 1981 and 1984 boats in the amount of $76,390, plus interest and penalties, to petitioner, Robert Morris and Sunshine. The Department's action was based upon the mooring of the 1981 and 1984 boats at Montauk as well as on the allegation that Sunshine was a corporate resident of New York. On appeal, it was claimed that no sales tax was due as Sunshine was exempt from the use tax as a nonresident corporation. In May 1990, an ALJ concluded: (1) that Sunshine was entitled to the nonresident exemption pursuant to Tax Law § 1118 (2); and (2) that, notwithstanding the Department's contentions, the corporate veil should not be pierced to impose personal liability for the taxes upon either petitioner or Robert Morris. In 1988, the sales and use tax on the 1981 boat was paid to the New Jersey Department of the Treasury.

The Department appealed to respondent Tax Appeals Tribunal (the Tribunal). In May 1991, the Tribunal sustained the ALJ's determination of no imposition of sales or use taxes upon Sunshine, concluding that
140 Sunshine was a nonresident corporation, which did no business in New York; it also *140 sustained the determination pertaining to Robert Morris that he had insufficient control of Sunshine to justify piercing the corporate veil. But the Tribunal reversed as to petitioner Joseph Morris and pierced the corporate veil, concluding that he was the equitable owner and controlling principal of Sunshine and therefore personally liable for the tax. The Tribunal also held that petitioner Joseph Morris did not qualify for the nonresident tax exemption due to his rental of a New York City apartment when the 1981 and 1984 boats were purchased. The Tribunal modified the total amount of tax assessed against him to reflect a credit for the sales and use tax paid to the State of New Jersey on the 1981 boat.

Petitioner commenced a CPLR article 78 proceeding in the Appellate Division to review the Tribunal's determination. The Appellate Division sustained all of the Tribunal's conclusions, relieving Sunshine and Robert Morris of any liability and holding "that there is substantial evidence to support the Tribunal's decision to impute equitable ownership, and the resulting liability for the tax assessed, to petitioner" *(Matter of Morris v New York State Dept. of Taxation Fin.,* 183 A.D.2d 5, 8). We granted petitioner leave to appeal and now reverse.

II

In *Walkovszky v Carlton* (18 N.Y.2d 414), we stated the general rule that:

> "Broadly speaking, the courts will disregard the corporate form, or, to use accepted terminology, `pierce the corporate veil', whenever necessary `to prevent fraud or to achieve equity'. *(International Aircraft Trading Co.* v. *Manufacturers Trust Co.,* 297 N.Y. 285, 292.)" *(Id.,* at 417.)

The concept of piercing the corporate veil is a limitation on the accepted principles that a corporation exists independently of its owners, as a separate legal entity, that the owners are normally not liable for the debts of the corporation, and that it is perfectly legal to incorporate for the express purpose of limiting the liability of the corporate owners *(see, Bartle v Home Owners Coop.,* 309 N.Y. 103, 106; *Rapid Tr. Subway Constr. Co. v City of New York,* 259 N.Y. 472, 487-488; Presser, Piercing the Corporate Veil § 1.01, at 1-4 — 1-5).

141 The doctrine of piercing the corporate veil is typically *141 employed by a third party– seeking to go behind the corporate existence in order to circumvent the limited liability of the owners and to hold them liable for some underlying corporate obligation *(see, e.g., Billy v Consolidated Mach. Tool Corp.,* 51 N.Y.2d 152; *Port Chester Elec. Constr. Corp. v Atlas,* 40 N.Y.2d 652; *Walkovszky v Carlton, supra; Bartle v Home Owners Coop., supra).* The concept is equitable in nature and assumes that the corporation itself is liable for the obligation sought to be imposed *(see,* 1 Fletcher, Cyclopedia of Private Corporations § 41, at 603 [perm ed]). Thus, an attempt of a third party to pierce the corporate veil does not constitute a cause of action independent of that against the corporation; rather it is an assertion of facts and circumstances which will persuade the court to impose the corporate obligation on its owners *(see, id.,* at 602-603).

– There are, however, cases *(see, e.g., Matter of Orda v State Tax Commn.,* 25 A.D.2d 332, *affd* 19 N.Y.2d 636; *Matter of Redman v Mealey,* 270 App. Div. 75) generally involving tax matters where the corporation's owner has sought to pierce the corporate veil to claim some deduction or other benefit due to the corporation *(see also, Moline Props. v Commissioner,* 319 U.S. 436).

Because a decision whether to pierce the corporate veil in a given instance will necessarily depend on the attendant facts and equities, the New York cases may not be reduced to definitive rules governing the varying circumstances when the power may be exercised *(see,* Presser, Piercing the Corporate Veil § 2.33 [1], at 2-291 — 2-293). Generally, however, piercing the corporate veil requires a showing that: (1) the owners exercised complete domination of the corporation in respect to the transaction attacked; and (2) that such domination was used to commit a fraud or wrong against the plaintiff which resulted in plaintiff's injury *(see, Matter of Guptill Holding Corp. v State of New York,* 33 A.D.2d 362, 364-365, *affd* 31 N.Y.2d 897; *Lowendahl v Baltimore Ohio R.R. Co.,* 247 App. Div. 144, 157, *affd* 272 N.Y. 360; *American Protein Corp. v AB Volvo,* 844 F.2d 56, 60 [2d Cir 1988] [analyzing New York law and citing *Lowendahl (supra)]; International Aircraft Trading Co. v Manufacturers Trust Co.,* 297 N.Y. 285, 292; *see generally,* Presser, Piercing the Corporate Veil § 2.33 [3], at 2-304 — 2-313).

While complete domination of the corporation is the key to piercing the corporate veil, especially when the owners use the corporation as a mere device to further their personal rather than the corporate business *(see,*
142 *Walkovszky, supra,* at 417), such domination, standing alone, is not enough; some *142 showing of a wrongful or unjust act toward plaintiff is required *(see, Guptill, supra,* at 365; *Lowendahl, supra,* at 157; *Passalacqua Bldrs. v Resnick Developers S.,* 933 F.2d 131, 138 [2d Cir 1991] [applying New York law]; *see generally,* 18 Am Jur 2d, Corporations, § 51). The party seeking to pierce the corporate veil must establish that the owners,

through their domination, abused the privilege of doing business in the corporate form to perpetrate a wrong or injustice against that party such that a court in equity will intervene *(see, Guptill, supra,* at 365; *National Labor Relations Bd. v Greater Kan. City Roofing,* 2 F.3d 1047, 1052-1053).

III

In deciding whether respondents have established a sufficient basis for piercing the corporate veil under these general rules, we first address the element of petitioner's control of the corporation. Because petitioner was not a stockholder of Sunshine, he argues that, as a matter of law, he was not in a position to exercise the necessary domination of the corporation *(see,* 1 O'Neal and Thompson, O'Neal's Close Corporations § 1.10, ch 1, at 47 [3d ed], for the proposition that almost all of the cases dealing with the issue of piercing the corporate veil involve control by a stockholder or stockholders of closely held corporations). Respondents contend, nevertheless, that Joseph Morris, although not a stockholder — through his status as Sunshine's president and its only director and his close relationship with his brother and nephew, the only stockholders — was in a position to and did dominate the corporation with respect to the transactions at issue *(see, Lowendahl, supra,* at 157). The Appellate Division accepted this argument, holding: "we perceive that we should be concerned with `reality and not form [and] with how the corporation operated and [petitioner's] relationship to that operation' [citation omitted]" *(Matter of Morris v New York State Dept. of Taxation Fin.,* 183 A.D.2d 5, 8, *supra).*

We have found no definitive authority on the issue of whether a nonshareholder could be personally liable under a theory of piercing the corporate veil *(but see, Establissement Tomis v Shearson Hayden Stone,* 459 F. Supp. 1355, 1366 , n 13 [declining to hold, as a matter of law, that defendant, a nonshareholder and president of a corporation wholly owned by his wife, could not be held responsible for a corporate obligation]). It is not
143 necessary to decide the question, however, *143 because respondents fell far short of meeting their burden on the second critical point: that petitioner, through his domination, misused the corporate form for his personal ends so as to commit a wrong or injustice on the taxing authorities of New York State *(see, Guptill, supra,* at 364-365; *Lowendahl, supra,* at 157). The specific finding of the ALJ that there is no indication of "fraud or wrongdoing" on the part of petitioner or the corporation, it must be noted, was not disturbed on review by either the Tax Appeals Tribunal or the Appellate Division. But, respondents maintain that *there was* wrongful conduct in any event and characterize the purchase of the boats by Sunshine as part of an illicit scheme to use the corporation to avoid New York taxes. We disagree.

There is no contention that there was anything improper in the formation of Sunshine for the stated purpose of purchasing, owning and leasing boats. Sunshine, it appears, in the early years after its incorporation, carried on its stated business; the very basis of the Department's successful 1982 assessment of the use tax against Sunshine for the 1978 boat was that the corporation *was conducting its business* within the State of New York — i.e., buying boats and chartering them to businesses for entertaining clients *(see, Sunshine Developers, supra).*

Indeed, as in the 1982 assessment, the Department initially argued that Sunshine was liable for the current assessment because of its business presence in New York. However, once the ALJ and the Tribunal determined in this proceeding that Sunshine was a nonresident corporation and *not engaged in business in New York* and, therefore, entitled to the nonresident exemption on the 1981 and 1984 boats *(see, Matter of Sunshine Developers,* 1990 N.Y. Tax LEXIS 183 [State of N Y Div of Tax Appeals, May 3, 1990]; *Matter of Sunshine Developers,* 1991 N.Y. Tax LEXIS 267 [Tax Appeals Tribunal, May 2, 1991]), respondents abandoned that course and took a different tack. They now claim that in doing no business during the period when the 1981 and 1984 boats were purchased, Sunshine must have operated solely as a sham to do the personal business of petitioner. They further argue that, because Sunshine was a sham, it existed solely for the purpose of avoiding taxes due on its asset.

However, there is no evidence of an intent to defraud by using the corporation as a tax shield. The corporation,
144 not petitioner, purchased and owned the boats. There is no suggestion *144 that any obligations of the corporation remained unpaid, including use taxes found to be due in New York. There is no reason to believe that if respondents had succeeded in their current assessment against the corporation on the 1984 boat, as they had in their 1982 assessment, Sunshine would not have paid the tax. That the Tribunal sustained the nonresident tax exemption for Sunshine on the 1984 purchase and declined to sustain it as to petitioner does not give rise to a claim of fraud or wrongdoing by petitioner.

Finally, there is a fundamental problem with respondents' claim that petitioner has somehow perverted the protective benefits of the corporate privilege to commit a wrong against respondents. This is not the usual case where a third party seeks to impose a corporate obligation on a controlling owner by penetrating the shield of limited liability. Quite the contrary. Here, there was no corporate obligation for respondents to impose. Sunshine, it has been determined, *was entitled to the nonresident exemption* for the 1984 boat and owes nothing. Thus, the claim against petitioner cannot be for what the corporation owed. Respondents, nevertheless, seek to collect the tax directly from petitioner because, unlike Sunshine, he maintained a rental apartment in New York and assertedly was deprived of his nonresident exemption. But, to pursue petitioner under the doctrine of piercing the corporate veil presupposes that "the corporation is liable" (1 Fletcher, Cyclopedia of Private Corporations § 41, at 603 [perm ed]; *see, e.g., National Labor Relations Bd. v Greater Kan. City Roofing,* 2 F.3d 1047, 1051, *supra; Transamerica Cash Reserve v Dixie Power Water,* 789 P.2d 24, 26 [Utah]; *Anderson v Durbin,* 740 S.W.2d 417, 418 [Tenn]). To hold petitioner liable by piercing the corporate veil for a debt Sunshine does not owe, we think, would be inconsistent with the essential theory of the doctrine.

We are not persuaded by respondents' argument that we should disregard the corporate entity and sustain the tax against petitioner under the theory articulated in Federal tax cases *(see, e.g., Moline Props. v Commissioner,* 319 U.S. 436, 438-439, *supra; Nelson v Commissioner of Internal Revenue,* 281 F.2d 1, 6-7 [5th Cir 1960]; *Jackson v Commissioner of Internal Revenue,* 233 F.2d 289, 290 [2d Cir 1956]; *Paymer v Commissioner of Internal Revenue,* 150 F.2d 334 [2d Cir 1945]). In general, in matters relating to revenue a corporation will be recognized as having a separate taxable identity unless it is shown to have had no legitimate business purpose
145 either in its *145 formation or its subsequent existence or that it was a sham or set up for tax avoidance *(see, Moline, supra,* at 438-439; *Nelson, supra,* at 6). First, of course, we are dealing here not with Federal law but with New York decisional law and a New York sales and use tax *(see,* Tax Law § 1101 *et seq.).* But, even applying the rule of the Federal cases the result would be the same, for it appears that Sunshine *had a legitimate business purpose* in its formation and carried on its business of owning and chartering boats thereafter. There is no showing that it was set up as a sham or for the purpose of tax avoidance.

In view of the foregoing, we need not address petitioner's further contention that he was improperly denied a nonresident's exemption under Tax Law § 1118 (2).

The judgment of the Appellate Division should be reversed, with costs, and respondent Tax Appeals Tribunal's decision, insofar as it held petitioner personally liable for the use tax assessed and penalty imposed, annulled.

Chief Judge KAYE and Judges SIMONS, TITONE, BELLACOSA and SMITH concur; Judge LEVINE taking no part.

Judgment reversed, etc.

146 *146

No. 09 CIV. 01046(DC)
United States District Court, S.D. New York

Trabucco v. Intesa Sanpaolo, S.P.A.

695 F. Supp. 2d 98 (S.D.N.Y. 2010)
Decided Mar 19, 2010

No. 09 CIV. 01046(DC).

99 March 19, 2010. *99

Orans, Elsen, Lupert Brown LLP by: Robert L. Poltz, Esq., Leslie A. Lupert, Esq., New York, NY, for Plaintiffs.

Crowell Moring LLP by: Daniel L. Selenko, Esq., Rodney M. Zerbe, Esq., New York, NY, for Defendants.

100 *100

OPINION

DENNY CHIN, District Judge.

101 This diversity action was instituted for breach of contract and fraud. Defendants *101 move, pursuant to Fed.R.Civ.P. 12(b)(2), to dismiss the complaint for lack of personal jurisdiction. They also move, pursuant to Fed.R.Civ.P. 12(b)(6), to dismiss the action for failure to state a claim upon which relief can be granted. For the
2 reasons set forth below, the motion is denied in part and granted in part. *2

BACKGROUND

I. The Facts

The facts alleged in the complaint are assumed to be true for purposes of this motion.

A. The Parties

Plaintiffs Ermanno Trabucco and Angelina Panvini (the "Trabuccos") are citizens of the United States, domiciliaries of Nassau County, New York, and joint owners of a brokerage account managed by Intesa Sanpaolo Private Banking, S.p.A. ("Private Banking"). (Am. Compl. ¶¶ 2-3). Private Banking is a wholly-owned subsidiary of Intesa Sanpaolo, S.p.A. ("Intesa"), an Italian Banking corporation. (Id. ¶ 5). Private Banking does not maintain an office in the State of New York. (Id.). The parent corporation, Intesa, maintains a branch office in New York and is licensed to conduct banking business in New York. (Id.).

The Trubuccos opened an account with Banca Commerciale Italiana ("BCI"), a predecessor company to Intesa, over 30 years ago. (Id. ¶ 8). Since that time the Trabuccos have maintained an account with BCI and its successor companies. (Id.). These entities have regularly sent statements and other account-related information

by fax and mail to the Trabuccos' home in New York. (Id. ¶ 12). By March 2005 Intesa had replaced BCI as the parent corporation of the banking group and began the process of transferring the Trabucco account to Intesa's
3 Private Banking *3

subsidiary. (Id.). As part of the transfer process, Private Banking sent the account agreement that governed the relationship during the disputed period to the Trabuccos' address in New York. (Id.). Among these documents were U.S. tax documents and a document that declared the Trabuccos to be non-residents of Italy. (Id.).

B. The February 22, 2007 Sale of Newmont Stock

On or about February 22, 2007, Trabucco spoke by phone from his residence in Nassau County, New York, with a Private Banking representative in Italy. Trabucco instructed the representative to buy 50,000 shares of Newmont Mining Corp. ("Newmont") at the market price, which was then approximately $47 per share. (Id. ¶ 9). Instead of fulfilling Trabucco's order to buy 50,000 shares, Private Banking sold 50,000 shares from the 100,000 Newmont shares already present in the Trabuccos' account. (Id. ¶ 10). The 50,000 shares were sold at a price of $47.5745 for total proceeds of $2,378,725. (Id.). The sale of Newmont shares was executed over the New York Stock Exchange ("NYSE") by a New York-based broker hired by Private Banking. (Id. ¶ 11). Once the sale of 50,000 Newmont shares was effectuated, Trabucco held 50,000 shares of Newmont — instead of the
4 150,000 shares that he would have held had Private Banking properly executed the buy order. (Id. ¶ 13). *4

C. Trabucco's Discovery of the Error and Private Banking's Reaction

Trabucco did not discover the mistake until November 1, 2008, when he sent a fax instructing Private Banking
102 to transfer a total of 150,000 shares of Newmont stock to a broker in New York. (Id.). When *102 Private Banking informed Trabucco that he only held 50,000 shares of Newmont, Trabucco requested that a Private Banking representative check the recording of Trabucco's February 22, 2007 telephone order. (Id. ¶ 14). The representative confirmed that Trabucco requested that Private Banking buy — not sell — 50,000 shares of Newmont on that date. (Id.). Private Banking has confirmed — orally and in writing — that the bank erred when it sold rather than purchased 50,000 Newmont shares on February 22, 2007. (Id. ¶ 17).

Trabucco demanded that Private Banking correct the error by replacing the missing 100,000 shares of Newmont at the February 22, 2007 market price. (Id. ¶ 14). Private Banking agreed to do so but told Trabucco that this replacement would be more quickly and easily effectuated if Trabucco permitted Private Banking to purchase the missing shares with funds already in the Trabuccos' account and then, at a later date, reimburse the Trabuccos for the per share cost in excess of the February 22, 2007 market price. (Id. ¶ 13). Although Private Banking made representations to Trabucco that he would be compensated for the use of the Trabuccos' personal
5 funds to correct the mistake, the *5

Trabuccos allege that Private Banking never intended to compensate the Trabuccos. (Id. ¶ 18). Between the 6th and 8th of November 2008, Private Banking purchased 100,000 shares of Newmont (using the Trabuccos' funds) for an average price of $54.6633 — about $7 above the February 22, 2007 market price. (Id. ¶ 15). Private Banking has not compensated the Trabuccos for the losses resulting from the mistaken trade. (Id. ¶ 16).

II. Prior Proceedings

The Trabuccos commenced this action against Intesa by filing a summons and complaint on February 5, 2009. On May 8, 2009, Trabucco filed an amended complaint, naming both Intesa and Private Banking as defendants. The Trabuccos claim that the mistaken trade constitutes a breach of the account agreement and both Intesa and

Private Banking should be held liable for the resulting damages. (Id. ¶¶ 21-25). The Trabuccos also claim that Private Banking and Intesa should be held liable for fraudulently inducing the Trabuccos to provide money to correct the mistaken trade. (Id. ¶¶ 26-30).

DISCUSSION

First, I address the question whether this Court has personal jurisdiction over Private Banking and Intesa. I conclude that it does. Next, I address defendants' forum non conveniens argument and find that the Southern District of New York is an appropriate forum to hear the case. Then, I address the substantive claims relating to
6 breach of contract and fraud. *6

I conclude that the Trabuccos have stated a contract claim for relief as to Private Banking, but have failed to state a fraud claim as to Private Banking. Finally, I address Intesa's argument that the Trabuccos have not alleged facts that would establish that Intesa may be held accountable for Private Banking's acts or omissions. I reject the argument.

I. Personal Jurisdiction

A. Applicable Law

To determine whether the court may exercise personal jurisdiction over a non-domiciliary, a district court engages in a two-part analysis. First, the court must determine whether jurisdiction exists under the laws of the forum state (here, New York). Second, the court must determine whether the exercise of jurisdiction under state
103 law satisfies federal due process requirements. See Bank Brussels Lambert *103 v. Fiddler Gonzalez Rodriguez, 171 F.3d 779, 784 (2d Cir. 1999).

1. Standard on 12(b)(2) Motion to Dismiss

On a motion to dismiss for lack of personal jurisdiction, the plaintiff bears the burden of demonstrating that the court has jurisdiction over the defendant. Kernan v. Kurz-Hastings, Inc., 175 F.3d 236, 240 (2d Cir. 1999) (citation omitted). At the pleadings stage, a plaintiff is required only to make a prima facie showing of jurisdiction. DiBella v. Hopkins, 187 F. Supp. 2d 192, 198 (S.D.N.Y. 2002). The Court must "construe all of the
7 pleadings and affidavits `in the light *7

most favorable to plaintiff' and must resolve doubts in the plaintiff's favor." Jacobs v. Felix Bloch Ergen Verlag fur Buhne Film und Funk KG, 160 F. Supp. 2d 722, 731 (S.D.N.Y. 2001) (quoting Hoffritz for Cutlery, Inc. v. Amajac, Ltd., 763 F.2d 55, 57 (2d Cir. 1985)).

2. N.Y. C.P.L.R. § 302(a)(1)

C.P.L.R. § 302(a)(1) provides a New York court with long-arm jurisdiction over a person who "transacts any business within the state." N.Y. C.P.L.R. § 302(a)(1). "The key inquiry is whether the defendant purposefully availed itself of the benefits of New York's laws." Courtroom Television Network v. Focus Media, Inc., 264 A.D.2d 351, 695 (N.Y. App. Div. 1st Dep't 1999).

A cause of action "arising from" the acts of a person who "transacts any business within the state or contracts anywhere to supply goods or services in the state" provides the Court a basis for exercising jurisdiction over such a person. N.Y. C.P.L.R. § 302(a)(1); see also Bank Brussels Lambert, 171 F.3d at 789. A non-domiciliary defendant transacts business within the state when he "purposefully avails [himself] of the privilege of conducting activities within [New York], thus invoking the benefits and protections of its laws." Cutco Indus.,

Inc. v. Naughton, 806 F.2d 361, 365 (2d Cir. 1986) (internal quotation omitted). Proof of even one transaction in the state is sufficient to invoke jurisdiction under § 302(a)(1). See Kreutter v. McFadden Oil Corp., 71
8 N.Y.2d 460, 467 (1988). *8

The Second Circuit developed a four-factor test in Agency Rent A Car Sys. v. Grand Rent A Car Corp., 98 F.3d 25, 29 (2d Cir. 1996), to determine whether the defendant "transact[ed] business within the state" for the purposes of § 302(a)(1). The factors are:

> (i) whether the defendant has an on-going contractual relationship with a New York [plaintiff]; (ii) whether the contract was negotiated or executed in New York and whether, after executing a contract with a New York [plaintiff], the defendant has visited New York for the purpose of meeting with parties to the contract regarding the relationship; (iii) what the choice-of-law clause is in any such contract; and (iv) whether the contract requires [the defendant] to send notices and payments into the forum state or subjects them to supervision by [a] corporation in the forum state.

Id. at 29. Courts have also looked at the place of contract performance and held that "in determining jurisdiction, the place of performance is more critical than the place of the execution of a contract." Cooper, Robertson Partners, L.L.P. v. Vail, 143 F. Supp. 2d 367, 371 (S.D.N.Y. 2001) (citation omitted).

3. N.Y. C.P.L.R. § 301

Alternatively, a foreign corporate defendant may be subject to suit under C.P.L.R. § 301 if the defendant has
104 "engaged in such a continuous and systematic *104 course of `doing business' . . . as to warrant a finding of its `presence' in the jurisdiction." Koehler v. Bank of Bermuda, Ltd., 101 F.3d 863, 865 (2d Cir. 1996) (citation
9 omitted). Sporadic business *9 activity in New York will not meet this standard; rather, "the court must be able to say from the facts that the [defendant] is present in the state not occasionally or casually, but with a fair measure of permanence and continuity." Landoil Res. Corp. v. Alexander Alexander Servs., Inc., 77 N.Y.2d 28, 33-34 (1990) (citation omitted).

4. Due Process

The exercise of personal jurisdiction must also satisfy the due process clause of the U.S. Constitution. Due process requires that a non-resident defendant have "certain minimum contacts [with the forum] . . . such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice." Calder v. Jones, 465 U.S. 783, 788 (1984). If the defendant "purposefully avails itself of the privilege of conducting activities within the forum State," it may reasonably anticipate the prospect of defending a suit in the forum state and therefore asserting jurisdiction would comport with the requirements of due process. World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 297 (1980) (citation omitted).

B. Application 1. Personal Jurisdiction over Private Banking

The Trabuccos have alleged that Private Banking "purposefully availed [itself] of the privilege of conducting activities within" New York and that the cause of action "arises from" those activities within New York. Cutco
10 Indus., Inc. v. *10 Naughton, 806 F.2d 361, 365 (2d Cir. 1986); see also N.Y. C.P.L.R. § 302(a)(1).

First, the Trabuccos have alleged that Private Banking has an "ongoing contractual relationship" with New York plaintiffs.Agency Rent A Car, 98 F.3d 25 at 29. Private Banking and the Trabuccos executed an account agreement in March 2005. (Am. Compl. ¶ 8). Private Banking sent the account documents to the Trabuccos' New York address. (Id.). This relationship had continued for two years when Private Banking executed the mistaken trade in February 2007. (Id.).

Second, the contract between the Trabuccos and Private Banking required Private Banking to "send notices and payments into the forum state." Agency Rent A Car, 98 F.3d 25 at 29. Private Banking was in regular communication by phone, fax, and mail with Trabucco at his New York phone number, New York fax number, and New York mailing addresses. (Am. Compl. ¶ 8). As part of the reporting requirements governed by the account agreement, Trabucco received monthly account statements and confirmations of all executed trades. (Id. ¶ 8). The continuous communication of account-related information to the Trabuccos' residence supports the idea that Private Banking "purposefully availed" itself of the laws of New York. See Agency Rent A Car, 98 F.3d at 30 (holding that "continuous transmission of payments and reports to New York" lends significant
11 support to "purposeful availment" of forum). *11

Third, a significant aspect of the contract was "performed" in New York. See Barrett v. Tema Dev., 463 F. Supp. 2d 423, 432 (S.D.N.Y. 2006) (noting that whether real estate investment agreement contemplated investment in New York is relevant to "purposeful availment" inquiry). As part of the brokerage services that
105 Private Banking provided to the Trabuccos, Private *105 Banking executed stock trades on the NYSE. (Am. Compl. ¶ 11). Indeed, the instant action arises from Private Banking's activities in New York. Trabucco called Private Banking from New York to place his buy order. (Id.). Then, Private Banking engaged a New York agent and executed the Newmont trade on the NYSE. (Id.).

Though defendents present evidence that the contract between Private Banking and the Trabuccos contains an Italian choice-of-law provision (Decl. of Alessandra Vitali Rosati ¶ 20), and that the contract was actually executed in Italy, these factors do not tip the scale against jurisdiction. When a New York plaintiff sufficiently alleges that a foreign defendant has contracted to provide services in New York and has committed a breach of contract in New York, it cannot come as a surprise that the foreign defendant will be haled into court in New York. Such an exercise of personal jurisdiction comports with the New York long-arm statute and the due process clause because Private Banking's contacts with New York are sufficient that "the maintenance of the
12 suit does not offend traditional notions of *12

fair play and substantial justice." Calder v. Jones, 465 U.S. at 788.

2. Personal Jurisdiction over Intesa

Private Banking's parent corporation, Intesa, has a branch office in New York and regularly engages in business in New York. (Am. Compl. ¶ 4). This level of contact with New York confers general "doing business" jurisdiction. See Bryant v. Finnish Int'l Airlines, 15 N.Y.2d 426, 432 (1965) (holding that a corporation that maintains an office and does business in New York is subject to jurisdiction under § 301).

II. Forum Non Conveniens

A. Applicable Law

Under the common law doctrine of forum non conveniens, a court with proper jurisdiction and venue over a matter may refrain from hearing the case if another significantly more appropriate forum exists. See Nations Bank of Florida v. Banco Exterior de Espana, 867 F. Supp. 167, 169 (S.D.N.Y. 1994). Forum non conveniens motions are governed by a three-step inquiry:

> At step one, a court determines the degree of deference properly accorded the plaintiff's choice of forum. At step two, it considers whether the alternative forum proposed by the defendants is adequate to adjudicate the parties' dispute. Finally, at step three, a court balances the private and public interests implicated in the choice of forum.

Norex Petroleum Ltd. v. Access Indus., Inc., 416 F.3d 146, 153 (2d Cir. 2005) (citing Iragorri v. United Techs.
13 Corp., 274 F.3d 65, 73-74 (2d Cir. 2001) (en banc)). *13 **B. Application 1. Deference Accorded to Plaintiffs' Choice of Forum**

A plaintiff's choice of forum is generally entitled to great deference when the plaintiff has sued in the plaintiff's home forum. Iragorri, 274 F.3d at 71 (citingKoster v. (American) Lumbermens Mut. Cas. Co., 330 U.S. 518, 524 (1947)). Moreover, there is no allegation that the Trabuccos have chosen a New York forum for reasons of forum shopping. The breach of contract occurred here as part of a NYSE trade; the Trabuccos live here; and Trabucco claims that his poor health prevents him from traveling to Italy to litigate the case. (Am. Compl. ¶¶ 9,
106 11, 17). The physical location of evidence is a wash — there is evidence on both sides of the *106 Atlantic. Though Italy would be a perfectly acceptable alternative forum, New York has an interest in deciding a dispute with a substantial connection to the state. The public and private interests weigh in favor of leaving the Trabuccos' choice of forum undisturbed.

III. Contract Claims

A. Applicable Law 1. Fed.R.Civ.P. 12(b)(6)

To survive a motion to dismiss pursuant to Rule 12(b)(6), "a complaint must contain sufficient factual matter, accepted as true, to `state a claim to relief that is plausible on its face.'" Ashcroft v. Iqbal, 129 S.Ct. 1937, 1949
14 (2009) *14

(citing Bell Atl. Corp. v. Twombly, 550 U.S. 544, 570 (2007)). The Supreme Court in Iqbal set out a "two-pronged" approach for courts considering a motion to dismiss. Id. at 1950.

First, the court accepts plaintiff's factual allegations as true and draws all reasonable inferences in his favor. See id.;see also Vietnam Ass'n for Victims of Agent Orange v. Dow Chem. Co., 517 F.3d 104, 115 (2d Cir. 2008). The court considers only the factual allegations in the complaint and "any documents that are either incorporated into the complaint by reference or attached to the complaint as exhibits." Blue Tree Hotels Inv. (Can.), Ltd. v. Starwood Hotels Resorts Worldwide, Inc., 369 F.3d 212, 217 (2d Cir. 2004). Legal conclusions must be supported by factual allegations. Iqbal, 129 S.Ct. at 1949.

Second, the court determines whether the allegations "plausibly give rise to an entitlement to relief." Id. A plausible claim "pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." Id. at 1949 (citing Twombly, 550 U.S. at 556).

B. Application 1. Private Banking

To plead a breach of contract claim, a plaintiff must allege:[1] "(1) the existence of a contract; (2) performance by
15 the *15 party seeking recovery; (3) nonperformance by the other party; and (4) damages attributable to the breach." Ixe Banco, S.A. v. MBNA America Bank, N.A., No. 07-0432 (LAP), 2008 WL 650403, at *5 (S.D.N.Y. Mar. 7, 2008) (citing Musket Corp. v. PDVSA Petroleo, S.A., 512 F. Supp. 2d 155, 160 (S.D.N.Y. 2007)). The Trabuccos have pled that a contract — the account agreement — existed between Private Banking and themselves. The Trabuccos have also pled that Private Banking failed to perform under the contract by mistakenly selling Newmont stock when Private Banking was instructed to buy Newmont stock. Finally, the
107 Trabuccos have asserted that their damages exceed $700,000 as a result of an increase in Newmont's *107 stock price between the mistaken trade on February 22, 2007 and the replacement of the 100,000 shares on

November 6-8, 2008. The Trabuccos support their legal conclusion of breach of contract with factual
16 allegations. Therefore, Private Banking's motion to dismiss is denied. See Iqbal, 129 S.Ct. at 1950. *16 **2. Intesa**

[1] Intesa and Private Banking allege that the account agreement contains a choice-of-law provision requiring disputes under the account agreement to be governed by Italian law. (Decl. of Alessandra Vitali Rosati ¶ 20). Rule 44.1 of the Federal Rules of Civil Procedure states "[a] party who intends to raise an issue concerning the law of a foreign country shall give notice by pleadings or other reasonable written notice." This rule has been interpreted to mean that "the party invoking non-U.S. law bears at least the modest burden of notifying an opposing party and the court that non-U.S. law will be at issue." In re Ishihara Chem. Co., Ltd., 121 F. Supp. 2d 209, 216 (E.D.N.Y. 2000), vacated on other grounds, 251 F.3d 120 (2d Cir. 2001). Both Intesa and Private Banking cite to New York law in their memoranda of law and they fail to direct the court to substantive differences between New York and Italian law. Therefore, I apply New York law to determine whether the pleading standards corresponding to the fraud and contract claim have been met.

The Trabuccos do not assert that a contract existed between them and Intesa. For the Trabuccos' claim against Intesa to survive Intesa's motion to dismiss, they must plead factual allegations to support the legal conclusion that Intesa "so dominates" Private Banking that it should be held liable for the actions of its subsidiary. See id. at 1950.

a. Piercing the Corporate Veil

Under New York law, one corporation is considered to be a mere alter ego when it "has been so dominated by . . . another corporation . . . and its separate identity so disregarded, that it primarily transacted the dominator's business rather than its own." Gartner v. Snyder, 607 F.2d 582, 586 (2d Cir. 1979). Then, the dominating corporation will be held liable for the actions of its subsidiary. Tecnoclima, S.p.A. v. PJC Group of N.Y., Inc., No. 89-4437 (CSH), 1991 WL 33357, at *8 (S.D.N.Y. Feb. 27, 1991). Alter ego cases typically involve the determination of "which corporate parties may be cast in damages for the breach" of a contract. Id. In this analysis, control is the key. Wm. Passalacqua Builders, Inc. v. Resnick Developers, Inc., 933 F.2d 131, 138 (2d Cir. 1991). Courts will only "pierce the corporate veil" where there has been "complete control by the dominating party that leads to a wrong against third parties." Id. Facts relevant to the "complete control" inquiry are:

> (1) the absence of the formalities and paraphernalia that are part and parcel of the

17 *17

> corporate existence, . . . (2) inadequate capitalization, (3) whether funds are put in and taken out of the corporation for personal rather than corporate purposes, (4) overlap in ownership, officers, directors, and personnel, (5) common office space, address, and telephone numbers of corporate entities, (6) the amount of business discretion displayed by the allegedly dominated corporation, (7) whether the related corporations deal with the dominated corporation at arms length, (8) whether the corporations are treated as independent profit centers, (9) the payment or guarantee of debts of the dominated corporation by other corporations in the group, and (10) whether the corporation in question had property that was used by other of the corporations as if it were its own.

Wm. Passalacgua Builders, 933 F.2d at 139 (citations omitted).

b. Application

The Trabuccos allege that they opened an account with BCI, an Intesa predecessor corporation, over 30 years ago and have maintained the account ever since. (Am. Compl. ¶ 8). They allege that in March 2005, the Intesa-controlled banking group transferred the Trabucco account from Intesa to Intesa's Private Banking subsidiary. (Id.). As a part of the account-transfer process, Private Banking sent an account agreement to the Trabuccos, but failed to notify the Trabuccos that their contractual relationship with Intesa was being replaced by a similar relationship with Private Banking. (Id.). Adding to the confusion, the same bank representative handled the
10… Trabuccos' account even as it was transferred from BCI to Intesa to Private Banking. (Id.). *10818

These facts support the conclusion that Intesa asserted substantial control over Private Banking with respect to the Trabucco account. Intesa substituted its discretion for that of Private Banking when it directed Private Banking to assume responsibility for the Trabucco account. Furthermore, Intesa directed the same banking representative to handle the Trabucco account while it was controlled first by Intesa, and then by Private Banking. It is plausible that such action amounts to an "overlap in personnel" or "absence of [corporate] formalities."Wm. Passalacqua Builders, 933 F.2d at 139 (citations omitted). It is a "reasonable inference" that Intesa asserted the level of control over Private Banking necessary to satisfy the "veil piercing" inquiry at this stage of the proceedings. Iqbal, 129 S.Ct. at 1949.

The Trabuccos have sufficiently pled a contract claim against Private Banking, an Intesa subsidiary. The Trabuccos have also alleged facts sufficient to make their claims under the "veil piercing" inquiry plausible. Thus, the Trabuccos have satisfied the pleading standard to extend liability for a contract claim against Private Banking to Intesa, the corporate parent. For these reasons, Intesa's motion to dismiss the contract claim is
19 denied. *19

IV. The Fraud Claim

A. Fed.R.Civ.P. 9(b)

Fed.R.Civ.P. 9(b) requires that, whenever a complaint contains allegations of fraud, "the circumstances constituting fraud . . . shall be stated with particularity." See Fed.R.Civ.P. 9(b); see also Chill v. GE, 101 F.3d 263, 267 (2d Cir. 1996) (noting that "the actual fraudulent statements or conduct and the fraud alleged must be stated with particularity") (internal citations omitted). "[A] complaint making such allegations must `(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent.'" Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994) (quoting Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d Cir. 1993)). "In short, a plaintiff must `set forth the who, what, when, where and how of the alleged fraud.'"United States ex rel. Sarafoglou v. Weill Med. Coll. of Cornell Univ., 451 F. Supp. 2d 613, 623 (S.D.N.Y. 2006) (citation omitted).

B. Fraud Claims Based on Future Promises

When a fraud claim is based on a future promise, the plaintiff must additionally show that "the defendants had no intention of carrying out [the promise] at the time the promise was made."Olivieri v. McDonald's Corp., 678
20 F. Supp. 996, 1001 (E.D.N.Y. 1988) (citation omitted). To meet this standard the *20

plaintiff must go beyond "a mere showing of nonperformance." Id. (citation omitted). Courts have been hesitant to allow plaintiffs to tack fraud claims onto contract claims when the fraud claim amounts to nothing more than "allegations about [the defendent's] state of mind [regarding] the claim for breach of contract."Papa's-June Music, Inc. v. McLean, 921 F. Supp. 1154, 1162 (S.D.N.Y. 1996).

B. Application 1. Private Banking

On November 1, 2008, Trabucco discovered that Private Banking mistakenly sold (instead of bought) 50,000 shares of Newmont stock in his name. Private Banking confirmed — orally and in writing — that it made the mistake. The Trabuccos allege that on the days between November 1, 2008 and November 8, 2008, 109 representatives of Private Banking induced them into *109 using their own money to replace the missing Newmont shares by promising Trabucco that Private Banking would reimburse the account. The Trabuccos allege that the statements were fraudulent because Private Banking never intended to reimburse the Trabuccos and, to this day, has not made good on the promise to reimburse them.

The Trabuccos fail to allege facts supporting their legal conclusion that Private Banking never intended to reimburse their account. They allege that Private Banking has not performed on the promise to reimburse them, 21 but under New York law, the Trubuccos must go beyond "a mere showing of *21

nonperformance." Olivieri, 678 F. Supp. at 1001. Furthermore, the fraud claim is not sufficiently distinct from the contract claim. See Bridgestone/Firestone, Inc. v. Recovery Credit Servs. Inc., 98 F.3d 13, 20 (2d Cir. 1996) (citation omitted) (stating that conversion of a contract claim to a fraud claim is only permissible when: plaintiff demonstrates (i) a legal duty distinct from the contract claim; (ii) a fraudulent mispresentation extraneous to the contract; or (iii) damages that are unrecoverable as contract damages). For these reasons the fraud claim against Private Banking is dismissed.

2. Intesa

Because the Trabuccos have failed to sufficiently allege a fraud claim against Private Banking, the fraud claim against the parent corporation, Intesa, is also dismissed.

CONCLUSION

For the reasons set forth above, the motion to dismiss is denied as to the contract claims against both Private Banking and Intesa and granted as to the fraud claims against both Private Banking and Intesa. Private Banking and Intesa shall file an answer to the complaint within 21 days of this order.

SO ORDERED.

Wm. Passalacqua Builders v. Resnick Developers

933 F.2d 131 (2d Cir. 1991)
Decided May 14, 1991

Nos. 526, 536, Dockets 90-7558, 90-7598.

Argued November 26, 1990.

132 Decided May 14, 1991. *132

David J. Larson, Atlanta, Ga. (Peterson, Dillard, Young, Self Asselin, Atlanta, Ga., of counsel), Frank J. Franzino, New York City (Bryan, Levitan, Franzino Rosenberg, New York City, of counsel), for appellants Wm. Passalacqua Builders, Inc., et al.

Brian Gallagher, New York City (Kronish, Lieb, Weiner Hellman, New York City, of counsel), for defendants-appellees and cross-appellants other than Resnick Developers South, Inc.

Appeal from the United States District Court for the Southern District of New York.

Before OAKES, Chief Judge, and CARDAMONE and McLAUGHLIN, Circuit Judges.

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133 *133

CARDAMONE, Circuit Judge:

Nearly 20 years ago plaintiffs entered into a contract to build a hotel in Florida for defendant, Resnick Developers South, Inc. (Developers). Since then the real estate deal has gone sour, demands for payments for labor and services remain outstanding, and a judgment brought to collect the money owed plaintiffs still is unsatisfied. In their suit before the district court plaintiffs attempted to prove defendant was a "shell" corporation, the *alter ego* of other family-owned corporations or its individual stockholders. The purpose of the suit was to pierce defendant's corporate veil and to reach the assets of the real contracting parties; in this objective, plaintiffs failed.

But because the district court misconstrued the case law on this subject — causing it to grant improperly directed verdicts as to a majority of the defendants and to instruct improperly the jury — we remand the matter with instructions to hold a new trial. In doing so, we also review certain of the district court's prior rulings made on the long and tortuous road this case has taken.

BACKGROUND

The facts are essentially undisputed and were the subject of extensive stipulations in the district court. Plaintiffs William Passalacqua Builders, Inc. (Passalacqua), Safeco Insurance Co. of America (Safeco), and General Insurance Co. of America (General Insurance) are respectively, a building contractor and the assignees of the rights under a contract, the breach of which is the genesis of the instant litigation. Defendants Developers, 90079, Inc., Jack Resnick and Sons, Inc., Sunrise Builders, Inc., Jack Resnick Sons of Florida, Inc., Resnick of Boca, Inc., PJFAM Investments, Inc., and Resnick Development Corporation are corporate entities controlled entirely (with the exception of Boca) by members of the Resnick family or by other corporations controlled entirely by them, and defendants Jack Resnick, Burton Resnick, Pearl Resnick, Judith Resnick, Ira Resnick, Marilyn Katz, Stanley Katz, and Susan Abrams are members of that family by blood or marriage with extensive involvement in some or all of the family of Resnick corporations.

On October 23, 1972 plaintiff Passalacqua entered into a contract with defendant Resnick Developers South, Inc. to construct a project in Florida known as the Mayfair House. Disputes arose during construction and attempts to negotiate a price for the extra work needed to complete the contract were unable to be resolved. Passalacqua sought arbitration in 1974 and obtained an award upon which a final judgment was entered in
134 Florida in 1981 in the amount of $1,721,171 for damages caused *134 by Developers' breach of contract. Prior to entry of judgment, Passalacqua assigned its right to enforce the judgment to Safeco. Only $769,989.10 of the judgment was recovered by Safeco (under a mechanics lien replaced by a bond guaranteed by Jack and Burton Resnick) leaving a balance of $951,181.90 unpaid.

Following their inability to recover fully on the judgment against Developers, Safeco and General Insurance instituted the instant action in the United States District Court for the Southern District of New York in a complaint containing four counts: two for equitable relief seeking to pierce the corporate veil (counts I and II), one for fraud (count III), and one alleging an oral guarantee by one of the defendants to pay the sum owed (count IV). A number of the district court rulings prior to trial are raised as issues on this appeal. By order of February 8, 1984 the district court (Edelstein, J.) dismissed count IV on statute of limitations grounds, the alleged oral promise having been made more than six years previously, and also dismissed certain defendants under count III. This ruling was not appealed. By order of May 16, 1985 the same district court dismissed the fraud count III in its entirety based on its conclusion that Passalacqua was a non-diverse plaintiff, in that it was an inactive corporation that had its principal place of business in Florida — where it last transacted business — as opposed to Ohio, its state of incorporation. Because Passalacqua was an indispensable party to count III, its absence from the action compelled dismissal of the fraud count. *William Passalacqua Builders, Inc. v. Resnick Developers South, Inc.,* 608 F.Supp. 1261, 1263-64 (S.D.N.Y. 1985).

The district court ordered counts I and II — alleging that the defendants were liable under the equitable instrumentality or an *alter ego* theory of piercing the corporate veil — consolidated into a new amended complaint upon which the trial was held. *Id.* at 1265. It also ruled that it had jurisdiction over the alleged "alter ego" defendants, and declined to dismiss them on statute of limitations or jurisdictional grounds. *Id.* at 1264.

By order of July 12, 1985 the district court denied a motion to reargue this latter point, declined to certify the jurisdictional question for appellate review, and ordered sanctions against defendants under Rule 11 for filing what the court termed an "unnecessary motion" to dismiss the fourth amended complaint. *William Passalacqua Builders, Inc. v. Resnick Developers South, Inc.,* 611 F.Supp. 281, 285 (S.D.N.Y. 1985). Finally, by order of April 25, 1988 it denied defendants' motion to strike the plaintiff's jury demand.

The case was then tried to a jury before Senior District Court Judge Pollack in the Southern District from May 1-3, 1990. At the close of plaintiff's case, the district court granted defendants' motion to dismiss all individual and corporate defendants except Developers and Jack Resnick and Sons, Inc. At the close of all the evidence, the trial court again reserved decision on the motion to dismiss as to Jack Resnick and Sons, and charged the jury. In a special verdict — using a form with questions supplied by the court — the jury found that Jack Resnick Sons, Inc. was not the *alter ego* of Developers, and that Developers had conducted its own business for its own account. Judge Pollack then dismissed the remaining claims against all defendants, other than Developers, rendering the balance due on the 1981 judgment uncollectible. From the district court's judgment entered on May 3, 1990, plaintiffs appeal. Defendants cross-appeal from Judge Edelstein's grant of sanctions against them and contend he ruled incorrectly on several other issues, which we later discuss.

DISCUSSION [11] I History of Jury Trial Right

In deciding to try this case to a jury, the district court followed language from our opinion in *American Protein Corp. v. AB Volvo,* 844 F.2d 56, 59 (2d Cir.), *cert. denied,* 488 U.S. 852, 109 S.Ct. 136, 102 L.Ed.2d 109 (1988), in which we held "the issue of corporate disregard is generally submitted to the jury." *Id.* Because we 135 *135 have never addressed whether a right to a jury trial exists in a case where a judgment-creditor seeks to pierce the corporate veil and enforce a judgment — obtained against a subsidiary — against the parent corporation or individual shareholders alleged to have controlled the subsidiary, we revisit this area.

The Seventh Amendment provides that "[i]n Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved." U.S. Const. amend. VII. The jury trial right includes more than the common-law forms of action recognized in 1791; the phrase "Suits at common law" refers to "suits in which *legal* rights [are] to be ascertained and determined, in contradistinction to those where equitable rights alone [are] recognised [sic], and equitable remedies were administered." *Parsons v. Bedford,* 28 U.S. (3 Pet.) 433, 447, 7 L.Ed. 732 (1830) (Story, J.).

It is irrelevant whether the action actually existed in England in 1791 "for that Amendment requires trial by jury in actions unheard of at common law, provided that the action involves rights and remedies of the sort traditionally enforced in an action at law, rather than in an action in equity or admiralty." *Pernell v. Southall Realty,* 416 U.S. 363, 375, 94 S.Ct. 1723, 1729, 40 L.Ed.2d 198 (1974); *Curtis v. Loether,* 415 U.S. 189, 195, 94 S.Ct. 1005, 1008, 39 L.Ed.2d 260 (1974). In determining whether a particular action is one at law or in equity, it is necessary to examine "both the nature of the issues involved and the remedy sought." *Chauffeurs, Teamsters and Helpers, Local No. 391 v. Terry,* 494 U.S. 558, 110 S.Ct. 1339, 1345, 108 L.Ed.2d 519 (1990). "First, we compare the statutory action to 18th-century actions brought in the courts of England prior to the merger of the courts of law and equity. Second, we examine the remedy sought and determine whether it is legal or equitable in nature." *Tull v. United States,* 481 U.S. 412, 417-18, 107 S.Ct. 1831, 1835, 95 L.Ed.2d 365 (1987). The second inquiry is more important than the first. *See Granfinanciera S.A. v. Nordberg,* 492 U.S. 33, 42, 109 S.Ct. 2782, 2790, 106 L.Ed.2d 26 (1989).

Applying this analysis is difficult because courts and commentators rarely address the historic origins of the piercing doctrine at length. Some believe its origin is equitable. *See Bangor Punta Operations, Inc. v. Bangor Aroostook R.R. Co.,* 417 U.S. 703, 713, 94 S.Ct. 2578, 2584, 41 L.Ed.2d 418 (1974). ("[T]he corporate form may be disregarded in the interests of justice where it is used to defeat an overriding public policy . . . . In such cases, courts of equity, piercing all fictions and disguises, will deal with the substance of the action and not blindly adhere to the corporate form."); *United States v. Golden Acres, Inc.,* 684 F.Supp. 96, 103 (D.Del. 1988) ("Piercing the corporate veil is an action that sounds in equity."), *aff'd sub nom., Golden Acres, Inc. v. Sutton Place Corp.,* 879 F.2d 857 (3d Cir. 1989); Fletcher, Cyc. Corp. § 41 (1990 perm. ed.) ("Since the doctrine of piercing the corporate veil is an equitable one that is particularly within the province of the trial court, the right to a jury trial on the issue of piercing the corporate veil does not exist.").

Other courts conclude disregarding the corporate form is of legal origin or so touches on the determination of legal issues that it is for the jury to decide. *See American Protein,* 844 F.2d at 59 ("the issue of corporate disregard is generally submitted to the jury"); *FMC Fin. Corp. v. Murphree,* 632 F.2d 413, 421 n. 5 (5th Cir.

1980) ("This Court holds that the issue of corporate entity disregard is one for the jury."). And at least one early scholar has noted that, whatever its origin, the doctrine has been applied in courts both of law and equity. *See* Wormser, I.M., *Piercing the Veil of the Corporate Entity,* 12 Colum.L. Rev. 496, 497-99, 513-14 (1912) ("courts, whether of law, of equity or of bankruptcy, do not hesitate to penetrate the veil and to look beyond the juristic entity at the actual and substantial beneficiaries.").

The latter view appears to have the greatest historical support. According to Professor Phillip Blumberg, enforcement of shareholder liability for corporate obligations began as "a crude system in which any creditor
136 with an unsatisfied judgment *136 against the corporation sued any shareholder at common law." Blumberg, *The Law of Corporate Groups: Tort, Contract, and Other Common Law Problems in the Substantive Law of Parent and Subsidiary Corporations* § 2.02, at 52 (1987) (Blumberg, *The Law of Corporate Groups*); *cf. Widdrington v. Cudworth and Others,* (1662) Vidian's Exact Pleader, p. 3 (plaintiff who brought action in tort at common law claiming conspiracy to eject a fellow from Cambridge college, sued the fellows as a combination of individuals rather than the college as a corporation) (cited in Baker, *An Introduction to English Legal History* 524 (3d ed. 1990)).

The next stage in the evolution of this theory of disregard was the development of the equitable procedure known as a "creditor's bill." When fully formed, the creditor's bill had two parts. The first part was a proceeding in equity "instituted by any creditor with an unsatisfied judgment, usually on behalf of all creditors, against the corporate debtor," the purpose of which was to adjudge the extent of the total corporate liability to the group of creditors. Blumberg, *The Law of Corporate Groups* § 2.02 at 53. The second part was an action at common law against the shareholders individually to collect the amount owed in which only personal defenses were allowed to be raised. *See* Abbot, *Conflict of Laws and the Enforcement of the Statutory Liability of Stockholders in a Foreign Corporation,* 23 Harv.L.Rev. 37, 43-45 (1909); Restatement (Second) of the Conflict of Laws § 308, comment e (1971). These sources support the proposition that the nature of the ancient action disregarding the corporate form had equitable and legal components. Having examined the way this issue was treated historically, we turn next to examine the remedy sought.

Plaintiffs here seek enforcement of a money judgment obtained against Developers. The fact that plaintiffs seek money indicates a legal action. *See Pernell,* 416 U.S. at 370, 94 S.Ct. at 1727 ("`where an action is simply for the recovery . . . of a money judgment, the action is one at law'") (quoting *Whitehead v. Shattuck,* 138 U.S. 146, 151, 11 S.Ct. 276, 277, 34 L.Ed. 873 (1891)); *Dairy Queen, Inc. v. Wood,* 369 U.S. 469, 476, 82 S.Ct. 894, 899, 8 L.Ed.2d 44 (1962) (Insofar as complaint requests a money judgment "it presents a claim which is unquestionably legal").

Defendants contend that because plaintiffs have already secured a money judgment against Developers, their claim for money is merely incidental to their equitable piercing claim and, like disgorgement, does not require a jury trial. *See SEC v. Tome,* 833 F.2d 1086, 1096 n. 7 (2d Cir. 1987), *cert. denied,* 486 U.S. 1014, 108 S.Ct. 1751, 100 L.Ed.2d 213 (1988); *SEC v. Commonwealth Chem. Sec., Inc.,* 574 F.2d 90, 95-96 (2d Cir. 1978). We disagree. As just discussed, the action for piercing the corporate veil does not sound solely in equity. Further, while it is true that "[t]he right to a jury trial depends on the nature of the relief sought, not on what may ultimately be secured," *Damsky v. Zavatt,* 289 F.2d 46, 56 (2d Cir. 1961), the nature of the relief sought in the instant case is relief typically achieved in an action at law. Plaintiffs seek to establish defendants' liability for the judgment already obtained against Developers. This is analogous to the second phase of the old creditors' bill procedure in which the creditors, having obtained a judgment against the corporation in equity, then enforced that judgment against the individual stockholders at law.

Because the action for piercing the corporate veil appears to have its roots in both law and equity, and the nature of the relief sought here supports the conclusion that plaintiff's cause of action is legal in nature, it was entirely proper for the district court to submit the corporate disregard issue to the jury. *See Beacon Theatres, Inc. v. Westover,* 359 U.S. 500, 510-11, 79 S.Ct. 948, 956-57, 3 L.Ed.2d 988 (1959) ("`[jury] right cannot . . . be impaired by any blending with a claim, properly cognizable at law, of a demand for equitable relief in aid of the legal action or during its pendency'") (quoting *Scott v. Neely,* 140 U.S. 106, 109-10, 11 S.Ct. 712, 714, 35 L.Ed.
137 358 (1891)); *cf. Ross v. Bernhard,* 396 U.S. 531, 538, 542-43, 90 S.Ct. 733, 738, 740-41, 24 *137 L.Ed.2d 729 (1970) (finding a right to jury trial in a shareholder's derivative suit, a type of suit traditionally brought in courts of equity, because plaintiffs' case presented legal issues of breach of contract and negligence).

Moreover, as a practical matter separate from Seventh Amendment considerations, whether or not those factors — discussed later in our analysis — that will justify ignoring the corporate form and imposing liability on affiliated corporations or shareholders are present in a given case is the sort of determination usually made by a jury because it is so fact specific. *See* Blumberg, *The Law of Corporate Groups* § 7.02.2, at 144.

II The Directed Verdict [24] A. *Choice of Law*

Because this is a diversity case, we apply the choice of law rules of the forum state, in this instance New York. *Krauss v. Manhattan Life Ins. Co.,* 643 F.2d 98, 100 (2d Cir. 1981). Choice of law issues involving contractual disputes are resolved in New York by an "interest analysis." *See Intercontinental Planning Ltd. v. Daystrom, Inc.,* 24 N.Y.2d 372, 300 N.Y.S.2d 817, 248 N.E.2d 576 (1969); *see also Hutner v. Greene,* 734 F.2d 896, 899 (2d Cir. 1984), and therefore "the law of the jurisdiction having the greatest interest in the litigation" controls. *See Daystrom,* 24 N.Y.2d at 382, 300 N.Y.S.2d 817, 248 N.E.2d 576. In performing this analysis, we would ordinarily look to factors such as the place of: (1) contracting, (2) negotiation of the contract, (3) performance, (4) the location of the subject matter of the contract, and (5) the domicile, residence, nationality, place of incorporation, and place of business of the parties. *See State Trading v. Assuranceforeningen Skuld,* 921 F.2d 409, 417 (2d Cir. 1990); Restatement (Second) of Conflict of Laws § 188(2) (1971).

But, in the instant case the parties have assumed from the outset that New York law governs, as evidenced, for example, by reliance on New York law to support their respective contentions. *See Walter E. Heller Co. v. Video Innovations, Inc.,* 730 F.2d 50, 52 (2d Cir. 1984) (under New York law, "in the absence of a strong countervailing public policy, the parties to litigation may consent by their conduct to the law to be applied"). Further, the law in Florida — the only other state with significant contacts to this dispute — on corporate disregard is virtually identical to New York law. *See Bendix Home Systems, Inc. v. Hurston Enterprises, Inc.,* 566 F.2d 1039 (5th Cir. 1978). Thus, though the record is silent on whether the parties bargained for application of New York law, we conclude a New York court would apply New York law to the contract at issue here.

B. *New York Law*

We now consider the district court's granting of a directed verdict dismissing all individual and corporate defendants, except Developers and Jack Resnick and Sons, Inc., at the close of plaintiffs' case. Plaintiffs assert that dismissal should not have been granted for the corporate defendants and in favor of individual defendants Jack Resnick, Burton Resnick and Stanley Katz, conceding this relief's appropriateness with respect to Boca, and individual defendants Pearl, Judith, and Ira Resnick, Marilyn Katz, and Susan Abrams. In order to decide whether the district court properly granted dismissal in favor of the defendants named, we must analyze the requirements for disregarding the corporate form under New York law, and then determine whether the district court correctly applied those requirements to the facts of this case.

New York's view on this subject begins with *Berkey v. Third Avenue Ry. Co.,* 244 N.Y. 84, 155 N.E. 58 (1926), where Judge Cardozo said:

> Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent. . . . The logical consistency of a juridical conception will indeed be sacrificed at times when the sacrifice is essential to the end that some accepted public policy
> 138 may be defended or upheld. This is so, . . . *138 where the attempted separation between parent and subsidiary will work a fraud upon the law.

Id. at 95, 155 N.E. 58.

Ten years later *Lowendahl v. Baltimore Ohio R.R. Co.,* 247 A.D. 144, 287 N.Y.S. 62 (1st Dept.), *aff'd,* 272 N.Y. 360, 6 N.E.2d 56 (1936), set forth the New York rule for corporate disregard. Lowendahl took *Berkey*'s proposition as a starting point, and proceeded to explain that to pierce the corporate veil, the parent corporation must at the time of the transaction complained of: (1) have exercised such control that the subsidiary "has become a mere instrumentality" of the parent, which is the real actor; (2) such control has been used to commit fraud or other wrong; and (3) the fraud or wrong results in an unjust loss or injury to plaintiff. *Id.* 247 A.D. at 157, 287 N.Y.S. 62. The doctrine, it was said, is invoked "to prevent fraud or to achieve equity." *International Aircraft Trading Co. v. Manufacturers Trust Co.,* 297 N.Y. 285, 292, 79 N.E.2d 249 (1948). Professor Blumberg believes — and we agree — that the three-factor rule in New York and the *alter ego* theory sued on in this case are indistinguishable, do not lead to different results, and should be treated as inter-changeable. *See* Blumberg, *The Law of Corporate Groups* § 6.-03 at 120.

Under New York law it has been further held that when a corporation is used by an individual to accomplish his own and not the corporation's business, such a controlling shareholder may be held liable for the corporation's commercial dealings as well as for its negligent acts. *See Walkovszky v. Carlton,* 18 N.Y.2d 414, 417, 276 N.Y.S.2d 585, 223 N.E.2d 6 (1966). Where there is proof that defendants were doing business in their individual capacities to suit their own ends — shuttling their own funds in and out without regard to the corporation's form — this sort of activity exceeds the limits of the privilege of doing business in a corporate form and warrants the imposition of liability on individual stockholders. *Id.* at 420, 276 N.Y.S.2d 585, 223 N.E.2d 6. The critical question is whether the corporation is a "shell" being used by the individual shareowners to advance their own "purely personal rather than corporate ends." *Port Chester Elec. Constr. Corp. v. Atlas,* 40 N.Y.2d 652, 656-57, 389 N.Y.S.2d 327, 357 N.E.2d 983 (1976) (quoting *Walkovszky,* 18 N.Y.2d at 418, 276 N.Y.S.2d 585, 223 N.E.2d 6).

We capsulized this view of New York law in *American Protein,* 844 F.2d 56 (2d Cir. 1988), where we observed that control, whether of the subsidiaries by the parent or the corporation by its stockholders, is the key; the control must be used to commit a fraud or other wrong that causes plaintiff's loss. *Id.* at 60. *See Electronic Switching Indus., Inc. v. Faradyne Elec. Corp.,* 833 F.2d 418, 424 (2d Cir. 1987) (absent a showing that "control and domination was used to commit wrong, fraud, or the breach of a legal duty, or a dishonest and unjust act" New York law will not allow a piercing of the corporate veil); *Gorrill v. Icelandair/Flugleidir,* 761 F.2d 847, 853 (2d Cir. 1985) (same as *American Protein*).

Liability therefore may be predicated either upon a showing of fraud or upon complete control by the dominating corporation that leads to a wrong against third parties. *See Itel Containers Int'l Corp. v. Atlanttrafik Exp. Serv. Ltd.,* 909 F.2d 698, 703 (2d Cir. 1990) ("New York law allows the corporate veil to be pierced *either* when there is fraud *or* when the corporation has been used as an alter ego.") (emphasis in original); *Gartner v. Snyder,* 607 F.2d 582, 586 (2d Cir. 1979) ("Because New York courts disregard corporate form reluctantly, they

do so only when the form has been used to achieve fraud, or when the corporation has been so dominated by an individual or another corporation . . ., and its separate identity so disregarded, that it primarily transacted the dominator's business rather than its own and can be called the other's alter ego."); *cf. Kirno Hill Corp. v. Holt,* 618 F.2d 982, 985 (2d Cir. 1980) (in federal maritime law "The prerequisites for piercing a corporate veil are . . . clear . . .: [the defendant] must have used [the corporation] to perpetrate a fraud or have so dominated and
139 disregarded [the corporation's] *139 corporate form that [the corporation] primarily transacted [the defendant's] personal business rather than its own corporate business.")

Plaintiffs assert that the Resnick corporations were one whole entity — that is, Developers was dominated by the other corporations — and that Developers was really the agent of the Resnick family members who used it to pursue their own ends. To determine whether these assertions are valid, the triers of fact are entitled to consider factors that would tend to show that defendant was a dominated corporation, such as: (1) the absence of the formalities and paraphernalia that are part and parcel of the corporate existence, *i.e.,* issuance of stock, election of directors, keeping of corporate records and the like, (2) inadequate capitalization, (3) whether funds are put in and taken out of the corporation for personal rather than corporate purposes, (4) overlap in ownership, officers, directors, and personnel, (5) common office space, address and telephone numbers of corporate entities, (6) the amount of business discretion displayed by the allegedly dominated corporation, (7) whether the related corporations deal with the dominated corporation at arms length, (8) whether the corporations are treated as independent profit centers, (9) the payment or guarantee of debts of the dominated corporation by other corporations in the group, and (10) whether the corporation in question had property that was used by other of the corporations as if it were its own. *See generally,* Barber, *Piercing the Corporate Veil,* 17 Willamette L.Rev. 371, 398 (1981); *Director's Guild of America v. Garrison Prod.,* 733 F.Supp. 755, 760-61 (S.D.N.Y. 1990); *United States Barite Corp. v. M.V. Haris,* 534 F.Supp. 328, 330 (S.D.N.Y. 1982).

Applying these — or any other pertinent factors — to the infinite variety of situations that might warrant disregarding the corporate form is not an easy task because disregarding corporate separateness is a remedy that "differs with the circumstances of each case." *American Protein,* 844 F.2d at 60. The jury must decide whether — considering the totality of the evidence, *see William Wrigley, Jr. Co. v. Waters,* 890 F.2d 594, 601 (2d Cir. 1989) — the policy behind the presumption of corporate independence and limited shareholder liability — encouragement of business development — is outweighed by the policy justifying disregarding the corporate form — the need to protect those who deal with the corporation. Blumberg, *The Law of Corporate Groups* § 6.01, at 108 ("The particular objectives and policies of the area under consideration should control.").

C. *Review of the Present Record*

The Resnick family real estate business consisted of various partnerships and corporations, all controlled either directly or indirectly by family members. Developers was set up specifically in April 1972 to develop real estate in Florida. Throughout its existence it did not establish and maintain corporate indicia. It did not issue its shares timely, it had no employees except its officers — many of whom were also the officers and employees of the other corporate defendants — and neither held regular meetings, nor elected officers and directors as required by its certificate of incorporation. At the same time, Developers had separate books — though they were kept by Jack Resnick Sons, Inc. — maintained separate bank accounts, and filed separate tax returns (except when consolidated legally with other Resnick-controlled companies).

There was no evidence of any fraud by the Resnicks or any of the corporations they controlled, a fact plaintiffs concede. Yet, Developers was severely undercapitalized during the period the building contract was in effect, having only $10 in capital paid by 90079, Inc. — another Resnick-controlled entity — when it bought all of Developer's shares in 1973. All other funds available to Developers came in the form of loans, made initially by Resnick-controlled companies and eventually by Bankers Trust, the bank which agreed to fund the Mayfair House construction project. Bankers agreed to provide 100 percent financing in the form of a $9 million construction loan, secured only by a mortgage on the property and by the personal guarantees of *140 completion by Jack and Burton Resnick. Personal guarantees of completion only bind a party to complete the project; by their plain terms they do not guarantee payment of amounts owed to contractors working on the project. Hence, completion guarantees do not constitute capital of the corporation available for its creditors. *See* Fletcher, Cyc. Corp. at §§ 5079-5080.1 (defining "capital" of corporation).

Evidence also showed the lines of corporate control and responsibility among Resnick-controlled entities were often blurred. The Resnick corporations shared a common office in New York City, had the same office staff, and essentially the same officers and directors, albeit in different permutations and combinations. Burton Resnick, Jack Resnick, and Stanley Katz were officers of all the corporate defendants. Employees of one Resnick corporation were sometimes paid as though they actually worked for another corporation, and employees would represent to clients that they were an officer of one of the corporations when in fact they actually occupied that position in another Resnick corporation. For instance, Irving Katz was employed as treasurer of Jack Resnick Sons, Inc., but he signed letters as the controller of Developers, even though he was not an employee or officer of that corporation.

Financial transactions also revealed a high degree of intermingling among the various corporate entities. The Resnicks shuffled funds from one to another of their corporations frequently with the source of the funds chosen based on which of their corporations had sufficient funds at the time, rather than on any demonstrated business purpose of the corporation that was the source of the funds. Interest was not generally charged by the corporation advancing money to another Resnick entity. Funds were shifted in this fashion into and out of Developers' bank accounts with regularity, but all such sums were duly noted in the corporate books and most loans from other Resnick-controlled corporations or individual family members were repaid. Other proof showed the Resnick corporations paid personal expenses of officers and employees in certain instances, and provided Resnick relatives with below-market deals on real estate.

In addition, the corporations did not deal at arms length with each other. For example, Burton Resnick testified that when Developers was purchased by 90079, Inc. for $10, he anticipated a three million dollar profit on the Mayfair House. Nor were the Resnick corporations treated as individual profit centers. Profit calculations were compiled that suggested that the distinctions between corporations were artificial, and it was actually the profit to the entire collection of Resnick-controlled corporations — as opposed to each separate entity — that was being calculated for the family to review.

Looking at these factors and considering the totality of the evidence, and drawing as we must all inferences favorably to the plaintiffs, *Konik v. Champlain Valley Physicians Hospital Medical Center,* 733 F.2d 1007, 1013 (2d Cir.), *cert. denied,* 469 U.S. 884, 105 S.Ct. 253, 83 L.Ed.2d 190 (1984), we think a jury could find a level of control that was substantial, and could be interpreted as sufficient domination to justify piercing the corporate veil to reach the assets of either the individual Resnick family members or the other Resnick-controlled corporate entities. Under New York law there was therefore enough evidence to allow this case to go to the jury with respect to all the corporate defendants, except Boca, and with respect to the individual defendants Jack Resnick, Burton Resnick, and Stanley Katz. Because the district court granted a directed verdict dismissing plaintiffs' complaint against these defendants, the case must therefore be remanded for a new trial.

III The Jury Charge

Substantially the same reasons that lead us to reverse the district court's directed verdict as to a majority of the defendants also lead us to conclude the district court erred in its instructions to the jury on New York's 141 disregard doctrine. First, the court instructed the jury that piercing the *141 corporate veil "is an equitable doctrine to prevent fraud or to deal with misrepresentation perpetrated by a contracting party. No fraud, no affirmative misrepresentation is charged against Jack Resnick Sons, Inc. None of that is claimed to have occurred here." This instruction incorrectly instructed the jury that plaintiffs were required to prove fraud. New York law, as discussed, permits the corporate form to be disregarded where excessive control alone causes the complained of loss.

Second, the district court then proceeded to instruct the jury that it could consider whether proceeds from the sales of condominium units went to Jack Resnick Sons, Inc., whether Developers was properly incorporated, maintained separate books, records and credit facilities, and properly filed tax returns. Concededly, these are some of the factors a jury may consider when deciding whether to disregard the corporate entity. But there was sufficient evidence to warrant instruction as to other factors, just discussed, regarding level of control. Plaintiffs properly preserved their objections to the count's charge. On remand, the trial court should instruct the jury with respect to these additional factors for its use in considering the piercing claim.

IV Dismissal of Plaintiff Passalacqua

In dismissing Plaintiff Passalacqua from this lawsuit, Judge Edelstein correctly concluded that when a corporation has ceased business activity, diversity jurisdiction under 28 U.S.C. § 1332(c) is determined not only by its state of incorporation, but also by the place it last transacted business, here Florida. *William Passalacqua Builders, Inc.,* 608 F.Supp. at 1263. Both the state of incorporation and the principal place of business should be considered in deciding whether diversity jurisdiction is present. To allow inactive corporations to avoid inquiry into where they were last active would give them a benefit Congress never planned for them, since under such a rule a defunct corporation, no matter how local in character, could remove a case to federal court based on its state of incorporation.

In *Fada of New York, Inc. v. Organization Serv. Co.,* 125 F.2d 120, 121 (2d Cir. 1942) (per curiam), we rejected the argument of a bankrupt that the district court lacked jurisdiction because New York was not a place of business at least six months preceding the filing of the bankruptcy petition. Because New York had been a principal place of business, we ruled that the bankruptcy petition had been properly filed in New York. *Id. Fada* is particularly instructive because the bankruptcy laws in effect at that time provided for jurisdiction either in the place of the corporation's domicile or in its principal place of business, and Congress amended § 1332(c) to follow these provisions in the bankruptcy laws. *See* S.Rep. No. 1830, 85th Cong. 2d Sess. 5 (1958), *reprinted in* 1958 U.S.Code Cong. Admin. News 3099, 3102; Friedenthal, *New Limitations on Federal Jurisdiction,* 11 Stan.L.Rev. 213, 222-25 (1959). Thus, the district court properly ruled that the place an inactive corporation last transacted business is relevant in determining diversity jurisdiction.

There also was ample evidence supporting the conclusion that Florida was Passalacqua's last principal place of business. It obviously transacted business there as evidenced by the activities which gave rise to this litigation. Further, at the time this lawsuit was filed in 1982, its corporate charter had lapsed in Ohio, but it was still a corporation in good standing in Florida. Hence, we agree with the district court that Passalacqua is a non-diverse plaintiff that should have been dismissed from the action. Yet, because Passalacqua is not indispensable to resolution of the remaining claims against defendants, Fed. R.Civ.P. 19(b) does not require that the entire complaint be dismissed.

V Evidentiary Ruling Barring Passalacqua's Testimony

During the course of the trial, the trial court refused to allow plaintiffs' counsel to ask William Passalacqua — 142 President of Passalacqua Builders and the man who *142 had negotiated the contract with Developers — the following four questions:

> [A]t the time that you signed that contract, were you aware of the financial structure of [Developers]?
>
> Mr. Passalacqua, why didn't you ask for any personal guarantees of the Resnick . . . ?
>
> Did you get any information about the Resnick organization in general before you signed that contract?
>
> Did you have any understanding of what the financial strength was of the Resnick organization before you signed that contract?

The district court then charged the jury as follows:

> One who deals with a corporation is entitled, and, indeed, obliged to do his own investigation of finances, if he is concerned with them — there is no proof here that Passalacqua was concerned — just as the one who deals with an individual is entitled and obliged to satisfy himself regarding the individual's financial health if that matter is considered significant.

The district court's decision to bar Passalacqua's testimony on the four questions at issue was prejudicial to plaintiffs in light of his instruction to construe Passalacqua's failure to investigate Developers finances against him. This was compounded by the charge to the jury on the issue of capitalization:

> Capital of a corporation is of no substantial significance, where, as here, a bank was putting up a hundred percent of the money that's needed to build the project . . . . It is not permissible to disregard corporate form solely because of inadequate capitalization.

Contrary to the trial court's charge, the degree of capitalization of a subsidiary is clearly relevant to the piercing inquiry, *see Fisser v. International Bank,* 282 F.2d 231, 240 (2d Cir. 1960), though the overall ability of the corporation to meet its obligations is obviously the more pertinent aspect of capitalization in that context. The charge on capitalization belittled its importance, a prejudicial error in light of the fact that Developers had only $10 in actual capital to meet its obligations, all other funds available for creditors being loans either from Bankers and other Resnick corporations.

Further, although it is true that knowledge of under-capitalization has been construed as a bar to inclusion of this factor for consideration in a piercing claim *Brunswick Corp. v. Waxman,* 459 F.Supp. 1222, 1232 (E.D.N.Y. 1978), *aff'd,* 599 F.2d 34 (2d Cir. 1979), here the trial court instructed the jury that Passalacqua had such knowledge, after barring him from giving testimony as to what he actually knew about that subject. This was plainly prejudicial to plaintiffs and, while not grounds for reversal standing alone, we mention it in light of the directed remand.

VI The Statute of Limitations

Defendants contend on their cross-appeal that Judge Edelstein erred when he ruled that jurisdiction existed over the alleged *alter ego* defendants in the action to enforce the judgment. *William Passalacqua Builders, Inc.,* 608 F.Supp. at 1264 n. 1; 611 F.Supp. at 284 n. 1. They claim, relying on the Supreme Court's opinion in *Zenith Radio Corp. v. Hazeltine Research, Inc.,* 395 U.S. 100, 110-12, 89 S.Ct. 1562, 1569-70, 23 L.Ed.2d 129 (1969), that the action should have been dismissed as barred by the six-year statute of limitations for breach of contract claims. Defendants' reliance on *Zenith* is misplaced. In *Zenith* the Court held it unconstitutional for a court to enforce a judgment against a parent corporation — alleged to be the *alter ego* of a subsidiary — who had controlled the litigation against the subsidiary, but who had never been subjected to the personal jurisdiction of the court. What the defendants ignore is the statement in *Zenith* that the judgment against the subsidiary could be *res judicata* against the parent in a court, as the district court here, that did have proper jurisdiction over the parent. *Id.* at 111, 89 S.Ct. at 1570.

Consequently, if the plaintiffs in this case can prove the defendants are in fact the *alter ego* of Developers,
143 defendants' *143 jurisdictional objection evaporates because the previous judgment is then being enforced against entities who were, in essence, parties to the underlying dispute; the *alter egos* are treated as one entity. *See Dudley v. Smith,* 504 F.2d 979, 982-83 (5th Cir. 1974). Assuming — as defendants concede — there was personal jurisdiction over the *alter ego* defendants, Judge Edelstein correctly refused to bar plaintiffs' claims on statute of limitations grounds.

VII Sanctions

We turn now to the sanctions issue. In 1985 the defendants filed a motion to dismiss an amended complaint filed pursuant to the district court's order of May 16, 1985. *William Passalacqua Builders, Inc.,* 611 F.Supp. at 285. According to the district court, plaintiffs' brief on this subject contained "the identical section on a motion for certification contained in the motion for reargument," filed the same day. Judge Edelstein concluded that this was "an unnecessary motion[,] . . . clearly the type of abuse of motion practice that Rule 11 of the Federal Rules of Civil Procedure was intended to discourage," and awarded plaintiffs attorney's fees. *Id.* Although we share the district court's disdain for defendants' use of a recycled memorandum of law on their motion to dismiss the fourth amended complaint, the timing of defendants' motions were dictated by the local rules and the district court's order dismissing the third amended complaint. We do not think defendants' motion to dismiss the fourth amended complaint was filed for an improper purpose, *see Stern v. Leucadia Nat'l Corp.,* 844 F.2d 997, 1005 (2d Cir.), *cert. denied,* 488 U.S. 852, 109 S.Ct. 137, 102 L.Ed.2d 109 (1988), and the district court did not find otherwise. Accordingly, we reverse as an abuse of discretion the order granting sanctions against defendants. *Cooter Gell v. Hartmarx Corp.,* ___ U.S. ___, 110 S.Ct. 2447, 2460-61, 110 L.Ed.2d 359 (1990).

Finally, we have considered the other issues raised by the parties and find them to be without merit.

CONCLUSION

Insofar as the trial court granted a directed verdict as to a majority of the defendants at the close of plaintiffs' case and granted a motion to dismiss as to most of the remaining defendants at the close of all the evidence, we reverse and remand for a new trial. The award of sanctions against defendants is reversed. In all other respects, the decisions of the two district courts are affirmed.

Affirmed, in part, reversed, in part, and remanded for a new trial.

11 U.S.C. § 365

Section 365 - Executory contracts and unexpired leases

(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.

(b)

(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee-

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to-

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title;

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; or

(D) the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

(3) For the purposes of paragraph (1) of this subsection and paragraph (2)(B) of subsection (f), 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, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;

(B) that any percentage rent due under such lease will not decline substantially;

(C) that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained 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 any tenant mix or balance in such shopping center.

(4) Notwithstanding any other provision of this section, if there has been a default in an unexpired lease of the debtor, other than a default of a kind specified in paragraph (2) of this subsection, the trustee may not require a lessor to provide services or supplies incidental to such lease before assumption of such lease unless the lessor is compensated under the terms of such lease for any services and supplies provided under such lease before assumption of such lease.

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

(1)

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

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

(2) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor; or

(3) such lease is of nonresidential real property and has been terminated under applicable nonbankruptcy law prior to the order for relief.

(d)

(1) In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected.

(2) In a case under chapter 9, 11, 12, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

(3)

(A) The trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period, except as provided in subparagraph (B). This subsection shall not be deemed to affect the trustee's obligations under the provisions of subsection (b) or (f) of this section. Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.

(B) In a case under subchapter V of chapter 11, the time for performance of an obligation described in subparagraph (A) arising under any unexpired lease of nonresidential real property may be extended by the court if the debtor is experiencing or has experienced a material financial hardship due, directly or indirectly, to the coronavirus disease 2019 (COVID-19) pandemic until the earlier of-

(i) the date that is 60 days after the date of the order for relief, which may be extended by the court for an additional period of 60 days if the court determines that the debtor is continuing to experience a material financial hardship due, directly or indirectly, to the coronavirus disease 2019 (COVID-19) pandemic; or

(ii) the date on which the lease is assumed or rejected under this section.

(C) An obligation described in subparagraph (A) for which an extension is granted under subparagraph (B) shall be treated as an administrative expense described in section 507(a)(2) for the purpose of section 1191(e).

(4)

(A) Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of-

(i) the date that is 210 days after the date of the order for relief; or

(ii) the date of the entry of an order confirming a plan.

(B)

(i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 210-day period, for 90 days on the motion of the trustee or lessor for cause.

(ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.

(5) The trustee shall timely perform all of the obligations of the debtor, except those specified in section 365(b)(2), first arising from or after 60 days after the order for relief in a case under chapter 11 of this title under an unexpired lease of personal property (other than personal property leased to an individual primarily for personal, family, or household purposes), until such lease is assumed or rejected notwithstanding section 503(b)(1) of this title, unless the court, after notice and a hearing and based on the equities of the case, orders otherwise with respect to the obligations or timely performance thereof. This subsection shall not be deemed to affect the trustee's obligations under the provisions of subsection (b) or (f). Acceptance of any such performance does not constitute waiver or relinquishment of the lessor's rights under such lease or under this title.

(e)

(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on-

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

(2) Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if-

(A)

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

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

(B) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.

(f)

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

(2) The trustee may assign an executory contract or unexpired lease of the debtor only if-

(A) the trustee assumes such contract or lease in accordance with the provisions of this section; and

(B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

(3) Notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such contract or lease or a right or obligation under such contract or lease on account of an assignment of such contract or lease, such contract, lease, right, or obligation may not be terminated or modified under such provision because of the assumption or assignment of such contract or lease by the trustee.

(g) Except as provided in subsections (h)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease-

(1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition; or

(2) if such contract or lease has been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title-

(A) if before such rejection the case has not been converted under section 1112, 1208, or 1307 of this title, at the time of such rejection; or

(B) if before such rejection the case has been converted under section 1112, 1208, or 1307 of this title-

(i) immediately before the date of such conversion, if such contract or lease was assumed before such conversion; or

(ii) at the time of such rejection, if such contract or lease was assumed after such conversion.

(h)

(1)

(A) If the trustee rejects an unexpired lease of real property under which the debtor is the lessor and-

(i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or

(ii) if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

(B) If the lessee retains its rights under subparagraph (A)(ii), the lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease and for the term of any renewal or extension of such lease, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such lease, but the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.

(C) The rejection of a lease of real property in a shopping center with respect to which the lessee elects to retain its rights under subparagraph (A)(ii) does not affect the enforceability under applicable nonbankruptcy law of any provision in the lease pertaining to radius, location, use, exclusivity, or tenant mix or balance.

(D) In this paragraph, "lessee" includes any successor, assign, or mortgagee permitted under the terms of such lease.

(2)

(A) If the trustee rejects a timeshare interest under a timeshare plan under which the debtor is the timeshare interest seller and-

(i) if the rejection amounts to such a breach as would entitle the timeshare interest purchaser to treat the timeshare plan as terminated under its terms, applicable nonbankruptcy law, or any agreement made by timeshare interest purchaser, the timeshare interest purchaser under the timeshare plan may treat the timeshare plan as terminated by such rejection; or

(ii) if the term of such timeshare interest has commenced, then the timeshare interest purchaser may retain its rights in such timeshare interest for the balance of such term and for any term of renewal or extension of such timeshare interest to the extent that such rights are enforceable under applicable nonbankruptcy law.

(B) If the timeshare interest purchaser retains its rights under subparagraph (A), such timeshare interest purchaser may offset against the moneys due for such timeshare interest for the balance of the term after the date of the rejection of such timeshare interest, and the term of any renewal or extension of such timeshare interest, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation of the debtor under such timeshare plan, but the timeshare interest purchaser shall not have any right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.

(i)

(1) If the trustee rejects an executory contract of the debtor for the sale of real property or for the sale of a timeshare interest under a timeshare plan, under which the purchaser is in possession, such purchaser may treat such contract as terminated, or, in the alternative, may remain in possession of such real property or timeshare interest.

(2) If such purchaser remains in possession-

(A) such purchaser shall continue to make all payments due under such contract, but may, offset against such payments any damages occurring after the date of the rejection of such contract caused by the nonperformance of any obligation of the debtor after such date, but such purchaser does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset; and

(B) the trustee shall deliver title to such purchaser in accordance with the provisions of such contract, but is relieved of all other obligations to perform under such contract.

(j) A purchaser that treats an executory contract as terminated under subsection (i) of this section, or a party whose executory contract to purchase real property from the debtor is rejected and under which such party is not in possession, has a lien on the interest of the debtor in such property for the recovery of any portion of the purchase price that such purchaser or party has paid.

(k) Assignment by the trustee to an entity of a contract or lease assumed under this section relieves the trustee and the estate from any liability for any breach of such contract or lease occurring after such assignment.

(l) If an unexpired lease under which the debtor is the lessee is assigned pursuant to this section, the lessor of the property may require a deposit or other security for the performance of the debtor's obligations under the lease substantially the same as would have been required by the landlord upon the initial leasing to a similar tenant.

(m) For purposes of this section 365 and sections 541(b)(2) and 362(b)(10), leases of real property shall include any rental agreement to use real property.

(n)

(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect-

(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for-

(i) the duration of such contract; and

(ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.

(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract-

(A) the trustee shall allow the licensee to exercise such rights;

(B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract; and

(C) the licensee shall be deemed to waive-

(i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and

(ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall-

(A) to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity.

(4) Unless and until the trustee rejects such contract, on the written request of the licensee the trustee shall-

(A) to the extent provided in such contract or any agreement supplementary to such contract-

(i) perform such contract; or

(ii) provide to the licensee such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment), including any right to obtain such intellectual property (or such embodiment) from another entity.

(o) In a case under chapter 11 of this title, the trustee shall be deemed to have assumed (consistent with the debtor's other obligations under section 507), and shall immediately cure any deficit under, any commitment by the debtor to a Federal depository institutions regulatory agency (or predecessor to such agency) to maintain the capital of an insured depository institution, and any claim for a subsequent breach of the obligations thereunder shall be entitled to priority under section 507. This subsection shall not extend any commitment that would otherwise be terminated by any act of such an agency.

(p)

(1) If a lease of personal property is rejected or not timely assumed by the trustee under subsection (d), the leased property is no longer property of the estate and the stay under section 362(a) is automatically terminated.

(2)

(A) If the debtor in a case under chapter 7 is an individual, the debtor may notify the creditor in writing that the debtor desires to assume the lease. Upon being so notified, the creditor may, at its option, notify the debtor that it is willing to have the lease assumed by the debtor and may condition such assumption on cure of any outstanding default on terms set by the contract.

(B) If, not later than 30 days after notice is provided under subparagraph (A), the debtor notifies the lessor in writing that the lease is assumed, the liability under the lease will be assumed by the debtor and not by the estate.

(C) The stay under section 362 and the injunction under section 524(a)(2) shall not be violated by notification of the debtor and negotiation of cure under this subsection.

(3) In a case under chapter 11 in which the debtor is an individual and in a case under chapter 13, if the debtor is the lessee with respect to personal property and the lease is not assumed in the plan confirmed by the court, the lease is deemed rejected as of the conclusion of the hearing on confirmation. If the lease is rejected, the stay under section 362 and any stay under section 1301 is automatically terminated with respect to the property subject to the lease.

11 U.S.C. § 365

Pub. L. 95-598, Nov. 6, 1978, 92 Stat. 2574; Pub. L. 98-353, title III, §§362, 402-404, July 10, 1984, 98 Stat. 361, 367; Pub. L. 99-554, title II, §§257(j), (m), 283(e), Oct. 27, 1986, 100 Stat. 3115, 3117; Pub. L. 100-506, §1(b), Oct. 18, 1988, 102 Stat. 2538; Pub. L. 101-647, title XXV, §2522(c), Nov. 29, 1990, 104 Stat. 4866; Pub. L. 102-365, §19(b)-(e), Sept. 3, 1992, 106 Stat. 982-984; Pub. L. 103-394, title II, §§205(a), 219, title V, §501(d)(10), Oct. 22, 1994, 108 Stat. 4122, 4128, 4145; Pub. L. 103-429, §1, Oct. 31, 1994, 108 Stat. 4377; Pub. L. 109-8, title III, §§309(b), 328, title IV, §404, Apr. 20, 2005, 119 Stat. 82, 100, 104; Pub. L. 116-260 div. FF, title X, §1001(f)(1), (2)(A), Dec. 27, 2020, 134 Stat. 3219.

Amendment of Subsection (d) *Pub. L. 116-260 div. FF, title X, §1001(f)(2)(A), Dec. 27, 2020, 134 Stat. 3219, provided that, effective on the date that is 2 years after Dec. 27, 2020, subsection (d) of this section is amended: (1) in paragraph (3)-(A) by striking "(A)" after "(3)";(B) by striking ", except as provided in subparagraph (B)" after "such 60-day period"; and(C) by striking subparagraphs (B) and (C); and(2) in paragraph (4), by striking "210" each place it appears and inserting "120".See 2020 Amendment notes below.*

HISTORICAL AND REVISION NOTES

LEGISLATIVE STATEMENTS*Section 365(b)(3) represents a compromise between H.R. 8200 as passed by the House and the Senate amendment. The provision adopts standards contained in section 365(b)(5) of the Senate amendment to define adequate assurance of future performance of a lease of real property in a shopping center.Section 365(b)(4) of the House amendment indicates that after default the trustee may not require a lessor* *to supply services or materials without assumption unless the lessor is compensated as provided in the lease.Section 365(c)(2) and (3) likewise represent a compromise between H.R. 8200 as passed by the House and the Senate amendment. Section 365(c)(2) is derived from section 365(b)(4) of the Senate amendment but does not apply to a contract to deliver equipment as provided in the Senate amendment. As contained in the House amendment, the provision prohibits a trustee or debtor in possession from assuming or assigning an executory contract of the debtor to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or the issuance of a security of the debtor.Section 365(e) is a refinement of comparable provisions contained in the House bill and Senate amendment. Sections 365(e)(1) and (2)(A) restate section 365(e) of H.R. 8200 as passed by the House. Sections 365(e)(2)(B) expands the section to permit termination of an executory contract or unexpired lease of the debtor if such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or for the issuance of a security of the debtor.Characterization of contracts to make a loan, or extend other debt financing or financial accommodations, is limited to the extension of cash or a line of credit and is not intended to embrace ordinary leases or contracts to provide goods or services with payments to be made over time.Section 365(f) is derived from H.R. 8200 as passed by the House. Deletion of language in section 365(f)(3) of the Senate amendment is done as a matter of style. Restrictions with respect to assignment of an executory contract or unexpired lease are superfluous since the debtor may assign an executory contract or unexpired lease of the debtor only if such contract is first assumed under section 364(f)(2)(A) of the House amendment.Section 363(h) of the House amendment represents a modification of section 365(h) of the Senate amendment. The House amendment makes clear that in the case of a bankrupt lessor, a lessee may remain in possession for the balance of the term of a lease and any renewal or extension of the term only to the extent that such renewal or extension may be obtained by the lessee without the permission of the landlord or some third party under applicable non-bankruptcy law.*

SENATE REPORT NO. 95-989*Subsection (a) of this section authorizes the trustee, subject to the court's approval, to assume or reject an executory contract or unexpired lease. Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides. A note is not usually an executory contract if the only performance that remains is repayment. Performance on one side of the contract would have been completed and the contract is no longer executory.Because of the volatile nature of the commodities markets and the special provisions governing commodity broker liquidations in subchapter IV of chapter 7, the provisions governing distribution in section 765(a) will govern if any conflict between those provisions and the provisions of this section arise.Subsections (b), (c), and (d) provide limitations on the trustee's powers. Subsection (b) requires the trustee to cure any default in the contract or lease and to provide adequate assurance of future performance if there has been a default, before he may assume. This provision does not apply to defaults under ipso facto or bankruptcy clauses, which is a significant departure from present law.Subsection (b)(3) permits termination of leases entered into prior to the effective date of this title in liquidation cases if certain other conditions are met.Subsection (b)(4) [enacted as (c)(2)] prohibits the trustee's assumption of an executory contract requiring the other party to make a loan or deliver equipment to or to issue a security of the debtor. The purpose of this subsection is to make it clear that a party to a transaction which is based upon the financial strength of a debtor should not be required to extend new credit to the debtor whether in the form of loans, lease financing, or the purchase or discount of notes.Subsection (b)(5) provides that in lease situations common to shopping centers, protections must be provided for the lessor if the trustee assumes the lease, including protection against decline in percentage rents, breach of agreements with other tenants, and preservation of the tenant mix. Protection for tenant mix will not be required in the office building situation.Subsection (c) prohibits the trustee from assuming or assigning a contract or lease if applicable nonbankruptcy law excuses the other party from performance to someone other than the debtor, unless the other* *party consents. This prohibition applies only in the situation in which applicable law excuses the other party from performance independent of any restrictive language in the contract or lease itself.Subsection (d) places time limits on assumption and rejection. In a liquidation case, the trustee must assume within 60 days (or within an additional 60 days, if the court, for cause, extends the time). If not assumed, the contract or lease is deemed rejected. In a rehabilitation case, the time limit is not fixed in the bill. However, if the other party to the contract or lease requests the court to fix a time, the court may specify a time within which the trustee must act. This provision will prevent parties in contractual or lease relationships with the debtor from being left in doubt concerning their status vis-a-vis the estate.Subsection (e) invalidates ipso facto or bankruptcy clauses. These clauses, protected under present law, automatically terminate the contract or lease, or permit the other contracting party to terminate the contract or lease, in the event of bankruptcy. This frequently hampers rehabilitation efforts. If the trustee may assume or assign the contract under the limitations imposed by the remainder of the section, the contract or lease may be utilized to assist in the debtor's rehabilitation or liquidation.The unenforcibility [sic] of ipso facto or bankruptcy clauses proposed under this section will require the courts to be sensitive to the rights of the nondebtor party to executory contracts and unexpired leases. If the trustee is to assume a contract or lease, the court will have to insure that the trustee's performance under the contract or lease gives the other contracting party the full benefit of his bargain.This subsection does not limit the application of an ipso facto or bankruptcy clause if a new insolvency or receivership occurs after the bankruptcy case is closed. That is, the clause is not invalidated in toto, but merely made inapplicable during the case for the purposes of disposition of the executory contract or unexpired lease.Subsection (f) partially invalidates restrictions on assignment of contracts or leases by the trustee to a third party. The subsection imposes two restrictions on the trustee: he must first assume the contract or lease, subject to all the restrictions on assumption found in the section, and adequate assurance of future performance must be provided to the other contracting party. Paragraph (3) of the subsection invalidates contractual provisions that permit termination or modification in the event of an assignment, as contrary to the policy of this subsection.Subsection (g) defines the time as of which a rejection of an executory contract or unexpired lease constitutes a breach of the contract or lease. Generally, the breach is as of the date immediately preceding the date of the petition. The purpose is to treat rejection claims as prepetition claims. The remainder of the subsection specifies different times for cases that are converted from one chapter to another. The provisions of this subsection are not a substantive authorization to breach or reject an assumed contract. Rather, they prescribe the rules for the allowance of claims in case an assumed contract is breached, or if a case under chapter 11 in which a contract has been assumed is converted to a case under chapter 7 in which the contract is rejected.Subsection (h) protects real property lessees of the debtor if the trustee rejects an unexpired lease under which the debtor is the lessor (or sublessor). The subsection permits the lessee to remain in possession of the leased property or to treat the lease as terminated by the rejection. The balance of the term of the lease referred to in paragraph (1) will include any renewal terms that are enforceable by the tenant, but not renewal terms if the landlord had an option to terminate. Thus, the tenant will not be deprived of his estate for the term for which he bargained. If the lessee remains in possession, he may offset the rent reserved under the lease against damages caused by the rejection, but does not have any affirmative rights against the estate for any damages after the rejection that result from the rejection.Subsection (i) gives a purchaser of real property under a land installment sales contract similar protection. The purchaser, if the contract is rejected, may remain in possession or may treat the contract as terminated. If the purchaser remains in possession, he is required to continue to make the payments due, but may offset damages that occur after rejection. The trustee is required to deliver title, but is relieved of all other obligations to perform.A purchaser that treats the contract as terminated is granted a lien on the property to the extent of the purchase price paid. A* *party with a contract to purchase land from the debtor has a lien on the property to secure the price already paid, if the contract is rejected and the purchaser is not yet in possession.Subsection (k) relieves the trustee and the estate of liability for a breach of an assigned contract or lease that occurs after the assignment.*

HOUSE REPORT NO. 95-595*Subsection (c) prohibits the trustee from assuming or assigning a contract or lease if applicable nonbankruptcy law excuses the other party from performance to someone other than the debtor, unless the other party consents. This prohibition applies only in the situation in which applicable law excuses the other party from performance independent of any restrictive language in the contract or lease itself. The purpose of this subsection, at least in part, is to prevent the trustee from requiring new advances of money or other property. The section permits the trustee to continue to use and pay for property already advanced, but is not designed to permit the trustee to demand new loans or additional transfers of property under lease commitments.Thus, under this provision, contracts such as loan commitments and letters of credit are nonassignable, and may not be assumed by the trustee.Subsection (e) invalidates ipso facto or bankruptcy clauses. These clauses, protected under present law, automatically terminate the contract or lease, or permit the other contracting party to terminate the contract or lease, in the event of bankruptcy. This frequently hampers rehabilitation efforts. If the trustee may assume or assign the contract under the limitations imposed by the remainder of the section, then the contract or lease may be utilized to assist in the debtor's rehabilitation or liquidation.The unenforceability of ipso facto or bankruptcy clauses proposed under this section will require the courts to be sensitive to the rights of the nondebtor party to executory contracts and unexpired leases. If the trustee is to assume a contract or lease, the courts will have to insure that the trustee's performance under the contract or lease gives the other contracting party the full benefit of his bargain. An example of the complexity that may arise in these situations and the need for a determination of all aspects of a particular executory contract or unexpired lease is the shopping center lease under which the debtor is a tenant in a shopping center.A shopping center is often a carefully planned enterprise, and though it consists of numerous individual tenants, the center is planned as a single unit, often subject to a master lease or financing agreement. Under these agreements, the tenant mix in a shopping center may be as important to the lessor as the actual promised rental payments, because certain mixes will attract higher patronage of the stores in the center, and thus a higher rental for the landlord from those stores that are subject to a percentage of gross receipts rental agreement. Thus, in order to assure a landlord of his bargained for exchange, the court would have to consider such factors as the nature of the business to be conducted by the trustee or his assignee, whether that business complies with the requirements of any master agreement, whether the kind of business proposed will generate gross sales in an amount such that the percentage rent specified in the lease is substantially the same as what would have been provided by the debtor, and whether the business proposed to be conducted would result in a breach of other clauses in master agreements relating, for example, to tenant mix and location.This subsection does not limit the application of an ipso facto or bankruptcy clause to a new insolvency or receivership after the bankruptcy case is closed. That is, the clause is not invalidated in toto, but merely made inapplicable during the case for the purpose of disposition of the executory contract or unexpired lease.*

EDITORIAL NOTES

AMENDMENTS2020-*Subsec. (d)(3). Pub. L. 116-260, §1001(f)(2)(A)(i), struck out subpar. (A) designation before "The trustee", ", except as provided in subparagraph (B)" after "such 60-day period" and subpars. (B) and (C). Prior to amendment, subpars. (B) and (C) related to extension of time for performance in case under subchapter V of chapter 11 where there was financial hardship due, directly or indirectly, to the coronavirus disease 2019 (COVID-19) pandemic and treatment of obligation as certain administrative expense, respectively. Pub. L. 116-260, §1001(f)(1)(A), designated existing provisions as subpar. (A), inserted ", except as provided in* *subparagraph (B)" after "such 60-day period" and added subpars. (B) and (C).Subsec. (d)(4). Pub. L. 116-260, §1001(f)(2)(A)(ii), substituted "120" for "210" in two places. Pub. L. 116-260, §1001(f)(1)(B), substituted "210" for "120" in two places.**2005**-Subsec. (b)(1)(A). Pub. L. 109-8, §328(a)(1)(A), inserted before semicolon at end "other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph".Subsec. (b)(2)(D). Pub. L. 109-8, §328(a)(1)(B), substituted "penalty rate or penalty provision" for "penalty rate or provision".Subsec. (c)(4). Pub. L. 109-8, §328(a)(2), struck out par. (4) which read as follows: "such lease is of nonresidential real property under which the debtor is the lessee of an aircraft terminal or aircraft gate at an airport at which the debtor is the lessee under one or more additional nonresidential leases of an aircraft terminal or aircraft gate and the trustee, in connection with such assumption or assignment, does not assume all such leases or does not assume and assign all of such leases to the same person, except that the trustee may assume or assign less than all of such leases with the airport operator's written consent."Subsec. (d)(4). Pub. L. 109-8, §404(a), amended par. (4) generally. Prior to amendment, par. (4) read as follows: "Notwithstanding paragraphs (1) and (2), in a case under any chapter of this title, if the trustee does not assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee within 60 days after the date of the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and the trustee shall immediately surrender such nonresidential real property to the lessor."Subsec. (d)(5) to (10). Pub. L. 109-8, §328(a)(3), redesignated par. (10) as (5) and struck out former pars. (5) to (9) which related to rejection of leases under which the debtor is an affected air carrier that is the lessee of an aircraft terminal or aircraft gate.Subsec. (f)(1). Pub. L. 109-8, §404(b), substituted "provided in subsections (b) and" for "provided in subsection". Pub. L. 109-8, §328(a)(4), struck out "; except that the trustee may not assign an unexpired lease of nonresidential real property under which the debtor is an affected air carrier that is the lessee of an aircraft terminal or aircraft gate if there has occurred a termination event" before period at end.Subsec. (p). Pub. L. 109-8, §309(b), added subsec. (p).**1994**-Subsec. (b)(2)(D). Pub. L. 103-394, §219(a), added subpar. (D).Subsec. (d)(6)(C). Pub. L. 103-429, §1(1), substituted "section 40102(a) of title 49" for "section 101 of the Federal Aviation Act of 1958 (49 App. U.S.C. 1301)". Pub. L. 103-394, §501(d)(10)(A), which directed the substitution of "section 40102 of title 49" for "the Federal Aviation Act of 1958 (49 U.S.C. 1301)", could not be executed because the phrase "(49 U.S.C. 1301)" did not appear in text.Subsec. (d)(10). Pub. L. 103-394, §219(b), added par. (10).Subsec. (g)(2)(A), (B). Pub. L. 103-394, §501(d)(10)(B), substituted "1208, or 1307" for "1307, or 1208".Subsec. (h). Pub. L. 103-394, §205(a), amended subsec. (h) generally. Prior to amendment, subsec. (h) read as follows:"(h)(1) If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, or a timeshare interest under a timeshare plan under which the debtor is the timeshare interest seller, the lessee or timeshare interest purchaser under such lease or timeshare plan may treat such lease or timeshare plan as terminated by such rejection, where the disaffirmance by the trustee amounts to such a breach as would entitle the lessee or timeshare interest purchaser to treat such lease or timeshare plan as terminated by virtue of its own terms, applicable nonbankruptcy law, or other agreements the lessee or timeshare interest purchaser has made with other parties; or, in the alternative, the lessee or timeshare interest purchaser may remain in possession of the leasehold or timeshare interest under any lease or timeshare plan the term of which has commenced for the balance of such term and for any renewal or extension of such term that is enforceable by such lessee or timeshare interest purchaser under applicable nonbankruptcy law."(2) If such lessee* *or timeshare interest purchaser remains in possession as provided in paragraph (1) of this subsection, such lessee or timeshare interest purchaser may offset against the rent reserved under such lease or moneys due for such timeshare interest for the balance of the term after the date of the rejection of such lease or timeshare interest, and any such renewal or extension thereof, any damages occurring after such date caused by the nonperformance of any obligation of the debtor under such lease or timeshare plan after such date, but such lessee or timeshare interest purchaser does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset."Subsec. (n)(1)(B). Pub. L. 103-394, §501(d)(10)(C), substituted "a right to" for "a right to to".Subsec. (o). Pub. L. 103-394, §501(d)(10)(D), substituted "a Federal depository institutions regulatory agency (or predecessor to such agency)" for "the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the Director of the Office of Thrift Supervision, the Comptroller of the Currency, or the Board of Governors of the Federal Reserve System, or its predecessors or successors,".Subsec. (p). Pub. L. 103-429, §1(2), which directed the amendment of subsec. (p) by substituting "section 40102(a) of title 49" for "section 101(3) of the Federal Aviation Act of 1958", could not be executed because subsec. (p) was repealed by Pub. L. 103-394, §501(d)(10)(E). See below. Pub. L. 103-394, §501(d)(10)(E), struck out subsec. (p), which read as follows: "In this section, 'affected air carrier' means an air carrier, as defined in section 101(3) of the Federal Aviation Act of 1958, that holds 65 percent or more in number of the aircraft gates at an airport-"(1) which is a Large Air Traffic Hub as defined by the Federal Aviation Administration in Report FAA-AP 92-1, February 1992; and"(2) all of whose remaining aircraft gates are leased or under contract on the date of enactment of this subsection."**1992**-Subsec. (c)(4). Pub. L. 102-365, §19(c), added par. (4).Subsec. (d)(5) to (9). Pub. L. 102-365, §19(b), added pars. (5) to (9).Subsec. (f)(1). Pub. L. 102-365, §19(d), substituted for period at end "; except that the trustee may not assign an unexpired lease of nonresidential real property under which the debtor is an affected air carrier that is the lessee of an aircraft terminal or aircraft gate if there has occurred a termination event."Subsec. (p). Pub. L. 102-365, §19(e), added subsec. (p).**1990**-Subsec. (o). Pub. L. 101-647 added subsec. (o).**1988**-Subsec. (n). Pub. L. 100-506 added subsec. (n).**1986**-Subsec. (c)(1)(A). Pub. L. 99-554, §283(e)(1), struck out "or an assignee of such contract or lease" after "debtor in possession".Subsec. (c)(3). Pub. L. 99-554, §283(e)(2), inserted "is" after "lease" and "and" after "property".Subsecs. (d)(2), (g)(1). Pub. L. 99-554, §257(j), (m) (1), inserted reference to chapter 12.Subsec. (g)(2). Pub. L. 99-554, §257(m)(2), inserted references to chapter 12 and section 1208 of this title.Subsec. (h)(1). Pub. L. 99-554, §283(e)(2), inserted "or timeshare plan" after "to treat such lease".Subsec. (m). Pub. L. 99-554, §283(e)(3), substituted "362(b)(10)" for "362(b)(9)".**1984**-Subsec. (a). Pub. L. 98-353, §362(a), amended subsec. (a) generally, making minor changes.Subsec. (b). Pub. L. 98-353, §362(a), amended subsec. (b) generally, inserting in par. (3) reference to par. (2)(B) of subsec. (f) of this section, in par. (3)(A) inserting provisions relating to financial condition and operating performance in the case of an assignment, and in par. (3)(C) substituting "that assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center" for "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".Subsec. (c). Pub. L. 98-353, §362(a), amended subsec. (c) generally, substituting in par. (1)(A) "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession or an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties" for "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties" and adding par. (3).Subsec. (d). Pub. L. 98-353,*

§362(a), amended subsec. (d) generally, inserting in par. (1) reference to residential real property or personal property of the debtor, inserting in par. (2) reference to residential real property or personal property of the debtor, and adding pars. (3) and (4).Subsec. (h)(1). Pub. L. 98-353, §402, amended par. (1) generally. Prior to amendment, par. (1) read as follows: "If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, the lessee under such lease may treat the lease as terminated by such rejection, or, in the alternative, may remain in possession for the balance of the term of such lease and any renewal or extension of such term that is enforceable by such lessee under applicable nonbankruptcy law."Subsec. (h)(2). Pub. L. 98-353, §403, amended par. (2) generally. Prior to amendment, par. (2) read as follows: "If such lessee remains in possession, such lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease, and any such renewal or extension, any damages occurring after such date caused by the nonperformance of any obligation of the debtor after such date, but such lessee does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset."Subsec. (i)(1). Pub. L. 98-353, §404, amended par. (1) generally, inserting provisions relating to timeshare interests under timeshare plans.Subsecs. (l), (m). Pub. L. 98-353, §362(b), added subsecs. (l) and (m).

STATUTORY NOTES AND RELATED SUBSIDIARIES

EFFECTIVE DATE OF 2020 AMENDMENT *Pub. L. 116-260 div. FF, title X, §1001(f)(2)(A), Dec. 27, 2020, 134 Stat. 3219, provided that the amendment made by section 1001(f)(2)(A) is effective on the date that is 2 years after Dec. 27, 2020. Pub. L. 116-260 div. FF, title X, §1001(f)(2)(B), Dec. 27, 2020, 134 Stat. 3219, provided that: "Notwithstanding the amendments made by subparagraph (A) [amending this section], the amendments made by paragraph (1) [amending this section] shall apply in any case commenced under subchapter V of chapter 11 of title 11, United States Code, before the date that is 2 years after the date of enactment of this Act [Dec. 27. 2020]."*

EFFECTIVE DATE OF 2005 AMENDMENT*Amendment by Pub. L. 109-8 effective 180 days after Apr. 20, 2005, and not applicable with respect to cases commenced under this title before such effective date, except as otherwise provided, see section 1501 of Pub. L. 109-8 set out as a note under section 101 of this title.*

EFFECTIVE DATE OF 1994 AMENDMENT*Amendment by Pub. L. 103-394 effective Oct. 22, 1994, and not applicable with respect to cases commenced under this title before Oct. 22, 1994, see section 702 of Pub. L. 103-394 set out as a note under section 101 of this title.*

EFFECTIVE DATE OF 1992 AMENDMENT *Pub. L. 102-365, §19(f), Sept. 2, 1992, 106 Stat. 984, provided that: "The amendments made by this section [amending this section] shall be in effect for the 12-month period that begins on the date of enactment of this Act [Sept. 3, 1992] and shall apply in all proceedings involving an affected air carrier (as defined in section 365(p) of title 11, United States Code, as amended by this section) that are pending during such 12-month period. Not later than 9 months after the date of enactment, the Administrator of the Federal Aviation Administration shall report to the Committee on Commerce, Science, and Transportation and Committee on the Judiciary of the Senate and the Committee on the Judiciary and Committee on Public Works and Transportation of the House of Representatives on whether this section shall apply to proceedings that are commenced after such 12-month period."*

EFFECTIVE DATE OF 1988 AMENDMENT*Amendment by Pub. L. 100-506 effective Oct. 18, 1988, but not applicable to any case commenced under this title before such date, see section 2 of Pub. L. 100-506 set out as a note under section 101 of this title.*

EFFECTIVE DATE OF 1986 AMENDMENT*Amendment by section 257 of Pub. L. 99-554 effective 30 days after Oct. 27, 1986, but not applicable to cases commenced under this title before that date, see section 302(a), (c)(1) of Pub. L. 99-554 set out as a note under section 581 of Title 28, Judiciary and Judicial Procedure.Amendment by section 283 of Pub. L. 99-554 effective 30 days after Oct. 27, 1986, see section 302(a) of Pub. L. 99-554.*

EFFECTIVE DATE OF 1984 AMENDMENT*Amendment by Pub. L. 98-353 effective with respect to cases filed 90 days after July 10, 1984, see section 552(a) of Pub. L. 98-353 set out as a note under section 101 of this title.*

AIRPORT LEASES *Pub. L. 102-365, §19(a), Sept. 2, 1992, 106 Stat. 982, provided that: "Congress finds that-"(1) there are major airports served by an air carrier that has leased a substantial majority of the airport's gates;"(2) the commerce in the region served by such a major airport can be disrupted if the air carrier that leases most of its gates enters bankruptcy and either discontinues or materially reduces service; and"(3) it is important that such airports be empowered to continue service in the event of such a disruption."*

11 U.S.C. § 363

Section 363 - Use, sale, or lease of property

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

(b)

(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate, except that if the debtor in connection with offering a product or a service discloses to an individual a policy prohibiting the transfer of personally identifiable information about individuals to persons that are not affiliated with the debtor and if such policy is in effect on the date of the commencement of the case, then the trustee may not sell or lease personally identifiable information to any person unless-

(A) such sale or such lease is consistent with such policy; or

(B) after appointment of a consumer privacy ombudsman in accordance with section 332, and after notice and a hearing, the court approves such sale or such lease-

(i) giving due consideration to the facts, circumstances, and conditions of such sale or such lease; and

(ii) finding that no showing was made that such sale or such lease would violate applicable nonbankruptcy law.

(2) If notification is required under subsection (a) of section 7A of the Clayton Act in the case of a transaction under this subsection, then-

(A) notwithstanding subsection (a) of such section, the notification required by such subsection to be given by the debtor shall be given by the trustee; and

(B) notwithstanding subsection (b) of such section, the required waiting period shall end on the 15th day after the date of the receipt, by the Federal Trade Commission and the Assistant Attorney General in charge of the Antitrust Division of the Department of Justice, of the notification required under such subsection (a), unless such waiting period is extended-

(i) pursuant to subsection (e)(2) of such section, in the same manner as such subsection (e)(2) applies to a cash tender offer;

(ii) pursuant to subsection (g)(2) of such section; or

(iii) by the court after notice and a hearing.

(c)

(1) If the business of the debtor is authorized to be operated under section 721, 1108, 1183, 1184, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.

(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless-

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

(3) Any hearing under paragraph (2)(B) of this subsection may be a preliminary hearing or may be consolidated with a hearing under subsection (e) of this section, but shall be scheduled in accordance with the needs of the debtor. If the hearing under paragraph (2)(B) of this subsection is a preliminary hearing, the court may authorize such use, sale, or lease only if there is a reasonable likelihood that the trustee will prevail at the final hearing under subsection (e) of this section. The court shall act promptly on any request for authorization under paragraph (2)(B) of this subsection.

(4) Except as provided in paragraph (2) of this subsection, the trustee shall segregate and account for any cash collateral in the trustee's possession, custody, or control.

(d) The trustee may use, sell, or lease property under subsection (b) or (c) of this section-

(1) in the case of a debtor that is a corporation or trust that is not a moneyed business, commercial corporation, or trust, only in accordance with nonbankruptcy law applicable to the transfer of property by a debtor that is such a corporation or trust; and

(2) only to the extent not inconsistent with any relief granted under subsection (c), (d), (e), or (f) of section 362.

(e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. This subsection also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under section 362).

(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, only if-

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

(g) Notwithstanding subsection (f) of this section, the trustee may sell property under subsection (b) or (c) of this section free and clear of any vested or contingent right in the nature of dower or curtesy.

(h) Notwithstanding subsection (f) of this section, the trustee may sell both the estate's interest, under subsection (b) or (c) of this section, and the interest of any co-owner in property in which the debtor had, at the time of the commencement of the case, an undivided interest as a tenant in common, joint tenant, or tenant by the entirety, only if-

(1) partition in kind of such property among the estate and such co-owners is impracticable;

(2) sale of the estate's undivided interest in such property would realize significantly less for the estate than sale of such property free of the interests of such co-owners;

(3) the benefit to the estate of a sale of such property free of the interests of co-owners outweighs the detriment, if any, to such co-owners; and

(4) such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.

(i) Before the consummation of a sale of property to which subsection (g) or (h) of this section applies, or of property of the estate that was community property of the debtor and the debtor's spouse immediately before the commencement of the case, the debtor's spouse, or a co-owner of such property, as the case may be, may purchase such property at the price at which such sale is to be consummated.

(j) After a sale of property to which subsection (g) or (h) of this section applies, the trustee shall distribute to the debtor's spouse or the co-owners of such property, as the case may be, and to the estate, the proceeds of such sale, less the costs and expenses, not including any compensation of the trustee, of such sale, according to the interests of such spouse or co-owners, and of the estate.

(k) At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

(l) Subject to the provisions of section 365, the trustee may use, sell, or lease property under subsection (b) or (c) of this section, or a plan under chapter 11, 12, or 13 of this title may provide for the use, sale, or lease of property, notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title concerning the debtor, or on the appointment of or the taking possession by a trustee in a case under this title or a custodian, and that effects, or gives an option to effect, a forfeiture, modification, or termination of the debtor's interest in such property.

(m) The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

(n) The trustee may avoid a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale, or may recover from a party to such agreement any amount by which the value of the property sold exceeds the price at which such sale was consummated, and may recover any costs, attorneys' fees, or expenses incurred in avoiding such sale or recovering such amount. In addition to any recovery under the preceding sentence, the court may grant judgment for punitive damages in favor of the estate and against any such party that entered into such an agreement in willful disregard of this subsection.

(o) Notwithstanding subsection (f), if a person purchases any interest in a consumer credit transaction that is subject to the Truth in Lending Act or any interest in a consumer credit contract (as defined in section 433.1 of title 16 of the Code of Federal Regulations (January 1, 2004), as amended from time to time), and if such interest is purchased through a sale under this section, then such person shall remain subject to all claims and defenses that are related to such consumer credit transaction or such consumer credit contract, to the same extent as such person would be subject to such claims and defenses of the consumer had such interest been purchased at a sale not under this section.

(p) In any hearing under this section-

(1) the trustee has the burden of proof on the issue of adequate protection; and

(2) the entity asserting an interest in property has the burden of proof on the issue of the validity, priority, or extent of such interest.

11 U.S.C. § 363

Pub. L. 95-598, Nov. 6, 1978, 92 Stat. 2572; Pub. L. 98-353, title III, §442, July 10, 1984, 98 Stat. 371; Pub. L. 99-554, title II, §257(k), Oct. 27, 1986, 100 Stat. 3115; Pub. L. 103-394, title I, §109, title II, §§214(b), 219(c), title V, §501(d)(8), Oct. 22, 1994, 108 Stat. 4113, 4126, 4129, 4144; Pub. L. 109-8, title II, §§204, 231, title XII, §1221(a), Apr. 20, 2005, 119 Stat. 49, 72, 195; Pub. L. 111-327, §2(a)(13), Dec. 22, 2010, 124 Stat. 3559; Pub. L. 116-54, §4(a)(6), Aug. 23, 2019, 133 Stat. 1086.

HISTORICAL AND REVISION NOTES

LEGISLATIVE STATEMENTS_Section 363(a) of the House amendment defines "cash collateral" as defined in the Senate amendment. The broader definition of "soft collateral" contained in H.R. 8200 as passed by the House is deleted to remove limitations that were placed on the use, lease, or sale of inventory, accounts, contract rights, general intangibles, and chattel paper by the trustee or debtor in possession.Section 363(c)(2) of the House amendment is derived from the Senate amendment. Similarly, sections 363(c)(3) and (4) are derived from comparable provisions in the Senate amendment in lieu of the contrary procedure contained in section 363(c) as passed by the House. The policy of the House amendment will generally require the court to schedule a preliminary hearing in accordance with the needs of the debtor to authorize the trustee or debtor in possession to_ *use, sell, or lease cash collateral. The trustee or debtor in possession may use, sell, or lease cash collateral in the ordinary course of business only "after notice and a hearing."Section 363(f) of the House amendment adopts an identical provision contained in the House bill, as opposed to an alternative provision contained in the Senate amendment.Section 363(h) of the House amendment adopts a new paragraph (4) representing a compromise between the House bill and Senate amendment. The provision adds a limitation indicating that a trustee or debtor in possession sell jointly owned property only if the property is not used in the production, transmission, or distribution for sale, of electric energy or of natural or synthetic gas for heat, light, or power. This limitation is intended to protect public utilities from being deprived of power sources because of the bankruptcy of a joint owner.Section 363(k) of the House amendment is derived from the third sentence of section 363(e) of the Senate amendment. The provision indicates that a secured creditor may bid in the full amount of the creditor's allowed claim, including the secured portion and any unsecured portion thereof in the event the creditor is undersecured, with respect to property that is subject to a lien that secures the allowed claim of the sale of the property.*

SENATE REPORT NO. 95-989*This section defines the right and powers of the trustee with respect to the use, sale or lease of property and the rights of other parties that have interests in the property involved. It applies in both liquidation and reorganization cases.Subsection (a) defines "cash collateral" as cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents in which the estate and an entity other than the estate have an interest, such as a lien or a co-ownership interest. The definition is not restricted to property of the estate that is cash collateral on the date of the filing of the petition. Thus, if "non-cash" collateral is disposed of and the proceeds come within the definition of "cash collateral" as set forth in this subsection, the proceeds would be cash collateral as long as they remain subject to the original lien on the "non-cash" collateral under section 552(b). To illustrate, rents received from real property before or after the commencement of the case would be cash collateral to the extent that they are subject to a lien.Subsection (b) permits the trustees to use, sell, or lease, other than in the ordinary course of business, property of the estate upon notice and opportunity for objections and hearing thereon.Subsection (c) governs use, sale, or lease in the ordinary course of business. If the business of the debtor is authorized to be operated under §721, 1108, or 1304 of the bankruptcy code, then the trustee may use, sell, or lease property in the ordinary course of business or enter into ordinary course transactions without need for notice and hearing. This power is subject to several limitations. First, the court may restrict the trustee's powers in the order authorizing operation of the business. Second, with respect to cash collateral, the trustee may not use, sell, or lease cash collateral except upon court authorization after notice and a hearing, or with the consent of each entity that has an interest in such cash collateral. The same preliminary hearing procedure in the automatic stay section applies to a hearing under this subsection. In addition, the trustee is required to segregate and account for any cash collateral in the trustee's possession, custody, or control.Under subsections (d) and (e), the use, sale, or lease of property is further limited by the concept of adequate protection. Sale, use, or lease of property in which an entity other than the estate has an interest may be effected only to the extent not inconsistent with any relief from the stay granted to that interest's holder. Moreover, the court may prohibit or condition the use, sale, or lease as is necessary to provide adequate protection of that interest. Again, the trustee has the burden of proof on the issue of adequate protection. Subsection (e) also provides that where a sale of the property is proposed, an entity that has an interest in such property may bid at the sale thereof and set off against the purchase price up to the amount of such entity's claim. No prior valuation under section 506(a) would limit this bidding right, since the bid at the sale would be determinative of value.Subsection (f) permits sale of property free and clear of any interest in the property of an entity other than the estate. The trustee may sell free and clear if applicable nonbankruptcy law permits it, if the other entity consents, if the interest is a lien and the sale price of the property is greater than the amount secured by the lien, if the interest is in bona fide dispute, or if the other entity could be compelled to accept a money* *satisfaction of the interest in a legal or equitable proceeding. Sale under this subsection is subject to the adequate protection requirement. Most often, adequate protection in connection with a sale free and clear of other interests will be to have those interests attach to the proceeds of the sale.At a sale free and clear of other interests, any holder of any interest in the property being sold will be permitted to bid. If that holder is the high bidder, he will be permitted to offset the value of his interest against the purchase price of the property. Thus, in the most common situation, a holder of a lien on property being sold may bid at the sale and, if successful, may offset the amount owed to him that is secured by the lien on the property (but may not offset other amounts owed to him) against the purchase price, and be liable to the trustee for the balance of the sale price, if any.Subsection (g) permits the trustee to sell free and clear of any vested or contingent right in the nature of dower or curtesy.Subsection (h) permits sale of a co-owner's interest in property in which the debtor had an undivided ownership interest such as a joint tenancy, a tenancy in common, or a tenancy by the entirety. Such a sale is permissible only if partition is impracticable, if sale of the estate's interest would realize significantly less for the estate that sale of the property free of the interests of the co-owners, and if the benefit to the estate of such a sale outweighs any detriment to the co-owners. This subsection does not apply to a co-owner's interest in a public utility when a disruption of the utilities services could result.Subsection (i) provides protections for co-owners and spouses with dower, curtesy, or community property rights. It gives a right of first refusal to the co-owner or spouse at the price at which the sale is to be consummated.Subsection (j) requires the trustee to distribute to the spouse or co-owner the appropriate portion of the proceeds of the sale, less certain administrative expenses.Subsection (k) [enacted as (l)] permits the trustee to use, sell, or lease property notwithstanding certain bankruptcy or ipso facto clauses that terminate the debtor's interest in the property or that work a forfeiture or modification of that interest. This subsection is not as broad as the anti-ipso facto provision in proposed 11 U.S.C. 541(c)(1).Subsection (l) [enacted as (m)] protects good faith purchasers of property sold under this section from a reversal on appeal of the sale authorization, unless the authorization for the sale and the sale itself were stayed pending appeal. The purchaser's knowledge of the appeal is irrelevant to the issue of good faith.Subsection (m) [enacted as (n)] is directed at collusive bidding on property sold under this section. It permits the trustee to void a sale if the price of the sale was controlled by an agreement among potential bidders. The trustees may also recover the excess of the value of the property over the purchase price, and may recover any costs, attorney's fees, or expenses incurred in voiding the sale or recovering the difference. In addition, the court is authorized to grant judgment in favor of the estate and against the collusive bidder if the agreement controlling the sale price was entered into in willful disregard of this subsection. The subsection does not specify the precise measure of damages, but simply provides for punitive damages, to be fixed in light of the circumstances.*

EDITORIAL NOTES

REFERENCES IN TEXT*Section 7A of the Clayton Act, referred to in subsec. (b)(2), is classified to section 18a of Title 15, Commerce and Trade.The Truth in Lending Act, referred to in subsec. (o), is title I of Pub. L. 90-321, May 29, 1968, 82 Stat. 146, as amended, which is classified generally to subchapter I (§1601 et seq.) of chapter 41 of Title 15, Commerce and Trade. For complete classification of this Act to the Code, see Short Title note set out under section 1601 of Title 15 and Tables.*

AMENDMENTS2019*-Subsec. (c)(1). Pub. L. 116-54 inserted "1183, 1184," after "1108,".* ***2010****-Subsec. (d). Pub. L. 111-327, §2(a)(13)(A), struck out "only" before dash at end of introductory provisions.Subsec. (d)(1). Pub. L. 111-327, §2(a)(13)(B), amended par. (1) generally. Prior to amendment, par. (1) read as follows: "in accordance with applicable nonbankruptcy law that governs the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust; and".Subsec. (d)(2). Pub. L. 111-327, §2(a)(13)(C), inserted "only" before "to the extent".* ***2005****-Subsec. (b)(1). Pub. L. 109-8, §231(a), substituted ", except that if the* *debtor in connection with offering a product or a service discloses to an individual a policy prohibiting the transfer of personally identifiable information about individuals to persons that are not affiliated with the debtor and if such policy is in effect on the date of the commencement of the case, then the trustee may not sell or lease personally identifiable information to any person unless-" and subpars. (A) and (B) for period at end.Subsec. (d). Pub. L. 109-8, §1221(a), substituted "only-" and pars. (1) and (2) for "only to the extent not inconsistent with any relief granted under section 362(c), 362(d), 362(e),or 362(f) of this title."Subsecs. (o), (p). Pub. L. 109-8, §204, added subsec. (o) and redesignated former subsec. (o) as (p).**1994-**Subsec. (a). Pub. L. 103-394, §214(b), inserted "and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties" after "property".Subsec. (b)(2). Pub. L. 103-394, §§109, 501, struck out "(15 U.S.C. 18a)" after "Clayton Act" and amended subpars. (A) and (B) generally. Prior to amendment, subpars. (A) and (B) read as follows:"(A) notwithstanding subsection (a) of such section, such notification shall be given by the trustee; and"(B) notwithstanding subsection (b) of such section, the required waiting period shall end on the tenth day after the date of the receipt of such notification, unless the court, after notice and hearing, orders otherwise."Subsec. (c)(1). Pub. L. 103-394, §501(d)(8)(B), substituted "1203, 1204, or 1304" for "1304, 1203, or 1204".Subsec. (e). Pub. L. 103-394, §219(c), inserted at end "This subsection also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under section 362)."**1986-**Subsec. (c)(1). Pub. L. 99-554, §257(k)(1), inserted reference to sections 1203 and 1204 of this title.Subsec. (l). Pub. L. 99-554, §257(k)(2), inserted reference to chapter 12.**1984-**Subsec. (a). Pub. L. 98-353, §442(a), inserted "whenever acquired" after "equivalents" and "and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title" after "interest".Subsec. (b). Pub. L. 98-353, §442(b), designated existing provisions as par. (1) and added par. (2).Subsec. (e). Pub. L. 98-353, §442(c), inserted ", with or without a hearing," after "court" and struck out "In any hearing under this section, the trustee has the burden of proof on the issue of adequate protection".Subsec. (f) (3). Pub. L. 98-353, §442(d), substituted "all liens on such property" for "such interest".Subsec. (h). Pub. L. 98-353, §442(e), substituted "at the time of" for "immediately before".Subsec. (j). Pub. L. 98-353, §442(f), substituted "compensation" for "compenation".Subsec. (k). Pub. L. 98-353, §442(g), substituted "unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder" for "if the holder".Subsec. (l). Pub. L. 98-353, §442(h), substituted "Subject to the provisions of section 365, the trustee" for "The trustee", "condition" for "conditions", "or the taking" for "a taking", and "interest" for "interests".Subsec. (n). Pub. L. 98-353, §442(i), substituted "avoid" for "void", "avoiding" for "voiding", and "In addition to any recovery under the preceding sentence, the court may grant judgment for punitive damages in favor of the estate and against any such party that entered into such an agreement in willful disregard of this subsection" for "The court may grant judgment in favor of the estate and against any such party that entered into such agreement in willful disregard of this subsection for punitive damages in addition to any recovery under the preceding sentence".Subsec. (o). Pub. L. 98-353, §442(j), added subsec. (o).*

STATUTORY NOTES AND RELATED SUBSIDIARIES

EFFECTIVE DATE OF 2019 AMENDMENT*Amendment by Pub. L. 116-54 effective 180 days after Aug. 23, 2019, see section 5 of Pub. L. 116-54 set out as a note under section 101 of this title.*

EFFECTIVE DATE OF 2005 AMENDMENT *Pub. L. 109-8, title XII, §1221(d), Apr. 20, 2005, 119 Stat. 196, provided that: "The amendments made by this section [amending this section and sections 541 and 1129 of this title and enacting provisions set out as a note under this section] shall apply to a case pending under title 11, United States Code, on the date of enactment of this Act [Apr. 20, 2005], or filed under that title on or after that* *date of enactment, except that the court shall not confirm a plan under chapter 11 of title 11, United States Code, without considering whether this section would substantially affect the rights of a party in interest who first acquired rights with respect to the debtor after the date of the filing of the petition. The parties who may appear and be heard in a proceeding under this section include the attorney general of the State in which the debtor is incorporated, was formed, or does business."Amendment by sections 204 and 231(a) of Pub. L. 109-8 effective 180 days after Apr. 20, 2005, and not applicable with respect to cases commenced under this title before such effective date, except as otherwise provided, see section 1501 of Pub. L. 109-8 set out as a note under section 101 of this title.*

EFFECTIVE DATE OF 1994 AMENDMENT*Amendment by Pub. L. 103-394 effective Oct. 22, 1994, and not applicable with respect to cases commenced under this title before Oct. 22, 1994, see section 702 of Pub. L. 103-394 set out as a note under section 101 of this title.*

EFFECTIVE DATE OF 1986 AMENDMENT*Amendment by Pub. L. 99-554 effective 30 days after Oct. 27, 1986, but not applicable to cases commenced under this title before that date, see section 302(a), (c)(1) of Pub. L. 99-554 set out as a note under section 581 of Title 28, Judiciary and Judicial Procedure.*

EFFECTIVE DATE OF 1984 AMENDMENT*Amendment by Pub. L. 98-353 effective with respect to cases filed 90 days after July 10, 1984, see section 552(a) of Pub. L. 98-353 set out as a note under section 101 of this title.*

CONSTRUCTION OF SECTION 1221 OF PUB. L. 109-8 *Pub. L. 109-8, title XII, §1221(e), Apr. 20, 2005, 119 Stat. 196, provided that: "Nothing in this section [see Effective Date of 2005 Amendment note above] shall be construed to require the court in which a case under chapter 11 of title 11, United States Code, is pending to remand or refer any proceeding, issue, or controversy to any other court or to require the approval of any other court for the transfer of property."*

THE SALE OF REAL PROPERTY FREE AND CLEAR OF A LEASE: MAKING SENSE OF SECTIONS 363(f) AND 365(h) OF THE BANKRUPTCY CODE

ANTHONY ASEBEDO*

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* The author works at the law firm Meegan, Hanschu & Kassenbrock, of Gold River, California, where he practices in the areas of bankruptcy and debtor/creditor law. The author obtained his Juris Doctorate from Northwestern School of Law of Lewis & Clark College, Portland, Oregon, in 1991. The opinions expressed in this Article are solely those of the author and do not represent the views of Meegan, Hanschu & Kassenbrock, a law partnership.

"There's got to be a way to get
those stiffs off my property!"
- Rev. Wilbur Glenworthy

INTRODUCTION

In a satirical 1965 movie, the Reverend Wilbur Glenworthy is the shady owner of Whispering Glades, a pricey and garish necropolis overlooking Los Angeles.[1] He determines that the business is facing a dead-end because it is running out of burial plots.[2] The action in the movie, *The Loved One*, involves Glenworthy's exploitation of America's fascination with space travel through a scheme to rocket-launch the troublesome "Loved Ones" into "orbits of eternal grace" (after which Glenworthy plans to redevelop the property into a high-profit, high-turnover retirement facility for wealthy senior citizens).[3]

A real-world landlord, like the fictional Reverend Glenworthy, might find its real property burdened by the presence of unwanted occupants (living rather than dead) who have possession under leases that are no longer economically attractive to the landlord. During the recent past, when real property prices were rising rapidly and the rental market was relatively stagnant, investors found that rental properties like apartment complexes might have more value as condominiums for sale, making conversions an economically attractive option.[4] More recently, as the effects of the latest intervening real-estate market crash recede, sales of condominiums have rebounded in some areas of the country as both sales and rental markets gradually stabilize.[5] If the market continues to rebound, investors may once

[1] THE LOVED ONE (Metro-Goldwyn-Mayer 1965). This film, which was marketed as "offensive to everyone," is loosely based on the novel by Evelyn Waugh, THE LOVED ONE: AN ANGLO-AMERICAN TRAGEDY (1947).

[2] *Id.*

[3] *Id.*

[4] When residential real estate prices were accelerating upward, many U.S. cities saw a trend towards the conversion of apartment properties to condominiums. *See, e.g.*, Ryan Geddes, *Strict Criteria Govern Apartment-to-Condo Conversions*, JACKSONVILLE BUS. J., Apr. 23, 2004, http://www.bizjournals.com/jacksonville/stories/2004/04/26/focus2.html (describing "booming condominium market" and condominium conversions in Jacksonville, Florida); *see also* Peter Dreier, *Where'd My Apartment Go?*, L.A. TIMES, May 21, 2006, http://articles.latimes.com/2006/may/21/opinion/op-dreier21 (criticizing negative social effects of loss of low-income rental housing, including to condominium conversions, citing loss of at least 11,000 affordable rental units in Los Angeles to demolition and condominium conversion between 2001 and 2006). The sub-prime lending crash of 2008 and its effects reversed the trend, at least for a few years. *See* Howard Feuerstein & Michelle DaRosa, *Unsold Condos: Converting to Apartments Takes Some Savvy*, PORTLAND BUS. J., May 25, 2008, http://portland.bizjournals.com/portland/stories/2008/05/26/focus11.html (arguing "the tightening of the residential mortgage market means renting apartments might be easier than selling condos"; describing legal requirements for conversion of condominiums to apartments).

[5] *See* Adrian Campo-Flores & Conor Dougherty, *Overseas Money Pours into Miami Real Estate*, WALL ST. J., Dec. 1, 2013, http://www.wsj.com/articles/SB10001424052702303332904579223863203208576

again be looking for ways to convert rental properties into properties for sale, free of the burdens imposed by tenants in possession.

In *The Loved One*, the fictional Reverend Glenworthy manages (it seems) to solve his looming financial problems by ridding his property of its troublesome and lifeless occupants.[6] He does so by pulling a few strings, buying some favors from those in power, and through a series of outrageous and crafty maneuvers.[7]

In the non-fictional world, section 363(f) of the Bankruptcy Code (the "Code")[8] gives the trustee or debtor in possession, as the representative of the bankruptcy estate (the "Estate Representative"),[9] a powerful tool to sell property of the estate free and clear of "any interest in such property."[10] This provision has long been used to promptly sell property free and clear of interests, such as liens that are disputed or otherwise subject to being cleared from title, so as to maximize the sale price, with the interests to attach to the sale proceeds so that they can be sorted out later.[11]

On its face, section 363(f) can also be invoked by an Estate Representative to jettison the interests of unwanted tenants in the debtor-landlord's real property, who might wish to do so where the market for rental of the property is stagnant in comparison to the market for sale of the property.[12] Where freeing a real property from the leasehold interests of tenants and selling it would generate value over and above the related costs, so doing would serve a major goal of the Code, which is to maximize the debtor's estate for the benefit of creditors.[13] But so doing would of course adversely affect the interests of the tenants, as their expectation to continue in possession of the leased premises for the remaining term would be wiped out. So

(discussing market cycle and relative market strength for condominium properties due to overseas investment).

[6] THE LOVED ONE (Metro-Goldwyn-Mayer 1965).

[7] *See id. The Loved One* culminates with the rocket-launch of what the public believes to be the remains of an iconic U.S. astronaut. *Id.* The launch is apparently managed by Glenworthy's young genius-employee, not the U.S. government, whose officials, however, are richly rewarded by Glenworthy for their active acquiescence. *Id.*

[8] *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 363, 92 Stat. 2549 (1978) (referencing section 363(f)). Hereinafter, references in the text to sections are references to sections of the Code, at title 11 of the United States Code (11 U.S.C. §§ 101–1532 (2012)).

[9] A chapter 11 debtor, typically remaining in possession of the property of the bankruptcy estate, holds powers of a trustee. *See* 11 U.S.C. § 1107(a) (granting debtor in possession with rights (except right to compensation), powers, and most duties of a trustee). As such, where there is a reference in the Code to the trustee, with few exceptions, it applies to the debtor in a chapter 11 case in which no trustee has been appointed. *See* 7 COLLIER ON BANKRUPTCY, ¶ 1107.01, at 1107-3 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed. 2015).

[10] 11 U.S.C. § 363(f).

[11] *See id.*; 3 COLLIER ON BANKRUPTCY, ¶ 363.06[5], at 363-46 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed. 2015).

[12] *See infra* notes 222–381 and accompanying text.

[13] *See* Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 453 (1999) (describing the Code's goals as "preserving going concerns and maximizing property available to satisfy creditors"); Toibb v. Radloff, 501 U.S. 157, 163 (1991) (explaining chapter 11 "embodies the general Code policy maximizing the value of the bankruptcy estate").

doing would also adversely affect the interest of any lender who took a security interest in the tenant's lease.[14]

Although sales under section 363(f) are free and clear of leases, they are not free and clear of controversy. Over the years, courts and commentators have perceived the existence of a tension, or even conflict, between the powers conferred on Estate Representatives under section 363(f) to sell real property free of a tenant's interest in the lease, and the protections that are afforded tenants under section 365(h), which has long been considered a bulwark against attempts by an Estate Representative to dispossess a tenant by rejecting the lease agreement in bankruptcy.[15] In 2003, a panel of the Seventh Circuit Court of Appeals issued an opinion[16] considered by several observers to be seriously misguided. That opinion, *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*,[17] rejects the argument that a tenant's rights under section 365(h) trump the Estate Representative's powers under section 363(f) so as to prevent the sale of property free and clear of the tenant's lease.[18]

Certainly it would be a tenant's nightmare to be locked out of his premises after the property had been purchased from the Estate Representative free and clear of the tenant's lease.[19] The facts in *Qualitech* represented a case of first impression at the circuit level,[20] and shortly after the *Qualitech* opinion was published commentators saw the possibility of dire consequences if the decision was not dealt with through corrective action by Congress.[21]

But the *Qualitech* decision has stood for well over ten years now and did not result in amendments to the Code, raising the question of whether it has had any

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[14] *See generally* Robert M. Zinman, *Precision in Statutory Drafting: the Qualitech Quagmire and the Sad History of 365(h) of the Bankruptcy Code*, 38 J. MARSHALL L. REV. 97 (2004). Professor Zinman's article is a detailed and valuable review of the drafting and development of section 365(h) and its interplay with section 363(f). Professor Zinman reports that over the years leasehold lending has ebbed and flowed as it has reacted to judicial opinions interpreting section 365(h) (governing rejection of leases under which the debtor is lessor) and to periodic clarifications of the provision by Congress. *See id.* at 110–18 (discussing 1984 and 1994 amendments to section 365(h)).

[15] Section 365 governs the assumption and rejection of leases and executory contracts. *See infra* notes 126–220 and accompanying text.

[16] *See* Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp.), 327 F.3d 537, 547–48 (7th Cir. 2003) (holding debtor may sell its assets free of any interests of a tenant in possession of a lease that debtor rejected).

[17] *Id*. at 548 (discussed further at *infra* notes 274–81 and accompanying text).

[18] *See In re* Crumbs Bake Shop, Inc., 522 B.R. 766, 778 (Bankr. D.N.J. 2014) (stating "Seventh Circuit held that a sale under § 363(f) stripped a lessee of its rights to possession under § 365(h)").

[19] *See In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.*, 327 F.3d at 541 (demonstrating tenant faced this type of unfortunate situation).

[20] *Id*. at 540 ("In this case of first impression at the circuit level, we are asked to reconcile two distinct provisions of the Bankruptcy Code: 11 U.S.C. § 363(f) . . . and 11 U.S.C. § 365(h).").

[21] *See* Zinman, *supra* note 14, at 99–100 (arguing *Qualitech* "has the potential again to completely disrupt leasehold investments"); *see also* Michael St. Patrick Baxter, *Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in Precision Industries v. Qualitech Steel,* 59 BUS. LAW. 475, 475 (2004) (asserting *Qualitech* "will have profound implications not only on bankruptcy sales but on real estate leasing and real estate lease financing").

significant long-term effect on the market for leasehold lending.[22] Those years (including a real-estate boom and bust) having passed, it is a good time to take stock of the effect of *Qualitech* and to analyze whether section 363(f) is properly used to sell real property free of a tenant's leasehold interest, notwithstanding the terms in section 365(h).[23]

This Article provides such an analysis within the framework of landlord-tenant law in general and a discussion of the effect of the law on the administration of leases in bankruptcy cases. It concludes that the holding of *Qualitech*[24] is sound and, that under one or another of the specific circumstances set out in the statute, the Estate Representative for a debtor-landlord may sell real property of the estate under section 363(f) free of a tenant's leasehold interest, even though under section 365(h) the same Estate Representative might be unable to cause the lease contract to be terminated through rejection.

This Article argues that the interplay between section 363(f)[25] and section 365(h)[26] reflects tensions that exist under state law, where leases are treated both as the conveyance of an interest in real property and a contract between landlord and tenant spelling out terms for the tenant's possession of the premises. Section 363(f) reflects administration of the bankruptcy estate's interest in the interest in real property,[27] and section 365(h) reflects the administration of the estate's interest in the lease contract, which interests are determined under applicable state law.[28] Any tension between section 363(f) and section 365(h) thus reflects a tension under state law, but does not rise to a conflict that should lead a court to determine that section 365(h) must generally supersede section 365(f) when an Estate Representative seeks to apply it to a lease.

[22] *See* Joshua Stein, *Did the Sky Fall on Leasehold Mortgages? Ground Leasing After Qualitech*, PRAC. REAL ESTATE LAW., Mar. 2009, at 7 (as of 2009, Joshua Stein answered in the negative, arguing that the decision did not justify the "hysteria" it initially generated among commentators).

[23] *See* Adam J. Levtin & Susan M. Wachter, *Explaining the Housing Bubble,* 100 GEO. L.J. 1177, 1179 (2012) (stating that housing bubble, which lasted from 1997 to 2006, caused housing prices to fall by 33%).

[24] *In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.*, 327 F.3d at 547–48 (holding debtor may sell assets free of any interests of a tenant in possession of a lease).

[25] *See* Arvest Bannister Realty Co. v. Opus Commc'n, Inc., No. 12CV509, 2013 WL 81025, at *12 (D. Kan. Jan. 7, 2013) (noticing the question of whether section 363(f) "trumps" section 365(h), but finding no need to answer it in the present case).

[26] *See* 2 NORTON BANKRUPTCY LAW AND PRACTICE § 46:35, at 46-139 (William L. Norton, Jr. ed., 3d ed. 2015) (observing section 365(h) gives lessee additional rights when debtor in a bankruptcy case is the lessor).

[27] *See* COLLIER ON BANKRUPTCY, ¶ 1.05[2], at 1-20 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) (explaining section 363(f), under specific circumstances, allows trustee to sell property free and clear of third-party interests).

[28] *See In re* Scharp*,* 463 B.R. 123, 132–33 (Bankr. C.D. Ill. 2011) (holding section 365(h) does not trump state law because reference to non-bankruptcy law "preserves certain tenant rights but does not enhance them").

I. THE LANDLORD-TENANT RELATIONSHIP

The Code does not determine the extent of interests in property of the bankruptcy estate.[29] Instead, unless the Code or a countervailing federal interest provides otherwise, applicable non-bankruptcy or state law determines the bankruptcy estate's rights in property.[30] This means "rights a debtor has in property at the commencement of the case continue in bankruptcy—no more, no less."[31] When bankruptcy has intervened, the Supreme Court has been clear that "[i]n the absence of any controlling federal law, 'property' and 'interests in property' are creatures of state law."[32]

Nor does the Code typically determine the enforceability of creditors' claims in a bankruptcy case.[33] Instead, applicable non-bankruptcy or state law generally determines the nature and extent of creditors' claims against the bankruptcy estate.[34]

To analyze the debtor-landlord's and the creditor-tenant's respective rights under sections 363 and 365, it is therefore necessary to begin with a review of the respective rights in leased property provided to the landlord and the tenant under non-bankruptcy law. Generally, in the United States there are two primary sources of law governing the landlord-tenant relationship: the English common law of property and the law of contracts.

A. The Lease as an Estate in Property

The English common law of property of course has a lengthy history. After the Norman conquest, William the Conqueror distributed among his barons rights to

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[29] The property of the bankruptcy estate (i.e. the property subject to administration for the benefit of creditors) is established as set forth in section 541: "The commencement of a case . . . creates an estate. Such estate is comprised of all of the following property, wherever located and by whomever held." 11 U.S.C. § 541(a) (2012) (providing expansive list of categories of property omitted).

[30] *See* Butner v. United States, 440 U.S. 48, 55 (1979) (stating a mortgagee's interest in debtor's property in a Bankruptcy Act case is determined by state law); Kitchen v. Boyd (*In re* Newpower), 233 F.3d 922, 928 (6th Cir. 2000) (holding funds embezzled by debtor not part of estate pursuant to Michigan law).

[31] Frazer v. Drummond (*In re* Frazer), 377 B.R. 621, 626–27 (9th Cir. 2007) (citing McKenzie v. Irving Tr. Co., 323 U.S. 365, 370 (1945) (citations and internal quotation marks omitted).

[32] Barnhill v. Johnson, 503 U.S. 393, 398 (1992). Accordingly, while the Code may define the term "transfer" and while section 547 may authorize the recovery of funds transferred by the debtor pre-bankruptcy, the relevant state's version of the Uniform Commercial Code determines the rights of the parties to the funds in question and thus the timing of the transfer. *Id*. at 398–99.

[33] Claims are allowed in the bankruptcy case except, among other things, to the extent "unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured." 11 U.S.C. § 502(b)(1).

[34] *See* Raleigh v. Illinois, 530 U.S. 15, 20 (2000) (citing *Butner*, 440 U.S. at 54) (asserting "[t]he 'basic federal rule' in bankruptcy is that state law governs the substance of claims"); *see also* Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co., 549 U.S. 443, 452 (2007) (stating allowance of an unsecured claim, including attorneys' fees, is determined by contract and applicable state law).

use the land of England.[35] This established between them the relationship of lord and tenant.[36] Those who received such rights to land became obligated to perform services, such as military service, for the king's benefit.[37] Each baron in turn could parcel out rights to portions of his land to others, thus creating lord-and-tenant relationships between the baron and the recipients of such rights.[38] As it developed after the Norman conquest, the "fundamental principle of the feudal system . . . was that all land held by a subject was derived originally from the crown," and "[t]he relation thus established between the crown and the person to whom, either actually or by fiction of law, the grant was made, was termed 'tenure'."[39] The grantee could then make grants of their lands to others, "creating thereby 'sub-tenure' between themselves and their grantees, without affecting thereby the tenure already existing between themselves and the crown."[40]

This landlord-tenant relationship became the basis for the English common-law doctrine of estates in property, and the duration of one's right to possession of land and the rights incidental to possession were "made dependent on the character of the estate which [the tenant] [had] in the land."[41] Freehold estates, such as the fee estate, had no fixed period of duration,[42] and were typically conveyed by a written instrument known as a deed.[43] While the holder of a freehold estate did not "own" the land in the sense the sovereign did, he had far more than mere possession, and had rights to transfer his interest by way of "livery of seisin" to another.[44]

Non-freehold estates came to include primarily estates "for a fixed period, the termination of which [were] capable of ascertainment from the beginning, called

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[35] A fine summary of the impact of the 11th-century Norman conquest on the development of English law can be found in 1 GEORGE W. THOMPSON, THOMPSON ON REAL PROPERTY §§ 4.04–4.05 (David A. Thomas, ed., 2d Thomas ed. 2009 & Supp. 2011).

[36] *See* ROGER A. CUNNINGHAM, WILLIAM B. STOEBUCK & DALE A. WHITMAN, THE LAW OF PROPERTY §§ 1.6, 6.1 (2d ed. 1993).

[37] *See* 1 THOMPSON, *supra* note 35, § 4.05(b) (outlining various feudal relationships engendered by ongoing Viking military aggression against inhabitants of the English island).

[38] *See* CUNNINGHAM ET AL., *supra* note 36, § 6.1, at 249–50.

[39] HERBERT T. TIFFANY, THE LAW OF REAL PROPERTY AND OTHER INTERESTS IN LAND § 6, at 17 (1920); *see also* 1 THOMPSON, *supra* note 35, § 4.05(b), at 145–65 (summarizing early feudal relationships, commencing with Norman invasion, including discussion of types of tenure).

[40] TIFFANY, *supra* note 39, § 6, at 17.

[41] HERBERT T. TIFFANY, THE LAW OF REAL PROPERTY § 23, at 31 (3d ed. 1976 by Basil Jones & 2009-2010 cumulative supp. by Emily Bernheim) [hereinafter TIFFANY-JONES]. "Estate" is defined as "[t]he amount, degree, nature, and quality of a person's interest in land or other property; esp., a real-estate interest that may become possessory." *Estate*, BLACK'S LAW DICTIONARY (10th ed. 2014); *see also In re* Estate of Brunet, 207 P.2d 567, 568 (Cal. 1949) (contrasting term "technical sense" with "lay sense").

[42] *See* TIFFANY-JONES, *supra* note 41, § 25, at 33.

[43] *Id.* §§ 24–25; *see also* CUNNINGHAM ET AL., *supra* note 36, § 11.1, at 759 (stating "[t]he American legal system recognizes a variety of methods of transferring interests in land, but the deed is unquestionably the most common").

[44] TIFFANY, *supra* note 39, §§ 14–16, at 28–34; *see also* 1 THOMPSON, *supra* note 35, § 4.06 (discussing the development of common law, including estates and transfers of same).

'estates for years.'"[45] The estate conveyed by a lease was also known as a leasehold.[46]

Early on, the holder of an estate for years had few remedies to protect his possession of the property. If the landlord wrongfully denied him possession, the tenant-for-years held a personal action for damages against the landlord, but, not having been seised of the land, he had no action to recover possession of the property.[47] Eventually, however, the holder of an estate for years came to hold two actions to regain possession, and over time the "status of a tenant for a term of years was changed from that of a person owning an interest in land that was quasi-chattel to that of a person owning an interest in land that was chattel."[48]

Conversely, the landlord's remedies against the tenant for non-payment of rent were also limited. Having conveyed the leasehold to the tenant, the landlord was required to bring an action for unpaid rent and could not reclaim the leasehold by terminating the lease unless the parties had expressly agreed that he could do so.[49]

Under the common-law view of leases, then, the landlord is one who has conveyed a property interest to the tenant,[50] not primarily one who has made promises to his tenant.[51] This view is consistent with the conditions of agrarian

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[45] TIFFANY-JONES, *supra* note 41, § 25, at 34 (indicating estates less than a freehold other than the estate for years include the tenancy at will and the tenancy by sufferance). Coming before the Norman conquest, the tenancy at will was in England the "earliest type of landlord-tenant relationship," under which the landlord gave "a status or villeinage (i.e. the right to occupy a small plot of land as a feudal serf) to the tenant." Robert H. Kelley, *Any Reports of the Death of the Property Law Paradigm for Leases Have Been Greatly Exaggerated*, 41 WAYNE L. REV. 1563, 1573 (1995).

[46] *See* TIFFANY-JONES, *supra* note 41, § 72, at 107–08; *see also* RESTATEMENT OF PROP., div. II, intro. note (Freehold Estates), at 37–38 (AM. LAW INST. 1936) (contrasting freehold estates (including the fee simple absolute in the U.S.) with non-freehold estates (including the estate for years in the U.S.) and noting their origins in "the peculiarities of the evolution of the English law of land").

[47] *See* Kelley, *supra* note 45, at 1573–74.

[48] *Id*. at 1575; *see also* RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT, Introduction, at 1–6 (AM. LAW INST. 1977) (sketching development of landlord-tenant law in England as initially based on commercial relationship between landlord and tenant, developing into a relationship based on property principles, and then back to commercial relationship based on contract).

[49] "It is well-settled at old common law that unless the lease expressly so provides, the landlord is not entitled to terminate the lease for the tenant's failure to perform a promise in the lease." RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT § 13.1, reporter's note 9 (AM. LAW INST. 1977).

[50] "The tenant's interest is merely a purchase from the landlord for a prescribed period of time of the right to be in lawful, actual possession of the demised premises." Kelley, *supra* note 45, at 1566–67. The landlord thus has conveyed rights to exclusive use of the real property for the term of the lease, while retaining the right to recover possession at the end of the term as a reversionary interest. *See* Vallely Invs., L.P. v. BancAmerica Commercial Corp., 106 Cal. Rptr. 2d 689, 696 (Cal. Ct. App. 2001) (analyzing lessor's interest as a reversion that was senior to interest of the holder of a leasehold mortgage that was foreclosed) and cases cited therein. The landlord may convey title or the reversionary interest by sale. *See* Garetson v. Hester, 133 P.2d 863, 865 (Cal. Dist. Ct. App. 1943).

[51] Such promises are secondary to the conveyance of the leasehold: "At old common law the promises made by a landlord in a lease were independent obligations, so that the failure of the landlord to perform them did not give the tenant any right to disregard his obligations under the lease." RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT, ch. 7, intro. note (AM. LAW INST. 1977); *see also* 8 CORBIN ON CONTRACTS § 33A.13, at 232 (Joseph M. Perillo, ed., 1999 & 2009 Supp.) (discussing effect of common-

society, in which the landlord would give the tenant possession of the land in its raw state and the tenant would work and improve it for agrarian purposes.[52] At the same time, however, "the transfer of the right to possess the land did entail promises between landlord and tenant, [and thus] the landlord-tenant relationship was also viewed as having some aspects of a bilateral contract."[53]

As the common law of property developed in England's North American colonies and later in the United States of America after independence, the term "lease" came to have at least three connotations.[54] First, a lease was considered a conveyance of a property interest (that is, of an estate) in the English common-law tradition; second, it came to connote the contractual obligations that are created in connection with the conveyance; and finally, the term came to describe the written instrument for the conveyance and the covenants associated with the conveyance.[55]

B. The Evolving Contract-Law Approach to Real Property Leases

Over time, contract-law principles came to bear more directly on the development of landlord-tenant law in the United States. Robert H. Kelley's commentary describes the development of landlord-tenant law as a contest between the application of the principles of property law and the application of the principles of contract law:

> There is presently a paradigmatic revolution in landlord-tenant law. The battle is between a property law paradigm that is feudal in origin and extremely pro-landlord in nature and a contract law paradigm that reflects the realities of modern society and is balanced, or slightly pro-tenant, in nature. The two paradigms lie at opposite ends of a spectrum.[56]

A key principle of the property-law paradigm of leaseholds is that "[a] tenancy is created by the landlord's conveyance of an interest in real property to the

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law property principles on conditions in lease contracts: "It may be said, in general, that a lessee is bound to pay the agreed rent as long as the leasehold interest in the land is not ended").

[52] *See* Kelley, *supra* note 45, at 1576.

[53] *Id*. (citing ROBERT S. SCHOSHINSKI, AMERICAN LAW OF LANDLORD AND TENANT § 1.1 (1980)).

[54] To note the development of the common law in the United States is not to say that there are no differences among the states in regard to common-law rules governing estates in real property. In discussing property law in the United States after independence, one scholar notes as follows: "One of the persisting realities of America legal life is the existence of a separate and lively jurisprudence in each of the states, lying beneath a thin and often deceptive veneer of common law uniformity." 1 THOMPSON, *supra* note 35, § 7.01, at 466.

[55] One scholar notes that "[a]n estate for years [is often called a lease] . . . 'putting by a sort of metonymy, the instrument by which an estate for years is granted for the estate itself.'" TIFFANY-JONES, *supra* note 41, § 72, at 108 (quoting Harding v. Seeley, 23 A. 1118, 1119 (Pa. 1892) (Heydrick, J.)).

[56] Kelley, *supra* note 45, at 1564.

tenant."[57] By contrast, a key principle of the contract-law paradigm is that "[a] tenancy is created by, and consists of, a contract between the landlord and tenant."[58]

While the property-law and contract-law paradigms may represent two poles, it is probably most useful to note that the law embodies a combination or blending of the two. One scholar's review of the law leads to the observation that while there is a trend to apply contract rules to analyze landlord-tenant issues, "at present, the law of leases reflects its historical development: it remains a blend of property concepts and contractual doctrines developed for the service of a wide variety of objectives - agrarian, urban and financial."[59] While some view the application of contract-law principles as a remedy to apparently unfortunate outcomes of the application of property-law principles, they "are not always the panacea for lease problems that they may initially seem to be, nor are property rules always regressive in lease cases."[60]

California law offers a good example of this. A leading authority on real property law in California points out that:

> [A] lease creates two sets of rights and obligations, namely, those arising by law from the relationship of landlord and tenant (privity of estate), and the contractual obligations arising out of the express stipulations of the lease (privity of contract).[61]

As such, the California Civil Code provides that an estate for years is one of four kinds of estates in real property,[62] and that it is a "chattel[] real."[63] The status of a leasehold as a chattel real is reflected in California's statutory scheme for the enforcement of judgments and for noticing of actions that affect interests in real property. The Enforcement of Judgments Law[64] provides that "[a] judgment lien on real property attaches to all interests in real property in the county where the lien is created . . . but does not reach . . . a leasehold estate with an unexpired term of less

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[57] *Id.* at 1566 (citation omitted).
[58] *Id*. (citation omitted).
[59] 2 RICHARD R. POWELL, POWELL ON REAL PROPERTY § 16.02[1][b], at 16–18 (2008).
[60] *Id*.; *cf.* Kelley, *supra* note 45, at 1604 (arguing that "[t]he entire body of contract law, and only contract law, should be available to construe leases and to define and describe the rights, duties, and obligations of the landlord and the tenant").
[61] 17 HARRY D. MILLER, CALIFORNIA REAL ESTATE § 19.19, at 58–59 (3d ed. 2004 & 2011-2012 Supp.) (citations omitted).
[62] CAL. CIV. CODE § 761 (2007) (identifying estates of inheritance, estates for life, and estates at will).
[63] *Id*. § 765; *see also* Placer Sav. & Loan Ass'n v. Wash (*In re* Marino), 813 F.2d 1562, 1566 (9th Cir. 1987) (stating trustee may not avoid sale of debtor's leasehold under section 544(a)(3) of the Code because interest in California leasehold is personal property, not real property); Pac. Sw. Realty Co. v. Cnty. of L.A., 820 P.2d 1046, 1051 (Cal. 1991) (stating an estate for years is not a freehold estate but a form of personalty, even though substance of estate, being land, is real property).
[64] CAL. CIV. PROC. CODE §§ 680.010–724.260 (2009).

than two years."[65] This language, by giving the judgment creditor of a tenant a lien where the remaining term of the lease is two years or more, is consistent with the view that a leasehold is a type of estate in real property.

California's recording statutes also treat leaseholds as an interest in real property.[66] A notice of the pendency of an action involving claims against a person's interests in real property (the *lis pendens*),[67] when filed in the county records, is effective to impart notice where a defendant is a lessee, because the leasehold is an interest in real property and is not strictly an interest in personal property.[68]

In addition to providing for privity of estate between landlord and tenant, California statutory law provides that the lease of real property involves privity of contract. Thus, while real property leases are regulated as "Real or Immovable Property" under Division 2 of the Civil Code governing property,[69] they are also made subject of Division 3 of the Civil Code, governing obligations.[70] In Division 3, "hiring" is defined as "a contract by which one gives to another the temporary possession and use of property."[71] The Civil Code includes specific provisions governing the hiring of personal property[72] and others governing the hiring of real property, including residential real property.[73]

Despite the concurrence of privity of estate and privity of contract between landlord and tenant, courts in California construe the terms of the lease as a contract between landlord and tenant, and thus determine the various obligations between the parties according to contract principles rather than the principles of property law.[74] For example, in a 1942 opinion,[75] the California Supreme Court rejected a landlord's argument that its tenant's duty to pay rent would be independent of the landlord's covenant in the lease to protect the tenant from competition.[76] The court stated that "[w]hile it is true that a lease is primarily a conveyance in that it transfers

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[65] *Id*. § 697.340. In the provision defining the scope of a judgment lien as to personal property, leaseholds are not mentioned. *Id*. § 697.530.

[66] *See id.* §§ 405–405.39.

[67] *Id*. (providing definitions and provisions restricting notice to parties with claims affecting title to or the right to possession of specific real property); *see also* BGJ Assocs., LLC v. Super. Ct., 89 Cal. Rptr. 2d 693, 703 (Cal. Ct. App. 1999) (discussing purposes of *lis pendens* procedure).

[68] *See* Parker v. Super. Ct., 88 Cal. Rptr. 352 (Cal. Ct. App. 1970) (interpreting earlier version of *lis pendens* statute at Code of Civil Procedure section 409). The statutory provision subject of *Parker* has since been revised and clarified (now at § 405.4), but the similar language of the revised statute means that California courts are likely to look to decisions under the former statute such as *Parker*, holding that a real property lease is subject to the *lis pendens* procedure. *See* 3 BERNARD E. WITKIN, CALIFORNIA PROCEDURE, Actions § 377, at 485 (5th ed. 2008 & Supp. 2011).

[69] CAL. CIV. CODE §§ 755–945.5 (2007) (including estates for years (leases) among estates in property at section 761).

[70] *Id*. §§ 1940–1954.1.

[71] *Id*. § 1925.

[72] *Id*. §§ 1955–59.

[73] *Id*. §§ 1940–1954.1.

[74] *See* Medico-Dental Bldg. Co. of L.A. v. Horton & Converse, 132 P.2d 457, 462 (Cal. 1942).

[75] *Id.*

[76] *Id.*

an estate to the lessee, it also presents the aspect of a contract."[77] In practice, the court put contract principles above property-law principles: "[t]hose features of the lease which are strictly contractual in their nature should be construed according to the rules for the interpretation of contracts generally and in conformity with the fundamental principle that the intentions of the parties should be given effect as far as possible."[78]

More recent cases have continued this trend away from a resort to common-law principles and towards the use of principles of contract interpretation to determine the landlord's and the tenant's rights and duties.[79] *Golden West Baseball Co. v. City of Anaheim*, another California case, is a good example of this trend.[80] To resolve a dispute regarding the scope of the tenant's rights under a "lease" for a baseball stadium, the court in *Golden West Baseball Co.* rejected the notion that the parties' rights would be determined exclusively as a function of any property-law designation:

> Ultimately, the label given to [the team's] . . . "interest" [under the agreement] is of little importance. Arrangements between landowners and those who conduct commercial operations upon their land are so varied that it is increasingly difficult and correspondingly irrelevant to attempt to pigeonhole these relationships as "leases," "easements," "licenses," "profits," or some other obscure interest in land devised by the common law in far simpler times.[81]

In the commercial context, then, the *Golden West* court viewed contract-law principles as paramount to a determination of the parties' rights, with little regard to the "pigeonholes" of property law. Similarly, the Arizona Supreme Court has adopted contract-law principles to determine the materiality of breaches under commercial leases.[82] More removed from the property-law sphere is the residential

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[77] *Id.*
[78] *Id.*
[79] *See* 12 WITKIN, *supra* note 68, § 517, at 593–95 and cases cited therein.
[80] Golden W. Baseball Co. v. City of Anaheim, 31 Cal. Rptr. 2d 378, 395 (Cal. Ct. App. 1994) (asserting "[t]he contractual relationship between the parties must be analyzed based on the evidence and findings without regard to its classification under traditional common law concepts").
[81] *Id.*
[82] Found. Dev. Corp. v. Loehmann's, Inc., 788 P.2d 1189, 1193–94 (Ariz. 1990). In *Foundation*, where a landlord sought to terminate a commercial lease based on the tenant's late payment of a portion of annual CAM charges, the court held that equitable defenses to forfeiture survived enactment of A.R.S. § 33-361, which authorizes termination of a lease for a tenant's violation of "any provision" of the lease. The court applied the factors set forth in § 241 of the Restatement (Second) of Contracts (providing circumstances used to determine whether a breach is material). *Id.* at 1197. The court reached its conclusion after determining that the legislature enacted A.R.S. § 33-361 merely to reverse the common law rule that the promise to pay rent was independent of the landlord's promise to provide possession by conferring the

tenant, who is viewed as a consumer of housing entitled to certain rights and remedies that balance the power of landlords in the rental market, rather than as a party that accepts the rights and responsibilities of an estate in property.[83]

C. The Termination of a Lease Outside Bankruptcy

The *Qualitech* opinion[84] has been criticized because it condones the sale of a real property free and clear of the tenant's leasehold interest under section 363(f), where the tenant did not consent to the sale and where the landlord apparently would have been unable to terminate the lease by way of rejection under section 365.[85] Before addressing criticisms of *Qualitech*, however, it is necessary to review the circumstances under which a lease is properly terminated under state law, outside bankruptcy. Only then can one fully analyze the effect of section 363(f) on the rights of the landlord's Estate Representative to terminate a lease by selling the property free and clear of the leasehold.

1. The Termination of a Lease Without a Party's Default

Outside bankruptcy a lease may be terminated on a number of grounds. Most common, of course, is termination caused by expiration of the term stated in the lease. Under the common law, where the lease specifies a particular expiration date for the lease, the simple passage of time, without more, will cause the lease to terminate at the time specified.[86]

A lease might also be terminated under a provision giving a party the right to do so.[87] A typical example is the occurrence of a specific event giving rise to the right to terminate, such as where the premises are rendered unfit for the contemplated

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remedy of rescission, but not to prevent a court's application of equitable considerations to contract interpretation. *Id*. at 1193–94.

[83] *See generally* 1 THOMPSON, *supra* note 35, § 39.06(b)(5), at 608–09 (discussing restrictions on landlord's termination of residential leases).

[84] Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp.), 327 F.3d 537, 544 (7th Cir. 2003) (finding that the Code authorizes sale of debtor's property free of lessee's possessory interest).

[85] *See infra* notes 383–88 and accompanying text (noting criticisms of *Qualitech* decision).

[86] This rule is codified in many states. *See, e.g.*, CAL. CIV. CODE § 1933(1) (2010) (stating hiring terminates at end of term agreed upon); N.Y. REAL PROP. LAW § 232-b (Consol. 2014) (same; outside New York City). Where a lease provides for a periodic tenancy (for example, for successive one-year periods until a party provides notice of a termination), the simple passage of time will not suffice to terminate the lease until such time as notice of the election to terminate is given. *See, e.g.*, CAL. CIV. CODE § 1946 (2010) (requiring written notice).

[87] *See, e.g.*, Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc., 182 Cal. Rptr. 3d 235, 263 (Cal. Ct. App. 2015) (holding that when valid commercial lease contains a clause that allows for termination upon the occurrence of certain events, an exercise of the termination clause is enforceable and does not result in a forfeiture); Caswell v. Carpenter, 55 P.2d 1222, 1223 (Cal. 1936) (stating "the parties to a lease may agree upon a contingency that will bring a lease to an end before the expiration of the full term thereof is beyond question").

purpose.[88] A statute may provide for termination of the lease where the premises are destroyed,[89] but it may also provide that the lease may nonetheless include fully enforceable provisions that reallocate the risk of destruction to the tenant, or that require the landlord to rebuild in the case of destruction, without causing the lease to terminate.[90] For the most part, these grounds for termination are based on the contract-law principle that the parties have the right to determine the terms of their relationship.[91]

Other grounds for termination of a lease include mutual consent of the parties to the lease.[92] A statute may provide that where the entire leased property is taken through eminent domain proceedings, the lease will terminate.[93] If the lease, however, has provisions that dictate the remedies of each party upon such termination, such provisions will generally control.[94]

Property-law principles continue to play a role in the termination of a lease, the primary example being the tenant's acquisition of title to the premises that is superior to the landlord's, or the landlord's acquisition of the leasehold estate. Such situations cause the merger of the two estates that terminates the lease.[95] Termination on these grounds reflects the property-law principle that a reversionary interest in property merges with the holder's retained interest when both interests are acquired.[96] Property-law principles also play a role in determining when a tenant

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[88] *See, e.g.*, 11382 Beach P'ship v. Libaw, 82 Cal. Rptr. 2d 533, 536 (Cal. Ct. App. 1999) (finding termination by lessee on destruction of premises was not forfeiture); Alpern v. Mayfair Mkts., 258 P.2d 7, 11 (Cal. 1953) (finding tenant's option to terminate lease after destruction by fire did not constitute a forfeiture); *see also infra* note 90 and accompanying text (discussing termination of lease upon destruction of premises in absence of provision in lease).

[89] *See, e.g.*, CAL. CIV. CODE § 1933(4) (2010) (providing for termination of a hiring by the destruction of the thing hired); Mattal v. Am. Tr. Co., 25 Cal. Rptr. 517, 518–19 (Cal. Ct. App. 1962) (citing CAL. CIV. CODE § 1933 and holding that in absence of lease terms giving lessor duty to rebuild after destruction of premises, landlord not obligated to do so; lease provided solely for duty to repair premises).

[90] *See, e.g.*, *Mattal*, 25 Cal. Rptr. at 518–19 (stating tenant may, in commercial lease, waive statutory right to terminate lease in event of destruction of premises; contract-interpretation principles used to determine that provision in lease created duty by landlord to rebuild destroyed premises rather than merely to restore damaged premises).

[91] RESTATEMENT (SECOND) OF CONTRACTS ch. 8, intro. note (AM. LAW INST. 1981) (discussing freedom of contract and public policy makes certain contracts unenforceable).

[92] *See, e.g.*, CAL. CIV. CODE § 1933(2) (2010) (providing for termination of a hiring by mutual consent). The tenant's surrender of the leased premises would typically follow.

[93] *See, e.g.*, *id.* § 1265.110 (allowing termination where "all the property subject to a lease is acquired").

[94] *See, e.g.*, *id.* § 1265.160 (indicating that statutory provisions governing termination of lease in cases of condemnation are not to affect lessee's rights and obligations under terms of lease).

[95] *See, e.g.*, *id.* § 1933(3) (providing for termination of hiring by acquisition of title superior to that of the party letting or leasing the property).

[96] Silveira v. Ohm, 201 P.2d 387, 390 (Cal. 1949) (en banc) (discussing lessee's potential exercise of purchase option and apportionment of rent due until time merger occurs); Erving v. Jas. H. Goodman & Co. Bank, 153 P. 945, 946 (Cal. 1915) (determining tenant's acquisition of title to real property caused merger of leasehold with title and thus no rights to collect rents vested in purported assignee of leasehold); *see also* RESTATEMENT OF PROP. § 238 cmt. d (AM. LAW INST. 1936) (discussing modes by which a prior interest is terminated).

has remedies against a landlord where a third party claims an interest in the property and dispossesses the tenant.[97]

2. The Termination of a Lease Due to the Acts or Default of a Party

The Restatement notes that the "obligations of the tenant inherent in the landlord-tenant relationship which arise without the aid of any express promise by the tenant are to pay the rent reserved, not to commit waste, and not to use the leased property for an illegal purpose."[98] State laws thus give a landlord rights to terminate the lease where the tenant materially violates any of these basic duties. In many states, such acts automatically terminate the lease and give the landlord the right to expedited procedures to regain possession.[99] In others, such acts give the landlord the right to terminate the lease through designated procedures.[100]

Under state law, the tenant's abandonment of the premises may or may not result in termination of the lease.[101] For example, in California, a tenant's breach and abandonment before the end of the term terminates the lease.[102] But where the lease expressly so provides, the tenant's breach and abandonment gives the landlord the option to reject the surrender, in which case the landlord may sue to recover rent as it becomes due.[103]

Abandonment by a tenant of course is typically linked to the failure to pay rent, which is usually paid in installments over the term of the lease. As to the tenant's failure to pay an installment of rent before there is an abandonment, the landlord faces the business decision of choosing between seeking to collect unpaid rent from the tenant along with any agreed late-charges or fees (plus additional rent as it

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[97] *See* RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT §§ 4.1–4.3 (AM. LAW INST. 1977) (documenting rules governing existence or assertion of a paramount title, such as a mortgage given by a landlord). The editors note, "at common law, disputes between claimants to land were generally resolved in favor of the claimant whose interest came into existence first in time," and that modern recording statutes will generally govern such disputes today. *Id*. § 4.1 cmt. a.

[98] *Id.* ch. 12 intro. note.

[99] *See, e.g.*, CAL. CODE CIV. PRO. § 1161(4) (2007) (entitling landlord to terminate lease and bring unlawful detainer action where waste or nuisance is committed by tenant); NEV. REV. STAT. § 40.250(d) (2014) (entitling landlord to remedy under the unlawful detainer statute); N.J. STAT. ANN. § 33:1–54 (1994) (giving tenant five days' notice after liquor law violation, at the end of which the right of possession reverts to landlord).

[100] *See, e.g.*, MASS. GEN. LAWS ANN. ch. 139, § 19 (1974) (providing landlord right to terminate for prostitution, assignation, lewdness, illegal gaming, illegal possession, or sale of intoxicating liquor); N.Y. MULT. DWELL. LAW § 352 (Consol. 2014) (providing landlord right to terminate for prostitution).

[101] *See* RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT § 12.1, statutory note 7 (AM. LAW INST. 1977) (listing state laws dealing with abandonment by tenant).

[102] *See* CAL. CIV. CODE § 1951.2(a) (2010) ("[I]f a lessee of real property breaches the lease and abandons the property before the end of the term or if his right to possession is terminated by the lessor because of a breach of the lease, the lease terminates."); RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT § 12.1, statutory note 7 (AM. LAW INST. 1977) (listing state laws dealing with abandonment by tenant).

[103] *See* CAL. CIV. CODE § 1951.4 (2010) (noting other requirements for effective rejection).

comes due) or seeking to terminate the lease and remove the tenant from possession in favor of a more reliable tenant for the premises.

Under contract-law principles, one party's failure to perform a duty under the agreement gives rise to issues of whether the failure is material, whether the failure excuses the other's future performance,[104] and whether the failure gives rise to a remedy as significant as specific performance or termination of the contract.[105] As noted above, under early common-law principles, the landlord's remedies, after having conveyed the leasehold interest to the tenant, were limited to seeking damages for unpaid rent, unless the tenant had expressly agreed otherwise.[106] The tenant's remedies against the landlord were also generally limited to seeking damages even where the landlord denied the tenant possession.[107]

Today most states provide the landlord with a summary action for possession of the premises in the event of nonpayment of rent, and do not require a forfeiture or termination clause in the lease agreement.[108] For the most part, the landlord is entitled to recover from the tenant the amount of rent that is unpaid, and may terminate the lease through summary proceedings if the rent is not paid promptly after demand (and provided there is no legal excuse for the tenant's failure to pay rent).[109]

While states have enacted various statutes to address problems associated with the application of the older property-law principles in the landlord-tenant arena,[110]

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[104] *See* RESTATEMENT (SECOND) OF CONTRACTS § 237 (AM. LAW INST. 1981) (explaining that, with exceptions, it is a condition of each party's remaining duties that there be no uncured material default by other party to render performance due at an earlier time); Cuneo Law Grp., P.C. v. Joseph, 669 F. Supp. 2d 99, 125 (D.D.C. 2009) (involving material settlement agreement excusing other party's performance).

[105] RESTATEMENT (SECOND) OF CONTRACTS § 345 (AM. LAW INST. 1981) (outlining remedies such as awards of damages, specific performance, and declaratory relief). Cancellation (rescission) of the contract is an available equitable remedy that may require the court to order restitution of a benefit conferred. *See id*. § 158, cmt. b (discussing relief where contract voided, due generally to mistake). "The traditional goal of the law of contract remedies has not been the compulsion of the promisor to perform his promise but compensation of the promisee for the loss resulting from the breach." *Id.* ch. 16, intro. note. This reflects the principle of economics that a party's decision to breach the terms of a contract will result in a gain in overall economic efficiency after a determination by the breaching party that it will gain from the breach, despite having to pay damages to the other party to put it in the same economic position it would have been in if the breach had not occurred. *Id*. ch. 16, reporter's notes.

[106] *See supra* note 49 and accompanying text.

[107] *See supra* note 47 and accompanying text.

[108] *See* RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT § 12.1, statutory note (AM. LAW INST. 1977) (listing forty-four such jurisdictions, along with four jurisdictions requiring forfeiture before use of summary process where forfeiture must be provided for in lease and five jurisdictions requiring forfeiture clauses in some cases but not in others).

[109] *See id.* (summarizing notice and demand provisions among jurisdictions); *see, e.g.*, CAL. CIV. PROC. CODE §§ 1159–1179 (2007) (providing for three days' notice to pay rent or quit, unlawful detainer proceeding absent tenant abandonment, exceptions for hardship); *see also* N.Y. REAL PROP. ACTS. LAW §§ 701–67 (Consol. 2014) (providing for three days' notice for rent or possession, limited redemption rights if not waived in lease, stay of judgment).

[110] For example, in California, "[t]he Law Revision Commission, in a 1969 Report, reviewed the law on real property leases, found it unsatisfactory, and made a number of proposals for new legislation, which was

property-law principles continue to play a role. For example, in Arizona the legislature gave landlords the right to retake commercial premises for the violation of "any provision in the lease."[111] In a 1990 case, a landlord used that statutory provision as grounds to seek eviction of the tenant for withholding a portion of a single common-area-maintenance charge.[112] But the supreme court determined that this statutory right did not erase older principles from state law or justify an absolute application of the legislative provision, because so holding:

> [I]gnores the important interplay of property and contract law that preceded the enactment of [section 33-361 of the Arizona Revised Statutes]. The property rights concept—that a lease was a conveyance—was essential to maintain economic equilibrium in an agrarian environment. The fact that leasehold interests now prevail in the urban, business world does not diminish their importance.[113]

The legislature, said the court, did not overturn that equilibrium by erasing the common-law principles of the independence of promises in leases with an absolute rule to the contrary, but instead gave landlords the right to provide in a commercial lease for conditional promises, subject to courts' longstanding authority to determine that the breach of any conditional promise is subject to relief based on triviality, as well as fraud, accident, or mistake.[114] As such, the court determined that a "time of the essence" provision like the one at issue in the case was "merely a factor to be considered when determining if a breach is material," and would not, "absent other factors, automatically convert a trivial breach into a material one."[115] The court thus affirmed the trial court's judgment for the tenant.[116]

Omissions or acts of a landlord may also give rise to termination of a lease. For example, the landlord's unexcused failure to disclose a property interest superior to the landlord's may give rise to the tenant's right to terminate the lease as well as to damages.[117]

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adopted in 1970." 12 WITKIN, *supra* note 68, § 692, at 812. The legislation involved the more consistent application of contract-law principles. *Id*.

[111] ARIZ. REV. STAT. § 33-361(A) (2014).

[112] Found. Dev. Corp. v. Loehmann's, Inc., 788 P.2d 1189, 1190 (Ariz. 1990).

[113] *Id.* at 1194.

[114] *Id.* at 1194–95 (determining while the court generally strictly construes statutes that are in derogation of common law, the court decided not to strictly construe statute at issue because doing so would give landlord an undue advantage over tenant by permitting forfeiture for every breach).

[115] *Id*. at 1201.

[116] *Id*.

[117] *See* RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT § 4.1 (AM. LAW INST. 1977) (providing right to terminate before entry by tenant); *see also id*. § 4.2 (providing right to terminate after entry by tenant). The use of recording statutes by lenders creates a mechanism for disclosure to potential tenants of the existence of paramount title. *Id*. § 4.1.

Because the landlord's primary duty is to provide the tenant with use of the premises for the term of the lease, the unsuitability of the premises for the intended use may give rise to the tenant's right to terminate the lease.[118] In a number of states, at least in the residential context, the tenant may terminate the lease where the landlord has failed to make the premises habitable, and may also abate the payment of rent or pursue damages.[119] Also, the conduct of the landlord or someone whose conduct is attributable to the landlord who interferes with a permissible use of the leased property may give the tenant the right to terminate the lease.[120] Such a situation is commonly referred to as "constructive eviction," and arises where such conduct renders the premises unsuitable to the tenant's use for the intended purpose.[121]

The landlord-tenant relationship is thus built on both principles of contract law and common-law rules of the law of property. Over the years, state law has developed beyond the common-law to provide grounds under which the landlord (or the tenant) may terminate a lease despite the prior conveyance of the leasehold from landlord to tenant. Those grounds of course have limits that vary from state to state, but it is fair to say that the old common-law rules that severely limited terminations by either party have been scaled back considerably.

D. The Landlord's Sale, Outside Bankruptcy, of Real Property Subject to a Lease

The prospective buyer of a piece of real property will be concerned that he or she will obtain title to the property that is "marketable," that thus includes the legal and equitable estate and is free of undue encumbrances that would cause a reasonable buyer who is well-informed as to the facts and their legal effect to refrain from closing the sale.[122] Even with extensive public records regarding real property conveyances and transactions, there is always risk to a buyer that undisclosed issues exist regarding a seller's title, and thus in the United States today sales of real property are typically effected with the benefit of some form of title insurance.[123]

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[118] The common-law rule put the risk on the tenant, as to whether the condition of the premises would make it unsuitable for the use contemplated by the parties. *See supra* notes 47–48 and accompanying text; *see also* RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT ch. 5, intro. note (AM. LAW INST. 1977).

[119] *See* RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT § 5.1 (AM. LAW INST. 1977) (stating general rule); *id.* ch. 5, statutory note (summarizing various state laws governing tenant's rights to terminate lease).

[120] *Id.* § 6.1.

[121] *Id*.

[122] *See* Hocking v. Pac. Coast Title Ins. & Tr. Co., 234 P.2d 625, 628 (Cal. 1951) (noting that perfect title means "free from reasonable objection, such as litigation, palpable defects and grave doubts fairly deducible of record, and unencumbered").

[123] *See* AMER. LAND TITLE ASS'N, TITLE INSURANCE: A COMPREHENSIVE OVERVIEW 2 (2007) https://www.alta.org/about/TitleInsuranceOverview.pdf (including brief review of title issues).

Under the typical title insurance policy, the existence of a lease to the seller's property, like a judgment lien, a deed of trust or mortgage, or a restrictive covenant, is considered a matter that prevents title from being fully marketable.[124] The conveyance of title to the buyer will be subject to the lease to the tenant, and a relevant title insurance report should include the existence of the lease, which (or an abstract of which) would be recorded by the careful tenant at the outset of the lease.[125] Where a lease or abstract thereof has not been recorded, it may be necessary for a title insurer to inquire of persons in possession to determine their rights, as much as it is necessary to inquire of the seller.[126]

Where the seller is a landlord with respect to all or part of the property subject to sale, it is typical that the sale agreement provide for conveyance of the property subject to the lease, and for the buyer's assumption of the lease agreement; for the seller to deliver title free of a lease, it will be necessary for the lease to have terminated, typically by expiration of the term, and the tenants should be taken out of possession, through legal process if necessary.[127] Otherwise, the buyer will not be acquiring fully marketable title to the property.[128]

When a landlord files a petition for bankruptcy relief, the Estate Representative's rights in the estate's real property will be determined by applicable state law, which as explained above is generally characterized by the tension between the property-law principles and contract-law principles inherent in such law. What follows is an examination of how these rights are treated in cases under the Code.

II. REJECTION OF A LEASE UNDER THE CODE: THE ISSUE OF TERMINATION

As one of the lengthier sections in the Code, section 365 provides a "structure for processing executory contracts"[129] and unexpired leases.[130] Under section 365(a), an Estate Representative, with specific exceptions under subsections (b), (c), and (d), "may assume or reject any executory contract or unexpired lease of the

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[124] *See* 1 ALICE L. AKAWIE ET AL., CALIFORNIA REAL PROPERTY SALES TRANSACTIONS § 4.51 (4th ed. 2014) (listing examples of such matters).

[125] *See* Jane Armstrong, Searching For and Examining Title § 3.12 (2013).

[126] *See* 1 AKAWIE ET AL., *supra* note 124, § 4.71.

[127] *See id.* § 3.27.

[128] *See id*. §§ 4.72–4.73.

[129] *In re* El Paso Refinery, L.P., 220 B.R. 37, 40 (Bankr. W.D. Tex. 1998).

[130] Professor Westbrook notes that this structure is "very sophisticated, but it has grown terribly convoluted and hopelessly complex." He goes on to observe: "Section 365 itself has become so long there is an audible groan from a bankruptcy class when the day comes to open the [Bankruptcy] Code to that section." Jay Lawrence Westbrook, *The Commission's Recommendations Concerning the Treatment of Bankruptcy Contracts*, 5 AM. BANKR. INST. L. REV. 463 (1997) (title referring to NATIONAL BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS (FINAL REPORT) (1997). Carl Pickerell states that section 365 "constitutes one of, if not the, most convoluted sections of the Code." Carl N. Pickerell, *Executory Contracts Re-Revisited*, 83 AM. BANKR. L.J. 63, 63 (2009).

debtor."[131] After assumption,[132] an Estate Representative may also assign an executory contract or unexpired lease under the conditions set out in subsection (f).[133] Section 365 does not require the assumption or rejection of a contract or lease, although rejection may result from inaction.[134]

Section 365(g) provides simply, with two exceptions, that the rejection of an executory contract or unexpired lease "constitutes a breach of such contract or lease."[135] If the contract or lease had not been assumed at an earlier time in the bankruptcy case, such breach is deemed to occur immediately before the date the bankruptcy petition was filed.[136]

While a trustee or debtor in possession could breach a contract by simply refusing to perform, section 365 benefits the bankruptcy estate by deeming the breach to have occurred immediately before the bankruptcy filing.[137] This causes the non-debtor party's damages to constitute a pre-bankruptcy claim that is allowed among other unsecured claims that arose before the debtor's bankruptcy was filed, meaning that contract damages will simply be treated as one of typically many pre-bankruptcy claims whose holders might be able to recover only a small pro-rata

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[131] 11 U.S.C. § 365(a) (2012). Under section 365, the trustee's duties under sections 765 and 766 also create exceptions to the trustee's authority to assume or reject contracts of a debtor that is a commodity broker. Section 765(b) requires the trustee's compliance with instructions received from customers regarding disposition of commodity contracts and section 766 requires the trustee to distribute customer property pursuant to federal regulations. *See* 6 COLLIER ON BANKRUPTCY ¶ 765.01, ¶ 766.01, at 765-2 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed. 2011).

[132] When a contract or lease is assumed, the bankruptcy estate becomes bound to the terms of the contract, just as the debtor was bound before the filing of the bankruptcy petition, and therefore the bankruptcy estate must bear the ongoing burdens of the contract in order to realize its benefits. *See In re* Harry C. Partridge, Jr. & Sons, Inc., 43 B.R. 669, 672 (Bankr. S.D.N.Y. 1984) (regarding contract for construction services). Assumption of a contract means that any amounts payable by the debtor party under the contract are thereafter payable as an administrative expense of the bankruptcy case. *See In re* El Paso Refinery, L.P., 220 B.R. at 41; *see also* Nostas Assoc. v. Costich (*In re* Klein Sleep Prods. Inc.), 78 F.3d 18, 30 (2d Cir. 1996) (concluding administrative claim lies where lease is rejected by a trustee after the debtor in possession had assumed lease); Microsoft Corp. v DAK Indus., Inc. (*In re* DAK Indus., Inc.) 66 F.3d 1091, 1094 (9th Cir. 1995) (holding where executory contract rejected and creditor provided no consideration post-petition, no administrative claim lies despite benefit to estate from post-petition sales of software under contract).

[133] *See* 11 U.S.C. § 365(f).

[134] In the case of the debtor-tenant's non-residential lease, the failure to assume within the time allowed by the statute will result in rejection. *See id.*; *see also infra* notes 162–200 and accompanying text.

[135] 11 U.S.C. § 365(g). The two exceptions are set out in subsections (h)(2) and (i)(2), governing, respectively, the rejection of a timeshare contract by a seller's estate and the rejection of a contract for sale of real property or timeshare interest by a seller's estate.

[136] *See id.* § 365(g)(1); *see also* Miller v. Chateau Communities (*In re* Miller), 282 F.3d 874 (6th Cir. 2002) (stating trustee's rejection of month-to-month lease caused debtor-tenant's breach as of bankruptcy filing and related obligation was discharged; debtor incurred no post-petition obligation to landlord as she had abandoned property). If, however, the contract or lease had been assumed earlier in the case, the breach is deemed to occur at the time of rejection, but where the case involves conversion under sections 1112, 1208, or 1307, the breach is deemed to occur either immediately before conversion (where it had been assumed before such conversion) or at the time of rejection (where it had been assumed after such conversion). *See* 11 U.S.C. § 365(g)(2).

[137] *See* 11 U.S.C. § 502(g)(1).

distribution in the bankruptcy case.[138] Where the debtor is a non-residential tenant, section 365 requires the debtor in possession or trustee to perform post-petition obligations, including the payment of rent installments as they come due,[139] until such time as the lease is assumed or rejected. Thus, if assumption of a lease is not planned, the debtor or trustee will often seek prompt rejection of the lease and surrender of the premises to minimize a claim for the amount of post-petition rent that would accrue and have to be paid when any reorganization plan becomes effective.[140]

Despite the relative simplicity of the language of section 365(g), one court has observed that "[t]he effect of rejection is one of the great mysteries of bankruptcy law."[141] Regarding the effect of rejection, there is an inconsistency among judicial opinions involving a tenant's nonresidential lease.[142] As outlined below, while courts are fairly consistent in finding that rejection of a lease by the representative of a *landlord's* estate will not *per se* result in termination of the lease,[143] perhaps the majority of courts have determined that rejection of a lease by the representative of a *tenant's* bankruptcy estate, at least if it is nonresidential, will result in termination of the lease.[144]

To make sense of why the outcomes should differ where a landlord's estate rejects a lease and where a tenant's estate rejects a lease, a look at the drafting and amendment of the relevant subsections of section 365 is in order.

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[138] A claim arising from rejection of an unexpired lease is allowed or disallowed as if the claim "had arisen before the date of the filing of the [bankruptcy] petition." *Id.* § 502(g)(1). While pre-petition claims may ultimately receive only pennies on the dollar, claims based on post-petition transactions that benefit the bankruptcy estate are subject to full payment typically no later than the effective date of a chapter 11 plan or the final distribution in a chapter 7 liquidation. *See, e.g.*, *In re* Goody's Family Clothing, Inc., 610 F.3d 812, 817–18 (3d Cir. 2010) (explaining that while section 365(d)(3) requires payment of post-petition rent as it comes due, section 503(b)(1) gives landlord an administrative claim for the value of possession between petition date and first rent payment (so-called "stub rent")). When the lease is ultimately terminated in the bankruptcy case of a tenant, the landlord's claim for damages arising from unpaid rents is subject to a "cap," which typically serves to reduce the landlord's distribution in the case. *See* 11 U.S.C. § 502(b)(6) (providing for disallowance of claim "for damages resulting from the termination of a lease" to the extent the claim exceeds amount of rent under stated formula).

[139] *See* 11 U.S.C. § 365(d)(3) (stating with exception of obligations based on lease provision relating to insolvency, bankruptcy or the like, the "trustee shall timely perform all the obligations of the debtor . . . arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected").

[140] *See* Pac. Shores Dev., LLC v. At Home Corp. (*In re* At Home Corp.), 392 F.3d 1064, 1075 (9th Cir. 2004) (authorizing rejection that is effective on date debtor filed its motion to reject lease); TreeSource Indus. v. Midway Engineered Wood Prods., Inc. (*In re* TreeSource Indus.), 363 F.3d 994, 998 (9th Cir. 2004) (finding creditor's claim based on breached maintenance obligation not an administrative expense where the obligation was breached only when debtor rejected lease).

[141] *In re* Henderson, 245 B.R. 449, 453 (Bankr. S.D.N.Y. 2000).

[142] *See In re* Park, 275 B.R. 253, 257–59 (Bankr. E.D. Va. 2002) (discussing cases involving implied termination of leases under 11 U.S.C. § 365(d)(4)).

[143] *See infra* notes 145–75 and accompanying text.

[144] *See infra* notes 182–200 and accompanying text.

A. Rejection by the Landlord-Debtor: Section 365(h)

Section 365(h)(1)(A) provides as follows where a real property lease of a debtor-lessor is rejected:

> (i) if the rejection by the trustee amounts to such a breach as would entitle the lessee to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law, or any agreement made by the lessee, then the lessee under such lease may treat such lease as terminated by the rejection; or
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> (ii) if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.[145]

Thus, the lessor's rejection causes a breach of the lease and does not cause termination of the lease *per se*; instead a termination may result only to the extent as may be provided by contract or state law. Section 365(h) also states that the tenant that chooses to retain its rights under the rejected lease is entitled to offset "rent reserved under such lease" against the "value of any damages caused" by the landlord's nonperformance.[146] The provision says nothing as to whether tenant is entitled to any further remedies against the debtor or its bankruptcy estate on account of damages caused by the nonperformance. Section 365(h) thus simply sets out the result of a landlord's or its trustee's rejection of a real property lease: the tenant is entitled either to treat the lease as terminated if this result is available under state law, or to retain possession and offset the amount of damages determined under the lease agreement and state law against future rent payments.[147]

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[145] 11 U.S.C. § 365(h)(1)(A) (2012).
[146] *Id*. § 365(h)(1)(B).
[147] *Id*. § 365(h)(1); s*ee also In re* Revel AC, Inc., 532 B.R. 216, 229 (Bank. D.N.J. 2015) (holding that:

> [u]nder § 365(h), the Tenants are entitled to remain in possession for the balance of the terms set forth in the Agreements, and any renewal or extension period . . . During their time in possession, the Tenants retain the right to use and quiet enjoyment of the premises, as well as such rights appurtenant to the real property . . . Furthermore, the Tenants may offset (against rent) any damages caused, after rejection, by the Debtors' nonperformance.

Typically, outside bankruptcy a landlord's breach of a lease does not simply result in termination of the lease; that is, the breach does not cut off the tenant's rights under the contract. Any attempt by the landlord to evict the tenant could be countered by the tenant's defenses that she has tendered all rent payments as due and has otherwise performed all obligations under the lease. Under contract principles, the tenant would be entitled to recover damages caused by the landlord's failure to perform any obligations due under the lease.[148] On its face, then, section 365(h) preserves the result of a landlord's breach under state law.

The language of section 365(h) has evolved considerably since its enactment in 1978, and this evolution yields some insight into the "great mystery" of lease rejection. Professor Robert Zinman has reviewed the genesis and development of section 365(h) in his excellent 2004 article.[149] Professor Zinman begins his travels down the "Road to [section] 365(h)" with the observation that "the liquidation sections of the Bankruptcy Act [which preceded the Code] provided that rejection by the trustee of a bankrupt landlord would not 'deprive the tenant of his estate.'"[150] This provision was intended to prevent the landlord's bankruptcy from working a forfeiture of the tenant's estate and to prevent the trustee from causing a forfeiture.[151]

Professor Zinman also points out that the Penn Central Transportation Company bankruptcy proceeding, which was pending under the Bankruptcy Act at the time the Commission on the Bankruptcy Laws of the United States was meeting to propose revisions to existing bankruptcy law, caused great consternation among leasehold lenders.[152] This was because the Penn Central trustee sought to disaffirm (i.e. to reject) ground leases in New York City for property over the railroad tracks, on which high-rise buildings had been erected.[153] Lenders had financed construction

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[148] *See supra* notes 85–121 and accompanying text.

[149] Zinman, *supra* note 14, at 115 (discussing development of 11 U.S.C. § 365(h)).

[150] *Id*. at 102 (quoting Bankruptcy Act of 1898, ch. 541, § 70(b), 30 Stat. 544, 565–66 (codified as amended at 11 U.S.C. § 110(b) (1976) (repealed 1978)) (indicating liquidation provisions of the Bankruptcy Act were set out in section 70(b)).

[151] *See* Zinman, *supra* note 14, at 104 n.20 (noting Professor McLaughlin said "[t]he bankruptcy of a landlord, however, shall not work forfeiture of the tenant's estate and shall give the landlord's trustee in bankruptcy no election to terminate the estate"); *see also* James A. McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 583, 606 (1927).

[152] *See* Zinman, *supra* note 14, at 104–06.

[153] *Id.* at 103–05. As a "new, young attorney" at Metropolitan Life Insurance Company in 1960, Mr. Zinman's first memorandum concerned "the effect of a bankruptcy landlord's rejection of a lease on the tenant and others with interests in the lease, such as leasehold mortgagees." *Id.* at 102. The Penn Central Station is located in the underground levels of Pennsylvania Plaza, between Seventh Avenue and Eighth Avenue and between 31st and 33rd Streets in Midtown Manhattan. It is close to a number of Manhattan landmarks, including Madison Square Garden and the Empire State Building. *See* KENNETH T. JACKSON, ED., THE ENCYCLOPEDIA OF NEW YORK CITY 987 (2d ed. 2010). As such, the value of the leases involved in the Penn Central bankruptcy would have been substantial indeed. The bankrupt (as debtors were then known) received about $21 million a year in ground rents from tenants on the so-called "Park Avenue Properties." While this was "a lot of money in those days," it was also true that "the fixed rents under these long term leases, entered into years before, were well below market." Zinman, *supra* note 14, at 105 n.26;

and improvements under loans secured by the ground tenant's leasehold interest.[154] As these security interests were inferior to the grant of the leasehold to the ground-lease tenants, "the prospect of lease rejection, or even of rejection of the renewal and rental provisions, sent shivers through the real estate community."[155]

The Penn Central trustee argued that he merely sought to disaffirm his relatively few obligations under the leases and did so with the object of negotiating new, higher rental rates more appropriate to the existing market.[156] Among other things, the lessees argued that section 70(b) of the Bankruptcy Act, part of the liquidation provisions of the statute that permitted a trustee to disaffirm or reject unexpired real property leases, was not available to a trustee under section 77 in a corporate reorganization such as Penn Central's, and also that even if it were available, to permit the trustee to "exact increased rent payment on pain of eviction would be tantamount to depriving them of their estates, in violation of [section] 70(b)."[157]

The district court observed that the arguments of each side reflected issues "which have long occasioned debate among bankruptcy experts." [158] After discussing the issues only briefly, the court refused to authorize the trustee to disaffirm the ground leases in question.[159] The court did so primarily because disaffirmation of the arms-length transactions, even if "they are less attractive now than they might be, would aggravate rather than minimize financial disruption and chaos, a result at odds with the goals of the bankruptcy law.[160]

Given this background, section 365(h) was drafted in an attempt to deal with the uncertainties that existed under section 70(b) of the Bankruptcy Act, regarding whether terms providing for and governing the tenant's rights to renew a lease would survive rejection (they were to survive), and also whether rejection would be available to trustees under all chapters of the new Bankruptcy Code (it would be available under all chapters).[161] As enacted, section 365(h) made no reference to the termination or forfeiture of a rejected contract or lease, and it made no reference to a trustee's surrender of leased premises. In 1978 the provision read as follows:

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see also In re Penn Cent. Transp. Co., 458 F. Supp. 1346, 1354 (E.D. Penn. 1978) (noting property subject to disaffirmed leases was to be liquidated, and result of disaffirmance of under-market leases would be "to increase, quite substantially, the avails of the Asset Disposition Program").

[154] *In re Penn Cent. Transp. Co.*, 458 F. Supp. at 1354.

[155] Zinman, *supra* note 14, at 105.

[156] *In re Penn Cent. Transp. Co.*, 458 F. Supp. at 1354–55.

[157] *Id*. at 1355.

[158] *Id.* at 1354–55.

[159] *Id*. at 1356.

[160] *Id.* At the same time, the court observed that "[e]ven in liquidation proceedings, to which § 70(b) is clearly applicable, the bar against depriving the lessee of his estate cannot reasonably be interpreted as an absolute bar against all interference with the lessee's rights in the event of the lessor's bankruptcy." *Id*. at 1355.

[161] *See* Zinman, *supra* note 14, at 106–10.

> 1) If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, the lessee under such lease may treat the lease as terminated by such rejection, or, in the alternative, may remain in possession for the balance of the term of such lease and any renewal or extension of such term that is enforceable by such lessee under applicable nonbankruptcy law.
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> 2) If such lessee remains in possession, such lessee may offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease, and any such renewal or extension, any damages occurring after such date caused by the non-performance of any obligation of the debtor after such date, but such lessee does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset.[162]

As outlined by Professor Zinman, different drafting approaches were proposed for section 365(h), including his own proposal, originating in 1971, that language of section 70(b) of the Bankruptcy Act be amended "to provide that, without limiting the meaning of the tenant's estate, no rejection by the landlord's trustee could 'affect any right of renewal or extension . . . or increase the rental or additional sums to be paid by the lessee pursuant to the terms of the lease.'"[163] After considering a number of proposals, the drafters of section 365(h) settled on language that was informed by intention of the drafters of section 70(b) of the Bankruptcy Act, that rejection cannot deprive the tenant of its "estate," but which instead focused "in practical terms what would happen on rejection."[164]

Shortly after the Code became effective in October 1979, Congressman Don Edwards, a major proponent of the enactment, clarified that "[s]ection 365(h) is not intended to provide the debtor's lessee rights that would not otherwise exist outside bankruptcy."[165] This statement was intended to address concerns in the real estate lending community that the language of section 365(h) might be construed to permit

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[162] Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, 2574 (1978).

[163] Zinman, *supra* note 14, at 106 (quoting John J. Creedon & Robert M. Zinman, *Landlord's Bankruptcy: Laissez Les Lessees*, 26 BUS. LAW. 1391, 1435–36 (1971)).

[164] Zinman, *supra* note 14, at 109.

[165] *Id.* at 111 (quoting 126 CONG. REC. 31, 917 (1980)). The statement is consistent with the Supreme Court's view that the Code generally does not determine the extent of interests in property of the bankruptcy estate, which is instead determined under applicable state law. Butner v. United States, 440 U.S. 48, 55 (1979); *see also* Barnhill v. Johnson, 503 U.S. 393, 398 (1992). The statement confirms that "the tenant retained in bankruptcy whatever right it would have had under nonbankruptcy law to treat the lease as terminated, such as upon a breach by the landlord that would amount to constructive eviction." Zinman, *supra* note 14, at 113.

tenants of the debtor-landlord to endanger a lender's security interest by terminating leases where they could not do so outside bankruptcy.[166]

But there was continuing concern in the lending community that language in section 365(h) (tenant may "remain in possession") would lead to a conclusion that only a tenant's rights to possession were to remain intact after rejection, rather than the tenant's rights under state law to its property interests as lessee.[167] These concerns among others motivated the adoption of several amendments to section 365(h) in 1984.[168]

Notably, the 1984 amendments revised section 365(h) to state that after rejection the tenant may remain "in possession of the *leasehold* . . . under any lease . . . the term of which has commenced."[169] By using the term "leasehold" to refer to the tenant's retained rights, Congress adopted terms akin to the language of the Bankruptcy Act of 1898,[170] referring as much to a property interest in the hands of the tenant as to the specific provisions of a contract with the landlord.[171]

But within less than a decade after the 1984 amendments to section 365(h), a few courts began to interpret even the revised language to limit the tenant's post-rejection rights.[172] One opinion determined that post-rejection the tenant retained only the bare right to possession of the property itself.[173] Apparently, in response to such cases, leasehold lending dropped off, and, at the behest of the lending community, further amendments were made to section 365(h) in 1994.[174] After these further amendments, section 365(h) no longer made reference to the tenant's post-rejection retention of the "leasehold," but instead to "its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property."[175]

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[166] *See* Zinman, *supra* note 14, at 111.

[167] *Id*. at 111–14.

[168] *Id*. at 114–16.

[169] *Id*. at 114–15 (emphasis added) (quoting Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 402, 98 Stat. 333, 367 (1984)).

[170] *See* Zinman, *supra* note 14 and accompanying text (quoting section 70(b) of the Bankruptcy Act).

[171] *See supra* notes 35–47 and accompanying text (discussing principles of property law in development of law of leases).

[172] *See In re* Lee Rd. Partners Ltd., 169 B.R. 507, 509 (E.D.N.Y. 1994) (holding "in possession" under 11 U.S.C. 365(h)(1) was to be construed broadly, allowing lessee of lessor-debtor to remain in lease for balance of term).

[173] Zinman, s*upra* note 14, at 115–16 (discussing *In re* Carlton Rest., 151 B.R. 353, 356 (Bankr. E.D. Pa. 1993) (stating tenant, under lease that was rejected in landlord's earlier chapter 11 case, cannot assign lease in its own subsequent bankruptcy; section 362(h)(2) "does *not* provide that the lease continues, but merely accords a *lessee* the choice to remain in a rented premises *under the terms* of the lease")) (emphasis in original); *In re* Arden & Howe Assocs., Ltd., 152 B.R. 971 (Bankr. E.D. Cal. 1993) (asserting trustee's rejection of lease deprives tenant of right to enforce restrictive covenant in lease).

[174] Zinman, *supra* note 14, at 115–18.

[175] *Id.* at 117. Another commentator suggests that section 365(h) should provide that rejection "does not deprive the lessee of its rights under the lease," because the "if/then" language currently used may cause a

While section 365(h) had numbered approximately 150 words in 1978,[176] it had grown to approximately 580 words with the 1994 amendments.[177] One might fault the drafters of the provision for using the language specifically chosen, but the "sad history" of section 365(h) reveals an intent, from the start, to provide that the landlord's rejection would not add to or detract from the rights the tenant would have had after the landlord's breach of the lease contract under state law. This intent reflects the general principle that the parties' contract rights under the Bankruptcy Code are generally to be determined by applicable state law, except where the Code itself requires a change in such law.[178]

At the behest of leasehold lenders, then, section 365(h) has been revised in attempts to clarify that a landlord's rejection of the lease is not *per se* to terminate the lease.[179] Non-termination helps protect the leasehold lender's security interest under the relevant loan documents, and, as under state law, a landlord's breach of a lease outside bankruptcy would give the tenant resort to various remedies, not simply a right to declare the lease terminated, which would jeopardize the lender's security interest in the lease. Incidentally, non-termination is also consistent with the common-law concept of the leasehold as the conveyance of an interest in property, which conveyance is not tied specifically to the enforcement of the terms of the contract.[180]

As noted above, section 365(g) states simply that rejection of a lease or contract constitutes the breach of the lease or contract, and says nothing about its termination. Given section 365(h)'s history seeking to clarify that the tenant's rights appurtenant to the real property survive rejection of the lease by the landlord's Estate Representative, it is informative to turn next to discussion of the effects of the rejection of a lease by the representative of a tenant's estate.

B. Rejection by the Debtor-Tenant: Section 365(d)(4)

Under section 365(h), it is clear that the rejection of a lease by the debtor-landlord or its trustee should not, in and of itself, terminate the lease.[181] Should the result be different when the representative of a tenant's estate rejects a lease? As explained below, the result in general should not be different, but in practice it often is different.

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court to conclude that section 365(h) is evidence of an intent to make the right to retain possession absolute, where leases are otherwise subject to termination through the Estate Representative's avoidance powers. James S. Millar, *Fixing the Qualitech Problem by Revising § 365(h)*, 31 AMER. BANKR. INST. J., July 2012 at 36, 36–37, 82.

[176] *See* Bankruptcy Reform Act of 1978, Pub. L. 95-598, § 365, 92 Stat. 2549 (codified as amended at 11 U.S.C. § 365(h)(2012)).

[177] *See* 11 U.S.C. § 365(h).

[178] *See supra* notes 29–34 and accompanying text.

[179] *See* 11 U.S.C. § 365(h).

[180] *See supra* notes 46–55 and accompanying text.

[181] *See* Sir Speedy Inc. v. Morse, 256 B.R. 657, 659 (D. Mass. 2000).

As originally enacted, section 365(d) provided as follows:

> (d)(1) In a case under chapter 7 . . . if the trustee does not assume or reject an executory contract or unexpired lease of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected.
>
> (2) In a case under chapter 9, 11, or 13 . . . the trustee may assume or reject an executory contract or unexpired lease of the debtor at any time before confirmation of a plan, but the court . . . may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.[182]

Section 365(d)(1) thus simply imposed a specific time limit for a chapter 7 trustee's assumption or rejection of a lease, and made no reference to the status of the debtor under the lease (i.e. as tenant or as landlord), made no reference to termination of the lease upon rejection, and also made no reference to the surrender of any property subject to the lease after rejection.[183]

In 1984, however, section 365(d) was amended, "as the result of heavy lobbying by the lessors," the goal being to provide remedies for delays experienced by landlords in their recovery of possession of commercial premises after rejection by debtor-lessees and their trustees.[184] The 1984 amendments added subsections (d)(3) and (d)(4), and modified the language of subsections (d)(1) and (d)(2).[185]

Subsection (d)(1), providing for the sixty-day period for assumption or rejection, was modified to refer to only residential real property leases and personal property leases, thus restricting its scope.[186] Subsection (d)(2) was also modified, adding a reference to chapter 12 cases and also restricting the subsection to leases of residential real property and personal property.[187] Subsection (d)(3) was added to give the trustee or debtor in possession the duty to comply with most obligations under the contract or lease until assumption or rejection.[188]

Finally, new subsection (d)(4) provided for special treatment for nonresidential real property leases under which the debtor is lessee, without reference to the

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[182] Bankruptcy Reform Act of 1978, Pub. L. 95-598, § 365, 92 Stat. 2549 (codified as amended at 11 U.S.C. § 365(h)).

[183] *See* 11 U.S.C. § 365(d)(1); Theater Holding Corp., 681 F.2d 102, 104–05 (2d Cir. 1982).

[184] *In re* Bernard, 69 B.R. 13, 14 (Bankr. D. Haw. 1986); *see also* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. 98-353, Subtitle C, 98 Stat. 333, 367 (codified as 11 U.S.C. § 365(d)).

[185] *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. 98-353, Subtitle C, 98 Stat. 333, 367 (codified as 11 U.S.C. § 365(d)).

[186] *Id.*

[187] *Id.*

[188] *Id.*

chapter under which the bankruptcy petition was filed.[189] New subsection 365(d)(4) provided that a nonresidential real property lease is "deemed rejected, and the trustee shall immediately surrender such nonresidential real property to the lessor," where the lease has not been assumed or rejected within a sixty days of the bankruptcy filing.[190]

Some courts have looked to section 365(d)(4)'s requirement for surrender of the nonresidential property, to conclude that the deemed rejection effects the termination of the lease, not merely its breach.[191] Going further, other courts have determined that the nonresidential tenant's deemed rejection under section 365(d)(4) causes termination of a third party's rights related to the lease. For example, in one 1988 case, *In re Gillis,* the individual chapter 13 debtor was, with the landlord's consent, the assignee of a tenant's rights in certain commercial property, which the debtor in turn subleased to third parties, including his own corporation (the original lessee).[192] Before the bankruptcy filing, a lender had taken a security interest in the debtor's interest in the lease with the property owner to secure the debtor's repayment of certain loans.[193] As of the bankruptcy filing, the lender had started the process of collecting rents from subtenants and foreclosing on the debtor's interest after the debtor had defaulted under the terms of the loans.[194]

In the bankruptcy case, the owner brought a motion for allowance of an administrative claim to recover the value of unpaid post-petition rent after the case had been converted to chapter 7.[195] Because the debtor's lease with the owner had not been assumed within the time frame stated in section 365(d)(4), the bankruptcy court determined that the lease between the debtor and the owner had been rejected.[196] It further found that the rejection under section 365(d)(4) caused the lease with the owner to be terminated, and as a result "the Bank's security interest was completely extinguished."[197] This, said the court, occurred after the sixtieth day

[189] *Id*. at 362–63.
[190] *Id.* at 367; *but see* 11 U.S.C. § 365(d)(4) (2012) (providing for 120-day time period before deemed rejection).
[191] *See, e.g.*, *In re* Henderson, 245 B.R. 449, 453 (Bankr. S.D.N.Y. 2000) (explaining while rejection under section 365(a) typically breaches, but does not terminate, a lease, "rejection is tantamount to termination" in cases of rejection under section 365(d)(1), due to requirement of immediate surrender); *see also In re* Giles Assocs., Ltd., 92 B.R. 695, 698 (Bankr. W.D. Tex. 1988) (stating section 365(d)(4) terminates lease as to all parties, as "breach plus the surrender obligation can only be seen as termination of any of the trustee's or debtor's rights in the leasehold").
[192] *In re* Gillis, 92 B.R. 461, 462–63 (Bankr. D. Haw. 1988).
[193] *Id.* at 463.
[194] *Id*. The court states that the lender had obtained a "decree of foreclosure," regarding its interest in the lease, about a month before the bankruptcy filing. No foreclosure sale had apparently been conducted however, leaving intact the debtor's legal and equitable rights. *Id*. at 469–70.
[195] *Id*. at 464.
[196] *Id*. at 465.
[197] *Id.*

of bankruptcy,[198] and meant that the court had jurisdiction only of those rents collected in the 60 days after the order for relief was entered.[199]

The *Gillis* court reached its conclusions without even a cursory analysis of whether the language of section 365(g) should be considered, and thus whether the effect of the breach caused by the rejection should be considered in light of state law to determine if it caused termination of the lease. Instead, the court stated that "[t]he termination of the Lease pursuant to Section 365(d)(4) is absolute, and, based upon the Supremacy Clause and the doctrine of federal preemption, cannot be affected or impaired by . . . state law."[200] Thus, the *Gillis* court implied a termination of the lease from the language of section 365(d)(4), which expressly requires only the trustee's surrender of the property, regardless of what state law or the lease itself might have required due to the trustee's breach of the lease.

C. The Role of State Law in Lease Rejection

By contrast to *Gillis* and similar opinions, some courts have reached the conclusion that a deemed rejection under section 365(d)(4), despite the requirement that the trustee turn over possession to the landlord, does not *per se* involve termination of the lease.[201] One such case is *In re Park*.[202] The joint individual chapter 7 debtors had scheduled a commercial lease under which they were

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[198] Section 365(d)(4) was amended in 2005, to among other things, lengthen the 60-day period for the assumption or rejection. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 404(a) 199 Stat. 23, 104 (extending 60-day period to 120 days, but limiting extension of such period).

[199] *In re Gillis*, 92 B.R. at 469. The court did not distinguish between rents collected during that period and rents that became payable during that period.

[200] *Id.* at 465 (citing *In re* Spats Rest. & Saloon, 64 B.R. 442, 447 (Bankr. D. Nev. 1986) and *In re* Sw. Aircraft Servs., 53 B.R. 805, 810 (Bankr. C.D. Cal. 1985)). Further, regarding the extinguishment of the lender's security interest, the court looked merely to a general treatise on real property, a New York state case, and to *In re* Bernard, 69 B.R. 13, 14–15 (Bankr. D. Haw. 1986), which found a leasehold lender's rights to be extinguished based primarily on policy considerations, specifically that permitting the security interest to survive rejection would frustrate a Congressional intent to see that lessors avoid undue delay in recovering possession after a tenant's bankruptcy. *See In re Bernard*, 69 B.R. at 14–15. This scenario is certainly the leasehold lender's nightmare. *See generally* Zinman, *supra* note 14.

[201] *See, e.g.*, Eastover Bank for Sav. v. Sowashee Venture (*In re* Austin Dev. Co.), 19 F.3d 1077, 1082–83 (5th Cir. 1994) (noting that terms "termination" and "breach" are not interchangeable under state law, and stating that "[t]he cases that equate rejection with lease termination under § 365(d)(4) ultimately rest on a manufactured definition of termination as 'breach plus surrender of the premises'"); *In re* Picnic 'N Chicken, Inc., 58 B.R. 523, 525–26 (Bankr. S.D. Cal. 1986) (stating "[a]lthough there is a paucity of cases dealing with the issue of the effect of the debtor's rejection of an unexpired lease, . . . the better-reasoned decisions hold that rejection . . . does not necessarily terminate the lease agreement for all purposes," and noting that applicable "California law provides that breach of a lease is not synonymous with termination of that lease" (citations omitted)); 3 COLLIER ON BANKRUPTCY, ¶ 365.10[3], at 365-80 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed. rev. 2011) (stating "[t]he effect of rejection . . . is limited to a breach or abandonment by the trustee or debtor in possession rather than a complete termination of the lease"). *See generally* Zinman, *supra* note 14, at 149–61 (discussing the amendments to section 365 in detail).

[202] 275 B.R. 253 (Bankr. E.D. Va. 2002).

designated as the tenant.[203] The premises were used by the debtors' corporation for its business operations, and the debtors' trustee did not assume the lease within the time period required by section 365(d)(4).[204] Although it appears that the debtors or the corporation had continued to pay rent due under the lease post-petition, the landlord brought a motion seeking relief from the automatic stay to recover possession.[205]

In *Park*, the bankruptcy court was thus faced with an unusual factual situation: under the Code, the lease was deemed rejected, yet the debtors had kept rent payments current notwithstanding the rejection, and the landlord wanted relief from the automatic stay to evict the debtors.[206] The bankruptcy court determined that because the rejection terminated the estate's interest in the lease, and because the debtors' discharge had been entered by the court, the landlord's request for relief was moot.[207]

The court went on to explain that, as a matter of law, the trustee's rejection of the lease "did not, standing alone, terminate the debtors' leasehold interest."[208] The court discussed numerous cases holding that rejection under section 365(d)(4) does terminate the lease and other cases holding to the contrary, and found the latter cases (the minority) to be "better reasoned and . . . more persuasive."[209] Looking to the fact that section 365(d)(4) gives only the trustee, not the debtor, the duty to surrender the property, and to the fact that the debtor (in this case, individual debtors) may be the recipient of property abandoned by a trustee, the court concluded that "rejection by a trustee must be understood as affecting the rights and liabilities of the bankruptcy estate, not the debtor, at least where the debtor is an individual and was not a debtor in possession at the time the lease was rejected."[210]

Then, unlike the *Gillis* opinion, the *Park* opinion looks to applicable state law for the basis of its analysis.[211] Rejection is a breach of the lease, stated the court,

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[203] *Id.* at 254.
[204] *Id.*
[205] *Id.* 254–55.
[206] *Id*. at 256 (indicating "technical breach," but requiring interpretation as to whether "'material' breach allowing the landlord to treat the lease as terminated" occurred).
[207] *Id.* at 255 (asserting "[t]he automatic stay, as such, expired when the debtors received their discharge the day following the hearing"); *see also id*. at 256 (stating "[t]he trustee has no further interest in the lease").
[208] *Id*. at 259; *see also In re* CB Holding Corp., 448 B.R. 684, 686–87 (Bankr. D. Del. 2012) (asserting "[i]t is well-settled that the rejection of a lease pursuant to § 365 results in a prepetition breach; it does not constitute a termination of the lease") (quoting *In re* DBSI, Inc., 409 B.R. 720, 731 (Bankr. D. Del. 2009) (citations and internal quotation marks omitted)).
[209] *In re Park*, 275 B.R. at 258.
[210] *Id.* The statutory language is less clear regarding the termination issue where tenant who is a chapter 11 debtor in possession rejects a lease. *See* 11 U.S.C. § 502(b)(6) (2012) (providing for "cap" on "damages resulting from the termination of a lease" to extent the claim exceeds amount of rent under stated formula). One might ask whether use of the term "termination" rather than "rejection" in section 502(b)(6) is an indication that Congress intended that the section 502(b)(6) cap is meant to apply only where in fact a termination of the lease (not merely rejection) is ultimately effected.
[211] *See generally In re Park*, 275 B.R. at 258.

and "[i]n Virginia, the rule that only a 'material' breach of a contract will excuse performance by the other party is well-established."[212] The role of applicable state law is thus, under *Park*, an important point to a complete analysis of the effect of rejection.[213]

Given the language of section 365(g), which is applicable to all rejections, and the development of section 365(h) and its goal of preserving the Bankruptcy Act's protection of the tenant's rights notwithstanding rejection, some courts may be reading too much into the trustee's duty to surrender possession when a nonresidential lease of a debtor-lessee is deemed to have occurred under section 365(d)(4).[214] Further, confusion could be largely avoided by giving full deference to the principle that the bankruptcy estate's rights in property are typically governed by applicable state law, an approach that was taken by the Fifth Circuit in reversing the lower courts' determination that a "deemed rejection" under section 365(d)(4) caused termination of the relevant lease agreement.[215] So long as a debtor had an interest in a lease as of the bankruptcy filing, whether as a landlord or as a tenant, courts generally should look to state law to determine the legal effects of the breach of the lease that is occasioned by the Estate Representative's rejection under section 365.

A breach is generally, under state law, an unexcused failure to perform a duty that is due for performance under a contract.[216] The Restatement of Contracts, reflecting state law, distinguishes between a total breach and a partial breach of the contract, meaning that "[a]lthough every breach gives rise to a claim for damages, not every claim for damages is one for damages based on all of the injured party's remaining rights to performance under the contract."[217] A claim for damages based on all remaining rights is "one for damages for total breach."[218]

The circumstances of each bankruptcy case are properly considered in determining the effect of the breach caused by rejection. An extreme example, as in *Park*, may involve no defaults in performance when the rejection occurs.[219] In other

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[212] *Id*. at 256 n.7 (citations omitted).
[213] *See id.* at 259 (permitting landlords to seek possession under state law).
[214] *See supra* notes 191–200 and accompanying text.
[215] Eastover Bank for Sav. v. Sowashee Venture (*In re* Austin Dev. Co.), 19 F.3d 1077, 1083 (5th Cir. 1994) (stating "breach and termination of leases . . . are not synonymous terms under state law"; "cases that equate rejection with lease termination . . . ultimately rest on a manufactured definition of termination as 'breach plus surrender of the premises'"); *see also supra* notes 30–32 and accompanying text (discussing applicability of state law).
[216] *See* RESTATEMENT (SECOND) OF CONTRACTS § 235(2) (AM. LAW INST. 1979) (defining breach as non-performance when performance is due under contract).
[217] *Id*. § 236.
[218] *Id*.
[219] *See In re* Park, 275 B.R. 253, 259 (Bankr. E.D. Va. 2002) (holding "rejection of the lease by the trustee did not, standing alone, terminate the debtor's leasehold interest").

cases, there may be numerous breaches when the lease is rejected, making the rejection breach cause a total breach of the lease.[220]

Given the principles of lease rejection discussed above, it is clear that particularly under section 365(h) (where the tenant has the right to stay in possession), the representative of a landlord's bankruptcy estate should not successfully terminate the lease solely by way of rejection. It is also evident that rejection by a tenant's Estate Representative, notwithstanding section 365(d)(4), should not *per se* result in termination of the lease, either. The next appropriate topic, then, is to examine how section 363(f), which under *Qualitech* may be used by the representative of a landlord's estate to effect a sale of the real property free and clear of a tenant's rights under a lease, can, if at all, square with section 365(h).

III. SALES FREE AND CLEAR OF THE LEASEHOLD

Section 363, which consists of sixteen primary subsections, governs the use, sale, or lease of property of the debtor's bankruptcy estate.[221] Under section 363(c), if such use, sale, or lease is in the ordinary course of the debtor's business, the trustee or debtor in possession may conduct the transaction without a notice or a hearing.[222] Under section 363(b), if such use, sale, or lease is not in the ordinary course, the trustee or debtor in possession can conduct the transaction only after notice and a hearing.[223]

Section 363(f) confers authority to "sell property under subsection (b) or (c) free and clear of any interest in such property," if at least one of five conditions set out in subsections (f)(1) through (f)(5) is met.[224] However, "[t]he term 'any interest', as used in section 363(f), is not defined anywhere in the Bankruptcy Code."[225]

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[220] *See In re* El Paso Refinery, L.P., 220 B.R. 37, 41 (Bankr. W.D. Tex. 1998) (explaining debtor having stopped all performance, rejection as anticipatory breach of executory contract; comparing pre-Code cases, which held that filing of bankruptcy petition is anticipatory breach).

[221] *See generally* 11 U.S.C. § 363 (2012).

[222] *Id.* § 363(c); *see also* Moore v. Brewer (*In re* HMH Motor Servs., Inc.), 259 B.R. 440, 448–50 (Bankr. S.D. Ga. 2000) (outlining and applying two major tests for determination of whether challenged transaction was in "ordinary course" of business). "Notice and a hearing" is defined in 11 U.S.C. § 102(1).

[223] 11 U.S.C. § 363(b); *see also In re* Anchorage Nautical Tours, Inc., 145 B.R. 637, 642–43 (B.A.P. 9th Cir. 1992) (asserting chapter 11 debtor's surrender of vessel to lender that transferred rights to third party was not in ordinary course and consideration paid for transfer deemed subject to recovery).

[224] 11 U.S.C. § 363(f). While section 363(f) provides that property may be sold free and clear of "any interest in property," section 1141 provides that property dealt with by a chapter 11 plan can be made free and clear of "all claims and interests of creditors, equity security holders, and of general partners in the debtor." *Id*. § 1141(c). According to one commentary, "courts have largely ignored the absence of the word 'claims' in § 363(f)," and so doing have eroded prohibitions on pre-confirmation sales of essentially all assets of the debtor. George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 AM. BANKR. L.J. 235, 240–41 (2002).

[225] Folger Adam Sec., Inc. v. DeMatteis/MacGregor, J.V., 209 F.3d 252, 257 (3d Cir. 2000).

Before the enactment of the Code, courts authorized sales of property free and clear of liens.[226] In *Van Huffell v. Harkelrode*,[227] the Supreme Court determined that a bankruptcy court had authority to sell a real property free and clear of property tax liens, even though the Bankruptcy Act of 1898, then in effect, lacked provisions like those of its predecessor, the Bankruptcy Act of 1867, that expressly authorized such sales.[228] The Court stated that authority to order a sale free and clear of the tax lien was implied under the "general equity powers of the court" and the statutory duty to collect and distribute property of the bankrupt's estate and to resolve disputes concerning such property.[229]

Today the Code includes a definition of the term "lien," and section 365(f)(3) provides specifically for sales free of liens, only.[230] A "lien" is defined as a "charge against or interest in property to secure payment of a debt or performance of an obligation."[231]

Liens are thus only one type of interest in property. Courts have had little difficulty applying the Code's definition of the term "lien" in ruling on section 363(f) motions to sell real property free and clear of a lien.[232] For example, one court has determined that a *lis pendens* under Massachusetts law is simply a form of notice of a pending judicial proceeding involving real estate, and, because it does not secure payment or create or serve as a lien on real property, a party that recorded a pre-petition *lis pendens* against property subject to sale by an Estate Representative is simply an unsecured creditor without an interest in the property.[233]

In other cases, courts have made appropriate distinctions between liens and other interests in property when ruling on motions under section 365(f).[234]

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[226] *See* Van Huffell v. Harkelrode, 284 U.S. 225 (1931).

[227] *Id.*

[228] *Id*. at 228.

[229] *Id*. at 227–28; *see also* Rachel P. Corcoran, LL.M. Thesis, *Why Successor Liability Claims are Not "Interests in Property" Under Section 363(f)*, 18 AMER. BANKR. INST. L. REV. 697, 700–02 (2010) (providing analysis of *Van Huffell* and discussing pre-Code cases; noting that pre-Code cases involved sales of property free and clear of only encumbrances).

[230] *See* 11 U.S.C. § 363(f)(3) (asserting sale is proper where "such interest is a lien and the price . . . is greater than the aggregate value of all liens"). A brief discussion of section 363(f)(3) is *infra* at note 304 and accompanying text.

[231] *See id*. § 101(37) (stating "while the classification of a lien is a matter of federal law, the issue of whether a particular mortgage is a charge against or interest in property to secure payment of a debt . . . is one of state law"); *see also* Riley v. Sullivan (*In re* Sullivan), 387 B.R. 353, 358 (B.A.P. 1st Cir. 2008) (quoting *In re* Smith, 315 B.R. 636, 640 (Bankr. D. Mass. 2004)) (internal quotation marks omitted).

[232] *See In re* Adamson, 312 B.R. 16, 20 (Bankr. D. Mass. 2004); *see also In re* Mundy Ranch, Inc., 484 B.R. 416, 423–25 (Bankr. D.N.M. 2012) (authorizing sale free and clear of partition claim but not of *lis pendens* concerning such claim).

[233] *See In re Adamson*, 312 B.R. at 20–21.

[234] *See* WBQ P'ship v. Va. Dep't of Med. Assistance Servs. (*In re* WBQ P'ship), 189 B.R. 97, 105 (Bankr. E.D. Va. 1995) (determining that "liens" are subcategory of "interests" under section 363(f); holding state agency's right to recapture Medicare overpayments from operator of health care facility or buyer of same is not a lien against the operator's real property, but is an interest subject to section 363(f)(5)); *see also* P.K.R. Convalescent Ctrs. v. Virginia (*In re* P.K.R. Convalescent Ctrs.), 189 B.R. 90, 94, 96 (Bankr. E.D. Va. 1995) (same); *In re* Manning, 37 B.R. 755, 759 (Bankr. D. Colo. 1984) (explaining that while section 363(f)

Accordingly, when a trustee seeks to sell real property free and clear of a lien, section 363(f)(3), which applies only to liens, may be applicable, but another of the subsections may apply as well.[235]

A. What are "Interests in Such Property" Under Section 363(f)?

Because the Code lacks a definition of the phrase "interest in such property," courts have sometimes struggled to determine whether particular rights asserted by a party rise to an "interest in property" that is subject to section 363(f).[236] Such struggles are perhaps best exemplified by so-called "successor liability" cases, in which the buyer of business assets under an order authorizing sale under section 363(f) asserts that it acquires the assets free and clear of claims that third parties may otherwise assert against the buyer as the "successor" to the debtor-seller.[237]

For example, in *In re Leckie Smokeless Coal Co.*,[238] the Fourth Circuit determined that section 363(f) can be used to prevent the buyer of mining assets who continues the mining operations from becoming liable to fund miners' retirement benefits under the Federal Coal Industry Retiree Health Benefit Act of

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authorizes sale of property free and clear of interests in property, not merely lien against property, it does not authorize sale, in a debtor-partner's bankruptcy case, of the partnership's property free and clear of the partners' interests in such property).

[235] *See* Clear Channel Outdoor, Inc. v. Knupfer (*In re* PW, LLC), 391 B.R. 25, 30–37 (determining that consensual lien may be subject to lien-free sale under either subsections (3) or (5), but neither subsection was satisfied here). Each subsection of section 363(f) is discussed *infra* at notes 282–367 and accompanying text.

[236] In a general sense, one definition of "interest" is a "legal share in something; all or part of a legal or equitable claim to or right in property." BLACK'S LAW DICTIONARY (10th ed. 2014). A proceeding to determine the existence of interests in a thing (in property) is an *in rem* proceeding, while a proceeding to determine the rights and obligations of a person is an *in personam* proceeding. *See* Cent. Bank. v. Super. Ct. of Sacramento Cnty., 106 Cal. Rptr. 912, 914 (Cal. Ct. App. 1973); *see also* RESTATEMENT OF PROP. § 5 (AM. LAW INST. 1936) (defining "interest" as including "varying aggregates of rights, privilege, powers and immunities," including as to land and things).

[237] Under the common law, the buyer of business assets for cash does not become liable for the seller's liabilities:

> Traditionally, this rule [of nonliability] has been limited by four exceptions . . . where (1) there is an express or implied assumption of liability; (2) the transaction amounts to a consolidation, merger, or similar restructuring . . . (3) the purchasing corporation is a 'mere continuation' of the seller; and (4) the transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller's debts.

Upholsterers' Int'l Pension Fund v. Artistic Furniture of Pontiac, 920 F.2d 1323, 1325–26 (7th Cir. 1990) (citing Travis v. Harris Corp., 565 F.2d 443 (7th Cir. 1977)).

Other exceptions from the general rule are created by statute (*see infra* notes 238–44 and accompanying text regarding the Coal Act) and the imposition of liability for certain products offered to the public (*see* Ray v. Alad Corp., 560 P.2d 3 (Cal. 1977) (involving successor liability of ladder manufacturer).

[238] United Mine Workers of Am. 1992 Benefit Plan v. Leckie Smokeless Coal Co. (*In re* Leckie Smokeless Coal Co.), 99 F.3d 573 (4th Cir. 1996).

1992.[239] In *Leckie*, several debtors involved in coal mining filed successful motions in their chapter 11 cases seeking to sell their respective business assets under section 363(f).[240]

Declaratory relief was later requested in the district court when a post-sale dispute arose regarding whether the bankruptcy court's orders approving the sales cut off the retirement trusts' rights to payment for retiree benefits, where the buyers continued to mine coal with the purchased assets.[241] The debtors asserted that the sale order under section 363(f) served to affect the transfer of the assets free and clear of such claims of the retirement trusts.[242] In two decisions, the district court found in favor of the debtors, and the trusts' appeals in these cases were consolidated and went to the Fourth Circuit.[243]

The Fourth Circuit observed that "courts have not yet settled upon a precise definition of the phrase 'interest in such property'" as set out in section 363(f), and it faulted one of the lower court decisions for broadly interpreting the language, as simply a right to demand money of the debtor.[244] The court went on to observe that "while the plain meaning of the phrase . . . suggests that not all general rights to payment are encompassed by the statute, Congress did not expressly indicate that, by employing such language, it intended to limit the scope of [s]ection 363(f) to *in rem* interests, strictly defined."[245]

With those observations, and a very brief review of a few cases, the court went on to conclude:

> It is difficult to make further categorical observations concerning the intended meaning of the words "interest in" - indeed the precise boundaries of the phrase likely will be defined only as the courts continue to apply it . . . . Yet we hold that the [retirement trusts']

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[239] This legislation, commonly known as the Coal Act, is codified at 26 U.S.C. §§ 9701–9722 (2012). It seeks to remedy problems with the funding of retirement benefits for coal miners, where the number of employers contributing to such plans has severely declined. The statute defines "assigned operators" and "related persons," and makes such parties liable for payment of funds for retirement benefits. An operator's "successor in interest" is defined as a "related person," although the term "successor in interest" remains undefined. *See In re Leckie Smokeless Coal Co.*, 99 F.3d at 576–77.

[240] *In re Leckie Smokeless Coal Co.*, 99 F.3d at 577–79 ("On the Plan and Fund's motion, the objection was withdrawn from the Bankruptcy Court's consideration by Judge Elizabeth V. Hallanan of the Beckley Division of the United States District Court for the Southern District of West Virginia.").

[241] *See id.* at 575–76.

[242] *See id.* at 577–78.

[243] *See id.* at 575–76. The court determined that both buyers were not "successors in interest" under the Coal Act, so that liability would not attach, and in one decision the court determined in the alternative that the section 363(f) order served to extinguish liability that otherwise would attach under the Coal Act; *see also id.* at 575, 577–79 (providing background to the consolidated cases in this appeal).

[244] *Id.* at 581. In its critique of the district court's holding, the Fourth Circuit explained that courts have previously "recognized that general, unsecured claims do not constitute 'interests' within the meaning of § 363(f)."

[245] *Id.* at 582.

> rights to collect premium payments from [the debtor-sellers] constitute interests in the assets . . . . Those rights are grounded, at least in part, in the fact that those very assets have been employed for coal-mining purposes.[246]

The Coal Act gave to the trusts the right to collect payments from debtors as well as successors in interest that continued to use the relevant equipment for coal mining.[247] Because the debtors and the buyers would not have been obligated to make payments to the retirement trusts if they used the assets for purposes other than coal mining, the court reasoned that there existed a "relationship" between the trusts' rights to demand payment and the assets themselves. This, said the Fourth Circuit panel, created an interest in those assets that is subject to section 363(f).[248]

It might be asked just how close the "relationship" between the property sold and the creditor's right to payment must be to create an "interest" that is subject to severance under section 363(f). For the *Leckie* court, where the seller's use of the property creates rights to payment, there exists such a relationship.[249]

The Third Circuit in the TWA bankruptcy case used a similar line of reasoning in 2003.[250] There, citing *Leckie*, the Third Circuit concluded that there was a sufficient relationship between the debtor-airline's personal property sold, on the

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[246] *Id.*

[247] *See id.* ("Those rights are grounded, at least in part, in the fact that those very assets have been employed for coal–mining purposes: if Appellees had never elected to put their assets to use in the coal–mining industry, and had taken up business in an altogether different area, the Plan and Fund would have no right to seek premium payments from them.").

[248] *See id*. The court's decision is based entirely on section 363(f), and not on provisions of the Coal Act generally or specifically whether the buyers were "successors in interest" under that statute. *Id.* at 585 ("The courts below determined that the purchasers . . . would not be . . . successors in interest within the meaning of the [Coal] Act. We need not and do not now resolve the matter . . . having concluded that . . . the Bankruptcy Court may extinguish Coal Act successor liability pursuant to 11 U.S.C. § 363(f)(5)."). The court might have analyzed whether the Coal Act simply creates a right to payment from successor of a seller of assets (an *in personam* claim), as opposed to rights in the property sold (an *in rem* claim). In *In re P.K.R. Convalescent Ctrs., Inc.*, the Bankruptcy Court, found that a state agency's rights under state law to recover real property depreciation from the buyer of a Medicare provider's real property was an interest in the property cut off by section 363(f)(5). 189 B.R. 90 (Bankr. E.D. Va. 1995). That court did not consider whether the statute simply created *in personam* liability in the buyer, and rejected arguments that authority to collect such payments was derived from the agency's regulatory authority. *Id.* at 94–95; *see also In re* WBQ P'ship, 189 B.R. 97, 105 (Bankr. E.D. Va. 1995) ("In essence, DMAS's right of recapture runs with the property, so it is more than a mere claim against the debtor. DMAS's right of recapture is an 'interest in property' insofar as it grants DMAS the right to proceed against the transferee.") (applying Virginia law).

[249] *See In re Leckie Smokeless Coal Co.*, 99 F.3d at 582 (holding "[b]ecause there is therefore a relationship between (1) the Fund's and Plan's rights to demand premium payments from Appellees and (2) the use to which Appellees put their assets, we find that the Fund and Plan have interests in those assets within the meaning of section 363(f)").

[250] *See In re* Trans World Airlines, Inc., 322 F.3d 283, 285 (3d Cir. 2003) (affirming Bankruptcy Court's order approving the sale "free and clear" of successor liability "[b]ecause section 363(f) of the Bankruptcy Code permits a sale of property 'free and clear' of an 'interest in such property'" and "because the claims against TWA . . . were connected to or arise from the assets sold").

one hand, and certain rights held by employees under travel vouchers and certain employment-discrimination claims, on the other, to find that those rights and claims were cut off by the sale of the assets to another airline, which was approved under section 363(f)(5).[251] For the Third Circuit, even though the employment-discrimination claims were clearly not related specifically to the seller's use of the property in the airline business (they could accrue in any type of business), a sufficient connection existed between the claims and the airline business to merit the application of section 363(f).[252]

Other courts have given the term "interest in property" in section 363(f) a far smaller reach in the context of successor liability.[253] In *In re Fairchild Aircraft Corporation*,[254] the purchaser of the assets of an aircraft manufacturer sought declaratory relief regarding its potential obligations to tort claimants as a successor in interest.[255] The bankruptcy court had approved a sale of the manufacturer's business assets pursuant to a confirmed chapter 11 plan of reorganization, and the order provided for sale "free and clear of all liens, claims, and encumbrances except for those liens and encumbrances assumed by the buyer under the plan."[256]

The relevant sales contract provided that the buyer did not agree to assume any liabilities of the seller or the bankruptcy estate, and the plan did not have any provisions dealing with tort claims that might be asserted post-confirmation.[257] Although there was published notice of the confirmation hearing, the trustee did not make any "particular effort to reach [pre-petition aircraft-purchasers] in the plan process."[258]

After the plan was confirmed and assets sold, an aircraft, built by the debtor before it filed for chapter 11 relief, crashed and product-liability claims were asserted against the buyer of the debtor's assets on a successor liability theory.[259] As a "preemptive strike," the buyer brought an action in the bankruptcy court, seeking a declaration that any liability of the buyer was cut off by the order approving the sale.[260]

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[251] *Id.* at 289 (cutting off buyer's obligations to honor travel vouchers issued to former employees in settlement of a gender discrimination class action, as well as other employment claims under federal law, because the claims "were connected to or arise from the assets sold"); *see also In re* Gen. Motors Corp., 407 B.R. 463, 499–507 (Bankr. S.D.N.Y. 2009) (indicating order under section 363(f) serves to cut off products liability tort claims under successor liability theories).

[252] *In re Trans World Airlines, Inc.*, 322 F.3d at 285 (finding claims against Trans World Airlines, Inc., "were connected to or [arose] from the assets sold").

[253] *See In re* Fairchild Aircraft Corp., 184 B.R. 910 (Bankr. W.D. Tex. 1995), *vacated*, 220 B.R. 909 (Bankr. W.D. Tex. 1998) (equitable grounds).

[254] *Id.*

[255] *Id.* at 913.

[256] *Id.* at 914.

[257] *Id.*

[258] *Id*.

[259] *Id.* at 915.

[260] *Id*.

On counter-motions for summary judgment, the court rejected the buyer's assertion that the successor-liability claims were cut off:

> [The buyer] is entirely correct that the phrase *any interest* suggests that it be interpreted broadly, and could conceivably be interpreted to embrace "trailing" tort liability. But the phrase cannot be read in isolation. Section 363(f) does not authorize sales free and clear of *any interest* but rather of *any interest in such property*. These three additional words define the real breadth of *any interests*. The sorts of interests impacted by a sale "free and clear" are *in rem* interests which have attached to the property.[261]

The court went on to determine that the tort claimants, in light of the notice given and the reorganization plan's provisions, did not hold claims in the bankruptcy case that were dealt with and therefore subject to discharge.[262] Given the scope of the order approving the sale, and the terms and effect of the plan, the court concluded that the claimants did not in fact hold claims against the bankruptcy estate, leading to "the further conclusion that the . . . order confirming the plan could not have affected these liabilities."[263]

There is, then, no broad consensus as to the circumstances under which a buyer's "successor liability" may be cut off by consummation of a sale approved under section 363(f). It is clear, however, that courts determine the matter based on the circumstances of the case, and will also look for a tangible connection or nexus between the property sold and the claim asserted against the buyer.[264] Furthermore, courts will look to whether, on due-process grounds, the claimants are properly bound to the court order that would otherwise cut off their claims.[265]

B. Leaseholds as "Interests in Such Property" Under Section 363(f)

The proper scope of "any interest in such property" under section 363(f) has continued to generate controversy in a number of contexts other than "successor liability" cases.[266] But there appears to be little controversy that a lease of real

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[261] *Id*. at 917–18.

[262] *Id.* at 932–33.

[263] *Id*. at 933.

[264] *See In re* PBBPC, Inc., 467 B.R. 1, 8–10 (Bankr. D. Mass. 2012) (approving sale of business assets free and clear of employer unemployment compensation insurance rating under state law otherwise giving buyer successor status; noting cases, including *Leckie Coal*).

[265] *See In re Fairchild Aircraft Corp.*, 184 B.R. at 927–31 (explaining that because bankruptcy court has its "antecedents in equity," there is an "affirmative duty to assure that the process within the confines of the law, achieves fair and equitable results").

[266] *See* George W. Kuney, *Further Misinterpretation of Bankruptcy Code Section 363(f): Elevating In Rem Interests and Promoting the Use of Property Law to Bankruptcy-Proof Real Estate Developments*, 76 AM. BANKR. L.J. 289, 293–315 (2002). Professor Kuney concludes that many "courts have incorrectly interpreted

property, which obviously has an integral connection to the property, is an "interest in property" within the scope of section 363(f).[267] And this makes sense, first, because state law generally treats real-property leases as conveyances of an interest in the property leased as well as contracts for the use of the property.[268] And second, because property interests of the bankruptcy estate are typically determined by state law.[269] Courts have thus viewed the lessee's right to possess the leased property as an interest in the property within the scope of section 363(f).[270] As discussed below, where a lease is concerned courts find it more daunting to determine whether circumstances exist that satisfy any of the five conditions to approve a sale under section 363(f).

the statute to exclude traditional *in rem* interests that run with the land from the set of interests that may be stripped off property under § 363(f)." *Id*. at 291. He argues that the proper approach is not to exclude them from section 363(f) altogether, but to determine in each case whether any of the conditions to application of section 363(f) is satisfied, using applicable state law. *Id.* at 329–30; Kuney, *supra* note 224, at 262–66 (arguing that an interpretation of section 363(f) that includes, in its scope, claims as well as interests in property, has improperly encouraged asset sales without the notices and checks involved in plan-confirmation process); Corcoran, *supra* note 229, at 739–41 (arguing that majority of courts interpret section 363(f) to include successor liability claims, contrary to Supreme Court precedent, including Butner v. United States, 440 U.S. 48 (1979) and Barnhill v. Johnson, 503 U.S. 393 (1992)); *see also* Mich. Emp't Sec. Comm'n v. Wolverine Radio Co. (*In re* Wolverine Radio Co.), 930 F.2d 1132, 1145–47 (6th Cir. 1991) (stating debtor's workers compensation experience rating not interest in property subject to section 363(f)).

[267] *See* Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp.), 327 F.3d 537, 545 (7th Cir. 2003); *In re* Downtown Athletic Club of N.Y.C. Inc., Ch. 11 No. M-47 (JSM), 2000 U.S. Dist. LEXIS 7917, at *10 (S.D.N.Y. June 9, 2000) (finding leases asserted by former tenants under rent stabilization law subject to section 363(f)); *In re* Extra Room, Inc., Ch. 11 No. 4:09-bk-03694-EWH, 2011 Bankr. LEXIS 789, at *3, 4 (Bankr. D. Ariz. Mar. 7, 2011) (stating "a lessee's interest is an interest under § 363(f)"); *In re* MMH Auto. Grp., LLC, 385 B.R. 347, 362 (Bankr. S.D. Fla. 2008) (noting lack of dispute among parties "that a leasehold interest is an interest for purposes of section 363(f)"); C.H.E.G., Inc. v. Millennium Bank, 121 Cal. Rptr. 2d 443, 447 (Cal. Ct. App. 2002) (asserting "[u]niformly, courts reaching this issue have determined that a lease is an interest under section 363" (citing *In re* Taylor, 198 B.R. 142, 161 (Bankr. D.S.C. 1996) (explaining leasehold not lien; instead "a leasehold is a type of interest that fits within the plain text of § 363(f)(4)")). *But see In re* R.J. Dooley Realty, Inc., Ch. 11 No. 09-36777, 2010 Bankr. LEXIS 1761, at *22–23 (Bankr. S.D.N.Y. May 10, 2010) (determining that tenant under long-term lease of property sold not entitled under section 363(e) to adequate protection as holder of a protected interest). Another major issue is whether section 363(f) should apply to leaseholds in light of a perceived conflict with section 365(h). *See generally infra* notes 383–462.

[268] *See generally supra* notes 58–82.

[269] *See supra* notes 29–34.

[270] *See In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.,* 327 F.3d at 545–46 (citing BLACK'S LAW DICTIONARY 816 (7th ed. 1999)); *see also In re* Trans World Airlines, Inc., 322 F.3d 283, 289–90 (3d Cir. 2003); Future-Source LLC v. Reuters Ltd., 312 F.3d 281, 285 (7th Cir. 2002); *In re Downtown Athletic Club of N.Y.C. Inc.*, 2000 U.S. Dist. LEXIS 7917, at *4; *In re* Haskell, 321 B.R. 1, 6, 9, 10 (Bankr. D. Mass. 2005) (citing cases for "broad" interpretation of section 363(f) to include "possessory interests of tenants under leases," but going on to conclude that debtor failed to satisfy statutory provisions for sale free and clear); *In re Taylor*, 198 B.R. at 162; *C.H.E.G. Inc.*, 121 Cal. Rptr. 2d at 448 (presenting courts adopted lessee's right to possess leased property as interest in property under section 363(f)).

C. Potential Grounds for Sale of Real Property Free and Clear of a Tenant's Leasehold under Section 363(f)

The *Qualitech* decision created an uneasy stir among leasehold lenders because it held that the protections afforded the tenant under section 365(h) did not prevent the court, under the specific circumstances of the case, from approving the sale of real property by the Estate Representative for a landlord, free and clear of the tenant's lease under section 363(f).[271] In the Seventh Circuit, then, a tenant might be able to prevent the landlord's Estate Representative from dispossessing the tenant by rejection of the lease, but under *Qualitech* the tenant could find itself unable to prevent dispossession by way of the Estate Representative's sale of the real property free and clear of the lease under section 363(f).[272]

All the facts that existed in *Qualitech* are not clear from a reading of the published opinions. It is clear, however, that as a tenant, Precision Industries, Inc. ("Precision"), had what would appear to be a very attractive lease with Qualitech Steel Corporation ("Qualitech").[273] As a supplier to Qualitech, which owned and operated a steel mill, Precision leased a tract on the facility from Qualitech at the nominal rate of one dollar per year under a ten-year lease agreement.[274] Precision, as a supplier to Qualitech under a separate agreement, constructed a warehouse facility on the Qualitech premises to house supplies that were to be provided to Qualitech for its operations.[275] Should the parties continue under both agreements for their full terms, Qualitech would be entitled to buy the warehouse property for one dollar; if Qualitech were to terminate the agreements or to default thereunder, Precision would have the right to remove the improvements.[276]

Unfortunately for Precision, it came to experience a tenant's nightmare in its dealings with Qualitech. Only months after the lease was entered, Qualitech filed a chapter 11 bankruptcy petition, and some months later, Precision was forced out of possession when the bankruptcy court approved Qualitech's sale of the real property, as a debtor in possession, in a section 363(f) bankruptcy sale.[277]

After the bankruptcy court granted the buyer's request for an order enforcing the terms of the sale order and prohibiting Precision from enforcing the terms of the lease against the buyer, Precision appealed the bankruptcy court's order, to the United States District Court for the Southern District of Indiana.[278] In an

[271] *See supra* notes 16–22.

[272] Whether this situation causes a genuine conflict between the relevant statutory provisions is discussed *infra* at notes 383–462.

[273] *See In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp., Ch. 11 No. IP 00-247-C H/G, 2001 U.S. Dist. LEXIS 8328, at *5–6 (S.D. Ind. Apr. 24, 2001).

[274] *Id.*

[275] *Id*. at *5–6.

[276] *Id*. at *5.

[277] *Id*. at *7–13.

[278] *Id.* at *14–15. Precision also filed a complaint in the district court for trespass and other forms of relief against Qualitech, and the action was referred to the Bankruptcy Court. *See id*. at *13–14. A valuable

unpublished opinion, the district court agreed with Precision that the terms of section 365(h) prevented bankruptcy court from terminating Precision's leasehold by way of the sale under section 363(f), where Precision had rights to retain possession of the premises under section 365(h) after rejection of the lease.[279] It reversed the bankruptcy court's enforcement order and remanded for further proceedings regarding whether the buyer qualified as a good-faith purchaser under state law.[280] But the district court's determination in favor of the buyer was ultimately reversed on appeal to the Seventh Circuit Court of Appeals, and neither courts' written opinion makes clear precisely which of the five conditions of section 363(f) the bankruptcy court based its authorization for sale of Qualitech's real property.[281]

The alternative five conditions spelled out in section 363(f) under which a sale free and clear may be authorized are the following:

> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
> (2) such entity [the holder of the interest] consents;
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
> (4) such interest is in bona fide dispute; or
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.[282]

Given that a lease is generally an interest real property under state law, it makes sense at this point to review each condition stated in section 363(f), to determine each condition's potential applicability to a tenant's leasehold interest where the landlord is a debtor in bankruptcy. To the extent any of these conditions are readily applied to leases, tenants and leasehold lenders would have reason to fear the

discussion of the preclusion issues raised by the history of *Qualitech* can be found in Christopher Klein, et al., *Principles of Preclusion and Estoppel in Bankruptcy Cases*, 79 AM. BANKR. L.J. 839, 867–73 (2005) (describing *Qualitech* outcome through a prism of preclusion: the section 363(f) sale through issue preclusion and the section 363(e) adequate protection through claim preclusion).

[279] Section 365(h) is discussed generally *supra* notes 129–220 and accompanying text.

[280] *Precision Indus.,* 2001 U.S. Dist. LEXIS, at *66–67.

[281] In the opinion published by the Seventh Circuit, the court made several references to the record made in the bankruptcy court, but it does not discuss the basis for the bankruptcy court's decision. *See* Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp.), 327 F.3d 537, 541–42 (7th Cir. 2003) (referencing various to specific pages of the record).

[282] 11 U.S.C. § 363(f)(1)–(5) (2012); *see In re* Shary, 152 B.R. 724, 725 (Bankr. N.D. Ohio 1993) (stating the five conditions in section 363(f) are disjunctive and sale is proper where trustee can prove existence of any of the five conditions).

holding in *Qualitech*, which provides that section 365(h) is not a bar to sales free and clear of leases under section 363(f).[283]

1. Section 363(f)(1)

Under section 363(f)(1), the Estate Representative may sell property free and clear of an interest in property where "applicable nonbankruptcy law permits sale of such property free and clear of such interest."[284] Reviewing the reported cases, it would appear that the scope of section 363(f)(1) is not particularly broad. For example, a debtor in possession cannot sell a legal malpractice claim against its former counsel under section 363(f)(1), because state law provides that such a claim may not be assigned.[285] Neither can a debtor in possession under section 363(f)(1) sell its nursing home facility free and clear of the state's rights to recapture prior overpayments made for care at the facility, where state law expressly provides otherwise by explicitly requiring reimbursement of overpayments.[286] And a trustee may not use section 363(f)(1) as grounds to sell a partnership's assets free and clear of the interest of the partners,[287] nor may a trustee sell a debtor's remainder interest in real property free and clear of another party's life estate therein, where state law would not permit such sales and where other grounds for sale under section 363(f) do not exist.[288]

One situation for which section 363(f)(1) is well-suited is the sale of real property subject to a so-called covenant running with the land or title, also

[283] *See In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.*, 327 F.3d at 548 (holding that by interpreting section 363(f) and section 365(h) so that they do not conflict with each other, the bankruptcy court was permitted to allow the sale of Qualitech's property because Precision's possessory interest as a lessee was terminated).

[284] 11 U.S.C. § 363(f)(1); *see In re* Daufuskie Island Props., LLC, 431 B.R. 626, 643–44 (Bankr. D.S.C. 2010) (authorizing sale of real property free and clear of restrictive covenant where doctrine of changed circumstances permits such sale under state law).

[285] *See, e.g.*, *In re* C-Power Prods., Inc., 230 B.R. 800, 803–04 (Bankr. N.D. Tex. 1998) (finding other subsections of section 363(f) inapplicable: "C-Power Products cannot be deemed to have consented to the transfer . . . . [T]he non-assignability restriction is not a lien . . . "; holding the restriction is not an interest subject to bona fide dispute and the proceedings under state law could not compel C-Power to accept a money satisfaction for the restriction).

[286] *See In re* WBQ P'ship, 189 B.R. 97, 106–07 (Bankr. E.D. Va. 1995) (applying Virginia law but approving sale under section 363(f)(5) because the interest can be reduced to a claim and therefore subject to a hypothetical money satisfaction).

[287] *See In re* Manning, 37 B.R. 755, 759–60 (Bankr. D. Colo. 1985) (referencing Colorado partnership law to illustrate that "applicable non-bankruptcy law does not permit such a sale"), *remanded in part on other grounds*, 831 F.2d 205 (10th Cir. 1987) (explaining "the interest sought to be sold is the interest in real property. That is not 'property of the estate' as contemplated in § 363(b) and (c), to which § 363(f) refers").

[288] *See In re* Van Houton, 56 B.R. 891, 898 (Bankr. W.D. Mich. 1986) (referencing Michigan law to illustrate "if the trustee can find someone interested in purchasing the remainder only, he may do so, provided that the sale, its preparation, arrangement or advertisement in no way interfere with [the] life estate").

sometimes called a restrictive covenant.[289] Two recent cases are good examples.[290] In one case, a previous owner of certain real property subject to a trustee's motion to sell essentially all assets of the estate asserted a contractual right to obtain reconveyance of one of the real properties subject to the trustee's motion, should certain expenses associated with the property go unpaid.[291] The previous owner asserted this right under an agreement, a memorandum of which had been recorded, with the current owner (the debtor).[292] Having determined in an earlier adversary proceeding that the previous owner held an interest that came from a "covenant running with title," the court determined that "significantly changed" conditions existed in regard to the property.[293] Under South Carolina law, such conditions give property owners authority to sell affected property free and clear of that covenant, and thus, the court determined, a sale under section 363(f)(1) was authorized, free and clear of the covenant.[294]

In another case decided under Florida law, the bankruptcy court granted a debtor in possession's motion to sell real property free and clear of a restrictive covenant that required the sale of lots in a subdivision at a certain minimum price.[295] This decision was also based on the "changed conditions" doctrine that is available to sellers in that state.[296]

State law typically will not permit a landlord to terminate a lease unilaterally in order to sell real property free of the lease.[297] But that does not mean that section

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[289] *See* 8 HARRY D. MILLER, CALIFORNIA REAL ESTATE § 24:2 (3d. ed. 2004 & 2013-2014 Supp.) (defining covenants running with the land in California, outlining their statutory basis, and outlining common-law origin of equitable servitudes).

[290] *See In re* Daufuskie Island Props., LLC, 431 B.R. 626 (Bankr. D.S.C. 2010); *In re* Tousa, Inc., 393 B.R. 920 (Bankr. S.D. Fla. 2008).

[291] *See In re Daufuskie Island Props., LLC*, 431 B.R. at 634–35 (stating that MCI asserted right to repurchase the 1996 Property under Article 5 of the Transfer Agreement, including the provision for purchaser's additional obligations).

[292] *See id*. (stating "MCI filed an adversary proceeding seeking declaratory judgment of its rights and interests in the 1996 Property under the Transfer Agreement and the Memorandum of Agreement" in which the Memorandum of Agreement was "recorded to provide record notice of the Article 5 reconveyance rights in the Transfer Agreement"). The court had already denied the debtor's motion under section 365 to reject the agreement. *Id*. at 634 (stating "the debtor filed a motion to reject the Transfer Agreement as an executory contract under 11 U.S.C. § 365(a) . . . the Court stated its ruling denying the Motion to Reject").

[293] *Id.* at 644–45 (holding that "the Court [] finds that a changed condition exists in this case that permits the Court to find the restrictive covenant contained in Article 5 unenforceable and a nullity").

[294] *See id*. at 646. The court also approved the sale under section 363(f)(4) (finding interest in bona fide dispute).

[295] *See In re* Tousa, Inc., 393 B.R. 920, 922–23 (Bankr. S.D. Fla. 2008) (concluding downturn in real estate market made restrictive covenant unreasonable).

[296] *See id.* at 924. In *Tousa*, to find changed circumstances the court looked primarily to the "tumultuous real estate market" in Florida following the so-called "subprime" lending crisis.

[297] *See generally supra* notes 86–119 and accompanying text; CAL. CIV. CODE § 1214 (2012) (stating conveyance of leasehold of less than one year void as to good-faith purchaser unless recorded); *id*. § 1217 (indicating unrecorded instrument valid between parties and those having notice); *see, e.g.*, Scholey v. Steele, 138 P.2d 733, 734 (Cal. Ct. App. 1943) (noting transferee of title bound to terms of lease). There may be, however, an agreement between the landlord and tenant to the contrary. *See In re* MMH Auto. Grp.,

363(f)(1) is irrelevant to leases. For example, in many states, the failure to record a lease makes the lease unenforceable against a good-faith purchaser of the property.[298] A bankruptcy court, then, could authorize a trustee to sell a debtor's real property free and clear of an unrecorded lease, at least where the tenant is given proper notice of the motion to sell the property and the circumstances are such that the tenant's occupancy is not evident so as to put a potential buyer on notice of the existence of the leasehold. This may have been the situation in *Qualitech*.[299] It is also possible that a mortgage prior to the unrecorded lease in *Qualitech* supported sale under section 363(f)(1).[300]

2. Section 363(f)(2)

Section 363(f)(2) authorizes a sale free and clear of an entity's interest, where "such entity consents" to the sale.[301] So, if the relevant interest is that of a lessee, the sale can be authorized under section 363(f)(2) with the tenant's consent.[302] Tenants and their lenders should exercise care when learning of a debtor-landlord's, or trustee's, intent to sell the property, as some courts are willing to infer consent under section 363(f)(2) from an interest-holder's failure to appear in the bankruptcy court and object to the proposed sale.[303] In such cases, the interest-holder's failure to appear and object is risky.

LLC, 385 B.R. 347, 370–71 (Bankr. S.D. Fla. 2008) (holding agreement giving owner right to "buy out" lease under Florida law should lease impair financing or sale of the property).

[298] *See, e.g.*, CAL. CIV. CODE § 1214 (stating conveyance of leasehold of less than one year void as to good-faith purchaser unless recorded); *id*. § 1217 (indicating unrecorded instrument valid between parties and those having notice); *see also In re MMH Auto. Grp., LLC*, 385 B.R. at 369–70 (finding sale under section 363(f)(1) improper where buyer had constructive knowledge of unrecorded lease and therefore was not a bona fide purchaser under Florida law; sale authorized under section 363(f)(5)).

[299] *See* Zinman, *supra* note 14, at 128–29 (discussing possible application of section 363(f)(1) by bankruptcy court in *Qualitech*, under Indiana law, where tenant under unrecorded lease had apparently vacated the premises as of the time the motion was brought).

[300] Professor Zinman also discusses whether section 363(f)(1) may have applied in *Qualitech*, where there was a mortgage prior in time to Precision's lease of the property. *Id*. at 129–30 n.107. *See also* the discussion of the potential application of section 363(f)(5) to a lease, either recorded or unrecorded, at *infra* notes 322–68 and accompanying text.

[301] *See generally* 11 U.S.C. § 363(f)(2) (2012).

[302] Clearly, a leasehold lender would wish to deter the tenant from agreeing to a sale that would result in termination of the leasehold that secures the loan without adequate compensation to the lender. Writing from the perspective of the lender drafting documents for the taking of a security interest in the leasehold, Professor Zinman concludes: "It does not appear that 363(f)(2) can be conclusively drafted around." Zinman, *supra* note 14, at 132. He does, however, explore provisions in the financing documents that would at least discourage the tenant from giving consent to a sale free and clear of the leasehold. *Id*.

[303] *See In re* Elliot, 94 B.R. 343, 345 (Bankr. E.D. Pa. 1988) (affirming judgment on pleadings against lender seeking to set aside lien-free sale after failure of secured creditor to object after proper notice given); *see also In re* Haven Eldercare, LLC, 390 B.R. 762, 771 (Bankr. D. Conn. 2008) (demonstrating no objection from unspecified interest holders; two days' notice of proposed sale given); *In re* James, 203 B.R. 449, 453 (Bankr. W.D. Mo. 1997) (failing to object deemed lien holder's consent to sale). *But see In re* DeCelis, 349 B.R. 465, 467–69 (Bankr. E.D. Va. 2006) (because Code imposes no duty to respond to

3. Section 363(f)(3)

Section 363(f)(3) permits a sale free and clear of an interest in property specifically where the interest is a lien, and where the sale price exceeds the aggregate value of all liens.[304] As noted above, a lien is defined in the Code as one kind of interest in property that secured payment of a debt or performance of an obligation, and a lease is another kind of such interest.[305] Section 363(f)(3) is therefore by its own terms not available to authorize sale of real property free and clear of leasehold interests.

4. Section 363(f)(4)

Section 363(f)(4) permits a sale free and clear of an interest in property where the interest is in "bona fide dispute."[306] Courts have interpreted this provision to require a showing that the interest itself is objectively in dispute.[307] It is not sufficient that there is a dispute only over amounts that might be due under

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notices, consent of co-owner under section 363(f)(2) not to be implied without some affirmative conduct) (citing *In re* Roberts, 249 B.R. 152 (Bankr. W.D. Mich. 2003)); *In re* Silver, 338 B.R. 277, 280–81 (Bankr. E.D. Va. 2004) (holding only secured creditor that appeared and supported motion to sell deemed to consent; conditional approval of sale is not consent without full payment).

[304] *See generally* 11 U.S.C. § 363(f)(3). Courts differ on whether the sale price must exceed the face amount of debt secured by liens against the property, or instead must exceed only the economic value of the liens. *Compare In re* Beker Indus. Corp., 63 B.R. 474, 476–77 (Bankr. S.D.N.Y. 1986) (permitting sale of real property under section 363(f)(3) where sale price less than amount owed on claims secured by property; considering "interplay of § 506(a) and § 363(f)(3)"), *with In re* Heine, 141 B.R. 185, 189 (Bankr. D.S.D. 1992) (declining to authorize sale under section 363(f)(3) where no evidence that auction sale price would exceed agreed lien amount). But as at least two courts have pointed out, if the sale price is less than the aggregate amount owed on obligations secured by the property, it can, at best, only equal, but not exceed, the economic value of such liens, and thus section 363(f)(3) is not satisfied. *See In re* PW, LLC, 391 B.R. 25, 40 (B.A.P. 9th Cir. 2007) (holding that when "the value of the property being sold is less than the total amount of claims held by secured creditors, the total of all allowed secured claims will equal, not exceed the sales price"); *In re* Healthco Int'l, Inc., 174 B.R. 174, 176 (Bankr. D. Mass. 1994) (stipulating that "no procedure [exists] under non-bankruptcy law under which a lien holder can be compelled to accept less than full payment in satisfaction of its lien").

[305] *See supra* notes 230–31 and accompanying text.

[306] *See* 11 U.S.C. § 363(f)(4).

[307] "A 'bona fide dispute' exists under section 363(f)(4) when there is an objective basis for either factual or legal dispute as to the validity of an interest in property." *In re* Nicole Energy Servs., 385 B.R. 201, 229 (Bankr. S.D. Ohio 2008) (quoting *In re* Downour, Ch. 11 No. 06–30854, 2007 WL 963258, at *1 (Bankr. N.D. Ohio Mar. 28, 2007)) (sale of litigation claims); *In re* Gulf States Steel, Inc., 285 B.R. 497, 507 (Bankr. N.D. Ala. 2002); *In re* Collins, 180 B.R. 447, 452 (Bankr. E.D. Va. 1995) (requiring production of evidence of "objective basis" for dispute regarding validity of lien). The moving party bears the burden of showing that a bona fide dispute exists. *See also* Revel AC, Inc. v. IDEA Boardwalk, LLC (*In re* Revel AC, Inc.), 802 F.3d 558, 574 (3d Cir. 2015) ("[T]he mere filing of a declaratory judgment action doesn't itself create a *bona fide* dispute under § 363(f)(4)."). In *Revel*, the Third Circuit panel characterized a plaintiff's allegations in opposition to a motion to sell the property free and clear of a lease as "fanciful if not disingenuous." *Id*. The allegations were therefore inadequate to create an objective and thus bona fide dispute.

contract.[308]Where such a dispute is demonstrated, however, the bankruptcy estate can obtain the value of its interest by way of a sale, and the disputed interest is then transferred to proceeds, thus permitting the dispute to be resolved later.[309]

Section 363(f)(4)[310] has been applied specifically to sales of real property free and clear of a leasehold interest. In *In re Downtown Athletic Club of New York City, Inc.*,[311] the district court reversed the bankruptcy court's summary judgment in favor of former tenants remaining in possession of rental units in a building sold pursuant to a debtor's plan of reorganization.[312] In that case, the debtor operated a health club and restaurant on the lower floors of its high-rise building, and rented upper-floor apartments to members.[313] All members had been given notice of a bar date for the filing of claims in the bankruptcy case, the bar date passed, and the bankruptcy court, again on notice to the members, confirmed a plan of reorganization authorizing the sale of the building "free and clear of all liens, claims, encumbrances, and other interests of any kind."[314] After the sale, the debtor leased the lower portion of the building from the buyer for its health-club operations, and the buyer took control of the upper floors.[315]

Without having written leases, certain members and a former member remained in possession of apartments on the upper floors, and the buyer brought an action for injunctive relief (to enjoin any action by members to obtain leases under rent-control legislation) as well as declaratory relief (that the defendants held no interest in the building).[316] The bankruptcy court awarded summary judgment in favor of the tenants on the narrow issue of whether the debtor's discharge prevented the tenants from forcing the buyer to comply with rent-control regulations (it ruled that the discharge did not prevent it).[317]

The district court, however, reversed and remanded, observing that the sale was approved under section 363(f), where there was a "bona fide dispute about whether Defendants have an interest in the property."[318] The dispute involved whether local

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[308] *See In re* Taylor, 198 B.R.142, 162–63 (Bankr. D.S.C. 1996) (finding dispute regarding amount due to landlord insufficient to establish bona fide dispute as to validity of lease, where under applicable state law arrearage would not serve to work termination or forfeiture of lease); *In re* Stroud Wholesale, Inc., 47 B.R. 999, 1002 (Bankr. E.D.N.C. 1985) (holding dispute regarding amount of claim of tax-lien claimant not a bona fide dispute under section 363(f)(4)).

[309] *See In re* Clark, 266 B.R. 163, 171 (B.A.P. 9th Cir. 2001) (stating this process avoids delays in liquidating bankruptcy estate's assets).

[310] *See generally* 11 U.S.C. § 363(f)(4) (stipulating trustee may sell property "free and clear of any interest in such property of an entity other that the estate, only if . . . such interest is in bona fide dispute").

[311] Ch. 11 No. M-47 (JSM), 2000 U.S. Dist. LEXIS 7917 (S.D.N.Y. June 9, 2000).

[312] *Id.* at *5 (holding that CBA obtained title to Downtown Athletic Club building free and clear of any interests).

[313] *Id.* at *1 (referring to debtor's thirty-five story building that the proceeding revolved around).

[314] *Id.*

[315] *Id.*

[316] *Id.* at *2.

[317] *Id.*

[318] *Id.* at *4.

rent-control legislation would apply to the building and give the tenants rights to retain possession after expiration of the term of the lease.[319] The court determined that as a consequence of the sale and pursuant to section 363(f)(4), any rights of the defendants to obtain leases under local law were cut off, and the bankruptcy court had "failed to recognize that the sale . . . extinguished any ongoing interest of the defendants in the building."[320]

Subsection (f)(4) is thus a potentially powerful tool for sales free of a leasehold. If there is any objective basis for a dispute regarding the validity of the lease, it could serve as a basis for a trustee's or debtor's sale of the real property, free and clear of the lease where the tenant is holding over or where the parties are litigating the tenant's rights to possession.[321]

5. Section 363(f)(5)

Section 363(f)(5) "is the most enigmatic" of the five conditions for sale of property free and clear of interests.[322] Section 363(f)(5) predicates authority to sell free and clear on the following: where the holder of the interest "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of its interest."[323] In one case, this statutory language led opposing parties before the Bankruptcy Appellate Panel for the Ninth Circuit to propose "competing constructions [that] seem either to render [the provision] so specialized as never to be invoked, or all-powerful, subsuming all the other paragraphs of [section] 363(f)]."[324] The provision does not limit the scope of such a proceeding except to a

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319 *Id.*

320 *Id.* at *3.

321 A sale might be approved free and clear of a disputed lease, and thereafter the court might determine that there was no enforceable lease. In that case, the purported tenant would presumably be entitled to no part of the sale proceeds. But should the court determine that the disputed lease was enforceable, it would presumably be required to determine what, if any, portion of the sale proceeds should be paid to the tenant on account of its terminated possessory interest. *See* 11 U.S.C. § 363(e) (2012) (requiring adequate protection of interest in property to be sold); *id.* § 361 (stating three non-exclusive forms of adequate protection, including cash payment to holder of interest, the value of which is decreased by a sale of property). It appears that presently there are no reported cases in which a bankruptcy court has been required to determine what form or amount of adequate protection is to be afforded a tenant where the sale of the property is authorized free and clear of the leasehold. For a brief discussion of adequate protection, *see infra* notes 368–379 and accompanying text.

322 Zinman, *supra* note 14, at 134.

323 11 U.S.C. § 363(f)(5); *see also* Zinman, *supra* note 14, at 134 (indicating that based on statutory language, "[i]t would seem clear that the proceeding referred to is a hypothetical one that may encompass proceedings outside of the bankruptcy") (quoting *In re* Heathco Int'l, Inc., 174 B.R. 174 (Bankr. D. Mass. 1994)).

324 *In re* PW, LLC, 391 B.R. 25, 38 (B.A.P. 9th Cir. 2008) (explaining "the competing constructions [of section 363(f)(5)] seem either to render it so specialized as never to be invoked, or all-powerful, subsuming all other paragraphs of § 363(f)"). In regard to statutory interpretation, the appellate panel observed that section 363(f)(5) presents "an even greater conundrum" than section 365(f)(3). *In re Heathco Int'l, Inc.*, 174 B.R. at 176.

"legal or equitable proceeding," and it does not specify whether such a proceeding is one brought that might be brought by the Estate Representative, or by a third party instead.[325]

A number of judicial opinions applying section 363(f)(5) focus on a proceeding that could be brought by a debtor or its trustee, such as a plan-confirmation proceeding within a chapter 11 case in which the holder of a lien against property could be forced under section 1129(b)(2) to accept in a chapter 11 plan a money satisfaction of its secured claim, a so-called "cram down" of the creditor's claim.[326] Another reported case involves the debtor's or trustee's enforcement of "partial release" provisions in a contract, under which a lender has agreed with the borrower to release a lien upon payment of a minimum or specified amount.[327]

A tenant might be reassured by the fact that "[a]t first blush it would not seem that [section 363(f)(5)] would permit sale of property free and clear of a lease, since, normally, the tenant may not be required to take money in exchange for the lease,"[328] at least by the landlord. But, if one assumes that the hypothetical proceeding is one that could be brought not just by the landlord-debtor or its trustee, but by a third party as well, the scope of section 363(f)(5) stands to expand significantly.

For example, if one considers an eminent domain proceeding, in which the government is empowered to take property for public purposes,[329] section 363(f)(5) could effectively subsume the other subsections because there are many property interests, such as fee titles, security interests, and leaseholds, all of which are subject to taking by the government, with payment of just compensation to the interest-holder.[330]

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[325] *See generally* 11 U.S.C. § 363(f).

[326] *See, e.g.*, *In re* Terrace Chalet Apts., Ltd., 159 B.R. 821, 829 (N.D. Ill. 1993) (holding chapter 11 debtor has authority to sell real property under section 363(f)(5) where it demonstrates that lien holder's claim could be satisfied under section 1129(b)(2) and that it is acting in good faith); *In re* Hunt Energy Co., 48 B.R. 472, 485 (Bankr. N.D. Ohio 1985) (finding both senior and junior liens subject to section 363(f)(5) where claims could be crammed down with offer of indubitable equivalent of interests under section 1129(b)(2)(A)(iii)); *In re* Red Oak Farms, Inc., 36 B.R. 856, 858 (Bankr. W.D. Mo. 1984) (resolving lender's request for relief from automatic stay and determining that chapter 11 debtor would be unable to satisfy section 1129(b)(2)(A) so as to support lien-free sale under section 363(f)(5)); *see also In re Healthco Int'l, Inc.*, 174 B.R. at 177 (allowing sale free and clear of tax lien in chapter 7 case where lien subject to subordination under 11 U.S.C. § 724(b)).

[327] *See In re* E. Airport Dev., LLC, 443 B.R. 823, 830 (B.A.P. 9th Cir. 2010) (citing *In re PW, LLC*, 391 B.R. at 47) (affirming sale).

[328] *See* Zinman, *supra* note 14, at 135 (proposing section 363(f)(5) as basis for "sale free and clear").

[329] Eminent domain is a term used to describe the government's inherent power to take private property for public use, and both federal and state statutes provide for proceedings in which the necessity for such taking and the compensation to be paid for such taking are determined. *See generally* Julius L. Sackman & Russel D. Van Brunt, NICHOLS ON EMINENT DOMAIN, ch. 1 (Matthew Bender 3d ed. rev. 2010) (describing history and theories of nature of eminent domain, including as an exercise of power in an *in rem* action that strips the owner of title and leaves him or her with an *in personam* claim for compensation).

[330] *See* Kuney, *supra* note 224, at 251 (calling section 363(f)(5) the "Standard that Could Have Swallowed the Others"); Zinman, *supra* note 14, at 137–38 (observing that use of eminent domain as basis for sale

Another hypothetical preceding that has been said to satisfy section 363(f)(5) is the foreclosure proceeding.[331] In such a proceeding, liens inferior to the lien being foreclosed are typically entitled to sale proceeds only after costs of sale and payment of the amount due to the foreclosing lien holder.[332] In a foreclosure, junior lien holders might receive partial payment, or no payment at all, from sale proceeds. Furthermore, junior liens are wiped out by foreclosure, and the buyer takes title free of such liens.[333] Under this view, where a junior lien holder might receive only partial payment and is compelled to lose its lien, there is a basis for a sale under section 363(f)(5).[334]

In the case of leases that are later in time to a security interest, and where there is no binding agreement to subordinate the lien to the lease, a hypothetical foreclosure of the security interest under state law would wipe out the lease.[335] While it might be tempting to argue that section 363(f)(5) should therefore apply, it must be asked whether the lessee is entitled under state law to any sale proceeds. If not, then the lessee cannot be said to receive a "money satisfaction" of its interest in the property as set forth in section 363(f)(5).[336] Thus, although sales under section 363(f)(5) based on hypothetical foreclosure proceedings would not be as numerous as in the case of sales based on hypothetical eminent domain proceedings, it would

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under section 363(f)(5) has advantages over more limited basis of "cram down" under section 1129(b)(2), noting that "it has the disadvantage of being too good, by half. Virtually all property . . . may be subject to condemnation").

[331] Zinman, *supra* note 14, at 138–39 (listing other situations involving foreclosure such as mortgage interest and tax liens).

[332] *See, e.g.*, CAL. CIV. CODE § 2924k (1999) (describing priorities for distribution of proceeds for trustee's sale of real property).

[333] A common example is the foreclosure of a tax lien, which by statute is given priority, thus leaving junior liens subject to full or partial satisfaction from remaining proceeds. *See* Zinman*, supra* note 14, at 139 (noting hypothetical foreclosure of tax liens on leases and real estate fees can result in "invocation of [section] 363f(5) to permit a sale free and clear of the lease").

[334] "Uniform Commercial Code ordinary course of business sales and foreclosure sales are commonly recognized hypothetical proceedings that can satisfy § 363(f)(5)." Kuney, *supra* note 224, at 251–52 (noting claimants can be forced to accept monetary satisfaction through foreclosure process); *see also In re* Bos. Generating, LLC, 440 B.R. 302, 303 (Bankr. S.D.N.Y. 2010) (looking to "[n]umerous legal and equitable procedures" to support section 363(f)(5) sale where junior lien holders objected to sale that would yield insufficient proceeds to fully pay secured claims); *In re* Jolan, Inc., 403 B.R. 866, 870 (Bankr. W.D. Wash. 2009) (finding section 363(f)(5) applicable where hypothetical disposition of personal property by secured creditor possible and junior creditor would receive only partial payment; looking to tax sales and probate sales as potential bases for sales under section 363(f)(5)).

[335] *See* Principal Mut. Life Ins. Co. v. Vars, Pave, McCord & Freeman, 77 Cal. Rptr. 2d 479, 484 (Cal. Ct. App. 1998) (noting California law states "[a] subordinate lease, which was made after a trust deed was executed, is wiped out by the foreclosure of that deed, along with the tenant's rights and obligations under the lease"); Bateman v. Brown, 297 S.W. 773, 775 (Tex. App. 1927) (noting Texas law recognizes "[a] foreclosure of a lien, created prior to the lease . . . puts an end to the lease itself").

[336] *See In re* Hassen Imps. P'ship, 502 B.R. 851, 860 (C.D. Cal. 2013) (overturning bankruptcy court approval of section 363(f)(5) sale where local government's equitable servitude would be wiped out by foreclosure, but local government would receive nothing).

give the provision a potentially very wide scope.[337] In addition, courts have (generally in dicta) identified hypothetical receiver's sales, probate sales, and tax sales as potential bases for sales under section 363(f)(5).[338]

At least in some states, another hypothetical proceeding that would satisfy section 363(f)(5)'s terms with regards to leases, would be one to enforce a judgment against the tenant. For example, under California law governing the enforcement of judgments, a "lessee's interest in real property may be applied to the satisfaction of a money judgment," so long as the lease agreement gives the lessee the right to sublet the property or assign the leasehold and where certain conditions are met, or where the lessor gives written consent.[339] In California and in states with similar statutory provisions, tenants who obtain the contractual right to sublet the premises or to assign the leasehold interest may unwittingly give their landlord's bankruptcy trustee grounds to argue that section 363(f)(5) can be satisfied for a sale of the real property free of the lease. Since the lease is hypothetically subject to a proceeding to enforce judgment under which the tenant would be forced to accept a money satisfaction of the leasehold interest. It is not clear that courts would be comfortable permitting the language of section 363(f)(5) to produce such a wide-ranging result.[340]

Despite (or perhaps because of) the potentially dizzying scope of section 363(f)(5) by way of hypothetical third-party proceedings, at least two bankruptcy courts have found that such an application of the provision is unjustified.[341] In *In re Haskell, L.P.*,[342] the Bankruptcy Court for the District of Massachusetts rejected the view that a hypothetical eminent domain proceeding would justify sale of real property free of a lease under section 363(f)(5), and thus, denied the trustee's request as lacking any "supporting case law or other legal authority."[343] The court found "the only logical interpretation" is to require that "the trustee or the debtor be the party able to compel monetary satisfaction for the interest that is subject of the

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[337] *See* Zinman, *supra* note 14, at 138–39 (noting other situations where an entity "may be compelled to accept a money satisfaction of its interest").

[338] *See, e.g.*, *In re Jolan, Inc.*, 403 B.R. at 870 (finding section 363(f)(5) applicable where hypothetical disposition of personal property by secured creditor possible and junior creditor would receive only partial payment).

[339] CAL. CIV. PROC. CODE § 695.035(a) (2009); *see* Regency Outdoor Advert., Inc. v. Carolina Lanes, Inc., 37 Cal. Rptr. 2d. 552, 558 (Cal. Ct. App. 1995) (affirming trial court's denial of tenant's motion to quash writ of execution issued under § 695.035, on grounds other than those cited by trial court).

[340] This would be hypothetical proceeding in which the debtor-landlord would not necessarily be a party, but would be one in which the interest holder (the tenant) is forced to accept and pay over to a hypothetical creditor a money satisfaction of the lease interest. There appears to be no reported cases in which a sale free and clear of the leasehold has been approved on this basis.

[341] *See In re* Haskell, L.P., 321 B.R. 1, 9 (Bankr. D. Mass. 2005) (ruling section 363(f)(5) "requires that the trustee or the debtor be the party able to compel monetary satisfaction for the interest which is the subject of the sale"); *see also In re* Patriot Place, Ltd., 486 B.R. 773, 815–16 (Bankr. W.D. Tex. 2013) (holding lack of legal authority and lease provisions does not rise to section 363(f)(5) of Bankruptcy Code).

[342] 321 B.R. at 1.

[343] *Id.* at 9.

sale."[344] The *Haskell* opinion does not provide a detailed analysis of the statutory language, and instead focuses on the issue of whether there is a conflict between section 365(h) (giving lessees the right to retain possession of premises under a rejected lease) and section 363(f).[345] But the *Haskell* opinion at least raises the issue of whether the literal language of the provision, without restriction on the party to bring a hypothetical proceeding, fails to be "logical" (or to comport with the rules of statutory construction) because it causes subsection (5) of section 363(f) virtually to subsume the other subsections when the governing proceeding would be an eminent domain proceeding.[346]

Like the *Haskell* court, the Bankruptcy Court for the Western District of Texas has rejected an argument that a hypothetical eminent domain proceeding, where a debtor in possession sought authority to sell real property free and clear of a lease under a proposed plan, would satisfy section 363(f)(5).[347] In rejecting the debtor's argument, the court noted that there was no provision in the lease contract that would support a finding that the tenant had agreed to accept a money satisfaction of its interest, and in fact the contract provided to the contrary.[348] Turning to whether a hypothetical proceeding exists that would permit a sale under section 363(f)(5), the court cited and concurred in *Haskell*'s express rejection of the hypothetical eminent domain proceeding as a basis for approval.[349] The court also discussed *Qualitech*, and faulted the seller's citation to that case because the *Qualitech* opinion did not identify the specific subsection under which the sale had been approved.[350]

It is apparent that the language of section 363(f)(5) does not on its face restrict the hypothetical proceedings to those that could be initiated by the debtor in possession or the trustee.[351] Congress used the passive voice in section 363(f)(5), leaving open the view that a sale free and clear is available under section 363(f)(5) so long as any party could bring the relevant proceeding. But a theoretical eminent domain proceeding as grounds for a sale under section 365(f) could, as noted above,

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[344] *Id*.

[345] *Id.* at 3 (listing four legal issues). For a discussion of cases addressing a perceived conflict between section 365(h) and section 363(f), including *Haskell*, *see infra* notes 389–432 and accompanying text.

[346] *Id*. *at* 8–9.

[347] *See In re Patriot Place, Ltd.*, 486 B.R. at 816 (citing *In re Haskell, L.P.*, 321 B.R. at 9).

[348] *Id*. (quoting terms of lease agreement, which stated "[i]n the event of any sale of the Premises by Landlord, Landlord shall be and is entirely freed and relieved of all liability under any and all of its covenants and obligations contained in or derived from this lease").

[349] *Id*.

[350] *Id*. at 817 (discussing *In re* MMH Auto. Grp., LLC, 385 B.R. 347, 370–72 (Bankr. S.D. Fla. 2008), which is discussed *infra* notes 355–66 and accompanying text).

[351] In dicta, one court noted, "[i]t is important to focus on the hypothetical nature of [the] language of § 363(f)(5). The section provides that so long as the junior interest 'could be compelled' it is sufficient to authorize a § 363(f)(5) sale. There is no requirement that the legal or equitable proceeding . . . actually occur." *In re* Levitt & Sons, LLC, 384 B.R. 630, 648 (Bankr. S.D. Fla. 2008). While the court's comment does not deal with the party that must bring such a proceeding, it points to the broad scope of the statute's "plain language."

make other subsections of section 365 largely irrelevant, because "[v]irtually all property . . . may be subject to condemnation."[352]

Does the language of section 363(f)(5) call for the use of hypothetical third-party proceedings under section 363(f)(5)? The Supreme Court has instructed courts, when faced with disputes regarding the meaning of statutory language, to adhere to the literal language before looking behind the language itself:

> The plain meaning of legislation should be conclusive, except in the "rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters." In such cases, the intention of the drafters, rather than the strict language, controls.[353]

Perhaps it is debatable whether section 363(f)(5) is in fact ambiguous, or whether the plain meaning of the language of section 363(f)(5) would produce a result demonstrably at odds with the intent of Congress in authorizing sales of property in section 365 generally. But where a literal reading of one subsection would effectively subsume other subsections of the provision, courts can readily infer that the literal reading was not what Congress intended to impose.[354] In any event, as Professor Kuney has observed, "[w]hat the real meaning—rather than the plain one—is and was has been left to the courts to consider on a case-by-case basis."[355]

A recent opinion on the issue, *South Motor Company v. Carter-Pritchett-Hodges, Inc.*,[356] is, however, instructive and provides some guidance regarding the practical application of section 363(f)(5). In that case, the buyer of real property from a chapter 7 trustee pursuant to a bankruptcy court order filed an adversary proceeding seeking a declaration that the interest in the property represented by an unrecorded billboard lease was terminated by way of an earlier bankruptcy-court order approving the sale of the property.[357]

In its bankruptcy schedules, the debtor had not identified any lease of the real property, although a previous owner had leased part of the property to an outdoor advertising firm that installed a billboard on the property under a 99-year lease that

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[352] Zinman, *supra* note 14, at 138.

[353] United States v. Ron Pair Enters., Inc., 489 U.S. 235, 242 (1989) (quoting Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982)); *see also* Conn. Nat'l Bank v. Germain, 503 U.S. 249, 253–54 (1992) ("[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words . . . are unambiguous, then this first canon is also the last: judicial inquiry is complete.") (citations and internal quotation marks omitted).

[354] *See In re* Haskell, L.P., 321 B.R. 1, 9 (Bankr. D. Mass. 2005) (rejecting hypothetical application of section 363(f)(5), and calling actual approach the "only logical interpretation" of the provision).

[355] Kuney, *supra* note 224, at 256.

[356] *In re* MMH Auto. Grp., LLC, 385 B.R. 347, 373 (Bankr. S.D. Fla. 2008).

[357] *Id.* at 352.

involved a single, up-front $15,000 payment to the owner-lessor.[358] The lease included a provision under which the owner could "buy out" the lessee in the event the lease made impossible sale or refinancing of the property.[359]

At the time the debtor had obtained title to the property, no lease or memorandum of the lease was recorded, but the debtor's predecessor had received from its seller a warranty deed for the property (which was recorded) that included a description of the lease. Furthermore, when the debtor bought the property, it had signed an agreement with the seller to assume the lease, and the lessee was advised of the sale by way of the debtor's request of the lessee for proof of insurance and arrangements for payment of utility charges.[360]

The billboard was on the property when the trustee sold it. However, the trustee, who in earlier litigation had recovered title to the property from a transferee of title and certain business assets of the debtor, did not notify the lessee of the proposed sale.[361] During the litigation that had resulted in the trustee's recovery of title, the trustee learned of the lease for the billboard, but he apparently did not disclose the existence of the lease to any interested party when he brought the motion to sell the property.[362]

In a lengthy opinion that briefly addresses the perceived conflict between section 363(f) and section 365(h), the court determined that the trustee's failure to notify the lessee of the motion to sell the property free and clear of interests meant that the court's order approving the sale was ineffective to terminate the lessee's interest in the property.[363]

The court, however, determined that it could well have approved the sale free and clear of the lease under section 363(f)(5), because in the lease-buyout provision the lessee had agreed that it could be required to accept a monetary amount in satisfaction of its interest in the property.[364] The appropriate remedy, therefore, was to require the trustee to pay the agreed buyout amount.[365]

The *South Motor Company* opinion looks to the contract between the debtor and its predecessor in interest as the basis for a determination that a sale under section 363(f)(5) was possible.[366] The court did not look more generally to a

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[358] *Id*. at 352–53.

[359] *Id*. at 370–71 (setting buy out amount at $60,000 plus interest); *id.* at 371 (quoting provision in the lease).

[360] *Id*. at 353.

[361] *Id.* at 353–54.

[362] *Id.* at 354.

[363] *Id*. at 359–61 (determining sale order could not be rescinded, and order could not simply be made inapplicable to the lessee, leaving only practical remedy an equitable one based on a balancing of the rights of the parties and their reliance on order).

[364] *Id.* at 372 ("Thus, where, as here, a tenant in a lease has agreed that the lease can be bought out under certain conditions, whether at a specific price or pursuant to a formula, that provision, like the rest of the lease, survives bankruptcy rejection and satisfies the requirement that the tenant could be compelled by the trustee to accept money in satisfaction of its interest even if the condition has not actually occurred.").

[365] *Id*. at 373.

[366] *Id.* at 352–53.

hypothetical proceeding involving a third party, but instead to the "buy out" provision of the contract that gave the debtor the right to bring a proceeding to force the other party to accept a money satisfaction of the leasehold.[367] To the extent courts limit the application of section 363(f)(5) to proceedings of the debtor or trustee, not a third party, the scope of relief will of course be more limited. This is the most sensible approach, because it makes the subsection harmonious with the other subsections and prevents it from subsuming them.

D. Leaseholds and Adequate Protection

Under section 363(e) of the Code, the holder of an interest in the property is entitled to seek "adequate protection" of that interest in connection with the debtor's or trustee's use, sale, or lease of the property. "[A]t any time, on request of an entity that has an interest in the property . . . the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest."[368]

Section 363 refers to adequate protection of an "interest in property," not merely a lien against property.[369] The most common scenario under which a bankruptcy court analyzes the need for adequate protection, however, involves a lender's lien against the property subject to an Estate Representative's motion to sell the property or to use the property in the operation of the business. For example, in a chapter 11 case, a debtor in possession may wish to use equipment subject to a lender's security interest to generate profits for the business.[370] The lender, unable to repossess the equipment because of the automatic stay of section 362, might request that the court order the debtor to make ongoing payments to the creditor to compensate the lender for wear and tear on the equipment that causes depreciation in its value and therefore a diminishment of value of the security interest.[371]

Payment to a lien holder or interest holder is one of three methods for providing adequate protection set out in the Code:

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[367] The Bankruptcy Appellate Panel for the Ninth Circuit has published an opinion with an analysis of section 363(f)(5) that also looks primarily to the rights of the debtor rather than a third party. In that opinion, the Appellate Panel called the meaning of the provision "anything but plain." *In re* PW, LLC, 391 B.R. 25, 41 (B.A.P. 9th Cir. 2008). It concluded that a "narrow view of paragraph 5" is warranted, and provided examples that all involve contractual provisions giving a party rights to a money satisfaction of another party's interest. *See id.* at 43 (providing examples). The opinion, however, involves only a lien, and does not expressly rule out a hypothetical proceeding by a third party.

[368] 11 U.S.C. § 363(e) (2012).

[369] Under the Code, a lien is defined as one type of interest in property. *See supra* notes 230–31 and accompanying text (providing definition of "lien" under Code).

[370] *See, e.g.*, *In re* Nixon Mach. Co., 9 B.R. 316, 317 (Bankr. E.D. Tenn. 1981) (stating one of five machines creditor sought to repossess was producing income for debtor's estate).

[371] *See id.* at 318 (ordering debtor to insure and maintain collateral and make periodic payments where machinery in turn to be leased by debtor to third parties).

> When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by —
>
> (1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that . . . use, sale, or lease under section 363 of this title . . . results in a decrease in the value of such entity's interest in such property;
>
> (2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or
>
> (3) granting such other relief, other than entitling such entity to compensation . . . as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.[372]

These methods of adequate protection are non-exclusive.[373] Courts are to assess requests for adequate protection on a case-by-case basis, and the touchstone of the court's analysis is the value of the interest in the property, which is to be preserved by a grant of adequate protection pursuant to section 361.[374]

When an Estate Representative brings a motion to use, sell, or lease property, it is up to holders of interests in the property to seek adequate protection. As noted above, reported cases commonly involve requests for adequate protection of a lien holder's interest in property, and such protection typically takes the form of payments to compensate for depreciation of the collateral as it is used by a trustee or debtor in possession.[375] Many reported cases also involve a lien holder's request

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[372] 11 U.S.C. § 361.

[373] The legislative history of the provision notes that the listed means of providing adequate protection "are neither exclusive nor exhaustive. They all rely, however, on the value of the protected entity's interest in the property involved. The section does not specify how value is to be determined, nor does it specify when it is to be determined. These matters are left to case-by-case interpretation and development. It is expected that the courts will apply the concept in light of facts of each case and general equitable principles." H.R. REP. No. 95-595, at 339 (1977); *see also* Pistole v. Mellor (*In re* Mellor), 734 F.2d 1396, 1400 (9th Cir. 1984) ("Although the existence of an equity cushion is not specifically mentioned in §361, it is the classic protection for a secured debt justifying the restrain of lien enforcement by a bankruptcy court.").

[374] *See* Lend Lease v. Briggs Transp. Co. (*In re* Briggs Transp. Co.), 780 F.2d 1339, 1347–49 (8th Cir. 1985) (exercising "broad discretion" under section 361 after analysis of "myriad factors," and this may or may not result in secured creditor's entitlement to post-petition interest); *see also* United Savings Ass'n v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 380–81 (1988) (holding secured creditor entitled under section 361 value of collateral itself, not right to foreclose and reinvest proceeds); *In re* Prime, Inc., 35 B.R. 697, 699 (Bankr. W.D. Mo. 1984) ("Where collateral is sold or depreciates, the notion of adequate protection requires replacement or payment so that the value of the creditor's interest is not dissipated.").

[375] *See In re Nixon Mach. Co.*, 9 B.R. at 317–18 ("Adequate protection is afforded if the creditor remains secured for that amount. That can usually be accomplished by paying depreciation so that the declining value of the collateral plus the payments keep the creditor secured for the same amount.").

for adequate protection payments where relief from the automatic stay to repossess collateral is not available to the lien holder.[376]

Adequate protection for a secured creditor's interest may come in the form of equity that exists due to the inherent value of the property, in which case no ongoing payments are required.[377] And if a real property is to be sold free and clear of a disputed lien under section 363(f)(4), the disputed lien would attach to the sale proceeds and the lien holder would be able to litigate its claim to sale proceeds after the sale. The lien holder is thus afforded a measure of protection by the fact that the proceeds are set aside.[378]

Where the court is considering a motion to sell real property free and clear of a lease, adequate protection for a lessee will likely pose more complex problems. The tenant should obviously be very concerned about safeguarding its property interest, which involves the possession and use of the same, and should thus request adequate protection be provided if objections to the sale are to otherwise be overruled.[379]

As noted in the *Qualitech* opinion:

> '[a]dequate protection' does not necessarily guarantee a lessee's continued possession of the property, but it does demand, in the alternative, that the lessee be compensated for the value of its leasehold—typically from the proceeds of sale. Lessees like Precision are therefore not without recourse . . . [t]hey have the right to seek protection under section 363(e), and upon request, the bankruptcy court is obligated to ensure that their interests are adequately protected.[380]

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[376] *See, e.g.*, Carteret Sav. Bank v. Nastasi-White, Inc., 106 B.R. 767, 773–74 (S.D.N.Y. 1989) (ordering periodic payments to secured creditor with interest and for amount to cover insurance costs); *see also* Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436, 1441 (4th Cir. 1985) (ordering periodic payments with market-rate interest, following holding in *In re* Am. Mariner Indus., Inc., 734 F.2d 426 (9th Cir. 1984)).

[377] *See In re Mellor*, 734 F.2d at 1400 ("[I]t has been held that the existence of an equity cushion, standing alone, can provide adequate protection. A sufficient equity cushion has been found to exist although not a single mortgage payment has been made.") (internal citations omitted).

[378] For a discussion of section 363(f)(4), *see supra* notes 306–21and accompanying text (discussing how courts interpret section 363(f)(4)); *In re* Clark, 266 B.R. 163, 171 (B.A.P. 9th Cir. 2001) ("Typically, the proceeds of sale are held subject to the disputed interest and then distributed as dictated by the resolution of the dispute; such procedure preserves all parties' rights by simply transferring interests from property to dollars that represent its value.").

[379] Professor Zinman points out that it may not be only the tenant's possessory interest that is subject to termination by a sale free of the lease, but also the security interest therein held by a leasehold lender. *See* Zinman, *supra* note 14, at 148 ("From the standpoint of the leasehold mortgage, the sine qua non of leasehold investments, adequate protection under § 363(e) may not provide the kind of confidence in the security for the loan that these lenders would normally expect. . . . The only really effective way to protect the tenant and leasehold mortgagee when the landlord attempts to sell the property free and clear of the lease is through corrective legislation."). The lender is thus an additional party in interest.

[380] Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp.), 327 F.3d 537, 548 (7th Cir. 2003); Travelers Ins. Co. v. Am. Agcredit Corp. (*In re* Blehm

So far, we have seen that a tenant's leasehold is afforded some protection in a landlord's bankruptcy, because in practice it is not easy to satisfy one of the conditions in section 363(f) as to leases, unless subsection (5) in particular is interpreted expansively. Further, the tenant's authority to request adequate protection under section 363(e) is a way for tenants to defend their rights.[381]

Is there, however, a conflict between section 363(f) and 365(h) that should prevent the landlord's Estate Representative from selling free and clear of the lease? Should section 365(h), which prevents the Estate Representative from terminating the lease by rejecting it, take precedence and thus prevent a sale of the property notwithstanding literal compliance with section 363(f)? Next, we turn to whether the Qualitech decision, which answered in the negative, was incorrect.

IV. THE ISSUE OF CONFLICT BETWEEN SECTIONS 363(F) AND 365(H)

In an outstanding article published shortly after the Seventh Circuit's *Qualitech* opinion was announced, Professor Robert M. Zinman wrote:

> Qualitech, in a sense, serves as a wake-up call. It is a call that makes it incumbent on those interested in preserving real estate leasehold investments to . . . urge Congress to address the complications resulting from the Qualitech decision with appropriate legislation.[382]

In recounting the "sad history" of section 365(h), Professor Zinman's article makes clear that the intent of the 1994 amendments was to preserve the tenant's rights related to possession where the Estate Representative in a landlord's bankruptcy case rejects an unexpired lease.[383] To the extent the *Qualitech* decision would give the Estate Representative a method to avoid section 365(h), by permitting the property to be sold free and clear of a tenant's lease, Professor Zinman called for remedial action.[384]

Others expressed concern that the *Qualitech* decision would "have profound implications not only on bankruptcy sales but on real estate leasing and real estate lease financing," and also non-real estate sales, such as sales of intellectual property.[385] In his critique of *Qualitech*, Michael St. Patrick Baxter wrote that "in an

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Land & Cattle Co.), 859 F.2d 137, 140 (10th Cir. 1988) (secured creditor free to seek adequate protection of its interest where trustee enters lease for use of real property collateral and agreement not merely for an administrative claim against the estate).

381 *See In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.*, 327 F.3d at 544 (discussing adequate protection); *supra* notes 281–379 and accompanying text.

382 Zinman, *supra* note 14, at 101.

383 *Id.* at 117 (explaining history and intent of 1994 amendments to Bankruptcy Code).

384 *Id.* at 101; *see supra* notes 145–75 and accompanying text.

385 Baxter, *supra* note 21, at 475.

effort to avoid an inescapable conflict between [section] 363(f) and [section] 365(h) and to give effect to both provisions, the Seventh Circuit created an artificial distinction between the 'rejection' of a lease (to which [section] 365 would apply) and the 'repudiation' of a lease through the sale of the underlying property (to which [section] 365(h) would not apply)."[386] In a similar vein, another commentator opined that *Qualitech* "incorrectly construed [section 363(f) and section 365(h)] in light of congressional intent and relevant policy issues" and that the decision of the Bankruptcy Court for the District of Massachusetts, *In re Haskell*, "correctly interprets the interplay between the two provisions and is the opinion that other courts should follow on this issue."[387]

A. Court Opinions Finding a Conflict Between Section 365(h) and Section 363(f)

Before *Qualitech*, the interplay between section 365(h) and section 363(f) was subject of few reported cases. Two such cases are worthy of review.[388]

In *In re Churchill Properties III, Limited Partnership*,[389] the chapter 11 debtor in possession owned an apartment complex, and the confirmation hearing of its proposed plan of reorganization was scheduled on the same date as hearings for two other motions: (1) a motion to sell the apartment property (the "Sale Motion") and (2) a motion to reject various executory contracts and leases (the "Rejection Motion").[390] The hearing on the Rejection Motion, however, was continued to a later date due to improper notice of the hearing.[391]

The bankruptcy court confirmed the proposed plan, and the order confirming the plan provided that it was "contingent on disposition of the [Rejection Motion]."[392] The court also granted the Sale Motion, and the order granting provided that the sale was free and clear "of any and all liens, claims, interests and encumbrances," with specified exceptions that did not include any lease.[393]

The Debtor's lease with C&H Enterprises ("C&H") for the operation of the laundry facility at the apartment complex was among the contracts subject to the Rejection Motion, notice of which was the only notice C&H received in regard to the bankruptcy case; the Rejection Motion was heard some months after the Sale Motion was heard, and was granted.[394] Later, C&H brought a motion for an order to the effect that under section 365(h) C&H had retained rights to possession of the

[386] *Id*. at 477.
[387] Daniel J. Ferretti, *Eviction Without Rejection - The Tenant's Bankruptcy Dilemma*, 39 CUMB. L. REV. 707, 708 (2008/2009) (citing *In re* Haskell, 321 B.R. 1 (Bankr. D. Mass. 2005)).
[388] *See id.* at 720 (introducing *In re* Taylor, 198 B.R. 142 (Bankr. D.S.C. 1996) and *In re* Churchill Props. III, LP, 197 B.R. 283 (Bankr. N.D. III. 1996)).
[389] 197 B.R. 283 (Bankr. N.D. Ill. 1996).
[390] *Id.* at 284.
[391] *Id*. at 285.
[392] *Id*.
[393] *Id.*
[394] *Id.* at 284–86.

premises notwithstanding the sale of the property.[395] The *Churchill Properties* court noted that C&H had "called upon [the court] to reconcile two apparently conflicting Code provisions: sections 363(f) and 365(h)(1)(A)(ii). Read and applied separately the respective provisions are innocuous. The difficulty arises when the two provisions must be applied together because each provision seems to provide an exclusive right that when invoked would override the interest of the other."[396]

The court noted a lack of reported decisions specifically on the interplay between section 365(h) and section 363(f),[397] but seeing a conflict between the provisions, the court observed that section 365(h) was more specific in scope than section 363(f).[398] Given the principle of statutory construction that the specific prevails over the general, and determining that "it would make little sense to permit a general provision, such as section 363(f) to override" the specific purpose of section 365(h), the court granted C&H's motion "to the extent that C&H should be permitted to retain its rights under section 365(h)(1)(A)(ii)."[399]

Just a month before the *Churchill Properties* court was called upon to deal with the interplay between the two provisions, another bankruptcy court had performed much the same task.[400] In *In re Taylor*,[401] a chapter 11 debtor sought to sell real property free and clear of various interests, including recorded leases under which tenants operated various nursing-home facilities.[402] The debtor had a lengthy history of disputes with its tenants.[403] The bankruptcy court had determined in one adversary proceeding that the various leases were enforceable according to their terms (although it did not rule on issues of default and termination); the bankruptcy court had also granted the tenants stays of subsequent litigation to evict the tenants and to obtain other relief, pending the outcome of appeal of the judgment regarding the enforceability of the leases.[404]

The debtor brought its motion for approval of the sale outside the ordinary course of business under section 363(b), and sought authority under section 363(f)(3) and section 363(f)(4) to sell the property free and clear of the leases.[405]

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[395] *Id.* at 284.

[396] *Id*. at 286.

[397] The court found only two reported cases of particular relevance, citing one for dicta "that a trustee can sell a building free and clear of a lease," and one that criticizes the first. *Id*. at 287 n.9 (citing *In re* Schnabel, 612 F.2d 315, 316 (7th Cir. 1980) and *In re* Stable Mews Assocs., 35 B.R. 60, 607 (Bankr. S.D.N.Y. 1983)).

[398] *Id.* at 288.

[399] *Id*.

[400] *See In re* Taylor, 198 B.R. 142, 164 (Bankr. D.S.C. 1996) (analyzing the conflict between sections 363(f) and 365(h)). Apparently the opinion was not reported in time for the *Churchill Properties* court to take note. *See supra* note 396.

[401] 198 B.R. at 167.

[402] *Id*. at 144 (detailing proposed sale of real property and personal property of five nursing home facilities).

[403] *Id.* at 147–48.

[404] *Id*. at 147–50 (listing factual findings including litigation filed and pending).

[405] *Id*. at 144–45. The motion also stated a request for relief under section 363(f)(1), but apparently the debtor abandoned such request. *Id*. at 145 n.3. Section 363(f)(3) permits sale free and clear of an interest in

The pending litigation with the tenants apparently deterred the debtor from assuming or rejecting any of the leases that were subject of the motion.[406]

In a lengthy opinion, the court reviewed the law applicable to leaseholds, and noted that by way of the lease, the tenants acquired the possessory interest in the property and the debtor as landlord retained the reversionary interest in the property.[407] After stating that the weight of authority is to the effect that the "conveyance aspect of a lease may not ordinarily disturbed by a debtor landlord or its trustee,"[408] the court turned the discussion towards the procedural side of the matter, by acknowledging a split of authority among courts as to whether leases are part of the bankruptcy estate until such time as they are assumed by the estate.[409] Based on several authorities, the court concluded that the leases in this case were part of the estate, without need for prior assumption of the lease contracts.[410]

The court went on to determine that the debtor had not produced evidence sufficient to establish the propriety of a sale under either section 363(f)(3) or section 363(f)(4).[411] But the court did not wind up its opinion at that. Instead, it went on to a detailed analysis of section 365(h).[412] It concluded that the legislative history and other factors demonstrate that this provision "seeks to prevent forcible evictions whenever possible."[413] This legislative history, the specificity of the tenant's rights under section 365(h), and the lack of case authority to support the debtor's request to sell property free of a lease neither assumed nor rejected led the court to conclude that sale of the property under section 363(f) could not be authorized:

> Even though there appears no express statutory provision that excludes the use of [section] 363(f) by [the debtor in possession], in order to recognize the apparent intentions of drafters of the

property where it is a lien and the sale price exceeds the aggregate value of liens. *See supra* note 378 and accompanying text. Section 363(f)(4) permits sale free and clear where the interest is in bona fide dispute. *See supra* notes 381–401 and accompanying text.

[406] The *Taylor* opinion does not so state, but this is a reasonable inference from the facts of the pending appeal and the stayed litigation. *See In re* Taylor, 198 B.R. 142, 167 n.21 (Bankr. D.S.C. 1996) ("This Court is not unsympathetic to the Debtor's dilemma of pursuing reorganization while issues that could lead to the termination of the leases remain stayed by an appeals bond.").

[407] *Id*. at 158–59 ("Therefore, the weight of authority is that the conveyance aspect of a lease may not ordinarily be unilaterally disturbed by a debtor landlord or his trustee.") (internal citations omitted).

[408] *Id*. at 159 (quoting *In re* Minges, 602 F.2d 38, 41 (2d Cir. 1979) (internal quotation marks omitted)).

[409] *Id*. at 159–60 ("To the contrary, the Bankruptcy Court for the Southern District of New York has noted that while some courts had held that executory contracts were not property of the estate prior to their assumption some of the same courts have nevertheless extended automatic stay protection to the debtor rights in the same executory contracts prior to assumption or rejection.").

[410] *Id.* at 160 ("After consideration of these various authorities, this Court believes that the Debtor's title to the real property as well as the package of rights the Debtor presently holds in regards to the unexpired leases (prior to any assumption or rejection) are sufficient property rights to meet the requirements of § 363(b) even if the property of the estate does not include the property rights of the lessees.").

[411] *Id.* at 160–63.

[412] *Id.* at 164–67 (analyzing if section 365(h) was applicable given facts of the case).

[413] *Id*. at 166 (discussing *In re* Lee Rd. Partners, Ltd., 155 B.R. 55 (Bankr. E.D.N.Y. 1993)).

> Bankruptcy Code as expressed so specifically in [section] 365(h), this Court agrees that [section] 365 is the necessary avenue which this Debtor must follow before this Court could authorize a transfer of the real property.[414]

The analysis of *Taylor*, then, does not center on a conflict between section 363(f) and section 365(h). The court instead puts the issue in primarily a procedural guise, in which the debtor would be required to assume, or reject, the lease before the court could consider whether to approve sale of the property under section 363(f).[415] Setting aside the issue of whether the discussion of section 365(h) is merely dicta unnecessary for the court's decision, one is left to consider whether the *Taylor* court would ultimately permit a sale under any subsection of section 363(f), where the Estate Representative had rejected the lease and the tenant asserted its rights to retain possession under section 365(h). By contrast, the *Churchill Properties* opinion is clearly based on its determination that there is a conflict between section 363(f) and section 365(h), and thus where the Estate Representative has rejected a lease, the court may not approve sale of the property free and clear of the lease where the tenant has elected under section 365(h) to retain possession.[416]

Some post-*Qualitech* opinions have sided with the *Churchill Properties* court. For example, *In re Haskell*,[417] the court was asked to rule on a chapter 11 debtor's motion under section 363(f)(5).[418] The debtor owned real property, a portion of which was leased to New England Baptist Hospital ("NEBH"), which operated an assisted-living facility on the property, and the debtor sought to sell the property free and clear of the lease to NEBH.[419] The lease had been recorded pre-petition and was subject to rejection under the debtor's proposed plan of reorganization and a motion that was granted after NEBH stated its lack of opposition to the motion.[420]

The debtor argued that it was authorized under section 363(f)(5) to sell the property free and clear of the lease because NEBH could be compelled in a

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[414] *Id.* at 167. Presumably, then, the court would have approved sale of the property subject to the assumed leases under section 363(b). It is less clear whether the court would have entertained a motion to sell the property free and clear of the leases after rejection, if the debtor could have demonstrated satisfaction of any of the conditions stated in section 363(f).

[415] *See id.* at 167.

[416] *See supra* notes 388–98 and accompanying text. After stating its view regarding the need to "follow" section 365 before a section 363(f) sale could be approved, the court also observes that South Carolina law "requires the continuation of a lease interest upon sale of the property." *In re Taylor*, 198 B.R. at 167.

[417] 321 B.R. 1, 9 (Bankr. D. Mass. 2005) (acknowledging persuasive authority of *Churchill Village* and *Taylor*).

[418] *Id*. at 5. Section 363(f)(5) authorizes a sale where the interest holder could be compelled in a legal or equitable proceeding to accept a money satisfaction. *See supra* notes 343–49 and accompanying text.

[419] *Id*. ("According to the Debtor, because NEBH could be compelled to accept a money satisfaction in exchange for its leasehold interest in the Property, § 363(f)(5) permits it to sell the Property free and clear of NEBH's leasehold interest.").

[420] *Id*. at 2–5 (discussing debtor's efforts to sell property in question free and clear of NEBH's 99-year leasehold interest in property).

hypothetical eminent domain proceeding to accept a monetary satisfaction of its lease interest.[421] NEBH argued that it could not in fact be forced to accept a monetary satisfaction, and responded that the leasehold would in any event be impossible to value, meaning that continued possession would be the only remedy that would provide adequate protection of NEBH's interest in the property.[422]

The *Haskell* opinion begins its analysis with a general review of the applicability of section 363(f) to sales free and clear of leases, and the effect of section 365(h) on the rights of tenants.[423] The opinion also includes a discussion of *Qualitech*, which is quoted in some length, mainly for the proposition that under section 363(e) a tenant is entitled to adequate protection of an interest in property subject to sale.[424]

The *Haskell* court denied the debtor's motion, rejecting the debtor's assertion that a purely hypothetical proceeding would satisfy section 363(f)(5).[425] Instead, the court determined that the proper interpretation of the language requires that "the trustee or the debtor be the party able to compel monetary satisfaction for the interest which is subject of the sale."[426] Further, said the court, relief was precluded by a lack of evidence regarding the value of NEBH's interest in the property, meaning that the debtor could not prove the amount necessary to a monetary satisfaction, particularly where the debtor had "not offered or provided adequate protection for NEBH's interest in the lease."[427]

Rather than limit its analysis to the debtor's failure to satisfy section 363(f), *Haskell* then turns to section 365(h).[428] The court observes that NEBH had the right post-rejection to remain in possession under section 365(h), and stated that relief in favor of the debtor under section 363(f) would be more than merely inconsistent with that right: "If the court were to grant the Debtor's Sale Motion, the provisions of [section] 365(h) would be eviscerated."[429] As such, "NEBH cannot be compelled

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[421] *Id*. at 5, 9; *see supra* notes 322–66 and accompanying text (discussing section 363(f)(5)).

[422] *Id*. at 5–6. NEBH also argued that section 510(a), giving effect to subordination agreements, prevents the sale because of the effect of a separate subordination agreement and a related non-disturbance agreement. The court did not decide that issue, however. *Id*. at 10.

[423] *Id.* at 3, 6 (explaining sales under 363(f) are "subject to the adequate protection requirement," which "may be provided by cash payments, additional or replacement liens, or such other relief as will result in the realization of the indubitable equivalent of such entity's interest in property." Also explaining Congress enacted section 365(h) to "[afford] tenants of debtors who are lessors special protections in the event a debtor as lessor rejects a lease").

[424] *Id*. at 7–8 (discussing *Qualitech*, which states that section 363(e) entitles a tenant to "adequate protection" for the value of its leasehold, which can either come in the form of continuing possession or financial compensation, typically from proceeds of debtor's proposed sale).

[425] *Id.* at 5, 9 (rejecting debtor's claim that section 363(f)(5) allows it to sell property in question free and clear of NEBH's leasehold interest as long as debtor is able to provide the court a hypothetical scenario in which NEBH could be forced to accept financial compensation in exchange for NEBH's leasehold interest).

[426] *Id.* at 9; *see supra* notes 343–49 and accompanying text.

[427] *Id*.

[428] *Id.* (stating that even if debtor fulfilled requirements of section 363(f)(5), NEBH would still have the right under section 365(h) to remain in possession of its leasehold interest).

[429] *Id*.

to accept for its rejected lease under [section] 363(f)(5) in view of the provisions of [section] 365(h)."[430]

The *Haskell* opinion thus identifies a conflict between section 365(h) and section 363(f) in the hands of the landlord's Estate Representative, and other courts have followed *Haskell*.[431] To varying degrees, these cases and much of the commentary on *Qualitech* conclude that when applied to leases, section 365(h) must take precedence over section 363(f), in light of the perceived conflict between the two provisions. But as discussed below, this analysis does not take into account the role that state law plays in the application of both sections to leases.[432] This failure leads the analysis to see conflict where none exists.

B. Conflict Between Section 363(f) and Section 365(h), or Tension that is a Reflection of State Law?

When do two statutory provisions "conflict?" Perhaps the most striking example occurs where one statute prohibits a specific activity, and another statute sanctions and regulates it. For example, the federal Controlled Substances Act, which prohibits the sale of cannabis to members of the public, is said to conflict with laws in Colorado and Washington that permit and regulate such sale.[433] The fact that one law is federal and the others are state laws raises the issue of the preemption of state law by federal law, but the statutes are said to "conflict" to the extent it is impossible to comply with both laws, or where one law stands as an obstacle to execution of the purpose of the other.[434]

In other cases, a legislature might include requirements or restrictions in one statute that create obstacles to the execution of the purpose of another statute passed

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[430] *Id*. at 9; *see also In re* Zota Petroleums, LLC, 482 B.R. 154, 163 (Bankr. E.D. Va. 2012) (considering *Haskell* and *Qualitech*, but following *Haskell*: "The rights of a tenant may not be extinguished by a § 363 sale; to hold to the contrary would give open license to debtors to dispossess tenants by utilizing the § 363 sale mechanism").

[431] Other cases side with *Haskell* rather than *Qualitech*: *In re* Samaritan Alliance, LLC, Ch. 11 No. 07-50735, 2007 Bankr. LEXIS 3896, at *11–12 (Bankr. E.D. Ky. 2007) (describing the teaching in *Haskell* as "instructive"); *cf.* Hewlett v. United States Bankruptcy Court, Ch. 11 No. C 07-05532 CRB, 2007 U.S. Dist. LEXIS 83994, *2 (N.D. Cal. 2007) (declining to apply *Qualitech* to the case at hand whilst acknowledging that 9th Circuit's jurisprudence was still unsettled on the matter of whether section 363(f) allows a lessee to be displaced despite protections contained in section 365(h)).

[432] *See* Butner v. United States, 440 U.S. 48, 55 (1979) (noting that property interests (such as leases) are created and defined by state law, and that such law applies to federal bankruptcy proceedings unless some federal interest (such as sections 363 or 365) requires a different result).

[433] *See generally* Todd Garvey & Brian T. Yeh, RL7-57000 CONG. RESEARCH SERV., STATE LEGALIZATION OF RECREATIONAL MARIJUANA: SELECTED LEGAL ISSUES 1–7, http://fas.org/sgp/crs/misc/R43034.pdf (discussing current conflicts between state and federal marijuana laws).

[434] *See id.* at 7–8. (discussing each type of preemption: express preemption, conflict preemption, and field preemption. Courts imply the existence of the latter two types from the language and structure of the federal statutes and if necessary from the legislative history); *see also* Wyeth v. Levine, 555 U.S. 555, 563–67 (2009) (finding no federal preemption of state tort law governing drug labeling).

by the same legislature. For example, in the extensive revisions to the Uniform Commercial Code (the "UCC") that became effective in most states in 2001, restrictions on assignment or transfer of security interests were made ineffective.[435] But at the same time, in some states that adopted these revisions there remains in place other legislation that prohibits assignment of rights and transfer of security interests in certain state-issued licenses, such as liquor licenses, which are defined as general intangibles in the UCC. This situation has left courts with the job of determining whether the statutes conflict and if so whether the UCC provision should take precedence because it was intended to supersede the prior legislation.[436]

Particularly as to various provisions within a comprehensive statute such as the Code, Congress perhaps best indicates the intent to avoid conflict by using the term "notwithstanding." For example, section 541 sweeps into the bankruptcy estate a large swath of property interests held by a debtor.[437] Meanwhile, section 522, "notwithstanding section 541," gives an individual debtor rights to exempt designated property from property of the bankruptcy estate.[438]

While these two provisions have very different effects on property subject to administration in the bankruptcy case, Congress, by use of the word "notwithstanding" in section 522, indicates to courts that the two sections do not "conflict," but that one statute is intended to carve out an exception to the scope of the other in the administration of individual bankruptcy cases.[439]

In other instances, it is more difficult for courts to construe provisions of the Code harmoniously, given the language used by Congress. A good example is the interplay between section 365(c)(1) and section 365(f)(1), where "the proper interpretation of [section] 365(c)(1) has been the subject of considerable disagreement among courts and commentators."[440] Section 365(c)(1) sets out one of

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[435] *See* U.C.C. § 9-408 (1998) (indicating among other things making ineffective terms that prohibit, restrict, or require consent to the "creation, attachment, or perfection of a security interest" in a general intangible); *see, e.g.*, CAL. COMM. CODE § 9408 (2002).

[436] *See, e.g.*, N.J. Div. of Taxation v. United Tr. Bank, 367 F. Supp. 2d 696 (D.N.J. 2005) (determining that alcoholic-beverage control law with prohibition on transfer or security interest in liquor license does not override section 9-408 of New Jersey's version of the Uniform Commercial Code, which prohibits restrictions on transfer of rights in general intangibles; instead the control law prevents debtor's rights in license from becoming asset of estate); *see also* Valley Bank and Tr. Co. v. Spectrum Scan, LLC (*In re* Tracy Broad. Corp.), 696 F.3d 1051 (10th Cir. 2012) (reconciling section 9-408 of Nebraska's version of Uniform Commercial Code with provisions of the Federal Communications Act restricting transfer of rights in FCC broadcast license).

[437] *See* 11 U.S.C. § 541 (2012) (describing broad swatch of property interests that may be included in debtor's bankruptcy estate).

[438] *Id.* § 522(b)(1) (allowing debtor to "exempt" certain property from inclusion in bankruptcy estate).

[439] *See generally id.* ("Notwithstanding section 541 of this title, an individual debtor may exempt from property of the estate the property listed in either paragraph (2) or, in the alternative paragraph (3) of this subsection.").

[440] *See* Perleman v. Catapult Entm't (*In re* Catapult Entm't), 165 F.3d 747, 749 (9th Cir. 1998) (discussing how court will apply statutory language to facts at hand and determine whether it prohibits Catapult, as debtor in possession, from assuming Perleman licenses without Perleman's consent).

three particular conditions under which the Estate Representative may not "assume or assign" an executory contract or unexpired lease, specifically where:

> (A) applicable law excuses a party, other than the debtor . . . from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
> (B) such party does not consent to such assumption or assignment.[441]

In *Perleman v. Catapult Entertainment*, the Ninth Circuit was asked to determine whether a "statutory trouble spot" was in play at the intersection between section 363(c)(1) and the following language of section 365(f)(1):

> Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.[442]

Perleman, the non-debtor licensor under an executory software licensing agreement, objected to motion of the licensee, a chapter 11 debtor, to assume the agreement pursuant to its reorganization plan, under which a merger of the debtor entity with other entities would occur.[443] Perleman argued that because federal patent law excused him from accepting performance from a party other than the debtor, the literal language of section 363(c)(1) prevented the bankruptcy court from granting the motion over his objection, despite the language of section 363(f)(1). The bankruptcy court, however, granted the motion and the district court affirmed.[444]

On appeal, the debtor argued that "a literal reading of [section] 365(c)(1) sets the statute at war with itself and its neighboring provisions," such that the court was required to deviate from the section's plain language in order to harmonize it with section 365(f)(1).[445] The trouble spot, said the debtor, was that section 365(c)(1)

[441] 11 U.S.C. § 365(c)(1).
[442] *Id.* § 365(f)(1). *See In re Catapult Entm't*, 165 F.3d at 751. In 2005, section 365(f)(1) was amended among other things to add language excepting subsection (b). *Accord* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 404(b), 119 Stat. 23, 108 (codified at 11 U.S.C. § 365(f)(1)).
[443] *In re Catapult Entm't*, 165 F.3d at 749.
[444] *Id*. Ninth Circuit does not explain lower courts' reasoning.
[445] *Id*. at 751.

would, if applied literally, prevent the debtor from assuming an agreement that was otherwise non-assignable under applicable nonbankruptcy law, even where the debtor did not seek to assign it but could simply assume it under section 365(f)(1).[446] The debtor argued that the prohibition stated in section 365(c)(1) could be harmonized with section 365(f)(1)'s general permission to assign otherwise non-assignable contracts only by interpreting it to prohibit the debtor's assumption *and* assignment, rather than the assumption *or* assignment, as expressly provided.[447] Otherwise, said the debtor, section 365(f)(1) would be rendered superfluous, in that any contract must be assumed before it can be assigned.[448]

But the Ninth Circuit, like the Sixth Circuit before it, reconciled the apparently "warring provisions" by close attention to the statutory language.[449] The court explained that section 365(c)(1) specifically gives effect to contractual provisions or nonbankruptcy law that excuse the non-debtor party from performance or accepting performance, while section 365(f)(1) overrides contractual provisions or non-bankruptcy law that, more generally, prohibit, restrict, or condition the assignment of the contract.[450] Accordingly, an anti-assignment clause cannot generally prevent assignment (as provided by section 365(f)(1)), but where contract or law specifically prevents assignment by excusing the non-debtor party from performance or accepting performance, then assumption or assignment will be prohibited absent consent (as provided by section 365(c)(1)).[451] One provision, then, generally overrides state law or contract regarding non-assignability, while the other carves out an exception regarding assumption or assignment where the contract or law excuses the non-debtor party from performance or acceptance for the specific reason stated.

In an argument analogous to the debtor's argument in *Perleman* as to section 365(f)(1) and section 365(c)(1), critics of *Qualitech* assert that section 363(f) is, in effect, "at war" with section 365(h), by creating an obstacle to carrying out the purpose of section 363(h). The *Qualitech* court rejected that view for two reasons.[452] First, looking at the overall statutory structure, the court observed that "the statutory provisions themselves do not suggest that one supersedes or limits the other."[453] This is demonstrated by the lack of cross references between section 365(h) and section 363(f) (where such cross references exist between other subsections) that would "indicate that certain of their provisions are subject to other

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[446] *Id.*
[447] *Id.* at 751–52.
[448] *Id.*
[449] *Id.* at 754 (explaining because statute speaks clearly, and its plain language does not produce a patently absurd result or contravene any clear legislative history, court had to "hold Congress to its words").
[450] *Id.* at 751.
[451] *Id.* at 752.
[452] *See generally* Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp.), 327 F.3d 537, 546–47 (7th Cir. 2003).
[453] *Id.* at 547.

statutory mandates."[454] Second, the "plain language of [section] 365(h)(1)(A) suggests that it has a limited scope."[455] Specifically, "[t]he two statutory provisions apply to distinct sets of circumstances," section 365 to leases of property and section 363 to sales of property, and there is no language in either section to demonstrate that section 365(h) "applies to any and all events that threaten the lessee's possessory rights."[456] The court looks to the adequate protection requirement of section 363(e) as the designated remedy where such rights are threatened by a motion to sell free of the lease.[457]

The lack of such language has thus helped tenants argue successfully in *Churchill Properties, Haskell*, *Zota Petroleum*, and other cases that section 365(h) must prevail, at least where the landlord's Estate Representative seeks to sell real property free and clear of a lease that has been rejected.[458]

But, consistent with the *Qualitech* opinion, a close look at the statutory scheme indicates that the provisions are not in fact "at war." The lack of conflict is perhaps more fundamentally explained, as noted above, by the fact that the bankruptcy estate's rights in any lease are to be governed by state law, and under state law a real property lease has the characteristics of both a conveyance of an interest in the property and a contract between the landlord and tenant. Outside bankruptcy, these characteristics are in tension with one another, as the property-law approach might lead a court to one result where the contract-law approach might lead to another. For example, even in the absence of a written lease agreement between a subtenant and a landlord, the privity of estate resulting from the subtenancy creates in many states the obligation to pay rent to the landlord.[459] At the same time, even though under property-law principles a tenant's duty to pay rent to the landlord results from the privity of estate, contract principles applicable to leases may cause this duty to be conditioned on performance of the landlord's performance of its duties under the lease.[460]

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[454] *Id*.
[455] *Id*.
[456] *Id*.
[457] *Id.* at 547–48 (explaining section 363 itself provides for mechanism to protect rights of parties whose interests may be adversely affected by sale of estate property).
[458] *In re* Churchill Props. III, Ltd. P'ship, 197 B.R. 283, 287 (Bankr. N.D. Ill. 1996); *see In re* Zota Petroleums, LLC, 482 B.R. 154, 163 (Bankr. E.D. Va. 2012) (explaining holding by highlighting fact that legislative history demonstrates the desire of "Congress to preserve the rights of a party to a real property leas that the lessor has rejected"); *In re* Haskell, L.P., 321 B.R. 1, 9 (Bankr. D. Mass. 2005).
[459] In many states, a party that does not formally assume an existing tenant's obligation to pay rent to the landlord, but who occupies the premises as a subtenant, "is liable [to pay rent to the landlord] by reason of his tenancy, and his obligation, arising out of privity of estate, continues at least through the period of his occupancy." Ellingson v. Walsh, O'Connor & Barneson, 104 P.2d 507, 509 (Cal. 1940); *see also* RESTATEMENT (SECOND) OF PROP.: LANDLORD & TENANT ch. 12, intro. note (AM. LAW INST. 1977) ("The obligations of the tenant . . . which arise without the aid of any express promise by the tenant are to pay the rent reserved, not to commit waste, and not to use the property for an illegal purpose.").
[460] *See supra* notes 70–75 and accompanying text (discussing California law).

Section 365(h), giving the tenant the right to retain possession despite the landlord's rejection (breach) of the lease, generally reflects the outcome of such a breach under state contract law. As discussed above, the landlord's breach does not mean simply that the landlord terminates the lease by so doing, at least unless the tenant consents to termination or other circumstances and applicable law results in a termination.[461]

Importantly, section 363(f), by giving the landlord's estate rights to sell real property free and clear of an interest such as a lease, represents a mechanism to administer the property-law characteristics of a lease under state law. With the exception of subsection (3), which is applicable to liens only,[462] the alternative conditions set out in section 363(f) in practice make use of applicable state law: Subsection (1) expressly permits a sale free and clear where applicable nonbankruptcy law would permit such a sale, and as discussed above, such situations have rarely arisen in reported cases.[463] Subsection (2) permits sale where the holder of the interest consents to the sale, which condition would apply under state law.[464] Subsection (4), by permitting the sale to occur where the interest is in bona fide dispute, permits the sale to go forward, with the interest attaching to the sale proceeds, and the dispute can be resolved later according to applicable state or non-bankruptcy law.[465] In that situation, and in others, the holder of the interest has the opportunity to argue that such option does not provide adequate protection of the interest, as where the interest may be worth more than the sale price.[466]

Finally, subsection (5) applies where the holder could be compelled in a legal or equitable proceeding to accept money for the interest.[467] Such proceedings would generally occur under state or non-bankruptcy law, although some courts have ruled that a plan confirmation proceeding where an interest-holder's claim is subject to "cram down" under section 1129(b) of the Code can be such a proceeding.[468] A straightforward example of the use of section 363(f)(5) is the situation in which the tenant's interest in the lease is subject to an enforceable "buy out" provision, and under state law the landlord could compel the tenant to accept money for the lease pursuant to the buy out provision. This is the situation that occurred in *South Motor Company of Dade County v. Carter-Pritchett-Hodges, Inc.*, a recent bankruptcy-level case that is discussed above.[469]

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[461] *See generally supra* notes 108–21 and accompanying text.

[462] Subsection (3), where the interest is a lien and the sale price exceeds the aggregate value of all liens, is inapplicable to leases. *See supra* note 304 and accompanying text.

[463] *See supra* notes 284–88 and accompanying text.

[464] *See supra* notes 302–03 and accompanying text.

[465] 11 U.S.C. § 365(f)(4) (2012).

[466] *See supra* notes 367–79 and accompanying text (discussing generally), and notes 417–29 and accompanying text (regarding *Haskell* decision).

[467] *See generally supra* notes 322–67 and accompanying text.

[468] *See supra* note 326 and accompanying text.

[469] *In re* MMH Auto. Grp., LLC, 385 B.R. 347, 370 (Bankr. S.D. Fla. 2008), discussed *supra* notes 355–65 and accompanying text.

In *South Motor Company*,[470] the landlord would not, outside bankruptcy, have been able to terminate the lease by simply breaching it, but it could, consistent with contract and state law, compel termination by way of the buy out provision.[471] Section 363(f)(5) preserves this result. Under *South Motor*, the Estate Representative for the landlord has rights to sell the property free and clear of the leasehold because the debtor had power to force the same result under a proceeding in state court.[472]

Thus it is apparent that there is no inherent conflict between section 363(f)(5) and section 365(h). The two provisions of the Code merely reflect the tension that exists under state law, between the lease-as-contract and the lease-as property-interest.

It is only where subsection (5) of section 365(f) is interpreted broadly does it pose some significant risk to tenants and their lenders. Specifically, where a court interprets the provision to permit a sale where any hypothetical party, not merely the debtor or its Estate Representative, could initiate the proceeding, then the Estate Representative is awarded a tool that would permit a result that could not be imposed by the debtor-landlord outside bankruptcy. As discussed above, should a court authorize a sale of real property under section 363(f)(5) free and clear of a lease on grounds that a government agency hypothetically could condemn the property and thereby terminate the lease, then the application of subsection (5) could become so broad as to subsume the other subsections. This is an outcome, however, that courts have avoided, by use of ordinary rules of statutory construction.[473]

V. CONCLUSION

The *Qualitech* opinion does not reveal the specific subsection of section 363(f) that was used to dispossess the tenant, but it is clear that the tenant did not object to the sale process and asserted its rights very late, only after the sale had been approved and it had been locked out of the premises.[474] While *Qualitech* stands for the proposition that courts are not *per se* to refuse a request for approval of a sale of real property free and clear of a lease solely on grounds that the tenant asserts rights under section 365(h),[475] the decision has not served to "open the floodgates" for such sales. This is because, in light of applicable state law, it is difficult to satisfy any particular condition of section 363(f) where the sale of property subject to a lease is subject of the motion and where section 363(f)(5) is properly limited in its

[470] *Id*. at 347.
[471] *Id*. at 371.
[472] *Id*. at 370–72.
[473] *See supra* notes 329–51 and accompanying text.
[474] Precision Indus., Inc. v. Qualitech Steel SBQ, LLC (*In re* Qualitech Steel Corp. & Qualitech Steel Holdings Corp.), 327 F.3d 537, 543 (7th Cir. 2003).
[475] *Id*. at 545.

scope.[476] It would appear, then, that while the fictional Reverend Glenworthy might have managed to jettison his property's unwanted occupants, Qualitech has not greatly increased the Estate Representative's chances, in a landlord's bankruptcy case, to use Section 363(f) to dispossess the tenant who wants to remain in possession.

[476] The difficulty in satisfying any of the subsections of section 363(f) to sell real property free and clear of a lease is apparent in *In re* Patriot Place, Ltd., 486 B.R. 773 (Bankr. W.D. Tex. 2013). In that case a creditor's plan would have permitted sale of the debtor's real property free and clear of certain leases under section 363(f)(4) or (f)(5), but in a lengthy analysis, the court rejected the request due to the failure to satisfy those provisions. The court went on to conclude that the other subsections of section 363(f) would also be unsatisfied. *Id*. at 814–19.

Fifth Circuit Weighs In on Bankruptcy Asset Sales Free and Clear of Leasehold Interests

By **Mark Douglas, Oliver Zeltner**
Jones Day
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The ability of a trustee or chapter 11 debtor-in-possession ("DIP") to sell bankruptcy estate assets "free and clear" of competing interests in the property has long been recognized as one of the most important advantages of a bankruptcy filing as a vehicle for restructuring a debtor's balance sheet and generating value. Still, section 363(f) of the Bankruptcy Code, which delineates the circumstances under which an asset can be sold free and clear of "any interest in such property," has generated a fair amount of controversy. This is so in part because the statute itself does not define "interest."

Although section 363(f) is generally acknowledged to encompass liens and security interests, some courts, taking into account both the language of the provision and its underlying purpose, have interpreted it much more broadly to also include leasehold interests, among other things. Broadly applied, however, section 363(f) arguably conflicts with certain other provisions of the Bankruptcy Code.

One of those provisions is section 365(h)(1) of the Bankruptcy Code. That section provides that, if the trustee or DIP rejects an unexpired real property lease under which the debtor is the lessor, the nondebtor lessee (and any permitted successor or assign, pursuant to subsection (h)(1)(D)) has the option of retaining its rights under the lease for the balance of the lease term "to the extent that such rights are enforceable under applicable nonbankruptcy law."

Courts disagree as to whether the rights of a lessee (or sublessee) under section 365(h)(1) are effectively extinguished where the debtor does not reject the lease and the leased real property is sold free and clear under section 363(f). Until 2022, only two federal courts of appeals had weighed in on this question, both staking out what was previously considered to be the minority view. In *Precision Industries, Inc. v. Qualitech Steel SBQ*, 327 F.3d 537 (7th Cir. 2003), the U.S. Court of Appeals for the Seventh Circuit disagreed with several lower courts and held that a real property lease can be extinguished in a free-and-clear sale of the property under section 363(f), at least where the lease has not been formally rejected. In *Pinnacle Rest. at* way. In *In re Royal Street Bistro, L.L.C.*, 26 F.4th 326 (5th Cir. 2022), the court denied certain tenants' motion for a writ of mandamus directing a district court to issue a stay pending appeal of a bankruptcy court order approving the sale of leased real property free and clear of the tenants' leasehold interests. However, instead of issuing a summary order without explanation, the Fifth Circuit issued a brief *per curiam* opinion in which it agreed with the result reached by the lower courts, but signaled disagreement with *Qualitech*'s holding and cautioned courts against "blithely accepting *Qualitech*'s reasoning and textual exegesis."

Free-and-Clear Sales

Section 363(f) of the Bankruptcy Code authorizes a trustee or DIP to sell property "free and clear of any interest in such property of an entity other than the estate" under any one of five specified conditions. These include, among other things, if applicable nonbankruptcy law permits a sale free and clear, if the sale price exceeds the aggregate value of all liens encumbering the property, or if the interest is in bona fide dispute.

A bankruptcy court's power to order sales free and clear of competing interests without the consent of the party asserting the interest has been recognized for more than a century. *See Ray v. Norseworthy*, 90 U.S. 128, 131–32 (1875); *Van Huffel v. Harkelrode*, 284 U.S. 225, 227 (1931). A court-ordered free-and-clear sale promotes the expeditious liquidation of estate assets by avoiding delay attendant to sorting out disputes concerning the validity and extent of competing interests, which can later be resolved in a centralized forum. It also facilitates the estate's realization of the maximum value possible from an asset. A prospective buyer would discount its offer significantly if it faced the prospect of protracted litigation to obtain clear title to an asset.

Section 363(e) of the Bankruptcy Code provides that, upon the request of an entity that has an "interest" in property proposed to be sold by the trustee or DIP, the court "shall prohibit or condition" the sale "as is necessary to provide adequate protection of such interest." Section 361 provides that "adequate protection may be provided" by periodic cash payments to protect against any decrease in value of the interest; an additional or replacement lien (if the interest is a lien); or other relief, such as an administrative expense claim, "as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property."

"Any Interest" Broadly Construed

Section 363(f) has been applied to a wide range of interests. Courts, however, disagree regarding the precise scope of the term "interest," which is not defined in the Bankruptcy Code or its accompanying legislative history. Most courts reject the narrow approach adopted in a minority of cases under which section 363(f) is limited to *in rem* property interests or only those claims that have already been asserted at the time the property is sold. Instead, the majority have construed the term broadly to encompass other obligations that may flow from ownership of property, including, for example, successor liability claims. *See, e.g.*, *Indiana State Police Pension Tr. v. Chrysler LLC (In re Chrysler LLC)*, 576 F.3d 108 (2d Cir. 2009), *judgment vacated on other grounds*, 558 U.S. 1087 (2009);*In re Trans World*

The scope of section 363(f) becomes an issue if a debtor-lessor seeks to sell property free and clear of the possessory interests of tenants or subtenants. This is so because section 365(h)(1) specifically protects such interests. As noted previously, section 365(h)(1) provides that, if the trustee or DIP rejects an unexpired real property lease under which the debtor is the lessor, the nondebtor lessee (and any permitted successor or assign) has the option to either: (i) treat the lease as terminated and file a claim for breach; or (ii) retain its rights under the lease for the balance of the lease term (including any renewal or extension periods) "to the extent that such rights are enforceable under applicable nonbankruptcy law."

In enacting section 365(h)(1), lawmakers sought to "codify a delicate balance between the rights of a debtor-lessor and the rights of its tenants" by preserving the parties' expectations in a real estate transaction. *In re Lee Road Partners, Ltd.*, 155 B.R. 55, 60 (Bankr. E.D.N.Y. 1993). The provision's legislative history indicates that lawmakers intended that rejection of a lease by a debtor-lessor should not deprive the tenant of its estate for the term for which it bargained. *See* H.R. Rep. No. 95-595, 349–50 (1977); S. Rep. No. 95-989, 60 (1978).

Qualitech

The apparent conflict between sections 363(f) and 365(h)(1) was considered as a matter of first impression at the court of appeals level by the Seventh Circuit in *Qualitech*. In that case, a chapter 11 debtor sold substantially all of its assets (including a steel mill with a warehouse leased to Precision Industries, Inc. ("Precision") for 10 years) to the mortgagee of the property. At the time of the sale, the debtor had neither assumed nor rejected the Precision lease. The order approving the sale provided that the assets were to be conveyed "free and clear of all liens, claims, encumbrances, and interests," other than those specifically excepted. The Precision lease, which was unrecorded, was not among the exceptions. Precision was notified of the sale but chose not to object. Instead, it negotiated with the ultimate buyer of the property regarding the assumption of its lease. Those negotiations proved futile, and Precision's lease agreement ultimately was deemed rejected in accordance with the terms of the debtor's chapter 11 plan.

Precision commenced litigation seeking a determination that, pursuant to section 365(h) of the Bankruptcy Code, it retained a possessory interest in the warehouse notwithstanding the sale of the property. The bankruptcy court ruled that, under the terms of both section 363(f) and the sale order, the new owner had obtained title to the property free and clear of Precision's leasehold interest. According to the court, that interest clearly qualified as "any interest" under the statute and was unequivocally "extinguished" by the terms of the sale order. The court also implicitly rejected the idea that section 365(h) somehow preserved Precision's rights.

Precision appealed to the district court, which reversed. Reasoning that sections 363(f) and 365(h) are incongruous, the district court held that "the terms of section 365(h) prevail over those of section 363(f) as applied to the rights of lessees." It concluded that the more specific terms of section 365(h) must override the more general scope of section 363(f), observing that "[t]here is no statutory basis for

The Seventh Circuit reversed. Given the U.S. Supreme Court's observations in other contexts that "interest" is a broad term, the Seventh Circuit concluded that the right conferred by a leasehold upon the lessee "readily may be understood as an 'interest' in the property" within the meaning of section 363(f).

The Seventh Circuit faulted the district court's reliance upon an apparent contradiction between the two provisions as a basis for reversing the bankruptcy court. First, the Seventh Circuit noted, the provisions themselves do not suggest that one supersedes or limits the other, whereas other subsections of both sections 363 and 365 contain specific cross-references to other provisions that have a limiting effect on their scope. The court then observed that the plain language of section 365(h) suggests that it is limited in scope. In particular, section 365(h) expressly applies only to situations where the trustee rejects a lease but retains ownership of the property. By contrast, if the trustee does not reject the lease but sells the underlying property under section 363(f), as occurred in *Qualitech*, the sale will be free and clear of the tenant's possessory interest (provided it meets one of the five conditions in section 363(f)).

According to the Seventh Circuit, a lessee is not without recourse if its leasehold rights are extinguished in this way. Section 363(e) gives the lessee the right to demand adequate protection of its interest in the property. This would most likely take the form of compensation for the value of its forfeited leasehold interest.

A number of lower courts have reached the same conclusion as the Seventh Circuit for some or all of the same reasons. *See, e.g.*, *In re Downtown Athletic Club of N. Y. City, Inc.*, 2000WL 744126 (S.D.N.Y. June 9, 2000);*South Motor Co. v. Carter-Pritchett-Hodges, Inc. (In re MMH Auto. Grp., LLC)*, 385 B.R. 347 (Bankr. S.D. Fla. 2008).

Other courts have ruled to the contrary, reasoning that section 363(f) and section 365(h) conflict when they overlap, but that the more specific section 365(h) trumps section 363(f), and the legislative history of the former clearly indicates that lawmakers intended to protect a tenant's leasehold estate when the landlord files for bankruptcy. *See, e.g.*, *Dishi & Sons v. Bay Condos LLC*, 510 B.R. 696 (S.D.N.Y. 2014) (criticizing *Qualitech* and adopting a third reading of the interplay between sections 363 and 365(h)); *In re Zota Petroleums, LLC*, 482 B.R. 154 (Bankr.E.D. Va. 2012);*In re Samaritan Alliance, LLC*, 2007 WL 4162918 (Bankr. E.D. Ky. Nov. 21, 2007); *In re Haskell, L.P.*, 321 B.R. 1 (Bankr. D. Mass. 2005); *InreChurchill Props. III, Ltd. P'ship*, 197 B.R. 283 (Bankr. N.D. Ill. 1996). Those decisions represented what was considered to be the majority view on this issue.

Some commentators have also criticized *Qualitech*, which, according to one commentator, had "the potential to profoundly impact the bankruptcy world." Michael St. Patrick Baxter, *Section 363 Sales Free and Clear of Interests: Why the Seventh Circuit Erred in*Precision Industries v. Qualitech Steel, 59 Bus. Law. 475, 475 (2004); *see also* Robert M. Zinman, *Precision in Statutory Drafting: The Qualitech Quagmire and the Sad History of §365(h) of the Bankruptcy Code*, 38 John Marshall L. Rev. (2004) (acknowledging the turmoil created by *Qualitech* and suggesting an alternative statutory reading).

the sale did not amount to rejection of the lease. The court explained that, on the basis of a "proper understanding of the concept of 'rejection,'" sections 363(f) and 365(h) can "easily" be read to give effect to each while preserving their respective purposes. *Spanish Peaks*, 872 F.3d at 899. Although a sale free and clear of a lease may be considered an effective rejection of the lease "in some everyday sense," the Ninth Circuit wrote, "it is not the same thing as the 'rejection' contemplated by section 365," which requires an "affirmative declaration by the trustee that the estate will not take on the obligations of a lease or contract made by the debtor." *Id.*

Because the leases at issue were not formally rejected by the chapter 7 trustee, and the leases were not deemed rejected under section 365(d)(1) or 365(d)(4)(A), the Ninth Circuit concluded that section 365(h) simply did not apply.

Citing the reasoning in *Qualitech*with approval, the Ninth Circuit panel explained that section 363(e) makes mandatory the adequate protection of an interest to be terminated in a free-and-clear sale if requested by the holder of the interest. Adequate protection could take the form of a lessee's continued possession of its leasehold interest. The broad definition of "adequate protection," the Ninth Circuit panel wrote, "makes it a powerful check on potential abuses of free-and-clear sales." *Id.* at 900.

Next, the court emphasized that section 363(f) authorizes free-and-clear sales only under certain circumstances, including when "applicable nonbankruptcy law permits sale of such property free and clear of such interest." Under applicable state law, the Ninth Circuit explained, a foreclosure sale to satisfy a mortgage terminates a subsequent lease on the mortgaged property. According to the court, "[the debtor's] bankruptcy proceeded, practically speaking, like a foreclosure sale … [and] had [the debtor] not declared bankruptcy, we can confidently say that there would have been an actual foreclosure sale," which would have terminated the leases.

The Ninth Circuit found it significant that section 365(h) recognizes appurtenant rights conferred by a lease "to the extent that such rights are enforceable under applicable nonbankruptcy law," and it saw "no reason to exclude the law governing foreclosure sales from the analogous language in section 363(f)(1)." *Id.*

Finally, the Ninth Circuit panel explained that its analysis "highlights a limitation inherent in the 'majority' approach"—namely, although section 365(h) embodies lawmakers' intent to protect lessees, "that intent is not absolute" and coexists with competing purposes, such as the goal of maximizing creditor recoveries. According to the court, its reading of sections 363(f) and 365(h) most faithfully balances those competing purposes in the way Congress intended. *Id.*

Other courts have adopted the *Spanish Peaks* rationale in authorizing sales free and clear of leasehold interests. *See, e.g., In re Giga Watt, Inc.*, 2021 WL 321890 (B.A.P. 9th Cir. Jan. 29, 2021); *In re Royal Alice Props., LLC*, 637 B.R. 465 (Bankr. E.D. La. 2021), *stay pending appeal denied*, 2022 WL 326636, *mandamus denied*, 26 F.4th 326 (5th Cir. 2022).

Royal Street

In August 2019, RAP filed for chapter 11 protection in the Eastern District of Louisiana. Shortly afterward, it commenced an adversary proceeding against AMAG Inc. ("AMAG"), the mortgagee of the properties, seeking a determination of the validity, extent, and priority of disputed liens AMAG had asserted against the properties.

While the adversary proceeding was pending, the court appointed a chapter 11 trustee. The court then granted summary judgment in favor of AMAG in the adversary proceeding. In July 2021, the trustee sought court approval of a settlement with AMAG and a sale of the properties free and clear of AMAG's liens and the Tenants' leasehold interests.

The Tenants responded by filing a motion for adequate protection of their leasehold interests under section 363(e) in the form of retained possession of the leased premises through the end of their purported 20-year leases. They also asked the court to require the trustee to assume or reject the leases, arguing that rejection would trigger the protections set forth in section 365(h).

The bankruptcy court approved the settlement and the sale, but denied the Tenants' motion for adequate protection and an order compelling the trustee to assume or reject the leases. According to the bankruptcy court: (i) because AMAG could have foreclosed on its mortgages under state law and thereby extinguished the Tenants' leasehold interests, the properties could be sold free and clear of those interests under section 363(f)(1), which permits a sale free and clear if "applicable bankruptcy law permits sale of such property free and clear of such interest"; and (ii) because Picture Pro had not paid any rent for several months and was therefore in default of its lease, that property could be sold free and clear of the lease under section 363(f)(4), which permits a sale free and clear if "such interest is in bona fide dispute."

The Tenants appealed the ruling to the district court and simultaneously sought an emergency stay of the bankruptcy court's order pending the appeal. The district court denied the motion for a stay. Both the bankruptcy court and the district court relied on *Qualitech* and *Spanish Peaks* in denying the Tenants' requested relief.

The Tenants then filed a petition with the Fifth Circuit for a writ of mandamus compelling the district court to issue a stay pending appeal.

The Fifth Circuit's Ruling

A three-judge panel of the Fifth Circuit issued a *per curiam* (summary) opinion denying the Tenants' petition for a writ of mandamus. Such opinions generally provide no explanation for the court's ruling.

However, in this case, the court explained that "A brief explanation of our conclusion is necessary because both the bankruptcy court and the district court premised their denials of relief to the [Tenants], in part, on unnecessary and likely incorrect interpretations of the relationship between Sections 363 and 365 of the Bankruptcy Code." *Royal Street*, 26 F.4th at 327.

declining to allow that tenant to stop the sale free and clear." *Id.* at 328.

However, the Fifth Circuit wrote, both lower courts "made the mistake of relying on [*Qualitech*] for the excessively broad proposition that sales free and clear under Section 363 override, and essentially render nugatory, the critical lessee protections against a debtor-lessor under Section 365(h)." *Id.* In addition, the Fifth Circuit noted that both lower courts also relied on *Spanish Peaks*, "which essentially adopted *Qualitech*, but noted, importantly, that the leases there (as in this case) were legally subordinated to a senior mortgagee's interest in the real property." As a result, according to the Fifth Circuit, "*Spanish Peaks*, like the case before us, is susceptible of a narrower reading." *Id.*

The Fifth Circuit acknowledged that the arguments on either side regarding the interplay between sections 363(f) and 365(h) are "textually sophisticated, fact-laden, and deeply rooted in commercial law far beyond the scope of the mandamus petition before us." Even so, it explained, "the essential state law rights of the tenants in this case are limited by the senior mortgagee's prior lien" on the properties. As such, "neither Section 363(e) nor 365(h)(1)(A)(ii) offers protection." *Id.* at 329.

The Fifth Circuit concluded that, even though the lower courts' reasoning was flawed, their rationale did not create "the kind of serious misinterpretation of law or facts that would support one of the criteria for mandamus relief." However, the Fifth Circuit cautioned, courts must not "blithely accept[] *Qualitech*'s reasoning and textual exegesis."

Outlook

In *Royal Street*, the Fifth Circuit denied the petition for mandamus because it agreed with the result reached by the lower courts, but took issue with the lower courts' rationale. For this reason, instead of issuing a summary opinion, the court of appeals elected to offer an explanation in which it clearly distanced itself from *Qualitech*'s broad pronouncements regarding the primacy of section 363(f) sales when it comes to leasehold interests that would otherwise be protected by section 365(h). The Fifth Circuit was also careful to note that *Spanish Peaks* does not speak as broadly on this point as the lower courts assumed in authorizing the *Royal Street* sale free and clear of the Tenants' leasehold interests, principally because, as in *Royal Street*, the leases in *Spanish Peaks* were never rejected (meaning that the protections of section 365(h) were not triggered) and the leasehold interests were legally subordinated to a mortgage under applicable state law.

In so ruling, the Fifth Circuit provided some rare appellate guidance on a question that has reached the federal courts of appeals only in a handful of cases, especially in connection with bankruptcy asset sales, where appeals are frequently foreclosed by the Bankruptcy Code's statutory mootness provisions.

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Fifth Circuit Weighs In on Bankruptcy Asset Sales Free and Clear of Le…

Mark Douglas, Oliver Zeltner, Jones Day

Right to Protection of Leasehold Interest in Real Property in a Section 363 Sale by a Debtor-Landlord: Section 363(f) versus Section 365(h)

Committee: Young and New Members

AMERICAN BANKRUPTCY INSTITUTE

Scott E. Schuster

McGuireWoods, LLP; Pittsburgh

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Two sections of the Bankruptcy Code seemingly stand at odds regarding the protections offered to lessees of real property owned by a bankrupt debtor. Section 365(h) strongly protects a lessee's right to possession of real property in the face of debtor's rejection of the lease. The legislative history of § 365(h) indicates that Congress had a desire to protect a lessee's expectations in real estate transactions. However, § 363(f) allows a trustee or debtor in possession (DIP) to sell real property free and clear of "any interest" in such property, including a leasehold interest.

The questions become (1) whether the lessee's possessory rights are only protected if the lease is rejected or, alternatively, whether the possessory right can be defeated through a Section 363(f) sale and (2) if a § 363(f) sale can dispose of a tenant's property rights, whether the lessee is entitled to adequate protection for its possessory interest. This article will explore the split among the courts regarding the relationship between § 363(f) and § 365(h).

Discussion

Obviously recognizing the impact that ejectment could have on residential and commercial tenants, Congress enacted § 365(h) to ensure that rejection of a lease by the landlord or its trustee does not divest the tenant of its interest in the lease. [1] Pursuant to § 365(h)(1)(A)(ii), if a lease term has already commenced when a trustee or DIP, as landlord, rejects the lease, then the tenant can fully exercise its rights under the lease. Section 365(h)(1)(A)(ii) states:

[T]he lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law. [2]

On the other hand, § 363(f) allows a DIP or trustee to sell property of the estate free and clear of "any interest" in such property under certain circumstances. While the Code does not define "any interest(s)," it is clear from the reported decisions that the term is sufficiently broad to include a "possessory interest as a lessee." [3]

As one court noted, "the vast majority of lower court decisions that have addressed this issue have held that a debtor cannot use the provisions of § 363(f) to get around the rights of tenants" set forth in Section 365(h)." [4] The majority of cases hold that the more specific provisions of § 365(h) dictate the manner and procedure by which a DIP may terminate its interests in a lease; those specific provisions, rather than the more general provisions of § 363(f), must be followed. [5] The *Haskell* Court held:

If the Court were to grant the [§ 363(f) sale motion to sell the property free and clear of a lessee's interests], the provisions of § 365(h) would be eviscerated. In other words, the debtor would be doing indirectly what it cannot do directly, namely, dispossessing [the tenant]. [6]

The minority position holds that statutory construction dictates that the two sections must be read in concert and that, notwithstanding § 365(h), a trustee or DIP may sell property free and clear of a leasehold interest if one of the conditions of § 363(f) can be satisfied. [7] Section

365(h), by its terms, applies "[i]f the trustee rejects an unexpired lease of real property." Under a strict reading of § 365(h), a lessee's interests are only protected in the event of rejection. The minority position concluded that § 365(h) therefore does not apply in a § 363 sale that divests "any interest" in the property but does not actually reject the lease. [8]

Qualitech is the only circuit-level case to address this issue. In *Qualitech*, the lessee and the debtor entered into a ground lease for real property on the campus of debtor's steel mill, and the debtor subsequently filed a voluntary bankruptcy petition. During the bankruptcy, the DIP sold the leased property to several secured creditors who then conveyed the land to the reorganized debtor. The sale was approved "free and clear" of all interests pursuant to § 363(f). The lessee received notice of the sale but did not object.

After the sale, the reorganized debtor ejected the lessee from the property. The lessee brought suit for possession and the bankruptcy court held that the § 363(f) sale extinguished the lease and therefore extinguished lessee's possessory interest in the property. On appeal, the district court reversed and held that § 365(h)(1)(A) protected lessee's possessory interest, regardless of the sale. On appeal, the Seventh Circuit Court of Appeal concluded that the property subject to a leasehold interest may be transferred free of the leasehold interest, if the conditions of Section 363(f) are satisfied:

[I]t is apparent that the two statutory provisions [§ 363(f) and § 365(h)] can be construed in a way that does not disable § 363(f) vis-à-vis leasehold interests. Where estate property under lease is to be sold, § 363 permits the sale to occur free and clear of a lessee's possessory interest—*provided that the lessee (upon request) is granted adequate protection for its interest.* Where the property is not sold, and the debtor remains in possession thereof, but chooses to reject the lease, § 365(h) comes into play and the lessee retains the right to possess the property. So understood, both provisions may be given full effect without coming into conflict with one another and without disregarding the rights of lessees. [9]

However, the Seventh Circuit explained:

"Adequate protection" does not necessarily guarantee a lessee's continued possession of the property, but it does demand, in the alternative, that the lessee be compensated for the value of its leasehold--typically from the proceeds of the sale. Lessees…are therefore not without

recourse in the event of a sale free and clear of their interests. They have the right to seek protection under § 363(e), and upon request, the bankruptcy court is obligated to ensure that their interests are adequately protected. [10]

Under § 363(e), any entity that has an interest in property to be sold may request that the court prohibit or condition such sale as is necessary to "provide adequate protection of such interest." In *Qualitech*, the Seventh Circuit confirmed the sale dispossessing the tenant *without* adequate protection because the tenant received notice of the sale but failed to object to the sale or seek adequate protection.

In *MMH Auto Group*, the U.S. Bankruptcy Court for the Southern District of Florida sided with the minority *Qualitech* position when faced with a tenant's objection to a previous sale. [11] The court upheld the sale under § 363(f)(5) because the express terms of the lease required the tenant to accept money in satisfaction of its leasehold interest (*i.e.*, it gave the landlord the right to buyout the lease). However, since the tenant never had notice of the sale, the court granted the tenant adequate protection for its leasehold interest despite the fact that tenant never objected to the sale while it was pending. The bankruptcy court set the adequate protection equal to the amount of the buyout that the tenant could have been forced to accept under the terms of the lease.

What happens if the sales proceeds are insufficient to pay the secured claims in full? Are the tenants' adequate protection rights superior to secured claims on the property being sold? Recently, in *In re R.J. Dooley Realty Inc.*, [12] the debtor sold real property to a buyer "free and clear" of pre-existing leases. The successful bidder had placed a "credit-bid" and therefore, there were no proceeds to pay the adequate protection to displaced tenants. A tenant filed a motion seeking to enjoin the transfer of the property free and clear of the leases. The tenant argued that the leases should not be terminated unless there were sufficient sales proceeds to provide the tenants with adequate protection, citing §§ 363(e) and 365(h).

Following the minority position, the court held that the property could be sold free and clear of the leasehold interests. With respect to the tenant's demand for adequate protection, the court held that providing adequate protection to a tenant to the detriment of secured creditors would be contrary to the Bankruptcy Code's priority scheme because tenants hold general unsecured claims. The court criticized the *Qualitech* opinion, stating that "the [*Qualitech*] court failed to consider that offering such adequate protection to a general unsecured creditor would catapult it ahead of its position behind secured, administrative, and priority unsecured creditors, in complete contravention of the priorities of the Bankruptcy Code." [13]

Consequently, the court held that the tenant did not have an "interest in property" within the meaning of § 363(e) and therefore was not entitled to adequate protection. The court stated that "bankruptcy causes fundamental relationship changes among the debtor, the creditors, and other parties with a relationship to the debtor." [14] Finally, the court concluded that "[t]he fact that a natural consequence of a [§ 363 sale]…might cause a tenant's lease to be terminated is not a public interest." [15]

Conclusion

The majority of courts considering the issue of whether a § 363 sale can divest tenants of their leasehold interests have upheld Congress' intention to strongly protect a lessee's right to possession, even in the face of a "free and clear" sale. Most of the courts that do not follow the majority position seemingly protect the lessee's right to adequate protection, assuming that the lessee acts promptly to preserve this right after a sale motion is filed. However, when advising lessees preparing to enter long-term leases and make substantial investments in leased property, cases such as *Dooley Realty* serve as a stark reminder that the right to absolute protection is not absolute and such investments may not be protected if the landlord files for bankruptcy.

1. 140 Cong. Rec. H.10752-1 (daily ed. Oct. 4, 1994).

2. 11 U.S.C. § 365(h)(1)(A)(ii).

3. *Precision Indus. Inc. v. Qualitech Steel SBQ LLC (In re Qualitech Steel Corp.)*, 327 F.3d 537, 545 (7th Cir. 2003).

4. *S. Motor Co. v. Carter-Pritchett-Hodges Inc. (In re MMH Auto. Grp. LLC)*, 385 B.R. 347, 363 (Bankr. S.D. Fla. 2008).

5. *See, e.g., In re Haskell LP,* 321 B.R. 1 (Bankr. D. Mass. 2005); *In re Taylor,* 198 B.R. 142 (Bankr. D. S.C. 1996).

6. 321 B.R. at 9.

7. *See Qualitech,* 327 F.3d 537; *Cheslock- Bakker & Assocs. Inc. v. Krener (In re Downtown Athletic Club of N.Y. City)*, No. M-47, 2000 U.S. Dist. LEXIS 7917 (S.D.N.Y. June 9, 2000); *Hill v. MKBS Holdings LLC (In re Hill)*, 307 B.R. 821 (Bankr. W.D. Pa. 2004).

8. *Id.*

9. *Qualitech*, 327 F.3d at 548 (emphasis added).

10. *Id.* (emphasis added).

11. 385 B.R. at 367.

12. No. 09-36777, 2010 Bankr. LEXIS 1761 (Bankr. S.D.N.Y. May 21, 2010).

13. *Id.* at *21.

14. *Id.* at *27.

15. *Id.* at *27-28.

Representing Tenants: When Landlords File for Bankruptcy

Last in Line

Contributing Editor:
Timothy J. Howard
Howard & Howard Attorneys PLLC
Peoria, Ill.
thoward@howardandhoward.com

The current U.S. economic recession was presaged by the earlier collapse of the real estate market. As every landlord of a shopping center or strip mall knows, all types of restaurants and retailers have sought relief under chapter 11 and begun to cut costs by closing locations. These companies are as diverse as Baker's Square, Circuit City, Linens 'N Things and Movie Gallery (Hollywood Video). As the economy continues to decline, the list of companies that will be using chapter 11 to reject leases and close stores will grow.

Timothy J. Howard

When the number of chapter 11 debtors rejecting leases is coupled with the number of successful companies like Starbucks Coffee that are closing locations to weather the current recession, we can safely predict that *landlords* of decimated shopping centers and strip malls will also seek relief in bankruptcy. Once distressed landlords file their bankruptcy cases, they will have the same opportunity to assume or reject leases as their debtor-tenants did. Consequently, lawyers who represent tenants need to be prepared for the different perspectives created under §365 of the Bankruptcy Code for tenants whose landlords file bankruptcy.

Landlord's Assumption or Rejection of the Lease

Most bankruptcy practitioners are well-versed with the fundamental rules under §365 that permit any trustee, which includes any debtor-in-possession (DIP), to assume or reject an unexpired lease of real property. First, the trustee cannot assume a lease unless the trustee cures or provides adequate assurances that he will promptly cure any defaults, other than defaults relating to the bankruptcy filing or the insolvency of the debtor. 11 U.S.C. §365(b). In the context of a landlord's bankruptcy, when the trustee or DIP assumes a lease, everyone is happy because the assumption results in a cure of all defaults, or in negotiated changes of terms between the debtor-landlord and the tenant.

> **About the Author**
>
> *Timothy Howard concentrates his practice in banking, commercial and bankruptcy law with Howard & Howard Attorneys PLLC in Peoria, Ill. He is admitted to the Illinois bar, Michigan bar, U.S. District Court for the Northern, Central and Southern Districts of Illinois, U.S. Court of Appeals for the Seventh Circuit and the U.S. Supreme Court.*

Second, under chapter 7, if the trustee in a landlord's bankruptcy does not assume or reject the unexpired lease of *residential* real property within 60 days after the order for relief (or such additional time as the court grants), the lease is *deemed* rejected. 11 U.S.C. §365(d)(1). In cases under chapters 9, 11, 12 or 13, the landlord may assume or reject an unexpired lease of *residential* real property at any time before confirmation of a plan or such additional time as permitted upon motion by the court. 11 U.S.C. §365(b)(2).

Third, whether the debtor is a landlord or a tenant, the debtor's duty before the decision to assume or reject an unexpired lease of *nonresidential* real property is the same. A trustee or DIP is required to timely perform all the obligations of the debtor (except those relating to the filing of a bankruptcy case or the debtor's financial condition) after the order of relief until such lease of nonresidential real property is assumed or rejected. 11 U.S.C. §365(d)(3). Consequently, in a landlord's bankruptcy, the debtor-landlord is also obligated to timely perform all of the landlord's obligations before the assumption or rejection of the unexpired lease.

What Does Rejection Mean to the Tenant?

Section 365(h) provides a special set of rules where the debtor is the landlord, rather than the tenant. The term "lessee" under §365(h) includes any "successor, assign or mortgagee permitted under the terms of such lease." 11 U.S.C. §365(h)(1)(D). When the debtor is the landlord who rejects an unexpired lease of real property and the rejection amounts to a breach as would entitle the tenant to treat such lease as terminated by virtue of its terms, applicable nonbankruptcy law or any agreement made by the lessee, then the tenant may treat such lease as terminated by the rejection. 11 U.S.C. §365(h)(1)(A)(i). If the tenant treats the lease as terminated, it may file a claim for any damages for breach of lease as if the rejection occurred immediately before the date of the filing of the petition. 11 U.S.C. §365(g)(1).

Alternatively, if the lease term has already commenced when the debtor-landlord rejects the lease, then the tenant can exercise its rights under §365(h), which states:

> [T]he lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

11 U.S.C. §365(h)(1)(A)(ii).

According to one court, the legislative history of §365(h) demonstrates Congress' intent to protect both the rights of the lessor and the lessee so far as to preserve expectations in real estate transactions. *In re Churchill Props. III Ltd. P'ship,* 197 B.R. 283, 288 (Bankr. N.D. Ill. 1996). Consequently, rejection of a lease by the landlord or its trustee does not divest the tenant of its interest in the lease, and the tenant's interest cannot be modified or

continued on page 80

changed merely because of a landlord's pending bankruptcy case. *Id.*

Although §365(d)(1) provides that if the trustee in a chapter 7 does not assume or reject an unexpired lease of residential real property within 60 days then the lease is deemed rejected, there is no such similar provision for "deemed rejection" of a nonresidential lease when the landlord is the debtor. *See, e.g., In re MMH Auto Group LLC,* 385 B.R. 347, 362-63 (Bankr. S.D. Fla. 2008). Consequently, whenever the landlord of nonresidential real property files a chapter 7 case, the tenant's counsel should take prompt action to determine whether the trustee will assume or reject the tenant's lease.

The trustee may think that the lease has value so that if the lease is assumed it will benefit the landlord's unsecured creditors. Obviously, this is not a problem for the tenant because the trustee's assumption of the lease requires the trustee to cure (or provide adequate assurance of prompt cure) any of the landlord's defaults under the lease. 11 U.S.C. §365(b)(1)(A). On the other hand, if the trustee is going to reject the lease, then the tenant needs to know that as soon as possible so that the tenant is in the best possible position to evaluate the impact of lease rejection on the tenant's continued use of the premises.

What are the tenant's options if the debtor-landlord rejects the lease? As previously noted, the landlord's rejection of the lease constitutes a breach of the lease. Even so, rejection does not constitute a *termination* of the lease unless the lease terms, applicable nonbankruptcy law, or an agreement between landlord and tenant treat the landlord's rejection as a termination of the lease. Thus, any tenant who learns that the debtor-landlord is rejecting the lease must *first* determine if the lease, or any other agreement or applicable law, enables the tenant to *treat* the lease as terminated once the landlord rejects that lease. 11 U.S.C. §365(h)(1)(A)(i). Alternatively, if the lease term has already commenced when the debtor-landlord rejects the lease, then §365(h) expressly permits the tenant to retain its rights under the lease for the balance of the term of the lease and any renewal or extension thereof to the extent its rights are enforceable under applicable nonbankruptcy law. 11 U.S.C. §365(h)(1)(A)(ii).

The primary function of rejection, therefore, is to permit the debtor-lessor to escape the burden of continuing to provide services to the tenant as set forth in the lease, such as common-area maintenance. *See, e.g., In re Flagstaff Realty Assocs.,* 60 F.3d 1031, 1034 (3d Cir. 1995). Section 365(h)(1)(B) contains the congressional response to the landlord's action to eliminate the financial burdens imposed by the rejected lease. When the tenant decides to remain in possession after the debtor-tenant rejects the lease, this section provides that the tenant:

> [M]ay offset against the rent reserved under such lease for the balance of the term after the date of the rejection of such lease and for the term of any renewal or extension of such lease, the value of any damage caused by the nonperformance after the date of such rejection, of any obligation under such lease, but the lessee shall not have any other right against the estate or the debtor on account of any damage occurring after such date caused by such nonperformance.

11 U.S.C. §365(h)(1)(B).

Consequently, a tenant is permitted to offset against the rent due (whether to the landlord, or the landlord's trustee or any subsequent owner) any damage that the tenant incurs that was caused by the landlord's nonperformance after the landlord rejected the lease. In other words, the tenant has the right to reduce future rent payments to the extent that the tenant spends the money to make repairs, improvements or perform maintenance that was the landlord's obligation under the now-rejected lease.

Sale of Debtor-Landlord's Real Property Subject to a Rejected Lease

What happens to the tenant when the debtor-landlord rejects the real estate lease *and* tries to sell the real property for the benefit of the bankruptcy estate? Obviously, successful sales of this kind under §363(f) usually involve the consent of the landlord, any lender and the tenants. Consequently, the reported cases involve those cases where consent to the sale is lacking, or where the tenant is not paying attention, or both.

From the perspective of tenant's counsel, the first issue is whether the tenant's leasehold is an "interest" that is subject to sale under §363(f). That section authorizes the trustee to sell property of the estate free and clear of certain claims, liens and "any interest," subject to certain conditions and limitations. The Bankruptcy Code does not define "any interest." Nevertheless, it is clear from the reported decisions that the term "any interest" as used in §363(f) is sufficiently broad to include a "possessory interest as a lessee." *Precision Industries Inc. v. Qualitech Steel SBQ LLC (In re Qualitech Steel Corp.),* 327 F.3d 537, 545 (7th Cir. 2003).

There is a split in the courts regarding the interrelationship between §§363(f) and 365(h) with respect to the transfer of real property free and clear of leasehold interests. There are cases that hold that the more specific provisions of §365(h) dictate the manner and procedure by which a debtor may terminate its interest in a lease and that they, rather than the more general provisions of §363(f), must be followed. For a discussion of this debate, *see In re MMH AutoGroup LLC,* 385 B.R. at 362.

In *MMH Automotive Group,* the bankruptcy court noted that there is nothing in §365(h) that prohibits a debtor-landlord from selling property in which there is a tenant in possession. Additionally, there is nothing in §365(h) that addresses a debtor-lessor's sale of property subject to a lease if the lease has been assumed or rejected. *In re MMH Auto Group LLC,* 385 B.R. at 366.

The Seventh Circuit's decision in *Qualitech* is the only circuit decision that addresses the impact of §§363(f) and 365(h) on each other. There, the Seventh Circuit was unequivocal that nowhere in either §§363(f) or 365(h):

> [I]s there a similar cross reference indicating that the broad right to sell estate property free of "any interest" is subordinate to the protections that Section 365(h) accords to lessees. The omission suggests that Congress did not intend for the latter section to limit the former.

Qualitech, 327 F.3d at 547.

The trustee in *Qualitech* sold the leased property "free and clear" of all interests. The tenant was in possession under a 10-year lease and failed to object to the sale. After it was locked out, the tenant filed a suit for trespass. The buyer filed a request with the bankruptcy court to clarify the sale order.

On appeal, the Seventh Circuit concluded that where an estate leasehold is to be sold, §363 permits the sale to occur free and clear of a lessee's possessory interest *provided that* the lessee, on request, is granted adequate protection for its interest. Section 363(e) directs the bankruptcy court, on the request of an entity with an "interest" in the property to be sold, to "prohibit or condition" such sale as is necessary to provide adequate protection of such interest. Because a leasehold qualifies as an "interest" in property for the purposes of §363(f), a lessee of real property being sold pursuant to §363(f) has the right to insist on adequate protection of its interest. *Qualitech,* 327 F.3d at 547-48.

The court explained that "adequate protection" does not *necessarily* guaranty a lessee's continued possession of the property. However, adequate protection does demand that the lessee be compensated for the value of its leasehold from the proceeds of the sale. Because the tenant in *Qualitech* failed to object to the sale and failed to file a request for protection of its interest, the Seventh Circuit held that the sale extinguished the tenant's possessory interest. *Id.* at 548.

On the other hand, the court in *In re Haskell LP,* 321 B.R. 1 (Bankr. D. Mass. 2005), rejected the Seventh Circuit's approach. In this case, the tenant objected to the motion for approval of sale by public auction of real property free and clear of the tenant's leasehold interest in a portion of that property. The bankruptcy court reviewed the split of authority, including the *Qualitech* case.

In *Haskell,* the bankruptcy court found that the tenant could not be forced to accept a money satisfaction of its claim for two reasons. First, the unrebutted evidence compelled the conclusion that the claim could not be quantified at that point in time in order to calculate the tenant's damages. Second, where the debtor-lessor rejected the lease, the tenant had the right to remain in possession, and because it could not be compelled to accept money for a rejected lease under §363(f)(5), a sale free and clear of its interest could not occur. The court found that under the circumstances and the facts of the case, adequate protection could only be achieved through continued possession of the leased premises.

Clearly, different facts yield different results. In *MMH Auto Group,* 385 B.R. 347 (Bankr. S.D. Fla. 2008), the purchaser of real property at a bankruptcy sale filed an adversary proceeding for determination of whether an unrecorded billboard lease was eliminated as an interest upon the entry of the order approving the sale made pursuant to §363(f). After examining the conflicting authorities on whether a trustee may sell a property free and clear of a leasehold interest, the bankruptcy court found that the owner of the billboard was entitled to have the value of its interest paid from the sales proceeds. The billboard lease contained an express, mutually agreed-on valuation of the leasehold interest, and because the lessee had contractually agreed to monetize the value of the leasehold interest, the court found that the sale was permitted under §365(f)(5). Accordingly, the tenant had the right under §363(e) to receive adequate protection of its leasehold interest.

Conclusion

As *Qualitech* demonstrates, tenants must be diligent in protecting their rights under real property leases. They must remain vigilant throughout their landlord's bankruptcy, and be "on the lookout" for any motion to sell the real estate that the tenant occupies. Pending the assumption or rejection, a tenant can insist that the landlord comply with all the terms of the lease and perform all of the landlord's duties thereunder. If a sale is proposed to be free and clear of the tenant's interest, a tenant must take timely action to object to the sale and to seek adequate protection of its interest. Otherwise, the tenant might wind up being "last in line"—and "out on the street." ■

PATENTS, TRADEMARKS,TRADE SECRETS AND COPYRIGHTS

Thomas A. O'Rourke
Bodner & O'Rourke
425 Broadhollow Road
Melville, New York 11747
631-249-7500
torourke@bodnerorourke.com

What are Intellectual Property Assets?

A company's IP assets can include a variety of items. IP Assets can include:

Patent Related Assets

1. Patents

2. Patent applications

3. Innovations that you have made that could be patentable inventions

Copyright Assets

1. Software, designs

2. Documentation or technical writing

3. User interface materials

4. Schematics

5. Artwork

6. Web site designs

7. Music

8. Photos, etc.

Trademark Assets

1. Registered trademarks

2. Applications for registrations

3. Distinctive signs or names the company is using, whether registered or not.

4. Distinctive labels

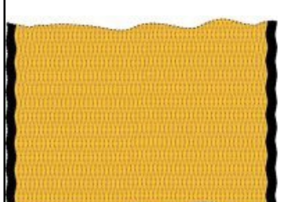
5. Distinctive product shapes

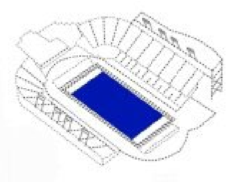
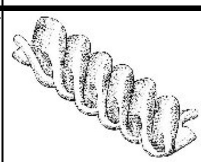
6. Distinctive packaging

7. Domain Names

8. Non-Traditional trademarks

Reg. No.	***Mark***
3361597	 **Goods: women's high fashion designer footwear** **Description of Mark: The mark consists of a lacquered red sole on footwear. The dotted lines are not part of the mark but are intended only to show placement of the mark.** **Owner: Christian Louboutin** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77141789**
3618321	[sound only] **Goods: Description of Mark: The mark consists of the sound of an oscillating humming buzz created by combining feedback from a microphone with a projector motor sound.** **Owner: Lucasfilm Entertainment Company Ltd.** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77419246**

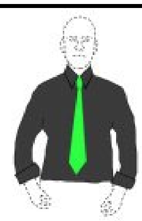
Reg. No.	*Mark*
3140700	[scent only] **Goods: office supplies, namely, file folders, hanging folders, paper expanding files** **Description of Mark: The mark consists of a peppermint scent or fragrance.** **Owner: The Smead Manufacturing Company** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=78649175**
3849102	[scent only] **Services: Advertising and marketing** **Description of Mark: The mark consists of a rose oil scent or fragrance.** **Owner: Kalin Manchev** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77871535**
3896100	[texture only] **Goods: wines** **Description of Mark: The mark consists of a leather texture wrapping around the middle surface of a bottle of wine. The mark is a sensory, touch mark.** **Owner: The David Family Group LLC** **http://tarr.uspto.gov/tarr?regser=registration&entry=3896100**
3888247	 **Goods: All-purpose straps; Straps for handling loads; Tie down straps** **Description of Mark: The mark consists of the colors gold and black as used on straps, the color gold being used to cover the surface of the strap with a black line forming a border on each side of the strap. The broken or dotted lines on the outer perimeters of the mark are used to show the position of the mark on the goods and the broken lines in the repeated diamond pattern shape in the interior of the strap is not a feature**

Reg. No.	Mark
	of the mark but used to indicate texture." Owner: Kinedyne Corporation http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77843362
3579003	 Goods: plastic baseball bats Description of Mark: The mark consists of the color yellow as applied to plastic baseball bats. The dotted lines show the placement of the mark on the identified goods. Owner: The Wiffle Ball, Inc. http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77400443
3707623	 Services: presentation of intercollegiate sporting events and sports exhibitions rendered in a stadium, etc. Description of Mark: The mark consists of the color blue used on the artifical turf in the stadium. The matter shown in broken lines on the drawing shows positioning of the mark and is not claimed as a feature of the mark. Owner: Boise State University http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77574724
3839907	

<table>
<tr><th>Reg. No.</th><th>Mark</th></tr>
<tr><td></td><td>Goods: Corn-based snack foods

Description of Mark: The mark consists of the configuration of a spiral-shaped chip.

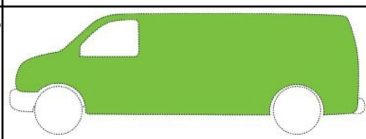
Owner: FRITO-LAY NORTH AMERICA, INC.

http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77766975</td></tr>
<tr><td>3878261</td><td>

Services: transmission of voice, audio, visual images and data by telecommunications networks, wireless communication networks, the Internet, information services networks and data networks

Description of Mark: The mark consists of a configuration of a human torso wearing a black collared shirt with rolled up sleeves and lime green tie with a traditional four in hand knot. The dotted lines in the drawing indicate placement of the mark. The matter shown by the dotted lines is not claimed as a part of the mark and serves only to show the position of the mark.’

Owner: The Madsen Group, LLC

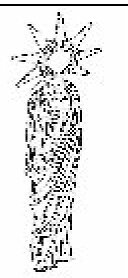
http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77853035</td></tr>
<tr><td>3847298</td><td>

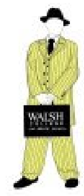
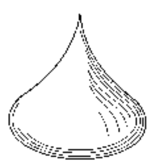
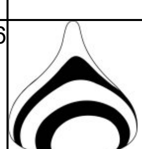
Goods and Services: Carpet, furniture and drapery cleaning services; services for the restoration of structures and/or contents damaged by fire, water and other catastrophes; Mold remediation services

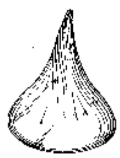
Description of Mark: The mark consists of the color green as applied to vehicles used to provide the services. The configuration of a vehicle shown by the dotted outline is intended to show the position of the mark on the vehicle and is not part of the mark.

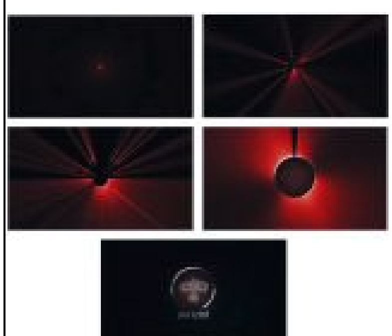
Owner: Servpro Intellectual Property, Inc.</td></tr>
</table>

Reg. No.	*Mark*
	http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77843574
3788865	 **Goods: Cakes** **Description of Mark: The mark consists of a configuration of a red and white cake. A thick white ribbon appears crossing over the width and length of the top surface of the cake with a thick white ribbon placed on top of the intersection of the large plus sign design on the top surface of the cake simulating a large bow on top of the cake. The base of the cake contains a series of connected textured scalloped designs appearing in white. The color black appears within the ribbon, bow and scalloped designs to show texture and depth in the mark but is not claimed as a feature of the mark. The dotted lines represent the outline of the square shape and representation of the cake and are not claimed as a feature of the mark.** **Owner: Image Brands, Inc. TA Red Velvet Cake** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77660153**
3743660	 **Goods: Candy mints** **Description of Mark: The mark consists of a configuration of a rectangular tin container with a lid, with a red border around the outer perimeter of the lid of the tin.** **Owner: Wm. Wrigley Jr. Company** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77488816**

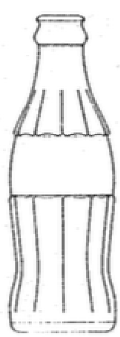
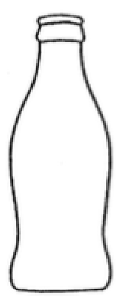
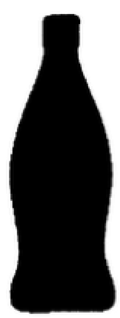
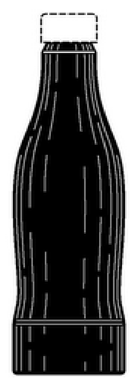
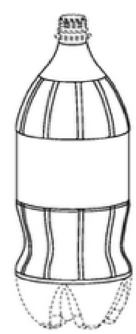
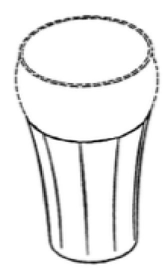
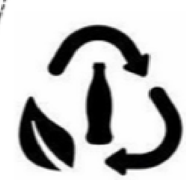
Reg. No.	*Mark*
3167134	 **Services: Tax preparation services** **Description of Mark: The drawing is a two-dimensional representation of the mark, which consists of the nonfunctional elements of a three dimensional Statue of Liberty costume.** **Owner: JTH Tax, Inc.** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=76617154**
3801204	 **Services: Entertainment services, namely, baseball games, competitions and exhibitions rendered live and through broadcast media including television and radio, and via a global computer network or a commercial on-line service; live performances by costumed characters and performances …** **Description of Mark: The mark consists of a costumed character wearing a baseball uniform and hat with the letter "B" on the hat and the wording "RED SOX" on the uniform. The mark is a two-dimensional depiction of a three-dimensional costumed character.** **Owner: Boston Red Sox Baseball Club Limited Partnership** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=78749000**
3893339	

Reg. No.	*Mark*
	 **Services: Educational services, namely, providing courses of instruction in classrooms and on-line at the college, graduate, and doctorate levels, …** **Description of Mark: The mark consists of the nonfunctional elements of a three-dimensional costume to be worn by a person in the advertising and rendering of the services. The proposed mark is comprised of the following specific elements: a black narrow-brimmed fedora-style hat, black shoes, a white dress shirt, a black necktie, a yellow suit with vertical black stripes, and a black briefcase featuring the white stylized lettering “WALSH COLLEGE” on two lines and “LIVE. BREATHE. BUSINESS.” on a single line below the first two lines. The dotted outline of a person is not part of the mark, but is merely intended to show the position of the costume. The drawing is a two-dimensional representation of the mark.** **Owner: Walsh College of Accountancy and Business Administration** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=85027509**
1986822	 **Goods: candy** **Description of mark: The trademark consists of the configuration of a conically-shaped candy piece approximately 7/8 of an inch high as measured from the base to the pinnacle and 15/16 of an inch in diameter as measured at the base of the candy piece. The lining in the mark is for shading purposes only and does not indicate color.** **Owner: HERSHEY CHOCOLATE & CONFECTIONERY LLC** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=74650913**
3059066	

Reg. No.	*Mark*
	Goods: candy **Description of mark: Color is not claimed as a feature of the mark. The mark consists of The trademark consists of the three dimensional configuration of a conically-shaped candy piece with alternating swirls or stripes wrapped around it. Color is not claimed as part of the mark.** **Owner: HERSHEY CHOCOLATE & CONFECTIONERY LLC** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=78578036**
1038025	 **Goods: solid chocolate** **Description of mark: THE MARK CONSISTS OF THE OVERALL INDIVIDUAL WRAPPING OF THE GOODS WHICH TAKES APPROXIMATELY THE CONFORMATION OF THE GOODS.** **Owner: HERSHEY CHOCOLATE & CONFECTIONERY LLC** **Description of mark: THE MARK CONSISTS OF THE OVERALL INDIVIDUAL WRAPPING OF THE GOODS WHICH TAKES APPROXIMATELY THE CONFORMATION OF THE GOODS.** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=72464602**
3495230	(Braille; sign language)  **Services: ENTERTAINMENT SERVICES IN THE NATURE OF LIVE MUSICAL PERFORMANCES; AND ENTERTAINMENT, NAMELY, LIVE MUSIC CONCERTS** **Owner: Morris, Stevland DBA Stevie Wonder** **Description of mark: Color is not claimed as a feature of the mark. The mark consists of the wording STEVIE WONDER in Braille code and the corresponding raised dots.** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77344790**
3964300	**(**Motion mark incorporating sound) Vanguard **Services: Providing services in the investment and financial fields; Webcasts in the fields of investing, finance, saving, business, financial planning, portfolio management, retirement planning, money**

Reg. No.	*Mark*
	management, investment strategy, and asset allocation; podcasts in the fields of investing, **Owner: The Vanguard Group, Inc.** **Description of mark: Color is not claimed as a feature of the mark. The mark is a motion mark incorporating sound. The mark consists of a 3-mast ship, which begins in the left and moves to the right. The word "VANGUARD" moves in from the right, as the ship approaches it from the left. The animation opens with the bow of the ship at the upper left corner of the screen, facing the viewer. The ship then turns so that the starboard side is perpendicular to the viewer. As this happens, the word "VANGUARD" appears from the right, getting smaller as if moving away from the viewer. The ship and the word stop as they meet each other in the middle. As this is happening, A piano plays an F4 eighth note, C4 eighth note, D4 eighth note, F4 eighth note, followed by an eighth rest, F4 eighth note, D4 eighth note, C4 eighth note, F4 eighth note, D4 eighth note, C4 quarter note, A4 eighth note, and C4 and F3 dotted half note. A cello begins with a whole rest, followed by an eighth rest, and then an F2 eighth note, C3 eighth note, D3 eighth note, F3 eighth note, G3 eighth note, A3 dotted half note, B2 quarter note, and C3 whole note. The French horns start with a whole rest, followed by a quarter rest, then a C4 eighth note, G4 dotted quarter note, and F4 dotted half note. The remaining instruments all start with two whole rests, followed by a quarter rest. After the rests, the flute plays an F5 eighth note, two tied E4 eighth notes, a D4 dotted quarter note, and a C5 whole note. The clarinet plays an A4 eighth note, two tied G4 eighth notes, and an F4 dotted quarter note tied to an F4 whole note. The first violin plays an F4 eighth note, two tied E4 eighth notes, an E4 dotted quarter note, and a C4 whole note. The second violin plays a C4 quarter note tied to a C4 eighth note, a Bb3 dotted quarter note, and an A3 whole note. The bass plays a G2 eighth note, A2 eighth note tied to another A2 eighth note, Bb2 dotted quarter note, and C3 whole note. A casaba percussion instrument plays a sixteenth pattern underneath.** http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=77961336
5402348	(motion mark in color)  **Services: Production of films, motion pictures or movies.** **Owner: Bad Robot IP, LLC** **Description of mark: The color(s) red, silver, black, and white is/are claimed as a feature of the mark. The mark consists of a motion mark in color. The nature of the motion is that of a single point of light that is eclipsed by a distant planet-like shape and an increasing number of laser lights appear to emanate from behind the planet-like shape, with the planet-like shape moving toward the foreground as the motion progresses, ultimately eclipsing all of the laser lights and then resolving into a circle-based logo featuring a robot head within the circle and the words "BAD ROBOT" underneath. The duration of the motion is approximately 11 seconds. The five stills in the sequence are spaced approximately 2 seconds apart. The stills are arranged consecutively from the beginning to near the end of the motion. The stills follow a progression from the top left (1st still) to the bottom center (5th still), moving from left to right across each row and then down to the next row. The precise sequence of the stills is as follows: In the 1st still, a single point of red light appears in the center of a black background. The background throughout the animation is black. In the 2nd still, the single point of red light is eclipsed by a distant black planet-like shape and**

Reg. No.	*Mark*
	numerous red laser lights interspersed with white streaks emanate out all around the planet-like shape with the planet-like shape moving toward the foreground as the motion progresses. The 3rd still shows an increasing number of red laser lights interspersed with white streaks emanating out all around the planet-like shape, with a white light glowing along the bottom right edge of the planet-like shape, which continues to move toward the foreground and where the lower portion of the frame is lit with a red light and the upper portion of the frame has a black background. The 4th still shows a black planet-like shape with a white light glowing along the upper left and bottom right edges and red light emanating from those areas towards the edges of the frame with a narrow wedge of area that is unlit and appears in black that extends from the top of the planet-like shape towards the edge of the frame. In the 5th still, the head and upper torso of a robot is shown in silver with eyes and nose initially shown in red which then fade to black, and with red backlighting emanating from behind the figure. The figure appears in a forward-facing position in the center of the white and silver circle, which appears brighter along the upper left and lower right edges, with the words "BAD ROBOT" with the letters "BAD ROB" in silver and the letters "OT" initially appearing in white, then fading to silver, visible below the circle. The animation ends by fading to an all-black background. **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=87034354**
5140450	(motion mark)  **Services: production and distribution of television programs and motion pictures.** **Owner: Roddenberry Entertainment Inc.** **Description of mark: Color is not claimed as a feature of the mark. The mark consists of a bright light, which appears and grows larger and brighter until it morphs into the logo of a stylized letter "R" within a circle. The term "RODDENBERRY" then appears underneath, with each letter rotating until it comes into place. The word "ENTERTAINMENT" then fades in underneath. The black rectangles surrounding each frame in the motion mark is not claimed as a feature of the mark, and is intended to show background only.** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=87055565**
3659390	(sound only) (6) FOR SITUATIONS FOR WHICH NO DRAWING IS POSSIBLE, SUCH AS SOUND https://www.youtube.com/watch?v=THhrq58cxgI **Goods: computer hardware; integrated circuits, integrated circuit chips; semiconductor processors; semiconductor processor chips; software programmable microprocessors; notebook and laptop computers; portable computers; handheld computers; computer hardware for the development, maintenance; and use of local and wide area computer networks; computer hardware for the development, maintenance, and use of interactive audio-video computer conference and home entertainment systems; servers; computer**

Reg. No.	*Mark*
	networking hardware; semiconductor devices; computer hardware for creating, facilitation, and managing remote access to and communication with local area networks, virtual private networks, wide area networks and global computer networks; computer hardware for wireless network communications and connectivity. **Owner: Intel Corporation** **Description of mark: The mark consists of a five tone audio progression of the notes D Flat, D Flat, G Flat, D Flat, and A Flat.** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=78721830**
3411881	(Sensory mark) 6) FOR SITUATIONS FOR WHICH NO DRAWING IS POSSIBLE, SUCH AS SOUND https://www.youtube.com/watch?v=cnaeIAEp2pU **Services: Entertainment services in the nature of an animated television series.** **Owner: Twentieth Century Fox FILM CORPORATION** **Description of mark: The mark consists of the spoken word "D'OH".** **http://tarr.uspto.gov/servlet/tarr?regser=serial&entry=76280750**
	Coca Cola "bottle shape" marks  Mark registration Ser. No. 73088384  Mark registration Ser. No. 74611506  Mark registration Ser. No. 74611507  Mark registration Ser. No. 77878543  Mark registration Ser. No. 77818735  Mark registration Ser. No. 75796806  Mark registration Ser. No. 85226870

Trade Secrets

This is information that has commercial value to you, that is not generally known and that a reasonable person could not just figure out. These can include:

1. Product formulas
2. Customer lists
3. Business strategies
4. Plans for technical enhancements to products

Contractual IP

This can include license agreements, a consulting contract with a design firm that made your web site, a development agreement with a university, a release from your former employer, non-disclosure agreements, employee agreements and confidentiality agreements.

Protecting Intellectual Property

PATENTS

Patents are granted for a term of twenty years from the filing date of the application and give its owner the right to exclude others from making, selling or using the claimed invention. Patents can be obtained for any new and useful process, machine, article of manufacture, or composition of matter, e.g., a new drug, a computer program, a method of doing business, a process for making a product or a machine used by the process in making the product can all be the subject of a patent. In addition, one can obtain design patents which are for any new, original, ornamental design. The term of design patents is 15 years from the date of issuance.

The Patent Application

Once a decision is made to file a patent application, the application must be prepared. The application must contain a written description that fully describes the invention. In addition, the inventor must disclose the best mode of the invention that the inventor is aware of at the time the application is filed. This "best mode" requirement means that if the inventor knows of a particular ingredient or step that makes the invention work better, this information must be disclosed in the application.

The written description usually includes drawings and ends in one or more claims that set forth what it is that the inventor claims is his invention. The claims are the metes and bounds of the patent. When a competitor uses the invention, it is the claims that determine whether there is infringement.

Provisional Patent Applications

In some instances, because of, for example, costs, time constraints or other reasons, a decision is made not to file the usual patent application. In such cases, a provisional application may be filed instead. These are frequently filed where the inventor is giving a speech or other type of presentation, where the invention will be revealed and the inventor is desirous of protecting the invention but there is insufficient time to file the normal patent application. The provisional application must have a written description of the invention just like the usual utility application.

Who May Be Listed as an Applicant for Patent Rights

Any person or "juristic entity" may be listed as the applicant for patent rights. However , unless special circumstances apply as listed in 37 CFR 1.64, only the inventor or joint inventors of the patent application may execute the oath or declaration that is required to be filed in a patent application.

Who Is the Inventor

An inventor is any one who contributes to the subject matter of one or more of the claims of the application. In many instances more than one person is an inventor. A person may be named as an inventor even if he or she did not work on the invention at the same time as the other inventor or inventors. Similarly, the fact that one person's contribution is less than the others does not preclude him or her from being named as an inventor.

The Patent Application Process

After the application is filed it will be processed by the United States Patent and Trademark Office. It usually takes many at least a year before the application is first reviewed by the Examiner. The Examiner will perform his own search and either allow or reject the claims. The claims can be rejected for a number of reasons such as, the subject matter claimed is not new or is obvious in view of the prior art, the claims are not as clear as the Examiner would like, etc. Once the application is allowed there is a Patent Office Issue Fee that is to be paid.

When to File the Patent Application

The patent application for an invention must be filed within one year or less of a disclosure of the invention by the inventor, joint inventor, or by another who obtained the subject matter disclosed directly or indirectly from the inventor or a joint inventor. According to the U.S. Patent Office website, a disclosure includes a public use or sale activity of the invention anywhere in the world.

TRADEMARKS

What is a Trademark

Trademarks are “brand names”, and the law of trademarks largely pertains to guarding commercial reputations, preventing confusion. Trademarks (or brand names) are commercial indicators of source and they distinguish one company's goods from another's. They may be words, logos or other symbols that tell consumers that goods come from, or are sponsored by, a particular company. Trademarks also include three-dimensional symbols, such as the "golden arches", sounds, colors, or even scents.

Selection of a Trademark

Trademarks may be classified as (i) fanciful – a coined word, e.g., “Kodak”, (ii) arbitrary – words in common use but not suggestive of the product or a characteristic of the product, e.g., “Polo” for shirts, (iii) descriptive – marks that are inherently not distinctive, being descriptive of the product, function, or intended use, e.g., “PM” for sleep aid, and (iv) generic – incapable of acting as a trademark, e.g., escalator. A trademark may become generic due to improper use. Fanciful trademarks are the strongest trademarks. Whatever their type, trademarks allow consumers to seek (or avoid) particular sources of products.

Acquiring Trademark Rights

Trademark rights arise in one of the following two ways: 1) By filing a mark with the United States Patent and Trademark Office (hereinafter, “USPTO”) based on a bona fide intent to use the mark on a product or in association with a service that is soon to be offered to the public, or 2) By actually using the mark in commerce on a product or in association with a service.

An application for registration may be filed based on either actual use of the mark or a bona fide intent to use the mark in commerce. The filing date of an application with the USPTO to register a trademark or service mark, which the applicant intends to use on a product or in association with a service, establishes a date of constructive use of the mark. The act of filing the application can create a nationwide priority of rights in the mark against any other person who subsequently adopts the same or a confusingly similar mark (contingent upon the mark ultimately issuing as a federal registration).

The intent to use the mark must be bona fide or the application may be invalid and the applicant may be subject to certain penalties for filing a fraudulent claim of intent. The federal registration will be issued only after the applicant has made actual use of the mark on the goods or in association with the service that it claims to have intent to use when the filing takes place. When actual use is made and the federal registration issues, the owner's rights in the mark are superior to all who have adopted the same or a similar mark for the same or a similar product or service subsequent to the filing date of the owner's application.

Advantages of a Federal Registration

Obtaining a federal registration provides significant advantages. Among these advantages are:

1. The benefit of nationwide constructive use and, thus, a right of priority, over all subsequent users as of the application filing date.

2. Constructive notice – it prevents acquisition of common law rights even by innocent adoption and use of the same or a similar mark by another.

3. It creates a legal presumption and is sometimes conclusive evidence of the registrant's right to exclusive use of the mark and the validity of the mark's registration.

4. Imported goods bearing a mark, which infringes a federally registered mark, may be excluded from entry into the U.S. by recordation with the U.S. Customs Service.

5. Based on the Paris Convention, registration furnishes the basis for foreign registration.

Trademark Application Process

An application for a federal registration of a trademark or service mark filed in the USPTO is examined by the Examiner to ensure that the mark is not likely, when used on or in connection with the goods or services of the applicant, to cause confusion, or mistake, or to deceive the consuming public with other registered trademarks. The Examiner also determines whether the mark is incapable of performing the identification function of a mark because, for example, it is the generic word for the product or service with which it is used or because it is descriptive of the products or service with which it is used.

The Examiner may ask for clarifications or amendments to the application before the application is finally allowed. The process of trademark prosecution may take up to a year or more to complete. One common ground for rejecting a trademark application is that the word is too descriptive of the goods to which it is applied. Such a mark is not permitted to be registered because it removes the word from general use.

Federal trademark registrations are valid for ten years and can be renewed for like periods, provided the mark is constantly used. Failure to use a mark in commerce can cause the rights in the mark to be lost. During the fifth year of a registration and before the beginning of the sixth year a statement of use must be filed to continue the registration in force.

The use of the registration symbol ® with a mark indicates that it is federally registered. The symbol "TM" is often used with unregistered trademarks to give notice to the public that the user is staking out a claim in the symbol as a trademark, but such use is optional. The symbol "SM" may similarly be used to designate an unregistered service mark.

Maintaining a Trademark

A trademark needs policing. Unchecked infringing activity or use of the trademark itself as a descriptive word may cause the trademark to lose significance in the market place as a source indicator and thus lose value as a trademark. A trademark should be used only as an adjective, never as a noun. In addition, the marketplace should be kept free of confusingly similar trademarks.

COPYRIGHTS

Who is Entitled to a Copyright

Copyrights are statutory property rights, which grant to authors or creators certain exclusive rights in their creations for a limited duration. Copyright law protects intangible original works of authorship which are fixed in a tangible medium of expression. In other words, copyright protects the expression of ideas, but not the ideas themselves. Copyright protects such works as books, pictures, graphic and sculptural works, music, photographs, movies and computer programs.

In order to receive copyright protection, the work must be original, i.e., independently created and not copied from other works. The requisite originality is minimal - any distinguishable variation of a prior work, if the variation is the product of the author's independent efforts a copyright will be available.

A copyright gives the author a number of exclusive rights. These rights include the right: (1) to reproduce the copyrighted work; (2) to make derivative works (e.g. a movie from a play); (3) to distribute copyrighted works to the public; (4) to perform, publicly, certain works (e.g. music); and, (5) to display, publicly, certain works (e.g. works of art). A copyright arises upon fixation of the work and, under current law, endures for the life of the author plus 70 years. For works made for hire, and for anonymous and pseudonymous works (unless the author's identity is revealed in Copyright Office records), the duration of copyright will be 95 years from publication or 120 years from creation, whichever is shorter. Publication is not a prerequisite for copyright protection - it applies to both unpublished and published works.

Copyright Registrations

Registration of a copyrighted work with the Copyright Office in Washington, D.C. is not generally required for existence of the copyright. Registration, however, is a prerequisite to a lawsuit for copyright infringement and to certain legal remedies. Registration also confers certain important advantages upon the copyright owner such as:

1) Establishing a public record of the copyright claim;

2) Before an infringement suit may be filed in court, registration is necessary for works of U.S. origin;

3) If made before or within 5 years of publication, registration will establish prima facie evidence in court of the validity of the copyright and of the facts stated in the certificate;

4) If registration is made within 3 months after publication of the work or before an infringement of the work, statutory damages and attorney's fees will be available to the copyright owner in court actions. Otherwise, only an award of actual damages and profits is available to the copyright owner; and

5) Copyright registration allows the owner of the copyright to record the registration with the U.S. Customs Service for protection against the importation of infringing copies of the registered work.

Copyright Registration Application

Registration may be made at any time within the life of the copyright. The familiar copyright notice is no longer required on copies of works published after March 1, 1989. However, it is still in the copyright owner's interest - to facilitate a suit for damages - to place a copyright notice on the published work. The notice should include the copyright symbol © or the word "Copyright" or its abbreviation (Copr.), the year of first publication of the work and the name of the copyright owner.

Ownership Issues

Copyright ownership vests in author of the work. In the case of joint authors, they are joint owners. Work made for hire is generally owned by the employer. (Work made for hire is defined as that which is prepared by an employee, work specially commissioned, or parties agree in writing it is a work made for hire).

Ownership of a copy of the work does not confer on the owner of the copy the same rights the owner of the copyright has. For example, ownership of a video tape of a movie permits you to view the movie at home but does not give you the right to make copies or to show the movie to others for a fee.

Transfer of Copyright

Any or all of the exclusive rights or any subdivision of those rights, of the copyright owner may be transferred. Transfers of copyright are normally made by contract and, indeed, the transfer of exclusive rights is not valid unless that transfer is in writing and signed either by the owner of the rights conveyed or such owner's authorized agent. Transfer of a right on a nonexclusive basis does not require a written agreement. The law does provide for the recordation in the Copyright Office of transfers of copyright ownership and although recordation is not required to effect a valid transfer between the parties, it provides certain legal advantages and may be required to validate the transfer as against third parties.

505 U.S. 763
112 S.Ct. 2753
120 L.Ed.2d 615
TWO PESOS, INC., Petitioner

v.

TACO CABANA, INC.

No. 91-971.

Argued April 21, 1992.
Decided June 26, 1992.

Rehearing Denied Sept. 4, 1992. See U.S. , 113 S.Ct 20.

Syllabus [*]

Respondent, the operator of a chain of Mexican restaurants, sued petitioner, a similar chain, for trade dress infringement under § 43(a) of the Trademark Act of 1946 (Lanham Act), which provides that "[a]ny person who . . . use[s] in connection with any goods or services . . . any false description or representation . . . shall be liable to . . . any person . . . damaged by [such] use." The District Court instructed the jury, *inter alia,* that respondent's trade dress was protected if it either was inherently distinctive—*i.e.,* was not merely descriptive or had acquired a secondary meaning—*i.e.,* had come through use to be uniquely associated with a specific source. The court entered judgment for respondent after the jury found, among other things, that respondent's trade dress is inherently distinctive but has not acquired a secondary meaning. In affirming, the Court of Appeals ruled that the instructions adequately stated the applicable law, held that the evidence supported the jury's findings, and rejected petitioner's argument that a finding of no secondary meaning contradicted a finding of inherent distinctiveness.

Held: Trade dress which is inherently distinctive is protectable under § 43(a) without a showing that it has acquired secondary meaning, since such trade dress itself is capable of identifying products or services as coming from a specific source. This is the rule generally applicable to trademark, see, *e.g.,* Restatement (Third) of Unfair Competition § 13, pp. 37-38, and the protection of trademarks and of trade dress under § 43(a) serves the same statutory purpose of preventing deception and unfair competition. There is no textual basis for applying different analysis to the two. Section 43(a) mentions neither and does not contain the concept of secondary meaning, and that concept, where it does appear in the Lanham Act, is a requirement that applies only to merely descriptive marks and not to inherently distinctive ones. Engrafting a secondary meaning requirement onto § 43(a) also would make more difficult the identification of a producer with its product and thereby undermine the Lanham Act's purposes of securing to a mark's owner the goodwill of his business and protecting consumers' ability to distinguish among competing producers. Moreover, it could have anticompetitive effects by creating burdens on the start-up of small business. Petitioner's suggestion that such businesses be protected by briefly dispensing with the secondary meaning requirement at the outset of the trade dress' use is rejected, since there is no basis for such requirement in § 43(a). Pp. _____.

932 F.2d 1113, affirmed.

WHITE, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and BLACKMUN, O'CONNOR, SCALIA, KENNEDY and SOUTER, JJ., joined. SCALIA, J., filed a concurring opinion. STEVENS, J., and THOMAS, J., filed opinions concurring in the judgment.

Kimball J. Corson, Phoenix, Ariz., for petitioner.

Richard G. Taranto, Washington, D.C., for respondent.

Justice WHITE delivered the opinion of the Court.

The issue in this case is whether the trade dress [1] of a restaurant may be protected under § 43(a) of the Trademark Act of 1946 (Lanham Act), 60 Stat. 441, 15 U.S.C. § 1125(a) (1982 ed.), based on a finding of inherent distinctiveness, without proof that the trade dress has secondary meaning.

I

Respondent Taco Cabana, Inc., operates a chain of fast-food restaurants in Texas. The restaurants serve Mexican food. The first Taco Cabana restaurant was opened in San Antonio in September 1978, and five more restaurants had been opened in San Antonio by 1985. Taco Cabana describes its Mexican trade dress as

"a festive eating atmosphere having interior dining and patio areas decorated with artifacts, bright colors, paintings and murals. The patio includes interior and exterior areas with the interior patio capable of being sealed off from the outside patio by overhead garage doors. The stepped exterior of the building is a festive and vivid color scheme using top border paint and neon stripes. Bright awnings and umbrellas continue the theme." 932 F.2d 1113, 1117 (CA5 1991).

In December 1985, a Two Pesos, Inc., restaurant was opened in Houston. Two Pesos adopted a motif very similar to the foregoing description of Taco Cabana's trade dress. Two Pesos restaurants expanded rapidly in Houston and other markets, but did not enter San Antonio. In 1986, Taco Cabana entered the Houston and Austin markets and expanded into other Texas cities, including Dallas and El Paso where Two Pesos was also doing business.

In 1987, Taco Cabana sued Two Pesos in the United States District Court for the Southern District of Texas for trade dress infringement under § 43(a) of the Lanham Act, 15 U.S.C. § 1125(a) (1982 ed.),[2] and for theft of trade secrets under Texas common law. The case was tried to a jury, which was instructed to return its verdict in the form of answers to five questions propounded by the trial judge. The jury's answers were: Taco Cabana has a trade dress; taken as a whole, the trade dress is nonfunctional; the trade dress is inherently distinctive; [3] the trade dress has not acquired a secondary meaning [4] in the Texas market; and the alleged infringement creates a likelihood of confusion on the part of ordinary customers as to the source or association of the restaurant's goods or services. Because, as the jury was told, Taco Cabana's trade dress was protected if it either was inherently distinctive or had acquired a secondary meaning, judgment was entered awarding damages to Taco Cabana. In the course of calculating damages, the trial court held that Two Pesos had intentionally and deliberately infringed Taco Cabana's trade dress.[5]

The Court of Appeals ruled that the instructions adequately stated the applicable law and that the evidence supported the jury's findings. In particular, the Court of Appeals rejected petitioner's argument that a finding of no secondary meaning contradicted a finding of inherent distinctiveness.

In so holding, the court below followed precedent in the Fifth Circuit. In *Chevron Chemical Co. v. Voluntary Purchasing Groups, Inc.,* 659 F.2d 695, 702 (CA5 1981), the court noted that trademark law requires a demonstration of secondary meaning only when the claimed trademark is not sufficiently distinctive of itself to identify the producer; the court held that the same principles should apply to protection of trade dresses. The Court of Appeals noted that this approach conflicts with decisions of other courts, particularly the holding of the Court of Appeals for the Second Circuit in *Vibrant Sales, Inc. v. New Body Boutique, Inc.,* 652 F.2d 299 (1981), cert. denied, 455 U.S. 909, 102 S.Ct. 1257, 71 L.Ed.2d 448 (1982), that § 43(a) protects unregistered trademarks or designs only where secondary meaning is shown. *Chevron, supra,* at 702. We granted certiorari to resolve the conflict among the Courts of Appeals on the question whether trade dress which is inherently distinctive is protectable under § 43(a) without a showing that it has acquired secondary meaning.[6] 502 U.S. ----, 112 S.Ct. 964, 117 L.Ed.2d 130 (1992). We find that it is, and we therefore affirm.

II

The Lanham Act [7] was intended to make "actionable the deceptive and misleading use of marks" and "to protect persons engaged in . . . commerce against unfair competition." § 45, 15 U.S.C. § 1127. Section 43(a) "prohibits a broader range of practices than does § 32," which applies to registered marks, *Inwood Laboratories, Inc. v. Ives Laboratories, Inc.,* 456 U.S. 844, 858, 102 S.Ct. 2182, 2190-2191, 72 L.Ed.2d 606 (1982), but it is common ground that § 43(a) protects qualifying unregistered trademarks and that the general principles qualifying a mark for registration under § 2 of the Lanham Act are for the most part applicable in determining whether an unregistered mark is entitled to protection under § 43(a). See *A.J. Canfield Co., v. Honickman,* 808 F.2d 291, 299, n. 9 (CA3 1986); *Thompson Medical Co. v. Pfizer Inc.,* 753 F.2d 208, 215-216 (CA2 1985).

A trademark is defined in 15 U.S.C. § 1127 as including "any word, name, symbol, or device or any combination thereof" used by any person "to identify and distinguish his or her goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown." In order to be registered, a mark must be capable of distinguishing the applicant's goods from those of others. § 1052. Marks are often classified in categories of generally increasing distinctiveness; following the classic formulation set out by Judge Friendly, they may be (1) generic; (2) descriptive; (3) suggestive; (4) arbitrary; or (5) fanciful. See *Abercrombie & Fitch Co. v. Hunting World, Inc.,* 537 F.2d 4, 9 (CA2 1976). The Court of Appeals followed this classification and petitioner accepts it. Brief for Petitioner 11-15. The latter three categories of marks, because their intrinsic nature serves to identify a particular source of a product, are deemed inherently distinctive and are entitled to protection. In contrast, generic marks—those that "refe[r] to the genus of which the particular product is a species," *Park' N Fly, Inc. v. Dollar Park and Fly, Inc.,* 469 U.S. 189, 194, 105 S.Ct. 658, 661, 83 L.Ed.2d 582 (1985), citing *Abercrombie & Fitch, supra,* at 9—are not registrable as trademarks. *Park' N Fly, supra,* 469 U.S., at 194, 105 S.Ct., at 661-662.

Marks which are merely descriptive of a product are not inherently distinctive. When used to describe a product, they do not inherently identify a particular source, and hence cannot be protected. However, descriptive marks may acquire the distinctiveness which will allow them to be protected under the Act. Section 2 of the Lanham Act provides that a descriptive mark that otherwise could not be registered under the Act may be registered if it "has become distinctive of the applicant's goods in commerce." §§ 2(e), (f), 15 U.S.C. §§ 1052(e), (f). See *Park' N Fly, supra,* at 194, 196, 105 S.Ct., at 661-662-663. This acquired distinctiveness is generally called "secondary meaning." See *ibid.; Inwood Laboratories, supra,* 456 U.S., at 851, n. 11, 102 S.Ct., at 2187; *Kellogg Co. v. National Biscuit Co.,* 305 U.S. 111, 118, 59 ,S.Ct. 109, 113, 83 L.Ed. 73 (1938). The concept of secondary meaning has been applied to actions under § 43(a). See, *e.g., University of Georgia Athletic Assn. v. Laite,* 756 F.2d 1535 (CA11 1985); *Thompson Medical Co. v. Pfizer Inc., supra.*

The general rule regarding distinctiveness is clear: an identifying mark is distinctive and capable of being protected if it *either* (1) is inherently distinctive *or* (2) has acquired distinctiveness through secondary meaning. Restatement (Third) of Unfair Competition, § 13, pp. 37-38, and Comment *a* (Tent. Draft No. 2, Mar. 23, 1990). Cf. *Park' N Fly, supra,* 469 U.S., at 194, 105 S.Ct., at 661-662. It is also clear that eligibility for protection under § 43(a) depends on nonfunctionality. See, *e.g., Inwood Laboratories, supra,* 456 U.S., at 863, 102 S.Ct., at 2193 (WHITE, J., concurring in result); see also, *e.g., Brunswick Corp. v. Spinit Reel Co.,* 832 F.2d 513, 517 (CA10 1987); *First Brands Corp. v. Fred Meyers, Inc.,* 809 F.2d 1378, 1381 (CA9 1987); *Stormy Clime Ltd. v. ProGroup, Inc.,* 809 F.2d 971, 974 (CA2 1987); *AmBrit, Inc. v. Kraft, Inc.,*812 F.2d 1531, 1535 (CA11 1986); *American Greetings Corp. v. Dan-Dee Imports, Inc.,* 807 F.2d 1136, 1141 (CA3 1986). It is, of course, also undisputed that liability under § 43(a) requires proof of the likelihood of confusion. See, *e.g., Brunswick Corp., supra,* at 516-517; *AmBrit, supra,* at 1535; *First Brands, supra,* at 1381; *Stormy Clime, supra,* at 974; *American Greetings, supra,* at 1141.

The Court of Appeals determined that the District Court's instructions were consistent with the foregoing principles and that the evidence supported the jury's verdict. Both courts thus ruled that Taco Cabana's trade dress was not descriptive but rather inherently distinctive, and that it was not functional. None of these rulings is before us in this case, and for present purposes we assume, without deciding, that each of them is correct. In going on to affirm the judgment for respondent, the Court of Appeals, following its prior decision in *Chevron,* held that Taco Cabana's inherently distinctive trade dress was entitled to protection despite the lack of proof of secondary meaning. It is this issue that is before us for decision, and we agree with its resolution by the Court of Appeals. There is no persuasive reason to apply to trade dress a general requirement of secondary meaning which is at odds with the principles generally applicable to infringement suits under § 43(a). Petitioner devotes much of its briefing to arguing issues that are not before us, and we address only its arguments relevant to whether proof of secondary meaning is essential to qualify an inherently distinctive trade dress for protection under § 43(a).

Petitioner argues that the jury's finding that the trade dress has not acquired a secondary meaning shows conclusively that the trade dress is not inherently distinctive. Brief for Petitioner 9. The Court of Appeals' disposition of this issue was sound:

"Two Pesos' argument—that the jury finding of inherent distinctiveness contradicts its finding of no secondary meaning in the Texas market—ignores the law in this circuit. While the necessarily imperfect (and often prohibitively difficult) methods for assessing secondary meaning address the empirical question of current consumer association, the legal recognition of an inherently distinctive trademark or trade dress acknowledges the owner's legitimate proprietary interest in its unique and valuable informational device, regardless of whether substantial consumer association yet bestows the additional empirical protection of secondary meaning." 932 F.2d, at 1120, n. 7.

Although petitioner makes the above argument, it appears to concede elsewhere in its briefing that it is possible for a trade dress, even a restaurant trade dress, to be inherently distinctive and thus eligible for protection under § 43(a). Brief for Petitioner 10-11, 17-18; Reply Brief for Petitioner 10-14. Recognizing that a general requirement of secondary meaning imposes "an unfair prospect of theft [or] financial loss" on the developer of fanciful or arbitrary trade dress at the outset of its use, petitioner suggests that such trade dress should receive limited protection without proof of secondary meaning. Reply Brief for Petitioner 10. Petitioner argues that such protection should be only temporary and subject to defeasance when over time the dress has failed to acquire a secondary meaning. This approach is also vulnerable for the reasons given by the Court of Appeals. If temporary protection is available from the earliest use of the trade dress, it must be because it is neither functional nor descriptive but an inherently distinctive dress that is capable of identifying a particular source of the product. Such a trade dress, or mark, is not subject to copying by concerns that have an equal opportunity to choose their own inherently distinctive trade dress. To terminate protection for failure to gain secondary meaning over some unspecified time could not be based on the failure of the dress to retain its fanciful, arbitrary, or suggestive nature, but on the failure of the user of the dress to be successful enough in the marketplace. This is not a valid basis to find a dress or mark ineligible for protection. The user of such a trade dress should be able to maintain what competitive position it has and continue to seek wider identification among potential customers.

This brings us to the line of decisions by the Court of Appeals for the Second Circuit that would find protection for trade dress unavailable absent proof of secondary meaning, a position that petitioner concedes would have to be modified if the temporary protection that it suggests is to be recognized. Brief for Petitioner 10-14. In *Vibrant Sales, Inc. v. New Body Boutique, Inc.,* 652 F.2d 299 (1981), the plaintiff claimed protection under § 43(a) for a product whose features the defendant had allegedly copied. The Court of Appeals held that unregistered marks did not enjoy the "presumptive source association" enjoyed by registered marks and hence could not qualify for protection under § 43(a) without proof of secondary meaning. *Id.* at 303, 304. The court's rationale seemingly denied protection for unregistered but inherently distinctive marks of all kinds, whether the claimed mark used distinctive words or symbols or distinctive product design. The court thus did not accept the arguments that an unregistered mark was capable of identifying a source and that copying such a mark could be making any kind of a false statement or representation under § 43(a).

This holding is in considerable tension with the provisions of the Act. If a verbal or symbolic mark or the features of a product design may be registered under § 2, it necessarily is a mark "by which the goods of the applicant may be distinguished from the goods of others," 60 Stat. 428, and must be registered unless otherwise disqualified. Since § 2 requires secondary meaning only as a condition to registering descriptive marks, there are plainly marks that are registrable without showing secondary meaning. These same marks, even if not registered, remain inherently capable of distinguishing the goods of the users of these marks. Furthermore, the copier of such a mark may be seen as falsely claiming that his products may for some reason be thought of as originating from the plaintiff.

Some years after *Vibrant,* the Second Circuit announced in *Thompson Medical Co. v. Pfizer Inc.,* 753 F.2d 208 (CA2 1985), that in deciding whether an unregistered mark is eligible for protection under § 43(a), it would follow the classification of marks set out by Judge Friendly in *Abercrombie & Fitch,* 537 F.2d, at 9. Hence, if an unregistered mark is deemed merely descriptive, which the verbal mark before the court proved to be, proof of secondary meaning is required; however, "[s]uggestive marks are eligible for protection without any proof of secondary meaning, since the connection between the mark and the source is presumed." 753 F.2d, at 216. The Second Circuit has nevertheless continued to deny protection for trade dress under § 43(a) absent proof of secondary meaning, despite the fact that § 43(a) provides no basis for distinguishing between trademark and trade dress. See, *e.g., Stormy Clime Ltd. v. ProGroup, Inc.,* 809 F.2d, at 974; *Union Mfg. Co. v. Han Baek Trading Co.,* 763 F.2d 42, 48 (1985); *LeSportsac, Inc. v. K Mart Corp.,* 754 F.2d 71, 75 (1985).

The Fifth Circuit was quite right in *Chevron,* and in this case, to follow the *Abercrombie* classifications consistently and to inquire whether trade dress for which protection is claimed under § 43(a) is inherently distinctive. If it is, it is capable of identifying products or services as coming from a specific source and secondary meaning is not required. This is the rule generally applicable to trademark, and the protection of trademarks and trade dress under § 43(a) serves the same statutory purpose of preventing deception and unfair competition. There is no persuasive reason to apply different analysis to the two. The "proposition that secondary meaning must be shown even if the trade dress is a distinctive, identifying mark, [is] wrong, for the reasons explained by Judge Rubin for the Fifth Circuit in *Chevron.*" *Blau Plumbing, Inc. v. S.O.S. Fix-It, Inc.,* 781 F.2d 604, 608 (CA7 1986). The Court of Appeals for the Eleventh Circuit also follows *Chevron, AmBrit, Inc. v. Kraft, Inc.,* 805 F.2d 974, 979 (1986), and the Court of Appeals for the Ninth Circuit appears to think that proof of secondary meaning is superfluous if a trade dress is inherently distinctive. *Fuddruckers, Inc. v. Doc's B.R. Others, Inc.,* 826 F.2d 837, 843 (1987).

It would be a different matter if there were textual basis in § 43(a) for treating inherently distinctive verbal or symbolic trademarks differently from inherently distinctive trade dress. But there is none. The section does not mention trademarks or trade dress, whether they be called generic, descriptive, suggestive, arbitrary, fanciful, or functional. Nor does the concept of secondary meaning appear in the text of § 43(a). Where secondary meaning does appear in the statute, 15 U.S.C. § 1052 (1982 ed.), it is a requirement that applies only to merely descriptive marks and not to inherently distinctive ones. We see no basis for requiring secondary meaning for inherently distinctive trade dress protection under § 43(a) but not for other distinctive words, symbols, or devices capable of identifying a producer's product.

Engrafting onto § 43(a) a requirement of secondary meaning for inherently distinctive trade dress also would undermine the purposes of the Lanham Act. Protection of trade dress, no less than of trademarks, serves the Act's purpose to "secure to the owner of the mark the goodwill of his business and to protect the ability of consumers to distinguish among competing producers. National protection of trademarks is desirable, Congress concluded, because trademarks foster competition and the maintenance of quality by securing to the producer the benefits of good reputation." *Park' N Fly,* 469 U.S., at 198, 105 S.Ct., at 663, citing S.Rep. No. 1333, 79th Cong., 2d Sess., 3-5 (1946) (citations omitted). By making more difficult the identification of a producer with its product, a secondary meaning requirement for a nondescriptive trade dress would hinder improving or maintaining the producer's competitive position.

Suggestions that under the Fifth Circuit's law, the initial user of any shape or design would cut off competition from products of like design and shape are not persuasive. Only nonfunctional, distinctive trade dress is protected under § 43(a). The Fifth Circuit holds that a design is legally functional, and thus unprotectable, if it is one of a limited number of equally efficient options available to competitors and free competition would be unduly hindered by according the design trademark protection. See *Sicilia Di R. Biebow & Co. v. Cox,* 732 F.2d 417, 426 (CA5 1984). This serves to assure that competition will not be stifled by the exhaustion of a limited number of trade dresses.

On the other hand, adding a secondary meaning requirement could have anticompetitive effects, creating particular burdens on the start-up of small companies. It would present special difficulties for a business, such as respondent, that seeks to start a new product in a limited area and then expand into new markets. Denying protection for inherently distinctive nonfunctional trade dress until after secondary meaning has been established would allow a competitor, which has not adopted a distinctive trade dress of its own, to appropriate the originator's dress in other markets and to deter the originator from expanding into and competing in these areas.

As noted above, petitioner concedes that protecting an inherently distinctive trade dress from its inception may be critical to new entrants to the market and that withholding protection until secondary meaning has been established would be contrary to the goals of the Lanham Act. Petitioner specifically suggests, however, that the solution is to dispense with the requirement of secondary meaning for a reasonable, but brief period at the outset of the use of a trade dress. Reply Brief for Petitioner 11-12. If § 43(a) does not require secondary meaning at the outset of a business' adoption of trade dress, there is no basis in the statute to support the suggestion that such a requirement comes into being after some unspecified time.

III

We agree with the Court of Appeals that proof of secondary meaning is not required to prevail on a claim under § 43(a) of the Lanham Act where the trade dress at issue is inherently distinctive, and accordingly the judgment of that court is affirmed.

It is so ordered.

Justice SCALIA, concurring.

I write separately to note my complete agreement with Justice THOMAS's explanation as to how the language of § 43(a) and its common-law derivation are broad enough to embrace inherently distinctive trade dress. Nevertheless, because I find that analysis to be complementary to (and not inconsistent with) the Court's opinion, I concur in the latter.

Justice STEVENS, concurring in the judgment.

As the Court notes in its opinion, the text of § 43(a) of the Lanham Act, 15 U.S.C. § 1125(a), "does not mention trademarks or trade dress." *Ante,* at ____. Nevertheless, the Court interprets this section as having created a federal cause of action for infringement of an unregistered trademark or trade dress and concludes that such a mark or dress should receive essentially the same protection as those that are registered. Although I agree with the Court's conclusion, I think it is important to recognize that the meaning of the text has been transformed by the federal courts over the past few decades. I agree with this transformation, even though it marks a departure from the original text, because it is consistent with the purposes of the statute and has recently been endorsed by Congress.

I

It is appropriate to begin with the relevant text of § 43(a).[1] See, *e.g., Moskal v. United States,* 498 U.S. ----, 111 S.Ct. 461, 112 L.Ed.2d 449 (1990); *K Mart Corp. v. Cartier, Inc.,* 486 U.S. 281, 291, 108 S.Ct. 1811, 1817-1818, 100 L.Ed.2d 313 (1988); *United States v. Turkette,* 452 U.S. 576, 580, 101 S.Ct. 2524, 2527, 69 L.Ed.2d 246 (1981). Section 43(a) [2] provides a federal remedy for using either "a false designation of origin" or a "false description or representation" in connection with any goods or services. The full text of the section makes it clear that the word "origin" refers to the geographic location in which the goods originated, and in fact, the phrase "false designation of origin" was understood to be limited to false advertising of geographic origin. For example, the "false designation of origin" language contained in the statute makes it unlawful to represent that California oranges came from Florida, or vice versa.[3]

For a number of years after the 1946 enactment of the Lanham Act, a "false description or representation," like "a false designation of origin," was construed narrowly. The phrase encompassed two kinds of wrongs: false advertising [4] and the common-law tort of "passing off." [5] False advertising meant representing that goods or services possessed characteristics that they did not actually have and passing off meant representing one's goods as those of another. Neither "secondary meaning" nor "inherent distinctiveness" had anything to do with false advertising, but proof of secondary meaning was an element of the common-law passing-off cause of action. See, *e.g., G. & C. Merriam Co. v. Saalfield,* 198 F. 369, 372 (CA6 1912) ("The ultimate offense always is that defendant has passed off his goods as and for those of the complainant").

II

Over time, the Circuits have expanded the categories of "false designation of origin" and "false description or representation." One treatise [6] identified the Court of Appeals for the Sixth Circuit as the first to broaden the meaning of "origin" to include "origin of source or manufacture" in addition to geographic origin.[7] Another early case, described as unique among the Circuit cases because it was so "forward-looking," [8] interpreted the "false description or representation" language to mean more than mere "palming off." *L'Aiglon Apparel, Inc. v. Lana Lobell, Inc.,* 214 F.2d 649 (CA3 1954). The court explained: "We find nothing in the legislative history of the Lanham Act to justify the view that [§ 43(a)] is merely declarative of existing law. . . . It seems to us that Congress has defined a statutory civil wrong of false representation of goods in commerce and has given a broad class of suitors injured or likely to be injured by such wrong the right to relief in the federal courts." *Id.,* at 651. Judge Clark, writing a concurrence in 1956, presciently observed: "Indeed, there is indication here and elsewhere that the bar has not yet realized the potential impact of this statutory provision [§ 43(a)]." *Maternally Yours, Inc. v. Your Maternity Shop, Inc.,* 234 F.2d 538, 546(CA2). Although some have criticized the expansion as unwise,[9] it is now "a firmly embedded reality." [10] The United States Trade Association Trademark Review Commission noted this transformation with approval: "Section 43(a) is an enigma, but a very popular one. Narrowly drawn and intended to reach false designations or representations as to the geographical origin of products, the section has been widely interpreted to create, in essence, a federal law of unfair competition. . . . It has definitely eliminated a gap in unfair competition law, and its vitality is showing no signs of age." [11]

Today, it is less significant whether the infringement falls under "false designation of origin" or "false description or representation" [12] because in either case § 43(a) may be invoked. The federal courts are in agreement that § 43(a) creates a federal cause of action for trademark and trade dress infringement claims. 1 J. Gilson, Trademark Protection and Practice § 2.13, p. 2-178 (1991). They are also in agreement that the test for liability is likelihood of confusion: "[U]nder the Lanham Act [§ 43(a)], the ultimate test is whether the public is likely to be deceived or confused by the similarity of the marks. . . . Whether we call the violation infringement, unfair competition or false designation of origin, the test is identical—is there a 'likelihood of confusion?' " *New West Corp. v. NYM Co. of California, Inc.,* 595 F.2d 1194, 1201 (CA9 1979) (footnote omitted). And the Circuits are in general agreement,[13] with perhaps the exception of the Second Circuit,[14] that secondary meaning need not be established once there is a finding of inherent distinctiveness in order to establish a trade dress violation under § 43(a).

III

Even though the lower courts' expansion of the categories contained in § 43(a) is unsupported by the text of the Act, I am persuaded that it is consistent with the general purposes of the Act. For example, Congressman Lanham, the bill's sponsor, stated: "The purpose of [the Act] is to protect legitimate business and the consumers of the country." [15] 92 Cong.Rec. 7524 (1946). One way of accomplishing these dual goals was by creating uniform legal rights and remedies that were appropriate for a national economy. Although the protection of trademarks had once been "entirely a State matter," the result of such a piecemeal approach was that there were almost "as many different varieties of common law as there are States" so that a person's right to a trademark "in one State may differ widely from the rights which [that person] enjoys in another." H.R.Rep. No. 944, 76th Cong., 1st Sess., 4 (1939). The House Committee on Trademarks and Patents, recognizing that "trade is no longer local, but . . .national," saw the need for "national legislation along national lines [to] secur[e] to the owners of trademarks in interstate commerce definite rights." *Ibid.*[16]

Congress has revisited this statute from time to time, and has accepted the "judicial legislation" that has created this federal cause of action. Recently, for example, in the Trademark Law Revision Act of 1988, Pub.L. 100-667, 102 Stat. 3935, Congress codified the judicial interpretation of § 43(a), giving its imprimatur to a growing body of case law from the Circuits that had expanded the section beyond its original language.

Although Congress has not specifically addressed the question whether secondary meaning is required under § 43(a), the steps it has taken in this subsequent legislation suggest that secondary meaning is not required if inherent distinctiveness has been established.[17] First, Congress broadened the language of § 43(a) to make explicit that the provision prohibits "any word, term, name, symbol, or device, or any combination thereof" that is "likely to cause confusion, or to cause mistake, or to deceive as to the affiliation, connection, or association of such person with another person, or as to the origin, sponsorship, or approval of his or her goods, services, or commercial activities by another person." 15 U.S.C. § 1125(a). That language makes clear that a confusingly similar trade dress is actionable under § 43(a), without necessary reference to "falsity." Second, Congress approved and confirmed the extensive judicial development under the provision, including its application to trade dress that the federal courts had come to apply.[18] Third, the legislative history of the 1988 amendments reaffirms Congress' goals of protecting both businesses and consumers with the Lanham Act.[19] And fourth, Congress explicitly extended to any violation of § 43(a) the basic Lanham Act remedial provisions whose text previously covered only registered trademarks.[20] The aim of the amendments was to apply the same protections to unregistered marks as were already afforded to registered marks. See S.Rep. No. 100-515, p. 40 (1988). These steps buttress the conclusion that § 43(a) is properly understood to provide protection in accordance with the standards for registration in § 2. These aspects of the 1988 legislation bolster the claim that an inherently distinctive trade dress may be protected under § 43(a) without proof of secondary meaning.

IV

In light of the general consensus among the Courts of Appeals that have actually addressed the question, and the steps on the part of Congress to codify that consensus, *stare decisis* concerns persuade me to join the Court's conclusion that secondary meaning is not required to establish a trade dress violation under § 43(a) once inherent distinctiveness has been established. Accordingly, I concur in the judgment, but not in the opinion of the Court.

Justice THOMAS, concurring in the judgment.

Both the Court and Justice STEVENS decide today that the principles that qualify a mark for registration under § 2 of the Lanham Act apply as well to determining whether an unregistered mark is entitled to protection under § 43(a). The Court terms that view "common ground," though it fails to explain why that might be so, and Justice STEVENS decides that the view among the Courts of Appeals is textually insupportable, but worthy nonetheless of adherence. See *ante,* at ____ (opinion of the Court); *ante,* at ____ (STEVENS, J., concurring in judgment). I see no need in answering the question presented either to move back and forth among the different sections of the Lanham Act or to adopt what may or may not be a misconstruction of the statute for reasons akin to *stare decisis*. I would rely, instead, on the language of § 43(a).

Section 43(a) made actionable (before being amended) "any false description or representation, including words or other symbols tending falsely to describe or represent," when "use[d] in connection with any goods or services." 15 U.S.C. § 1125(a) (1982 ed.). This language codified, among other things, the related common-law torts of technical trademark infringement and passing off, see *Inwood Laboratories, Inc. v. Ives Laboratories, Inc.,* 456 U.S. 844, 861, n. 2, 102 S.Ct. 2182, 2192, n. 2, 72 L.Ed.2d 606 (1982) (WHITE, J., concurring in result); *Chevron Chemical Co. v. Voluntary Purchasing Groups, Inc.,* 659 F.2d 695, 701 (CA5 1981), cert. denied, 457 U.S. 1126, 102 S.Ct. 2947, 73 L.Ed.2d 1342 (1982), which were causes of action for false descriptions or representations concerning a good's or service's source of production. See, *e.g., Yale Electric Corp. v. Robertson,* 26 F.2d 972, 973 (CA2 1928); *American Washboard Co. v. Saginaw Mfg. Co.,* 103 F. 281, 284-286 (CA6 1900).

At common law, words or symbols that were arbitrary, fanciful, or suggestive (called "inherently distinctive" words or symbols, or "trademarks") were presumed to represent the source of a product, and the first user of a trademark could sue to protect it without having to show that the word or symbol represented the product's source in fact. See, *e.g., Heublein v. Adams,* 125 F. 782, 784 (CC Mass.1903). That presumption did not attach to personal or geographic names or to words or symbols that only described a product (called "trade names"), and the user of a personal or geographic name or of a descriptive word or symbol could obtain relief only if he first showed that his trade name did in fact represent not just the product, but a producer (that the good or service had developed "secondary meaning"). See, *e.g., Florence Mfg. Co. v. J.C. Dowd & Co.,* 178 F. 73, 74-75 (CA2 1910). Trade dress, which consists not of words or symbols, but of a product's packaging (or "image," more broadly), seems at common law to have been thought incapable ever of being inherently distinctive, perhaps on the theory that the number of ways to package a product is finite. Thus, a user of trade dress would always have had to show secondary meaning in order to obtain protection. See, *e.g., Crescent Tool Co. v. Kilborn & Bishop Co.,* 247 F. 299, 300-301 (CA2 1917); *Flagg Mfg. Co. v. Holway,* 178 Mass. 83, 91, 59 N.E. 667 (1901); *Philadelphia Novelty Mfg. Co. v. Rouss,* 40 F. 585, 587 (CC SDNY 1889); see also J. Hopkins, Law of Trademarks, Tradenames and Unfair Competition § 54, pp. 140-141 (3d ed. 1917); W. Browne, Law of Trade-Marks §§ 89*b,* 89*c,* pp. 106-110 (2d ed. 1885); Restatement (Third) of the Law of Unfair Competition § 16, Comment *b* (Tent. Draft No. 2, Mar. 23, 1990) (hereinafter Third Restatement).

Over time, judges have come to conclude that packages or images may be as arbitrary, fanciful, or suggestive as words or symbols, their numbers limited only by the human imagination. See, *e.g., AmBrit, Inc. v. Kraft, Inc.,* 812 F.2d 1531, 1536 (CA11 1986) ("square size, bright coloring, pebbled texture, polar bear and sunburst images" of the package of the "Klondike" ice cream bar held inherently distinctive), cert. denied, 481 U.S. 1041, 107 S.Ct. 1983, 95 L.Ed.2d 822 (1987); see also Third Restatement §§ 13, 16. A particular trade dress, then, is now considered as fully capable as a particular trademark of serving as a "representation or designation" of source under § 43(a). As a result, the first user of an arbitrary package, like the first user of an arbitrary word, should be entitled to the presumption that his package represents him without having to show that it does so in fact. This rule follows, in my view, from the language of § 43(a), and this rule applies under that section without regard to the rules that apply under the sections of the Lanham Act that deal with registration.

Because the Court reaches the same conclusion for different reasons, I join its judgment.

[*] The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Lumber Co.,* 200 U.S. 321, 337, 26 S.Ct. 282, 287, 50 L.Ed. 499 (1906).

1. The District Court instructed the jury: " '[T]rade dress' is the total image of the business. Taco Cabana's trade dress may include the shape and general appearance of the exterior of the restaurant, the identifying sign, the interior kitchen floor plan, the decor, the menu, the equipment used to serve food, the servers' uniforms and other features reflecting on the total image of the restaurant." 1 App. 83-84. The Court of Appeals accepted this definition and quoted from *Blue Bell Bio-Medical v. Cin-Bad, Inc.,* 864 F.2d 1253, 1256 (CA5 1989): "The 'trade dress' of a product is essentially its total image and overall appearance." See 932 F.2d 1113, 1118 (CA5 1991). It "involves the total image of a product and may include features such as size, shape, color or color combinations, texture, graphics, or even particular sales techniques." *John H. Harland Co. v. Clarke Checks, Inc.,* 711 F.2d 966, 980 (CA11 1983). Restatement (Third) of Unfair Competition § 16, Comment *a* (Tent.Draft No. 2, Mar. 23, 1990).

2. Section 43(a) provides: "Any person who shall affix, apply, or annex, or use in connection with any goods or services, or any container or containers for goods, a false designation of origin, or any false description or representation, including words or other symbols tending falsely to describe or represent the same, and shall cause such goods or services to enter into commerce, and any person who shall with knowledge of the falsity of such designation of origin or description or representation cause or procure the same to be transported or used in commerce or deliver the same to any carrier to be transported or used,

shall be liable to a civil action by any person doing business in the locality falsely indicated as that of origin or in the region in which said locality is situated, or by any person who believes that he is or is likely to be damaged by the use of any such false description or representation." 60 Stat. 441.

This provision has been superseded by § 132 of the Trademark Law Revision Act of 1988, 102 Stat. 3946, 15 U.S.C. § 1121.

3. The instructions were that to be found inherently distinctive, the trade dress must not be descriptive.

4. Secondary meaning is used generally to indicate that a mark or dress "has come through use to be uniquely associated with a specific source." Restatement (Third) of Unfair Competition § 13, Comment *e* (Tent.Draft No. 2, Mar. 23, 1990). "To establish secondary meaning, a manufacturer must show that, in the minds of the public, the primary significance of a product feature or term is to identify the source of the product rather than the product itself." *Inwood Laboratories, Inc. v. Ives Laboratories, Inc.,* 456 U.S. 844, 851, n. 11, 102 S.Ct. 2182, 2187, n. 11, 72 L.Ed.2d 606 (1982).

5. The Court of Appeals agreed: "The weight of the evidence persuades us, as it did Judge Singleton, that Two Pesos brazenly copied Taco Cabana's successful trade dress, and proceeded to expand in a manner that foreclosed several important markets within Taco Cabana's natural zone of expansion." 932 F.2d, at 1127, n. 20.

6. We limited our grant of certiorari to the above question on which there is a conflict. We did not grant certiorari on the second question presented by the petition, which challenged the Court of Appeals' acceptance of the jury's finding that Taco Cabana's trade dress was not functional.

7. The Lanham Act, including the provisions at issue here, has been substantially amended since the present suit was brought. See Trademark Law Revision Act of 1988, 102 Stat. 3946, 15 U.S.C. § 1121.

1. The text that we consider today is § 43(a) of the Lanham Act prior to the 1988 amendments; it provides:

"Any person who shall affix, apply, or annex, or use in connection with any goods or services, or any container or containers for goods, a false designation of origin, or any false description or representation, including words or other symbols tending falsely to describe or represent the same, and shall cause such goods or services to enter into commerce, and any person who shall with knowledge of the falsity of such designation of origin or description or representation cause or procure the same to be transported or used in commerce or deliver the same to any carrier to be transported or used, shall be liable to a civil action by any person doing business in the locality falsely indicated as that of origin or in the region in which said locality is situated, or by any person who believes that he is or is likely to be damaged by the use of any such false description or representation." 15 U.S.C. § 1125(a) (1982 ed.).

2. Section 43(a) replaced and extended the coverage of § 3 of the Trademark Act of 1920, Ch. 104, 41 Stat. 534, as amended. Section 3 was destined for oblivion largely because it referred only to false designation of origin, was limited to articles of merchandise, thus excluding services, and required a showing that the use of the false designation of origin occurred "willfully and with intent to deceive." *Ibid.* As a result, "[a]lmost no reported decision can be found in which relief was granted to either a United States or foreign party based on this newly created remedy." Derenberg, Federal Unfair Competition Law at the End of the First Decade of the Lanham Act: Prologue or Epilogue?, 32 N.Y.U.L.Rev. 1029, 1034 (1957).

3. This is clear from the fact that the cause of action created by this section is available only to a person doing business in the locality falsely indicated as that of origin. See n. 1, *supra.*

4. The deleterious effects of false advertising were described by one commentator as follows: "[A] campaign of false advertising may completely discredit the product of an industry, destroy the confidence of consumers and impair a communal

or trade good will. Less tangible but nevertheless real is the injury suffered by the honest dealer who finds it necessary to meet the price competition of inferior goods, glamorously misdescribed by the unscrupulous merchant. The competition of a liar is always dangerous even though the exact injury may not be susceptible of precise proof." Handler, Unfair Competition, 21 Iowa L.Rev. 175, 193 (1936).

5. The common-law tort of passing off has been described as follows:

"Beginning in about 1803, English and American common law slowly developed an offshoot of the tort of fraud and deceit and called it 'passing off' or 'palming off.' Simply stated, passing off as a tort consists of one passing off his goods as the goods of another. In 1842 Lord Langdale wrote:

" 'I think that the principle on which both the courts of law and equity proceed is very well understood. A man is not to sell his own goods under the pretense that they are the goods of another man. . . .'

"In 19th century cases, trademark infringement embodied much of the elements of fraud and deceit from which trademark protection developed. That is, the element of fraudulent intent was emphasized over the objective facts of consumer confusion." 1 J. McCarthy, Trademarks and Unfair Competition § 5.2, p. 133 (2d ed. 1984) (McCarthy) (footnotes omitted).

6. 2 *id.,* § 27:3, p. 345.

7. *Federal-Mogul-Bower Bearings, Inc. v. Azoff,* 313 F.2d 405, 408 (CA6 1963).

8. Derenberg, 32 N.Y.U.L.Rev., at 1047, 1049.

9. See, *e.g.,* Germain, Unfair Trade Practices Under § 43(a) of the Lanham Act: You've Come a Long Way Baby—Too Far, Maybe?, 64 Trademark Rep. 193, 194 (1974) ("It is submitted that the cases have applied Section 43(a) to situations it was not intended to cover and have used it in ways that it was not designed to function").

10. 2 McCarthy § 27:3, p. 345.

11. The United States Trademark Association Trademark Review Commission Report and Recommendations to USTA President and Board of Directors, 77 Trademark Rep. 375, 426 (1987).

12. Indeed, in count one of the complaint, respondent alleged that petitioner "is continuing to affix, apply, or use in connection with its restaurants, goods and services a false designation o[f] origin, or a false description and representation, tending to falsely describe or represent the same," and that petitioner "has falsely designated the origin of its restaurants, goods and services and has falsely described and represented the same. . . ." App. 44-45; see Tr. of Oral Arg. 37.

13. See, *e.g., AmBrit, Inc. v. Kraft, Inc.,* 805 F.2d 974 (CA11 1986), cert. denied, 481 U.S. 1041, 107 S.Ct. 1983, 95 L.Ed.2d 822 (1987); *Blau Plumbing, Inc. v. S.O.S. Fix-It, Inc.,* 781 F.2d 604 (CA7 1986); *In re Morton-Norwich Products, Inc.,* 671 F.2d 1332, 1343 (C.C.P.A.1982); *Chevron Chemical Co. v. Voluntary Purchasing Groups, Inc.,* 659 F.2d 695 (CA5 1981), cert. denied, 457 U.S. 1126, 102 S.Ct. 2947, 73 L.Ed.2d 1342 (1982); see also *Fuddruckers, Inc. v. Doc's B.R. Others, Inc.,* 826 F.2d 837, 843-844 (CA9 1987); *M. Kramer Manufacturing Co. v. Andrews,* 783 F.2d 421, 449, n. 26 (CA4 1986).

14. Consistent with the common-law background of § 43(a), the Second Circuit has said that proof of secondary meaning is required to establish a claim that the defendant has traded on the plaintiff's good will by falsely representing that his goods are those of the plaintiff. See, *e.g., Crescent Tool Co. v. Kilborn & Bishop Co.,* 247 F. 299 (1917). To my knowledge, however, the Second Circuit has not explained why "inherent distinctiveness" is not an appropriate substitute for proof of secondary meaning in a trade dress case. Most of the cases in which the Second Circuit has said that secondary meaning is required did not involve findings of inherent distinctiveness. For example, in *Vibrant Sales, Inc. v. New Body Boutique, Inc.,* 652 F.2d 299 (1981), cert. denied, 455 U.S. 909, 102 S.Ct. 1257, 71 L.Ed.2d 448 (1982), the product at issue—a

velcro belt —was functional and lacked "any distinctive, unique or non-functional mark or feature." 652 F.2d, at 305. Similarly, in *Stormy Clime Ltd. v. ProGroup, Inc.,* 809 F.2d 971, 977 (1987), the court described functionality as a continuum, and placed the contested rainjacket closer to the functional end than to the distinctive end. Although the court described the lightweight bag in *LeSportsac, Inc. v. K Mart Corp.,* 754 F.2d 71 (1985), as having a distinctive appearance and concluded that the District Court's finding of nonfunctionality was not clearly erroneous, *id.,* at 74, it did not explain why secondary meaning was also required in such a case.

15. The Senate Report elaborated on these two goals:

"The purpose underlying any trade-mark statute is twofold. One is to protect the public so it may be confident that, in purchasing a product bearing a particular trade-mark which it favorably knows, it will get the product which it asks for and wants to get. Secondly, where the owner of a trade-mark has spent energy, time, and money in presenting to the public the product, he is protected in his investment from its misappropriation by pirates and cheats. This is the well-established rule of law protecting both the public and the trade-mark owner." S.Rep. No. 1333, 79th Cong., 2d Sess., 3 (1946).

By protecting trademarks, Congress hoped "to protect the public from deceit, to foster fair competition, and to secure to the business community the advantages of reputation and goodwill by preventing their diversion from those who have created them to those who have not. This is the end to which this bill is directed." *Id.*, at 4.

16. Forty years later, the USTA Trademark Review Commission assessed the state of trademark law. The conclusion that it reached serves as a testimonial to the success of the Act in achieving its goal of uniformity: "The federal courts now decide, under federal law, all but a few trademark disputes. State trademark law and state courts are less influential than ever. Today the Lanham Act is the paramount source of trademark law in the United States, as interpreted almost exclusively by the federal courts." Trademark Review Commission, 77 Trademark Rep., at 377.

17. "When several acts of Congress are passed touching the same subject-matter, subsequent legislation may be considered to assist in the interpretation of prior legislation upon the same subject." *Tiger v. Western Investment Co.,* 221 U.S. 286, 309, 31 S.Ct. 578, 583-584, 55 L.Ed. 738 (1911); see *NLRB v. Bell Aerospace Co.,* 416 U.S. 267, 275, 94 S.Ct. 1757, 1762, 40 L.Ed.2d 134 (1974); *Red Lion Broadcasting Co. v. FCC,* 395 U.S. 367, 380-381, 89 S.Ct. 1794, 1801-1802, 23 L.Ed.2d 371 (1969); *United States v. Stafoff,* 260 U.S. 477, 480, 43 S.Ct. 197, 199, 67 L.Ed. 358 (1923) (opinion of Holmes, J.).

18. As the Senate Report explained, revision of Section 43(a) is designed "to codify the interpretation it has been given by the courts. Because Section 43(a) of the Act fills an important gap in federal unfair competition law, the committee expects the courts to continue to interpret the section.

"As written, Section 43(a) appears to deal only with false descriptions or representations and false designations of geographic origin. Since its enactment in 1946, however, it has been widely interpreted as creating, in essence, a federal law of unfair competition. For example, it has been applied to cases involving the infringement of unregistered marks, violations of trade dress and certain nonfunctional configurations of goods and actionable false advertising claims." S.Rep. No. 100-515, p. 40 (1988) U.S.Code Cong. & Admin.News 1988, pp. 5577, 5605.

19. "Trademark protection is important to both consumers and producers. Trademark law protects the public by making consumers confident that they can identify brands they prefer and can purchase those brands without being confused or misled. Trademark laws also protec[t] trademark owners. When the owner of a trademark has spent conside[r]able time and money bringing a product to the marketplace, trademark law protects the producer from pirates and counterfeiters." *Id.,* at 4.

[20]. See 15 U.S.C. §§ 1114, 1116-1118.

US00D621127S

(12) **United States Design Patent**
Roskam

(10) **Patent No.: US D621,127 S**
(45) **Date of Patent: ** *Aug. 10, 2010**

(54) **DOUGHNUT PRODUCT WITH SIX APPENDAGES**

(75) Inventor: **Cameron O. Roskam**, Grand Rapids, MI (US)

(73) Assignee: **Roskam Baking Company**, Grand Rapids, MI (US)

(*) Notice: This patent is subject to a terminal disclaimer.

(**) Term: **14 Years**

(21) Appl. No.: **29/327,634**

(22) Filed: **Nov. 10, 2008**

(51) **LOC (9) Cl.** **01-01**
(52) **U.S. Cl.** **D1/115**
(58) **Field of Classification Search** D1/106, D1/115, 127–128, 199; D11/68, 33, 106; D24/101–104; D10/9; D7/571, 575, 576, D7/396.4; 426/104, 803; 428/20; D6/597–601
See application file for complete search history.

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D96,223	S	*	7/1935	Brennan	D1/120
D96,224	S	*	7/1935	Brennan	D1/129
D96,225	S	*	7/1935	Brennan	D1/129
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Primary Examiner—Cathron C Brooks
Assistant Examiner—Barbara Fox
(74) *Attorney, Agent, or Firm*—Price, Heneveld, Cooper, DeWitt & Litton LLP

(57) **CLAIM**

I claim the ornamental design for a doughnut product with six appendages, as shown and described.

DESCRIPTION

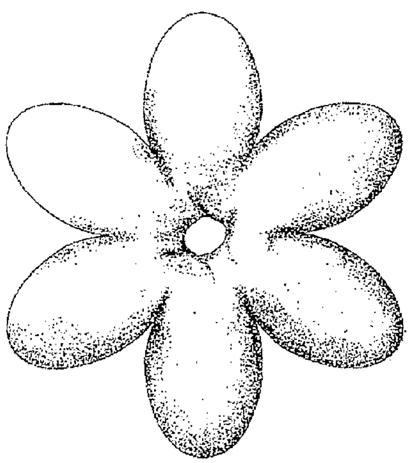
FIG. **1** is a top view of a doughnut product with six appendages of the present invention.

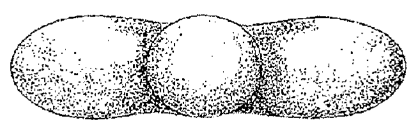
FIG. **2** is a bottom view of a doughnut product with six appendages of the present invention.

FIG. **3** is side perspective of a doughnut product with six appendages of the present invention; and,

FIG. **4** is a front/back perspective of a doughnut product with six appendages of the present invention.

1 Claim, 1 Drawing Sheet





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U.S. Appl. No. 29/327,507; entitled Doughnut Product With Six Appendages; filed on Nov. 7, 2008.

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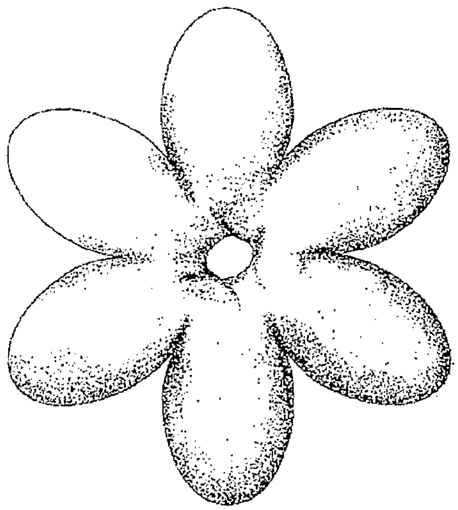

FIG. 1

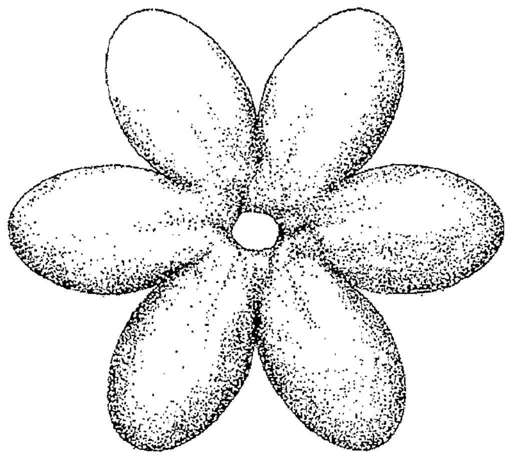

FIG. 2

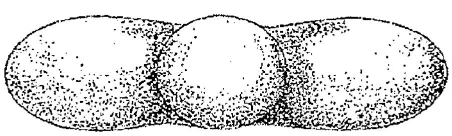

FIG. 3

FIG. 4

US00D695488S

(12) **United States Design Patent** (10) **Patent No.: US D695,488 S**
Lowry (45) **Date of Patent: ** Dec. 17, 2013**

(54) **DOUGHNUT**

(75) Inventor: **Stanley N. Lowry**, Kernersville, NC (US)

(73) Assignee: **HDN Development Corporation**, Wilmington, DE (US)

(**) Term: **14 Years**

(21) Appl. No.: **29/288,281**

(22) Filed: **Jun. 6, 2007**

(51) **LOC (9) Cl.** **01-01**

(52) **U.S. Cl.**
USPC **D1/106**

(58) **Field of Classification Search**
USPC D1/106–15, 128, 129, 199; D10/113; D21/386; D24/101–2, 104; D28/8.1–8.2; D30/160; 426/94, 104, 426/138, 549, 559, 383, 439–40, 496, 499, 426/512, 516, 556; 446/69, 107
See application file for complete search history.

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Primary Examiner — Karen E Kearney
(74) *Attorney, Agent, or Firm* — Kilpatrick Townsend & Stockton LLP

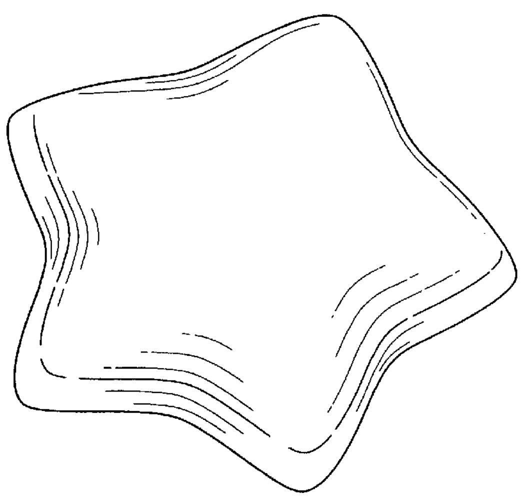
(57) **CLAIM**

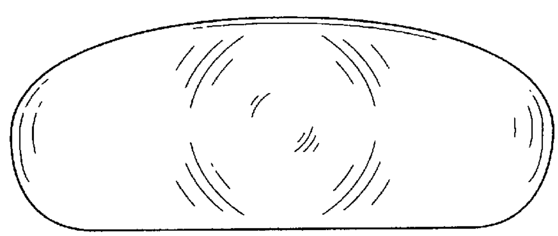
I claim the ornamental design for a doughnut, as shown.

DESCRIPTION

FIG. **1** is a perspective view of a doughnut comprising the present invention.
FIG. **2** is a top elevational view thereof.
FIG. **3** is a bottom elevational view thereof.
FIG. **4** is a front elevational view thereof.
FIG. **5** is a rear elevational view thereof.
FIG. **6** is a right side elevational view thereof; and,
FIG. **7** is a left side elevational view thereof.

1 Claim, 5 Drawing Sheets





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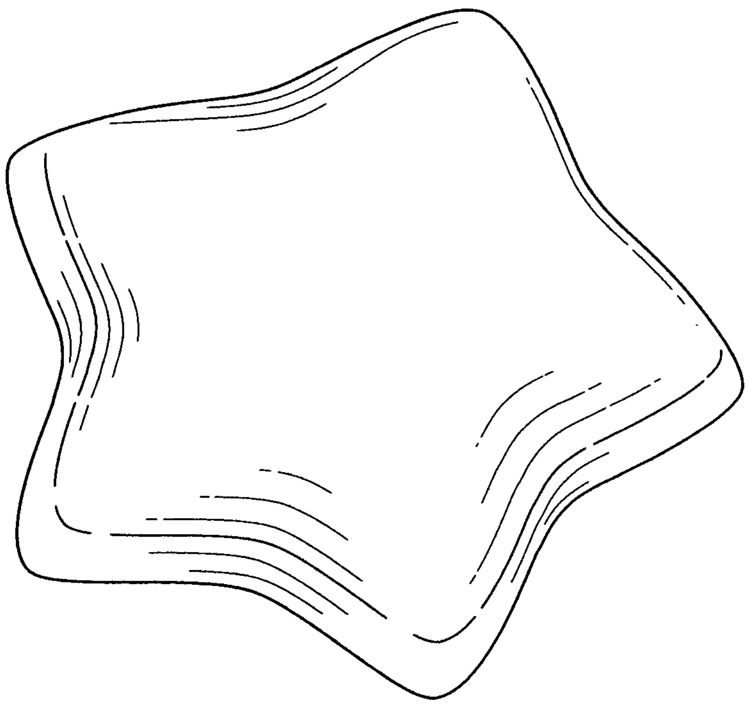

FIG. 1

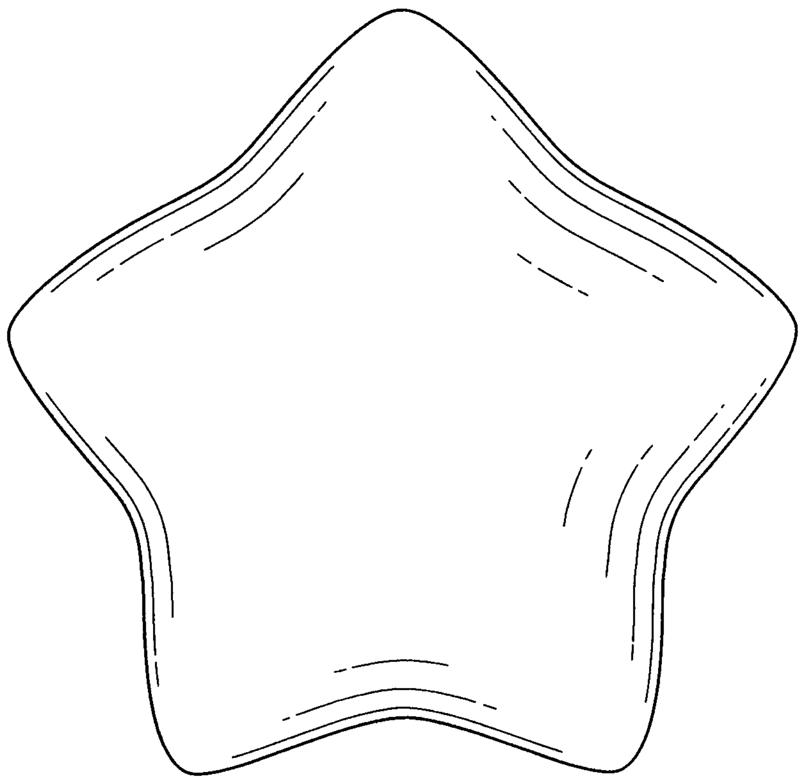

FIG. 2

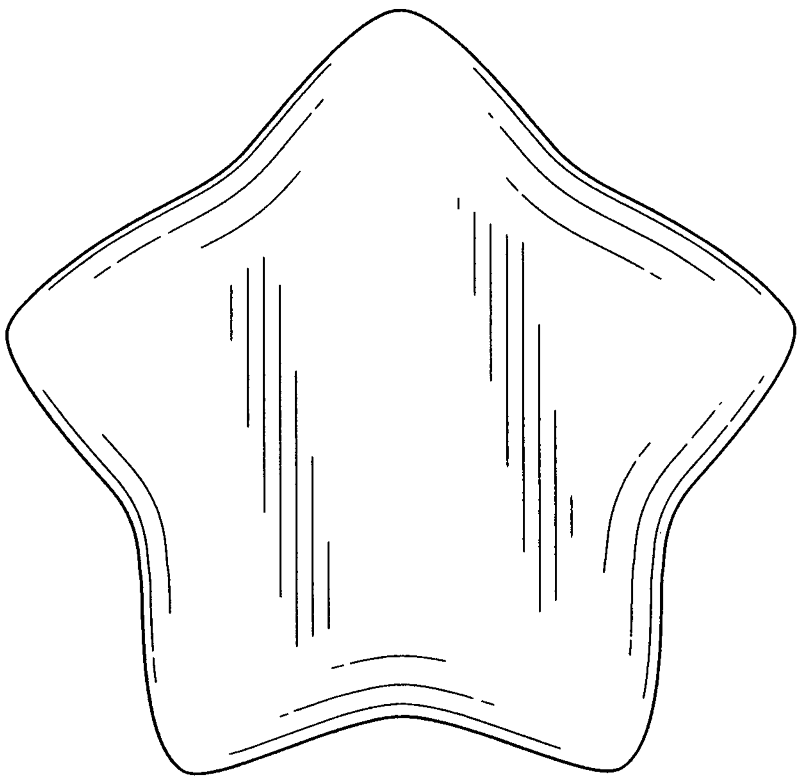

FIG. 3

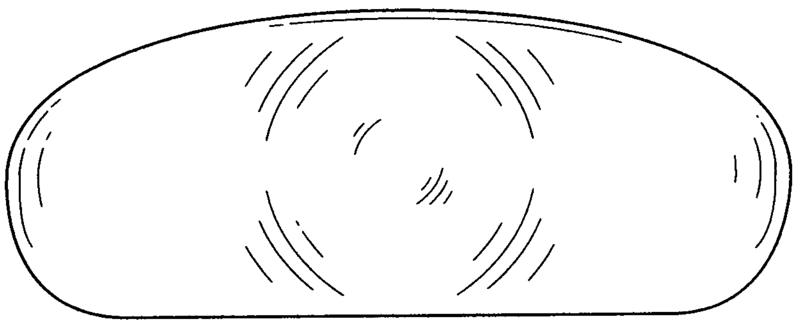

FIG. 4

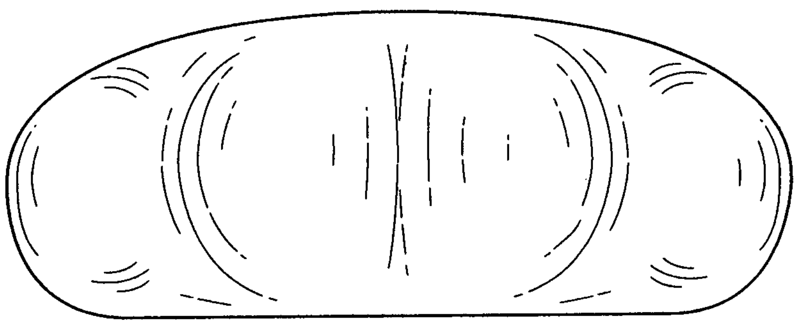

FIG. 5

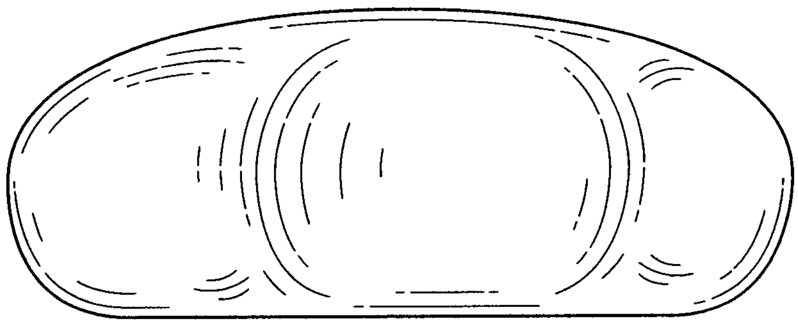

FIG. 6

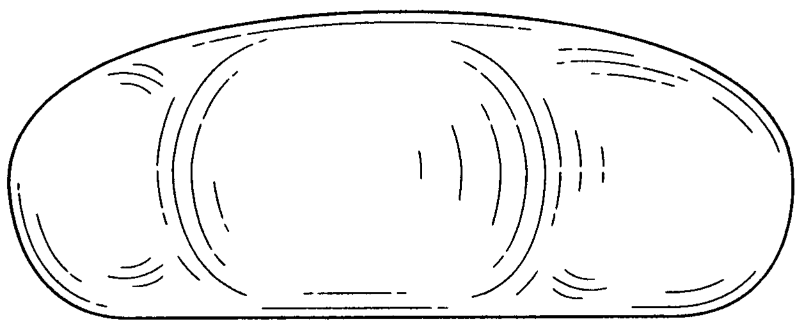

FIG. 7

US00D731141S

(12) United States Design Patent
Rogers et al.

(10) **Patent No.:** **US D731,141 S**
(45) **Date of Patent:** ** **Jun. 9, 2015**

(54) **DOUGHNUT**

(71) Applicant: **HDN Development Corporation**, Winston-Salem, NC (US)

(72) Inventors: **James Michael Rogers**, Winston-Salem, NC (US); **Lance Edward Jackson**, Clemmons, NC (US)

(73) Assignee: **HDN Development Corporation**, Winston-Salem, NC (US)

(**) Term: **14 Years**

(21) Appl. No.: **29/462,894**

(22) Filed: **Aug. 9, 2013**

(51) **LOC (10) Cl.** **01-01**

(52) **U.S. Cl.**
USPC **D1/107**; D1/129

(58) **Field of Classification Search**
USPC D1/100–130, 199; 426/92, 94, 104, 426/134, 138, 143, 275, 277, 279, 281–284, 426/292, 295, 391, 496, 514, 566, 572, 426/660; D21/604; D9/608; D24/102; D7/676; D11/31
See application file for complete search history.

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Primary Examiner — Deanna L Pratt
Assistant Examiner — Katie Mroczka
(74) *Attorney, Agent, or Firm* — Kilpatrick Townsend & Stockton LLP

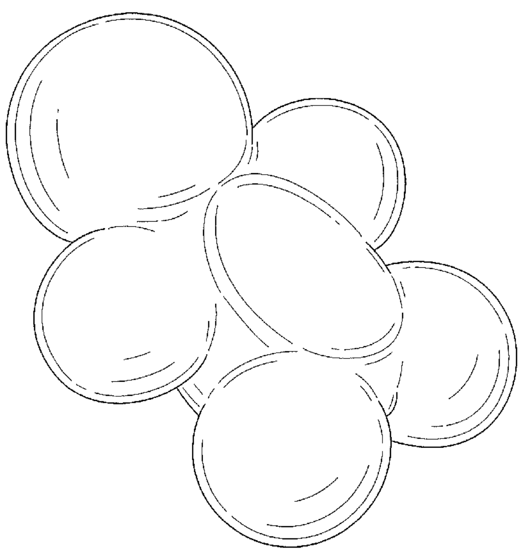
(57) **CLAIM**

We claim the ornamental design for a doughnut, as shown.

DESCRIPTION

FIG. **1** is a perspective view of a doughnut comprising the present invention.
FIG. **2** is a top elevational view of the doughnut shown in FIG. **1**.
FIG. **3** is a bottom elevational view of the doughnut shown in FIG. **1** and FIG. **2**.
FIG. **4** is a front elevational view of the doughnut shown in FIG. **1**, FIG. **2**, and FIG. **3**.
FIG. **5** is a rear elevational view of the doughnut shown in FIG. **1**, FIG. **2**, FIG. **3**, and FIG. **4**.
FIG. **6** is a side elevational view of the doughnut shown in FIG. **1**, FIG. **2**, FIG. **3**, FIG. **4**, and FIG. **5**; and,
FIG. **7** is another side elevational view of the doughnut shown in FIG. **1**, FIG. **2**, FIG. **3**, FIG. **4**, FIG. **5**, and FIG. **6**.

1 Claim, 7 Drawing Sheets



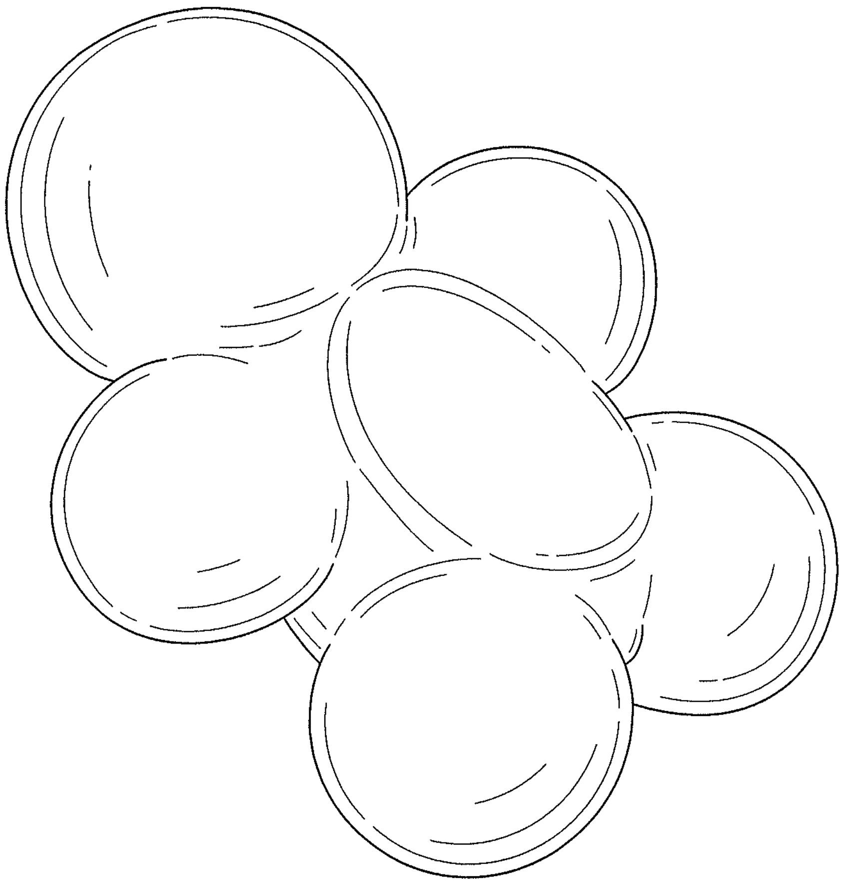


FIG. 1

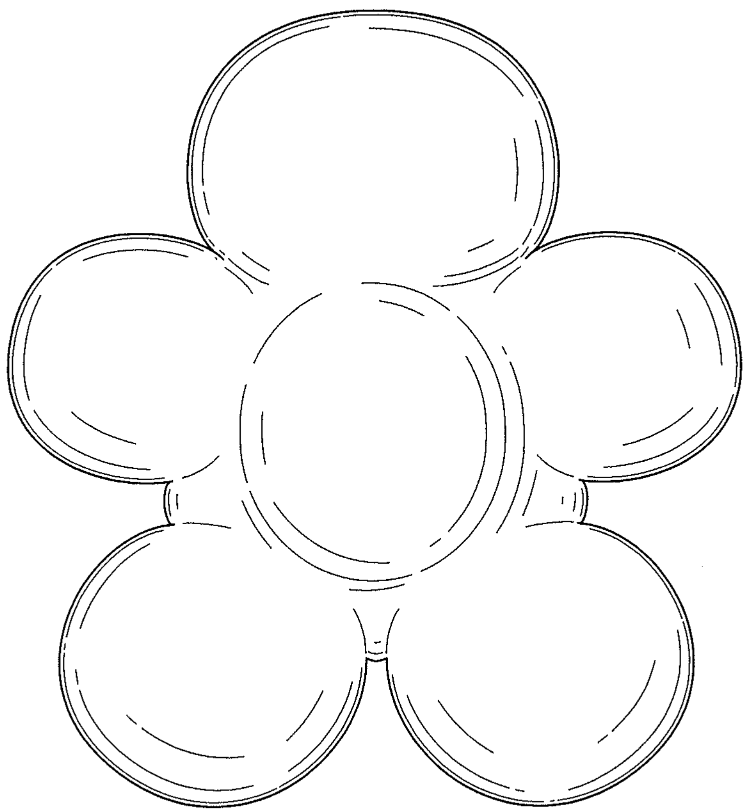


FIG. 2

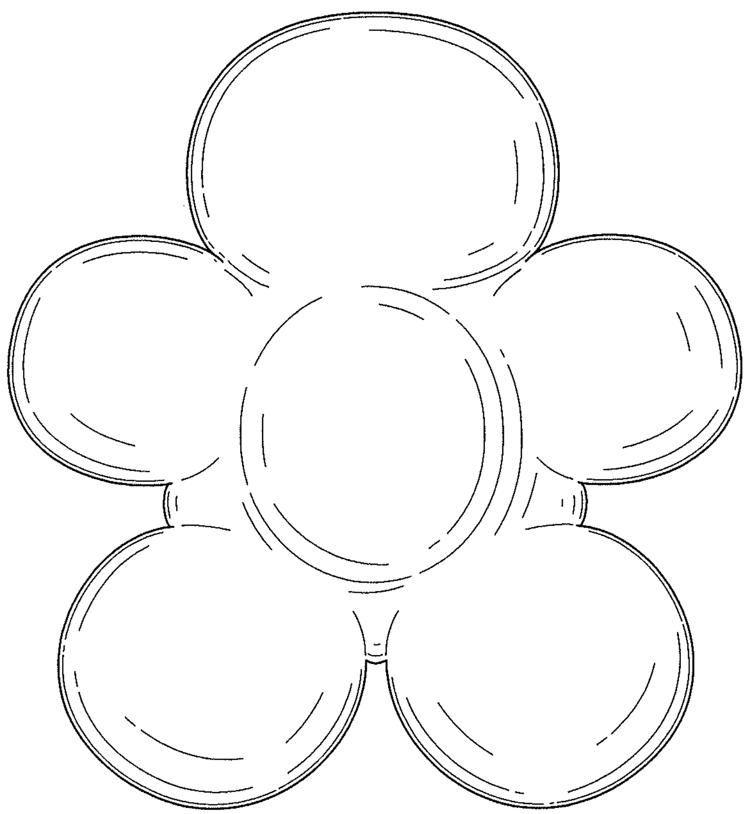


FIG. 3

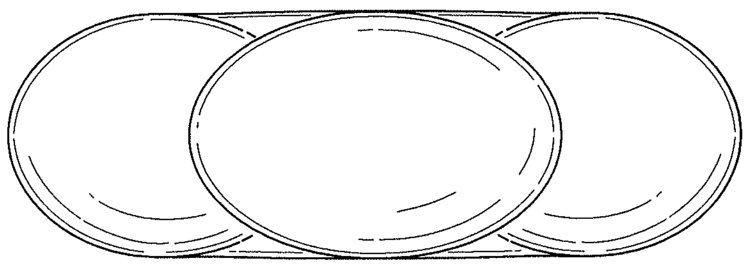


FIG. 4

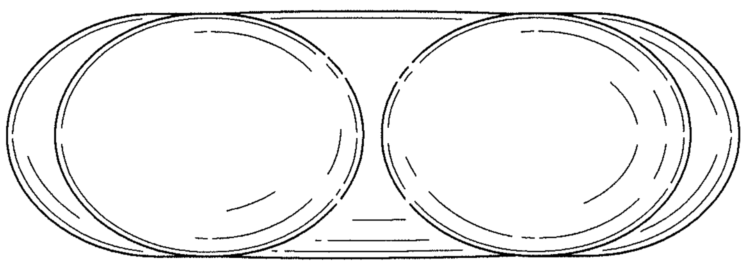


FIG. 5

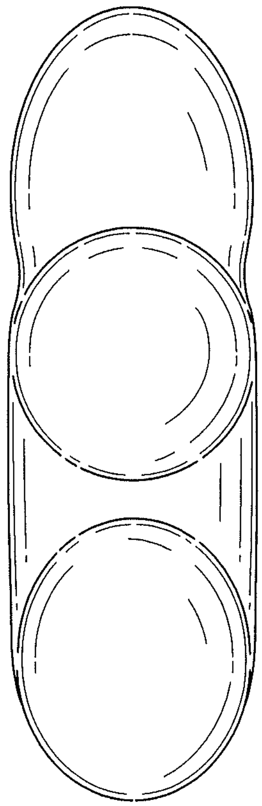


FIG. 6

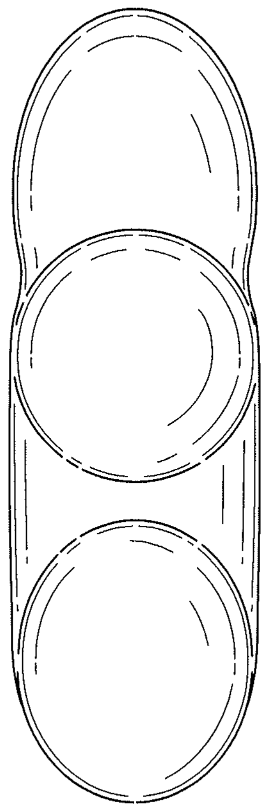


FIG. 7

US00D943238S

(12) **United States Design Patent**
Caputo

(10) **Patent No.: US D943,238 S**
(45) **Date of Patent: ** Feb. 15, 2022**

(54) **CUPCAKE WITH CONTRASTING ICING**

(71) Applicant: **GIVE AND GO PREPARED FOODS CORP.**, Etobicoke (CA)

(72) Inventor: **Steven Caputo**, Etobicoke (CA)

(73) Assignee: **Give and Go Prepared Foods Corp.**, Etobicoke (CA)

(**) Term: **15 Years**

(21) Appl. No.: **29/733,399**

(22) Filed: **May 1, 2020**

(51) **LOC (13) Cl.** **01-01**

(52) **U.S. Cl.**
USPC **D1/129**; D1/101; D1/102

(58) **Field of Classification Search**
USPC D1/100–130, 199; 426/94, 104, 138, 426/143, 144, 274, 283, 303, 391, 512, 426/514, 518, 549; D6/597, 601; D7/610, 675, 679, 560, 566, 568; D24/101–104; D28/8.1, 8.2; D21/385, D21/386, 707; D9/643; D11/157
CPC A23L 1/0067; A23L 1/005; A23L 1/0052; A23L 1/217; A23G 9/48; A23G 3/54; A23V 2002/00
See application file for complete search history.

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Primary Examiner — Katie Jane Stofko
(74) *Attorney, Agent, or Firm* — Bereskin & Parr LLP/S.E.N.C.R.L., s.r.l.

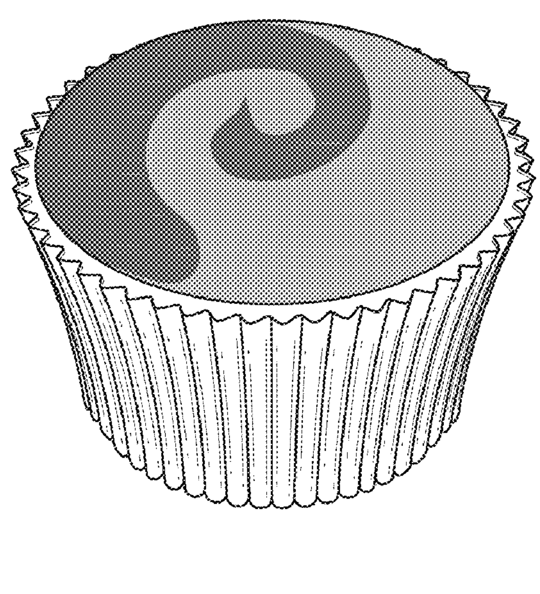
(57) **CLAIM**

The ornamental Design for a cupcake with contrasting icing, as shown and described.

DESCRIPTION

FIG. **1** is a perspective view of a cupcake with contrasting icing;
FIG. **2** is a front view of the cupcake with contrasting icing of FIG. **1**;
FIG. **3** is a rear view of the cupcake with contrasting icing of FIG. **1**;
FIG. **4** is a right side view of the cupcake with contrasting icing of FIG. **1**;
FIG. **5** is a left side view of the cupcake with contrasting icing of FIG. **1**;
FIG. **6** is a top view of the cupcake with contrasting icing of FIG. **1**; and,
FIG. **7** is a bottom view of the cupcake with contrasting icing of FIG. **1**.
The drawings include contrasting tones which represent surface ornamentation.

1 Claim, 4 Drawing Sheets



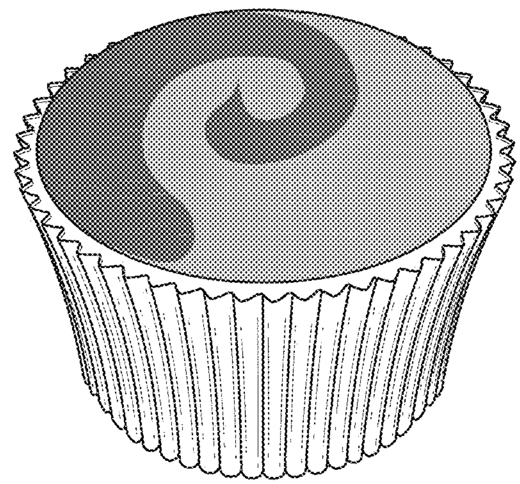


FIG. 1

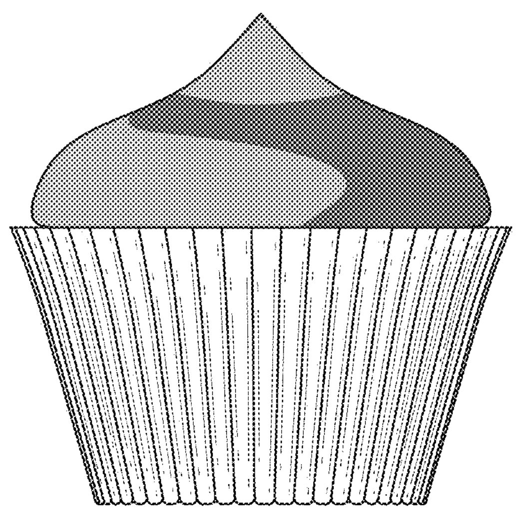


FIG. 2

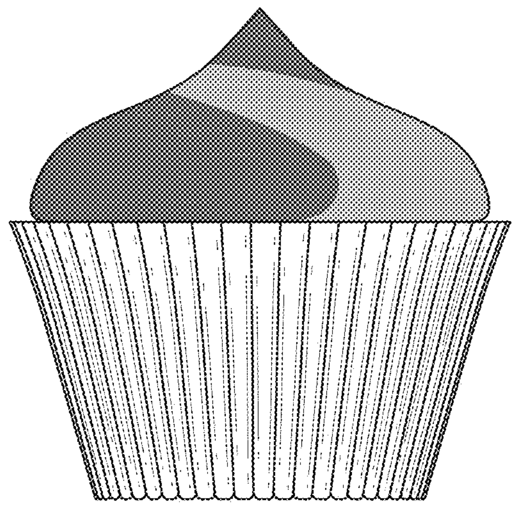


FIG. 3

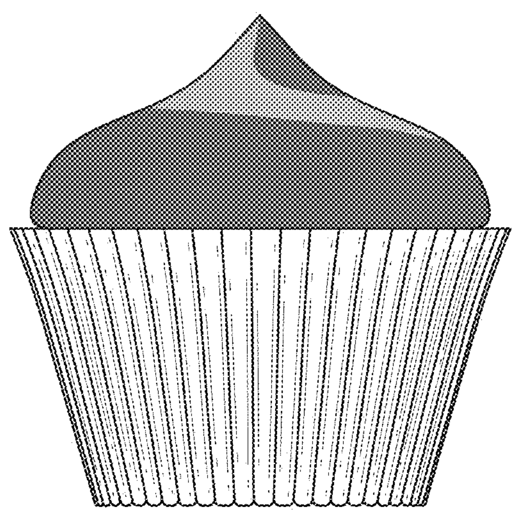


FIG. 4

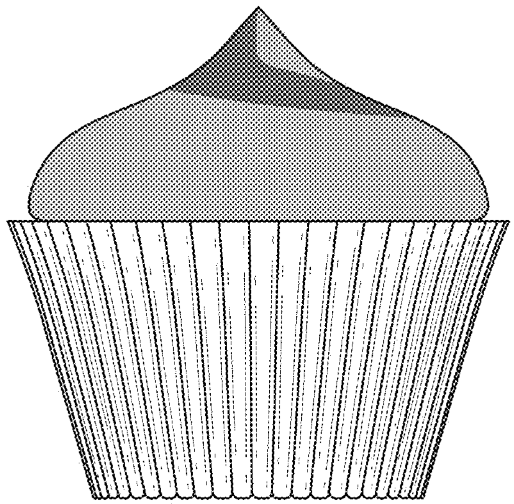


FIG. 5

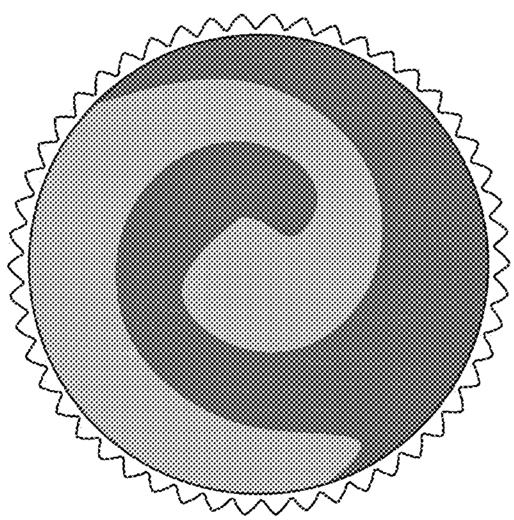


FIG. 6

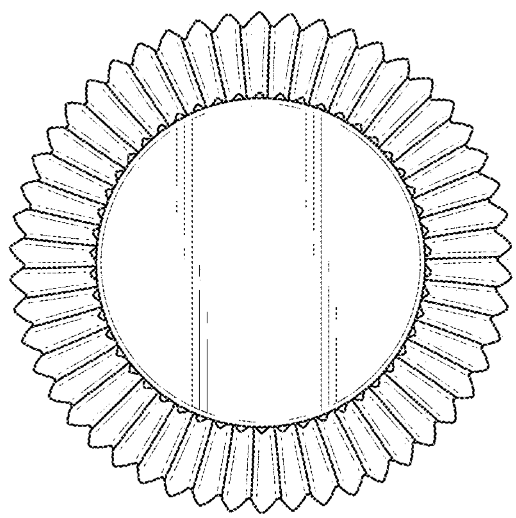


FIG. 7

Chapter 4

Selecting a Form of Business Ownership

The Ice Cream Men

Who would have thought it? Two ex-hippies with strong interests in social activism would end up starting one of the best-known ice cream companies in the country—Ben & Jerry's. Perhaps it was meant to be. It seems that Ben Cohen (the "Ben" of Ben & Jerry's) always had a fascination with ice cream. As a child, he made his own ice cream mixtures by smashing his favorite cookies and candies into his ice cream. But it wasn't until his senior year in high school that he became an official "ice cream man," happily driving his truck through neighborhoods filled with kids eager to buy his ice cream pops. After high school, Ben tried college but it wasn't for him. He attended Colgate University for a year and a half before he dropped out to return to his real love: being an ice cream man. He tried college again—this time at Skidmore, where he studied pottery and jewelry making—but, in spite of his selection of courses, still didn't like it.

In the meantime, Jerry Greenfield (the "Jerry" of Ben & Jerry's) was following a similar path. He majored in premed at Oberlin College and hoped to become a doctor. But he had to give up on this goal when he was not accepted into medical school. On a positive note, though, his college education steered him into a more lucrative field: the world of ice cream making. He got his first peek at the ice cream industry when he worked as a scooper in the student cafeteria at Oberlin. So, fourteen years after they met, Ben and Jerry reunited and decided to go into ice cream making big time. They moved to Burlington, Vermont—a college town in need of an ice cream parlor—and completed a $5 correspondence course from Penn State on making ice cream (they were practically broke at the time so they split the course). After getting an A in the course—not surprising, given that the tests were open book—they took the plunge: with their life savings of $8,000 (plus $4,000 of borrowed funds) they set up an ice cream scoop shop in a made-over gas station on a busy street corner in Burlington. The next big decision was which form of business ownership was best for them. This chapter introduces you to their options.

What's your favorite Ben & Jerry's flavor?

Source: http://en.wikipedia.org/wiki/File:BenJerry-UnitedSquare.jpg.

4.1 Factors to Consider

LEARNING OBJECTIVE

1. Identify the questions to ask in choosing the appropriate form of ownership for a business.

If you're starting a new business, you have to decide which legal form of ownership is best for you and your business. Do you want to own the business yourself and operate as a sole proprietorship? Or, do you want to share ownership, operating as a partnership or a corporation? Before we discuss the pros and cons of these three types of ownership—sole proprietorship, partnership, and corporation—let's address some of the questions that you'd probably ask yourself in choosing the appropriate legal form for your business.

1. What are you willing to do to set up and operate your business? Do you want to minimize the costs of getting started? Do you hope to avoid complex government regulations and reporting requirements?
2. How much control would you like? Do you want to own the company yourself, or do you want to share ownership with other people? Are you willing to share responsibility for running the business?

3. Do you want to be the sole benefactor of your efforts or are you willing to share profits with other people? Do you want to be in charge of deciding how much of the company's profits will be retained in the business?
4. Do you want to avoid special taxes? Do you want to avoid paying "business" income taxes on your business and then paying "personal" income taxes on profits earned by the business?
5. Do you have all the skills needed to run the business? Do you possess the talent and skills to run the business yourself, or would the business benefit from a diverse group of owners? Are you likely to get along with co-owners over an extended period of time?
6. Should it be possible for the business to continue without you? Is it important to you that the business survive you? Do you want to know that other owners can take over if you die or become disabled? Do you want to make it easy for ownership to change hands?
7. What are your financing needs? How do you plan to finance your company? Will you need a lot of money to start, operate, and grow your business? Can you furnish the money yourself, or will you need some investment from other people? Will you need bank loans? If so, will you have difficulty getting them yourself?
8. How much liability exposure are you willing to accept? Are you willing to risk your personal assets —your bank account, your car, maybe even your home—for your business? Are you prepared to pay business debts out of your personal funds? Do you feel uneasy about accepting personal liability for the actions of fellow owners?

No single form of ownership will give you everything you desire. You'll have to make some trade-offs. Because each option has both advantages and disadvantages, your job is to decide which one offers the features that are most important to you. In the following sections we'll compare the three ownership options (sole proprietorship, partnership, corporation) on the eight dimensions that we identified previously: setup costs and government regulations control, profit sharing, income taxes, skills, continuity and transferability, ability to obtain financing, and liability exposure.

KEY TAKEAWAYS

- Some of the questions that you'd probably ask yourself in choosing the appropriate legal form for your business include the following:

    1. *What are you willing to do to set up and operate your business*?
    2. *How much control do you want*?
    3. *Do you want to share profits with others*?
    4. *Do you want to avoid special taxes on your business*?
    5. *Do you have all the skills needed to run the business*?

6. *Should it be possible for the business to continue without you?*
7. *What are your financing needs?*
8. *How much liability exposure are you willing to accept?*

- No single form of ownership—sole proprietorship, partnership, or corporation—will give you everything you want. Each has advantages and disadvantages.

EXERCISE

(AACSB) Analysis

Review the eight questions identified in this section that you'd probably ask yourself in choosing the appropriate legal form. Rate each of the questions using this scale: [1] not at all important; [2] not very important; [3] somewhat important; [4] very important; [5] extremely important. Select the two questions that are most important to you and the two questions that are least important to you, and explain your responses to these four questions.

4.2 Sole Proprietorship

LEARNING OBJECTIVE

1. Describe the sole proprietorship form of organization, and specify its advantages and disadvantages.

A **sole proprietorship** is a business owned by only one person. The most common form of ownership, it accounts for about 72 percent of all U.S. businesses."Number of Tax Returns, Receipts, and Net Income by Type of Business," The 2012 Statistical Abstract: The National Data Book, January 30, 2011, http://www.census.gov/compendia/statab/cats/business_enterprise/sole_proprietorships_partnerships_corporations.html (accessed January 27, 2012). It's the easiest and cheapest type of business to form: if you're using your own name as the name of your business, you just need a license to get started, and once you're in business, you're subject to few government regulations.

Advantages and Disadvantages of Sole Proprietorships

As sole owner, you have complete control over your business. You make all important decisions, and you're generally responsible for all day-to-day activities. In exchange for assuming all this responsibility, you get all the income earned by the business. Profits earned are taxed as personal income, so you don't have to pay any special federal and state income taxes.

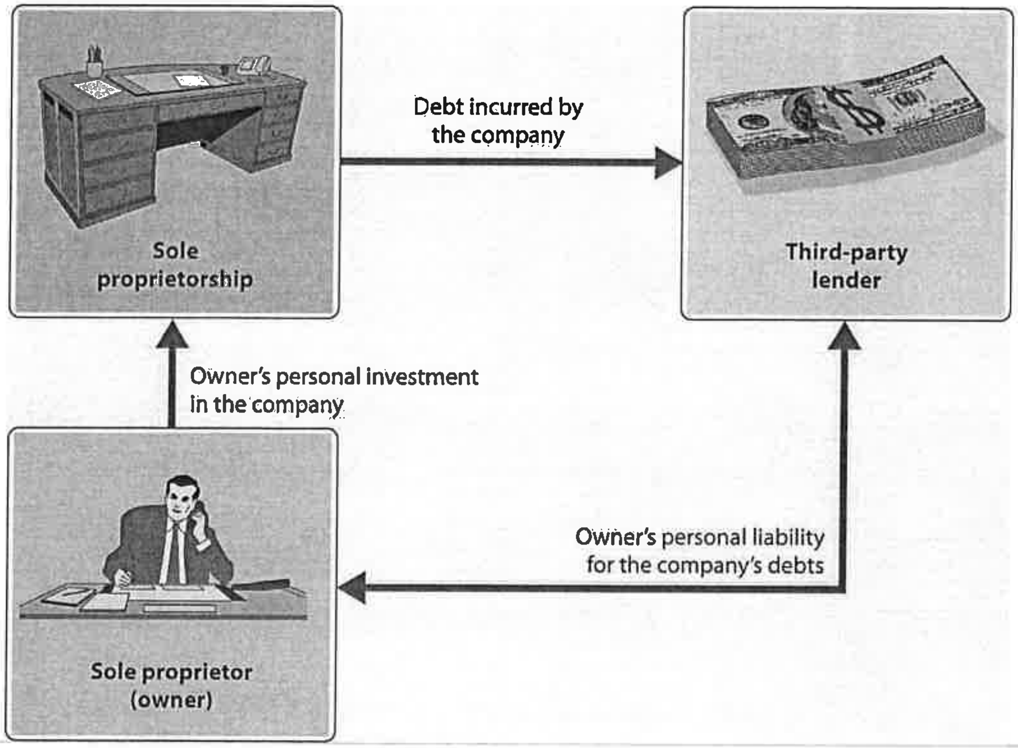
For many people, however, the sole proprietorship is not suitable. The flip side of enjoying complete control, for example, is having to supply all the different talents that may be necessary to make the business a success. And if you die, the business dissolves. You also have to rely on your own resources for financing: in effect, you *are* the business, and any money borrowed by the business is loaned to *you personally*. Even more important, the sole proprietor bears **unlimited liability** for any losses incurred by the business. As you can see from Figure 4.2 "Sole Proprietorship and Unlimited Liability", the principle of unlimited personal liability means that if the *company* incurs a debt or suffers a catastrophe (say, getting sued for causing an injury to someone), the *owner* is personally liable. As a sole proprietor, you put your personal assets (your bank account, your car, maybe even your home) at risk for the sake of your business. You can lessen your risk with insurance, yet your liability exposure can still be substantial. Given that Ben and Jerry decided to start their ice cream business together (and therefore the business was not owned by only one person), they could not set their company up as a sole proprietorship.

Figure 4.1

Sole proprietors enjoy complete control but also face increased risks.

© 2010 Jupiterimages Corporation

Figure 4.2 Sole Proprietorship and Unlimited Liability



KEY TAKEAWAYS

- A **sole proprietorship** is a business owned by only one person.
- It's the most common form of ownership and accounts for about 72 percent of all U.S. businesses.
- Advantages of a sole proprietorship include the following:

  1. Easy and inexpensive to form; few government regulations
  2. Complete control over your business
  3. Get all the profits earned by the business
  4. Don't have to pay any special income taxes

- Disadvantages of a sole proprietorship include the following:

  1. Have to supply all the different talents needed to make the business a success
  2. If you die, the business dissolves
  3. Have to rely on your own resources for financing
  4. If the company incurs a debt or suffers a catastrophe, you are personally liable (you have unlimited liability)

EXERCISE

(AACSB) Communication

Talk with a sole proprietor about his or her selected form of business ownership. Ask him or her which of the following dimensions (discussed in this section) were important in deciding to operate as a proprietor: setup costs and government regulations, control, profit sharing, income taxes, skills, continuity and transferability, ability to obtain financing, and liability exposure. Write a report detailing what you learned from the business owner.

4.3 Partnership

LEARNING OBJECTIVES

1. Identify the different types of partnerships, and explain the importance of a partnership agreement.
2. Describe the advantages and disadvantages of the partnership form of organization.

A **partnership (or general partnership)** is a business owned jointly by two or more people. About 10 percent of U.S. businesses are partnerships,"Number of Tax Returns, Receipts, and Net Income by Type of Business," The 2012 Statistical Abstract: The National Data Book, January 30, 2011, http://www.census.gov/compendia/statab/cats/business_enterprise/sole_proprietorships_partnerships_corporations.html (accessed January 27, 2012). and though the vast majority are small, some are quite large. For example, the big four public accounting firms are partnerships. Setting up a partnership is more complex than setting up a sole proprietorship, but it's still relatively easy and inexpensive. The cost varies according to size and complexity. It's possible to form a simple partnership without the help of a lawyer or an accountant, though it's usually a good idea to get professional advice. Professionals can help you identify and resolve issues that may later create disputes among partners.

The Partnership Agreement

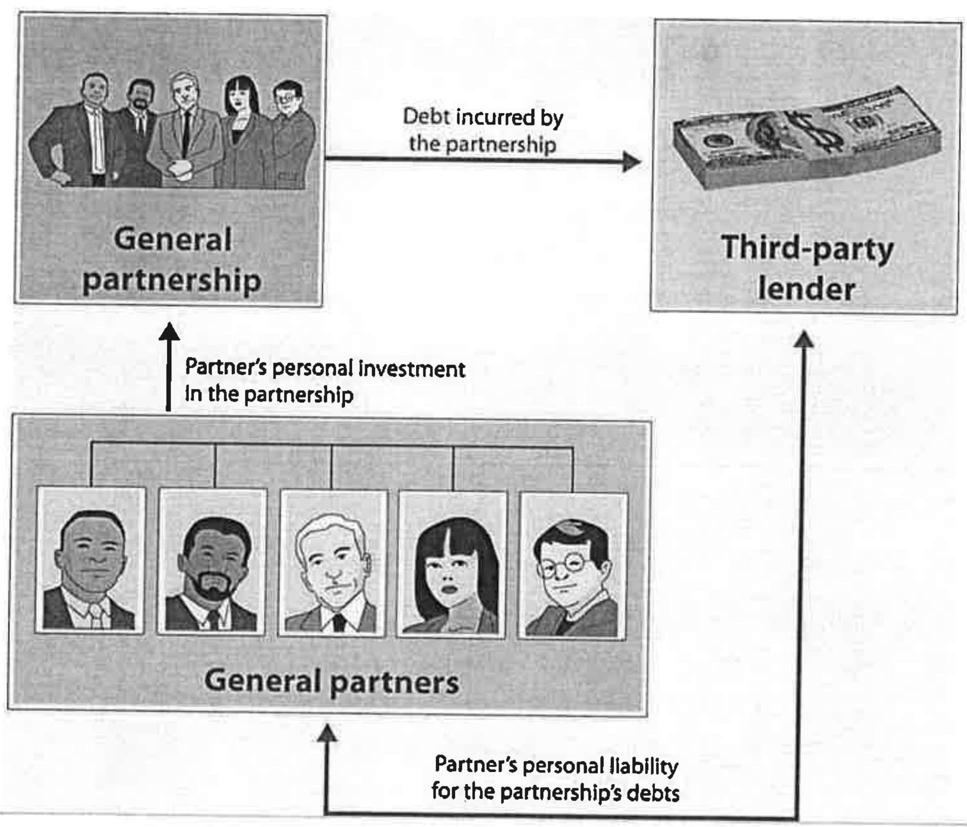
The impact of disputes can be lessened if the partners have executed a well-planned *partnership agreement* that specifies everyone's rights and responsibilities. The agreement might provide such details as the following:

- Amount of cash and other contributions to be made by each partner
- Division of partnership income (or loss)
- Partner responsibilities—who does what
- Conditions under which a partner can sell an interest in the company
- Conditions for dissolving the partnership
- Conditions for settling disputes

Unlimited Liability and the Partnership

Figure 4.3 "General Partnership and Unlimited Liability" shows that a major problem with partnerships, as with sole proprietorships, is unlimited liability: each partner is personally liable not only for his or her own actions but also for *the actions of all the partners*. In a partnership, it may work according to the following scenario. Say that you're a partner in a dry cleaning business. One day, you return from lunch to find your establishment on fire. You're intercepted by your partner, who tells you that the fire started because he fell asleep while smoking. As you watch your livelihood go up in flames, your partner tells you something else: because he forgot to pay the bill, your fire insurance was canceled. When it's all over, you estimate the loss to the building and everything inside at $1.2 million. And here's the really bad news: if the business doesn't have the cash or other assets to cover losses, *you can be personally sued for the amount owed*. In other words, any party who suffered a loss because of the fire can go after your personal assets.

Figure 4.3 General Partnership and Unlimited Liability



Limited Partnerships

Many people are understandably reluctant to enter into partnerships because of unlimited liability. Individuals with substantial assets, for example, have a lot to lose if they get sued for a partnership obligation (and when people sue, they tend to start with the richest partner). To overcome this defect of partnerships, the law permits a **limited partnership**, which has two types of partners: a single *general partner* who runs the business and is responsible for its liabilities, and any number of *limited partners* who have limited involvement in the business and whose losses are limited to the amount of their investment.

Advantages and Disadvantages of Partnerships

The partnership has several advantages over the sole proprietorship. First, it brings together a diverse group of talented individuals who share responsibility for running the business. Second, it makes financing easier: The business can draw on the financial resources of a number of individuals. The partners not only contribute funds to the business but can also use personal resources to secure bank loans. Finally, continuity needn't be an issue because partners can agree legally to allow the partnership to survive if one or more partners die.

Still, there are some negatives. First, as discussed earlier, partners are subject to unlimited liability. Second, being a partner means that you have to share decision making, and many people aren't comfortable with that situation. Not surprisingly, partners often have differences of opinion on how to run a business, and disagreements can escalate to the point of actual conflict; in fact, they can even jeopardize the continuance of the business. Third, in addition to sharing ideas, partners also share profits. This arrangement can work as long as all partners feel that they're being rewarded according to their efforts and accomplishments, but that isn't always the case.

Figure 4.4

Partnerships can have many advantages, but there are disadvantages to consider as well.

While the partnership form of ownership is viewed negatively by some, it was particularly appealing to Ben Cohen and Jerry Greenfield. Starting their ice cream business as a partnership was inexpensive and let them combine their limited financial resources and use their diverse skills and talents. As friends they trusted each other and welcomed shared decision making and profit sharing. They were also not reluctant to be held personally liable for each other's actions.

KEY TAKEAWAYS

- A general partnership is a business owned jointly by two or more people.
- About 10 percent of U.S. businesses are partnerships.
- The impact of disputes can be reduced if the partners have a partnership agreement that specifies everyone's rights and responsibilities.
- A partnership has several advantages over a sole proprietorship:
    - It's relatively inexpensive to set up and subject to few government regulations.
    - Partners pay personal income taxes on their share of profits; the partnership doesn't pay any special taxes.
    - It brings a diverse group of people together to share managerial responsibilities.
    - Partners can agree legally to allow the partnership to survive if one or more partners die.
    - It makes financing easier because the partnership can draw on resources from a number of partners.
- A partnership has several disadvantages over a sole proprietorship:
    - Shared decision making can result in disagreements.
    - Profits must be shared.
    - Each partner is personally liable not only for his or her own actions but also for those of all partners—a principle called **unlimited liability**.
- A **limited partnership** has a single general partner who runs the business and is responsible for its liabilities, plus any number of limited partners who have limited involvement in the business and whose losses are limited to the amount of their investment.

EXERCISE

(AACSB) Analysis

Grand Canyon Helicopter Adventures was started five years ago by Jayden Collins. The business has grown over the years, but is at a standstill now. Jayden would like to expand his business, but needs additional funds to do this. Also, he could really use help running the business. Though he is an excellent pilot with a perfect safety record, he's not very good at handling the day-to-day details needed to keep the business running smoothly. A friend of his, Rob Tocci, approached him recently and asked to join him in the business. Rob is fairly wealthy and has considerable business experience. Plus, he knows how to fly choppers—though he has had a few (thankfully nonfatal) mishaps. Jayden is a little apprehensive about sharing responsibility for running the business, but he doesn't mind sharing profits. On the other hand, he recognizes that he alone will not be able to grow the business.

Because Jayden doesn't want to incorporate, he has only two options: continue doing business as a sole proprietorship or find someone to join him in a partnership. You should evaluate these two alternatives, discuss the advantages and disadvantages of each option, and recommend the one you consider most appropriate. If you recommend forming a partnership, distinguish between a limited and a general partnership.

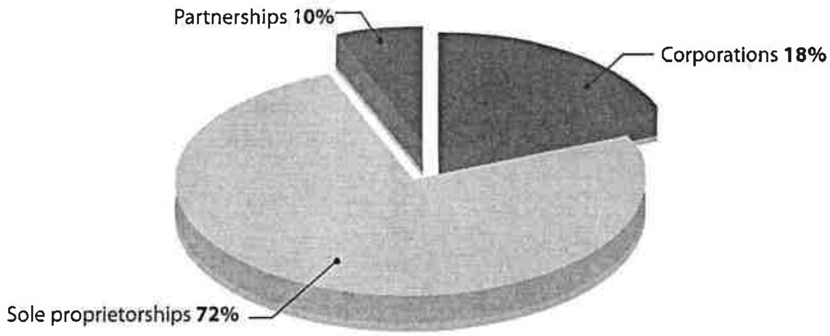
4.4 Corporation

LEARNING OBJECTIVES

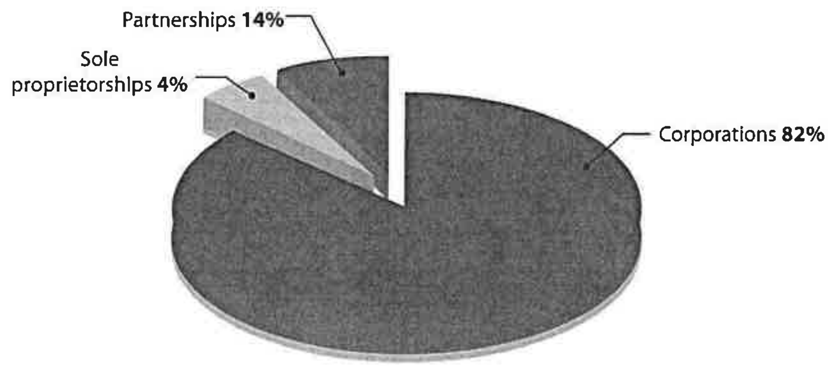
1. Explain how corporations are formed and how they operate.
2. Discuss the advantages and disadvantages of the corporate form of ownership.

A **corporation** (sometimes called a *regular* or C-corporation) differs from a sole proprietorship and a partnership because it's a legal entity that is entirely separate from the parties who own it. It can enter into binding contracts, buy and sell property, sue and be sued, be held responsible for its actions, and be taxed. As Figure 4.5 "Types of U.S. Businesses" shows, corporations account for 18 percent of all U.S. businesses but generate almost 82 percent of the revenues."Number of Tax Returns, Receipts, and Net Income by Type of Business," The 2012 Statistical Abstract: The National Data Book, January 30, 2011, http://www.census.gov/compendia/statab/cats/business_enterprise/sole_proprietorships_partnerships_corporations.html (accessed January 27, 2012). Most large well-known businesses are corporations, but so are many of the smaller firms with which you do business.

Figure 4.5 Types of U.S. Businesses



Number of businesses



Sales revenue

Source: "Number of Tax Returns, Receipts, and Net Income by Type of Business," The 2011 Statistical Abstract: The National Data Book, http://www.census.gov/compendia/statab/cats/business_enterprise/sole_proprietorships_partnerships_corporations.html *(accessed August 27, 2011); "Number of Tax Returns and Business Receipts by Size of Receipts," The 2011 Statistical Abstract: The National Data Book,* http://www.census.gov/compendia/statab/cats/business_enterprise/sole_proprietorships_partnerships_corporations.html *(accessed August 27, 2011).*

Ownership and Stock

Corporations are owned by **shareholders** who invest money in the business by buying shares of **stock**. The portion of the corporation they own depends on the percentage of stock they hold. For example, if a corporation has issued 100 shares of stock, and you own 30 shares, you own 30 percent of the company. The shareholders elect a **board of directors**, a group of people (primarily from outside the corporation) who are legally responsible for governing the corporation. The board oversees the major policies and decisions made by the corporation, sets goals and holds management accountable for achieving them, and hires and evaluates the top executive, generally called the CEO (chief executive officer). The board also approves the distribution of income to shareholders in the form of cash payments called **dividends**.

Benefits of Incorporation

The corporate form of organization offers several advantages, including limited liability for shareholders, greater access to financial resources, specialized management, and continuity.

Limited Liability

The most important benefit of incorporation is the **limited liability** to which shareholders are exposed: they are not responsible for the obligations of the corporation, and they can lose *no more than the amount that they have personally invested in the company*. Clearly, limited liability would have been a big plus for the unfortunate individual whose business partner burned down their dry cleaning establishment. Had they been incorporated, the *corporation* would have been liable for the debts incurred by the fire. If the corporation didn't have enough money to pay the debt, the individual shareholders would not have been obligated to pay anything. True, they would have lost all the money that they'd invested in the business, but no more.

Financial Resources

Incorporation also makes it possible for businesses to raise funds by selling stock. This is a big advantage as a company grows and needs more funds to operate and compete. Depending on its size and financial strength, the corporation also has an advantage over other forms of business in getting bank loans. An established corporation can borrow its own funds, but when a small business needs a loan, the bank usually requires that it be guaranteed by its owners.

Specialized Management

Because of their size and ability to pay high sales commissions and benefits, corporations are generally able to attract more skilled and talented employees than are proprietorships and partnerships.

Continuity and Transferability

Another advantage of incorporation is continuity. Because the corporation has a legal life separate from the lives of its owners, it can (at least in theory) exist forever. Transferring ownership of a corporation is easy: shareholders simply sell their stock to others. Some founders, however, want to restrict the transferability of their stock and so choose to operate as a **privately-held corporation**. The stock in these corporations is held by only a few individuals, who are not allowed to sell it to the general public. Companies with no such restrictions on stock sales are called **public corporations**; stock is available for sale to the general public.

Drawbacks to Incorporation

Like sole proprietorships and partnerships, corporations have both positive and negative properties. In sole proprietorships and partnerships, for instance, the individuals who own and manage a business are the same people. Corporate managers, however, don't necessarily own stock, and shareholders don't necessarily work for the company. This situation can be troublesome if the goals of the two groups differ significantly. Managers, for example, might be more interested in career advancement than the overall profitability of the company. Stockholders might care about profits without regard for the well-being of employees.

Another drawback to incorporation—one that often discourages small businesses from incorporating —is the fact that corporations are costly to set up. When you combine filing and licensing fees with accounting and attorney fees, incorporating a business could set you back by $1,000 to $6,000 or more depending on the size and scope of your business."How Much Does It Cost to Incorporate?" *San Francisco Chronicle*, http://allbusiness.sfgate.com/legal/contracts-agreements-incorporation/2531-1.html (accessed August 27, 2011). Additionally, corporations are subject to levels of regulation and governmental oversight that can place a burden on small businesses. Finally, corporations are subject to what's generally called "double taxation." Corporations are taxed by the federal and state governments on their earnings. When these earnings are distributed as dividends, the shareholders pay taxes on these dividends. Corporate profits are thus taxed twice—the corporation pays the taxes the first time and the shareholders pay the taxes the second time.

Five years after starting their ice cream business, Ben Cohen and Jerry Greenfield evaluated the pros and cons of the corporate form of ownership, and the "pros" won. The primary motivator was the need to raise funds to build a $2 million manufacturing facility. Not only did Ben and Jerry decide to switch from a partnership to a corporation, but they also decided to sell shares of stock to the public (and thus become a public corporation). Their sale of stock to the public was a bit unusual: Ben and Jerry wanted the community to own the company, so instead of offering the stock to anyone interested in buying a share, they offered stock to residents of Vermont only. Ben believed that "business has a responsibility to give back to the community from which it draws its support."Fred Chico Lager, *Ben & Jerry's: The Inside Scoop* (New York: Crown Publishers, 1994), 91. He wanted the company to be owned by those who lined up in the gas station to buy cones. The stock was so popular that one in every hundred Vermont families bought stock in the company.Fred Chico Lager, *Ben & Jerry's: The Inside Scoop* (New York: Crown Publishers, 1994), 103. Eventually, as the company continued to expand, the stock was sold on a national level.

KEY TAKEAWAYS

- A **corporation** (sometimes called a *regular* or C-corporation) is a legal entity that's separate from the parties who own it.
- Corporations are owned by **shareholders** who invest money in them by buying shares of **stock**.
- They elect a **board of directors** that's legally responsible for governing the corporation.

- A corporation has several advantages over a sole proprietorship and partnership:

    - An important advantage of incorporation is **limited liability**: Owners are not responsible for the obligations of the corporation and can lose no more than the amount that they have personally invested in the company.
    - Incorporation also makes it easier to access financing.
    - Because the corporation is a separate legal entity, it exists beyond the lives of its owners.
    - Corporations are generally able to attract skilled and talented employees.

- A corporation has several disadvantages over a sole proprietorship and partnership:

    - The goals of corporate managers, who don't necessarily own stock, and shareholders, who don't necessarily work for the company, can differ.
    - It's costly to set up and subject to burdensome regulations and government oversight.
    - It's subject to "double taxation." Corporations are taxed on their earnings. When these earnings are distributed as dividends, the shareholders pay taxes on these dividends.

EXERCISE

(AACSB) Analysis

SolarBike Company was formed as a partnership ten years ago by three sisters-in-law: Peg McLaughlin, Terry McLaughlin, and Joanie McLaughlin. All three worked diligently to design and produce the SolarBike: an electric bicycle propelled by the sun's rays. The good news is that the bike is a big hit with environmentalists and last year's sales reached $2 million. The bad news is that to keep up with growing demand for the bike, the company must expand its capacity at a cost of $1 million. Even though the company is doing well, it's unlikely that the partnership could get the needed $1 million in funds from a bank.

The company's predicament was discussed at a recent partnership meeting. Not only were the three partners unwilling to lend the company any more money, but also they voiced concern about being held responsible for their own actions as well as for all the partners' actions. Peg asked the group to consider incorporating and raising funds through the sale of stock. Joanie supported this idea, but Terry was against it.

The three partners hired you as a consultant to advise them on whether to remain as a partnership or to form a private corporation. In addition to your recommendation, you should discuss the advantages and disadvantages of both forms of organization and explain how they apply to SolarBike Company's situation.

4.5 Other Types of Business Ownership

LEARNING OBJECTIVE

1. Examine special types of business ownership, including S-corporations, limited-liability companies, cooperatives, and not-for-profit corporations.

In addition to the three commonly adopted forms of business organization—sole proprietorship, partnership, and regular corporations—some business owners select other forms of organization to meet their particular needs. We'll look at several of these options:

- S-corporations
- Limited-liability companies
- Cooperatives
- Not-for-profit corporations

Hybrids: S-Corporations and Limited-Liability Companies

To understand the value of S-corporations and limited-liability companies, we'll begin by reviewing the major advantages and disadvantages of the three types of business ownership we've explored so far: sole proprietorship, partnership, and corporation. Identifying the attractive and unattractive features of these three types of business ownership will help us appreciate why S-corporations and limited-liability companies were created.

Attractive and Unattractive Features of Corporations

What feature of corporations do business owners find **most attractive**? The most attractive feature of a corporation is limited liability, which means that the shareholders (owners) cannot be held personally liable for the debts and obligations of the corporation. For example, if a corporation cannot pay its debts and goes bankrupt, the shareholders will not be required to pay the creditors with their own money. Shareholders cannot lose any more than the amount they have invested in the company.

What feature of corporations do business owners find **least attractive**? Most would agree that the least attractive feature of a corporation is "double taxation." Double taxation occurs when the same earnings are taxed twice by the government. Let's use a simple example to show how this happens. You're the only shareholder in a very small corporation. This past year it earned $10,000. It had to pay the government $3,000 corporate tax on the $10,000 earned. The remaining $7,000 was paid to you by the corporation in the form of a dividend. When you filed your personal income tax form, you had to pay personal taxes on the $7,000 dividend. So the $7,000 was taxed twice: the corporation paid the taxes the first time and you (the shareholder) paid the taxes the second time.

Attractive and Unattractive Features of Sole Proprietorships and Partnerships

Now let's turn to the other two types of business ownership: sole proprietorship and partnership. What feature of these forms of business organization do owners find **most attractive**? The most attractive feature is that there is **no** "double taxation" with proprietorships and partnerships. Proprietorships and partnerships do not pay taxes on profits at the business level. The only taxes paid are at the personal level—this occurs when proprietors and partners pay taxes on their share of their company's income. Here are two examples (one for a sole proprietorship and one for a partnership). First, let's say you're a sole proprietor and your business earns $20,000 this year. The sole proprietorship pays no taxes at the "business" level. You pay taxes on the $20,000 earnings on your personal tax return. Second, let's say you're a partner in a three-partner firm (in which each partner receives one-third of the partnership income). The firm earns $90,000 this year. It pays no taxes at the partnership level. Each partner, including you, pays taxes on one-third of the earnings, or $30,000 each. Notice that in both cases, there is no "double taxation." Taxes were paid on the company earnings only once—at the personal level. So the total tax burden is less with sole proprietorships and partnerships than it is with corporations.

What feature of sole proprietorships and partnerships do business owners find **least attractive**? And the answer is...unlimited liability. This feature holds a business owner personally liable for all debts of his or her company. If you're a sole proprietorship and the debts of your business exceed its assets, creditors can seize your personal assets to cover the proprietorship's outstanding business debt. For example, if your business is sued for $500,000 and it does not have enough money to cover its legal obligation, the injured party can seize your personal assets (cash, property, etc.) to cover the outstanding debt. Unlimited liability is even riskier in the case of a partnership. Each partner is personally liable not only for his or her own actions but also for the actions of all the partners. If, through mismanagement by one of your partners, the partnership is forced into bankruptcy, the creditors can go after you for all outstanding debts of the partnership.

The Hybrids

How would you like a legal form of organization that provides the attractive features of the three common forms of organization (corporation, sole proprietorship and partnership) and avoids the unattractive features of these three organization forms? It sounds very appealing. This is what was accomplished with the creation of two hybrid forms of organization: **S-corporation** and **limited-liability company**. These hybrid organization forms provide business owners with limited liability (the attractive feature of corporations) and no "double taxation" (the attractive feature of sole proprietorships and partnerships). They avoid double taxation (the unattractive feature of corporations) and unlimited liability (the unattractive feature of sole proprietorships and partnerships). We'll now look at these two hybrids in more detail.

S-Corporation

In 1970, Karen and Mike Tocci, avid go-kart racing fans, bought a parcel of land in New Hampshire so their son, Rob, and his son's friends could drag race in a safe environment. The Tocci's continued interest in racing resulted in their starting a family-run business called Shannon Dragway. Over time, the business expanded to include a speedway track and a go-kart track and was renamed New Hampshire Motorsports Complex. In selecting their organization form, the Tocci's wanted to accomplish two main goals: (1) limit their personal liability; and (2) avoid having their earnings taxed twice, first at the corporate level and again at the personal level. An S-corporation form of business achieved these goals. They found they were able to meet the following S-corporation eligibility criteria:

- The company has no more than 100 shareholders
- All shareholders are individuals, estates, or certain nonprofits or trusts
- All shareholders are U.S. citizens and permanent residents of the U.S.
- The business is not a bank or insurance company
- All shareholders concur with the decision to form an S-corporation

Deciding to operate as an S-corporation presented the Tocci's with some disadvantages: They had no flexibility in the way profits were divided among the owners. In an S-corporation, profits must be allocated based on percentage ownership. So if an owner/shareholder holds 25 percent of the stock in the S-corporation, 25 percent of the company profits are allocated to this shareholder regardless of the amount of effort he or she exerts in running the business. Additionally, the owners had to follow a number of formal procedures, such as electing a board of directors and holding annual meetings. Finally, they were subjected to heavy recordkeeping requirements. Despite these disadvantages, the Tocci's concluded that on balance the S-corporation was the best form of organization for their business.

Limited-Liability Company

In 1977, Wyoming was the first state to allow businesses to operate as limited-liability companies. Twenty years later, in 1997, Hawaii was the last state to give its approval to the new organization form. Since then, the limited-liability company has increased in popularity. Its rapid growth was fueled in part by changes in state statutes that permit a limited-liability company to have just one member. The trend to LLCs can be witnessed by reading company names on the side of trucks or on storefronts in your city. It is common to see names such as Jim Evans Tree Care, LLC, and For-Cats-Only Veterinary Clinic, LLC. But LLCs are not limited to small businesses. Companies such as Crayola, Domino's Pizza, Ritz-Carlton Hotel Company, and iSold It (which helps people sell their unwanted belongings on eBay) are operating under the limited-liability form of organization.

In many ways, a limited-liability company looks a lot like an S-corporation. Its owners (called members rather than shareholders) are not personally liable for debts of the company, and its earnings are taxed only once, at the personal level (thereby eliminating double taxation). But there are important differences between the two forms of organizations. For example, an LLC:

1. Has fewer ownership restrictions. It can have as many members as it wants—it is not restricted to a maximum of 100 shareholders.
2. Its members don't have to be U.S. residents or citizens.
3. Profits do not have to be allocated to owners based on percentage ownership. Members can distribute profits in any way they want.
4. Is easier to operate because it doesn't have as many rules and restrictions as does an S-corporation. It doesn't have to elect a board of directors, hold annual meetings, or contend with a heavy recordkeeping burden.

As the approach used to allocate profits is very important (item 3 described previously), let's spend a few minutes going over an example of how the profit allocation process works. Let's say that you and a business partner started a small pet grooming business at the beginning of the year. Your business partner (who has more money than you do) contributed $40,000 to start-up the business and you contributed $10,000 (so your partner's percentage ownership in the business is 80 percent and yours is 20 percent). But your business partner has another job and so you did 90 percent of the work during the past year. Profit for the first year was $100,000. If your company was set up as a S-corporation, you would be required to allocate profits based on percentage ownership. Under this allocation scheme $80,000 of the profits would be allocated to your business partner and only $20,000 would be allocated to you. This hardly seems fair. Under the limited-liability form of organization you and your partner can decide what is a "fair" allocation of profits and split the profits accordingly. Perhaps you will decide that you should get 70 percent of the profits (or $70,000) and your business partner should get 30 percent (or $30,000).

Now, let's look at the fourth item—ease of operation. It is true that S-corporations have to deal with more red tape and paperwork and abide by more rules (such as holding annual meetings) than do limited-liability companies. Plus they are more complex to set up. But this does not mean that setting up and operating a limited-liability company is a breeze and should be taken lightly. One essential task that should be carefully attended to is the preparation of an operating agreement. This document, which is completed when the company is formed (and can be revised later), is essential to the success of the business. It describes the rights and responsibilities of the LLC members and spells out how profits or losses will be allocated.

We have touted the benefits of limited liability protection for an LLC (as well as for regular corporations and S-corporations). We now need to point out some circumstances under which an LLC member (or shareholder in a corporation) might be held personally liable for the debts of his or her company. A business owner can be held personally liable if he or she:

- Personally guarantees a business debt or bank loan which the company fails to pay
- Fails to pay employment taxes to the government that were withheld from workers' wages
- Engages in fraudulent or illegal behavior that harms the company or someone else
- Does not treat the company as a separate legal entity, for example, uses company assets for personal uses

As personal loan guarantees are the most common circumstance under which an LLC member is held personally liability for the debts of his or her company, let's explore this topic some more by asking (and answering) two questions:

1. **What is a loan guarantee?** It is a legal agreement made between an individual and a bank that says, "If my company does not repay this loan, I will." It is the same thing as co-signing a loan.
2. **Why would an LLC member give a bank a personal guarantee?** Because it is often the only way a business can get a loan. Bankers understand the concept of limited liability. They know that if the company goes out of business (and the loan is not guaranteed), the bank is stuck with

an unpaid loan because the LLC members are not personally liability for the debts of the company. Consequently, banks are reluctant to give loans to companies (particularly those just starting up) unless the loans are guaranteed by an owner.

A final note about hybrid forms of organization. In this section, we have looked at two organization forms that offer business owners limited liability and tax benefits. There are others not covered here such as Professional Limited-Liability Companies (PLLCs), which are set up by doctors, lawyers, accountants, and so on who provide professional services. And it is evident that the variations of organization forms available to businesses will continue to expand in the future.

Cooperatives

A **cooperative** (also known as a co-op) is a business owned and controlled by those who use its services. Individuals and firms who belong to the cooperative join together to market products, purchase supplies, and provide services for its members. If run correctly, cooperatives increase profits for its producer-members and lower costs for its consumer-members. Cooperatives are common in the agricultural community. For example, some 750 cranberry and grapefruit member growers market their cranberry sauce, fruit juices, and dried cranberries through the Ocean Spray Cooperative.Ocean Spray History (company Web site, about us, history), http://www.oceanspray.com/about/cranberry_history.aspx (accessed June 19, 2008). More than three hundred thousand farmers obtain products they need for production—feed, seed, fertilizer, farm supplies, fuel—through the Southern States Cooperative.Corporate information, Southern States Cooperative, http://www.southernstates.com/sscinfo/about (accessed June 19, 2008). Co-ops also exist outside agriculture. For example, REI (Recreational Equipment Incorporated), which sells quality outdoor gear, is the largest consumer cooperative in the United States with more than three million active members. The company shares its financial success each year with its members, who get a refund each year based on their eligible purchases.2006 REI Stewardship Report, http://www.rei.com/aboutrei/csr/2006/coop.html (accessed June 19, 2008).

Not-for-Profit Corporations

A **not-for-profit corporation** (sometimes called a nonprofit) is an organization formed to serve some public purpose rather than for financial gain. As long as the organization's activity is for charitable, religious, educational, scientific, or literary purposes, it should be exempt from paying income taxes. Additionally, individuals and other organizations that contribute to the not-for-profit corporation can take a tax deduction for those contributions. The types of groups that normally apply for nonprofit status vary widely and include churches, synagogues, mosques, and other places of worship; museums; schools; and conservation groups.

There are more than 1.5 million not-for-profit organizations in the United States."Number of Nonprofit Organizations in the United States, 1999–2009," Urban Institute, National Center for Charitable Statistics, http://nccsdataweb.urban.org/PubApps/profile1.php?state=US (accessed August 27, 2011). Some are extremely well funded, such as the Bill and Melinda Gates Foundation, which has an endowment of approximately $38 billion and has given away $25.36 billion since its inception."Foundation Fact Sheet," The Bill and Melinda Gates Foundation, June 30, 2011, http://www.gatesfoundation.org/about/Pages/foundation-fact-sheet.aspx (accessed August 27, 2011). Others are nationally recognized, such as United Way, Goodwill Industries, Habitat for Humanity, and the Red Cross. Yet the vast majority is neither rich nor famous, but nevertheless makes significant contributions to society.

KEY TAKEAWAYS

- The **S-corporation** gives small business owners limited liability protection, but taxes company profits only once, when they are paid out as dividends. It can't have more than one hundred stockholders.
- A **limited-liability company** (LLC) is similar to an S-corporation: its members are not personally liable for company debts and its earnings are taxed only once, when they're paid out as dividends. But it has fewer rules and restrictions than does an S-corporation. For example, an LLC can have any number of members.
- A **cooperative** is a business owned and controlled by those who use its services. Individuals and firms who belong to the cooperative join together to market products, purchase supplies, and provide services for its members.
- A **not-for-profit corporation** is an organization formed to serve some public purpose rather than for financial gain. It enjoys favorable tax treatment.

EXERCISE

(AACSB) Analysis

Create a table comparing a regular corporation, an S-corporation, and a limited-liability company on these dimensions: limited-liability protection, double taxation, restrictions on number of stockholders or members, rules, and restrictions. If you and several of your friends owned an ice skating rink, which form of ownership would you select? Why? Which form of ownership would you select for Google?

4.6 Mergers and Acquisitions

LEARNING OBJECTIVE

1. Define mergers and acquisitions, and explain why companies are motivated to merge or acquire other companies.

The headline read, "Wanted: More than 2,000 in Google Hiring Spree."Alexei Oreskovic, "Wanted: More than 2,000 in Google Hiring Spree," Reuters, November 19, 2010, http://www.reuters.com/article/2010/11/19/us-google-idUSTRE6AI05820101119 (accessed August 28, 2011); "Help Wanted: Google Hiring in 2011," The Official Google Blog, January 25, 2011, http://googleblog.blogspot.com/2011/01/help-wanted-google-hiring-in-2011.html (accessed August 28, 2011). The largest Web search engine in the world was disclosing its plans to grow internally and increase its workforce by more than 2,000 people, with half of the hires coming from the United States and the other half coming from other countries. The added employees will help the company expand into new markets and battle for global talent in the competitive Internet information providers industry. When properly executed, internal growth benefits the firm.

An alternative approach to growth is to merge with or acquire another company. The rationale behind growth through merger or acquisition is that 1 + 1 = 3: the combined company is more valuable than the sum of the two separate companies. This rationale is attractive to companies facing competitive pressures. To grab a bigger share of the market and improve profitability, companies will want to become more cost efficient by combining with other companies.

Mergers and Acquisitions

Though they are often used as if they're synonymous, the terms *merger* and *acquisition* mean slightly different things. A **merger** occurs when two companies combine to form a new company. An **acquisition** is the purchase of one company by another with no new company being formed. An example of a *merger* is the merging in 2010 of United Airlines and Continental Airlines. The combined company, the largest carrier in the world, flies under the name United Airlines, but its planes display the Continental Airlines logo. The merger will combine the scale of United Airlines with the management culture of Continental. Another example of a fairly recent *acquisition* is the purchase of Reebok by Adidas for $3.8 billion.Theresa Howard, "Adidas, Reebok lace up for run at Nike," *US Today*, August 3, 2005, http://www.usatoday.com/money/industries/manufacturing/2005-08-02-adidas-usat_x.htm (accessed June 20, 2008). The deal was expected to give Adidas a stronger presence in North America and help the company compete with rival Nike. Though Adidas still sells shoes under the Reebok brand, Reebok as a company no longer exists.

Motives behind Mergers and Acquisitions

Companies are motivated to merge or acquire other companies for a number of reasons, including the following.

Gain Complementary Products

Acquiring complementary products was the motivation behind Adidas's acquisition of Reebok. As Adidas CEO Herbert Hainer stated in a conference call, "This is a once-in-a-lifetime opportunity. This is a perfect fit for both companies, because the companies are so complementary....Adidas is grounded in sports performance with such products as a motorized running shoe and endorsement deals with such superstars as British soccer player David Beckham. Meanwhile, Reebok plays heavily to the melding of sports and entertainment with endorsement deals and products by Nelly, Jay-Z, and 50 Cent. The combination could be deadly to Nike."Theresa Howard, "Adidas, Reebok lace up for run at Nike," *US Today*, August 3, 2005, http://www.usatoday.com/money/industries/manufacturing/2005-08-02-adidas-usat_x.htm (accessed June 20, 2008).

Figure 4.6

Do you think by acquiring Reebok, Adidas has had an impact on Nike's command of the running shoe market?

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Attain New Markets or Distribution Channels

Gaining new markets was a significant factor in the 2005 merger of US Airways and America West. US Airways is a major player on the East Coast, the Caribbean and Europe, while America West is strong in the West. The expectations were that combining the two carriers would create an airline that could reach more markets than either carrier could do on its own."America West, US Air in Merger Deal," CNNMoney.com, May 20, 2005, http://money.cnn.com/2005/05/19/news/midcaps/airlines/index.htm (accessed June 20, 2008).

Realize More Efficient Economies of Scale

The purchase of Pharmacia Corporation (a Swedish pharmaceutical company) by Pfizer (a research-based pharmaceutical company based in the United States) in 2003 created the world's largest drug maker and the leading pharmaceutical company, by revenue, in every major market around the globe.

The acquisition created an industry giant with more than $48 billion in revenue and a research-and-development budget of more than $7 billion.Robert Frank and Scott Hensley, "Pfizer to Buy Pharmacia For $60 Billion in Stock," Wall Street Journal Online, WJS.com, July 15, 2002, http://www.chelationtherapyonline.com/technical/p39.htm (accessed June 20, 2008). Each day, almost forty million people around the glove are treated with Pfizer medicines.About Pfizer, company Web site: Pfizer.com, http://www.pfizer.com/about/history/pfizer_pharmacia.jsp (accessed August 28, 2011). Its subsequent $68 billion purchase of rival drug maker Wyeth further increased its presence in the pharaceutical market."Pfizer Agrees to Pay $68 Billion for Rival Drug Maker Wyeth," *New York Times*, January 25, 2009, http://www.nytimes.com/2009/01/26/business/26drug.html?pagewanted=2 (accessed August 28, 2011).

Hostile Takeover

What happens, though, if one company wants to acquire another company, but that company doesn't want to be acquired? You can end up with a very unfriendly situation. The outcome could be a *hostile takeover*—an act of assuming control that's resisted by the targeted company's management and its board of directors. Ben Cohen and Jerry Greenfield found themselves in one of these unfriendly situations: Unilever—a very large Dutch/British company that owns three ice cream brands—wanted to buy Ben & Jerry's, against the founders' wishes. To make matters worse, most of the Ben & Jerry's stockholders sided with Unilever. They had little confidence in the ability of Ben Cohen and Jerry Greenfield to continue managing the company and were frustrated with the firm's social-mission focus. The stockholders liked Unilever's offer to buy their Ben & Jerry's stock at almost twice its current market price and wanted to take their profits and run. In the end, Unilever won; Ben & Jerry's was acquired by Unilever in a hostile takeover. Despite fears that the company's social mission would end, this didn't happen. Though neither Ben Cohen nor Jerry Greenfield are involved in the current management of the company, they have returned to their social activism roots and are heavily involved in numerous social initiatives sponsored by the company.

KEY TAKEAWAYS

- A **merger** occurs when two companies combine to form a new company.
- An **acquisition** is the purchase of one company by another with no new company being formed.
- Companies merge or acquire other companies to gain complementary products, attain new markets or distribution channels, and realize more-efficient economies of scale.
- A hostile takeover is an act of assuming control that is resisted by the targeted company's management and its board of directors.

EXERCISE

(AACSB) Analysis

Go online and research the merger of XM and Sirius. Why did the two satellite radio stations merge? Should this merger have been approved by the Federal Communications Commission? Whom does the merger help? Whom does it hurt? If you were the decision maker, would you approve the merger? Why, or why not?

4.7 Cases and Problems

LEARNING ON THE WEB (AACSB)

Do you have an idea for a charitable organization you'd like to start? Think of some cause that's important to you. Then go online and review this article by Joanne Fritz, "How to Incorporate as a Nonprofit: A Check List" located at http://nonprofit.about.com/od/nonprofitbasics/ht/startingsteps.htm. Draft a mission statement for your not-for-profit organization, and indicate the types of people you'd ask to serve on your board of directors. Then list the steps you'd take to set up your not-for-profit organization.

CAREER OPPORTUNITIES

Where Do You Find Happiness?

Have you given much thought to whether you'd be happier working for a small company or for a big one? Here's your chance to compare and contrast the opportunities that small companies and big companies offer. First, read the article "Company Research—Investigate Small Companies" (http://jobsearch.about.com/cs/employerresearch/a/compresearch.htm). Then read the article "Benefits of Working in a Small Company vs. a Corporation" (http://www.streetdirectory.com/travel_guide/190820/careers_and_job_hunting/benefits_of_working_in_a_small_company_vs_a_corporation.html).Alison Doyle, "Company Research—Investigate Small Companies," About.com: Job Searching, http://jobsearch.about.com/cs/employerresearch/a/compresearch.htm (accessed August 28, 2011); Tony Jacowsk, "Benefits of Working in a Small Company vs. a Corporation," Business Resources, http://www.streetdirectory.com/travel_guide/190820/careers_and_job_hunting/benefits_of_working _in_a_small_company_vs_a_corporation.html (accessed August 28, 2011). Identify five advantages of working for a small company and five advantages of working for a big one. Indicate your choice of employer (small or big company), and explain why you selected this option.

ETHICS ANGLE (AACSB)

Bermuda Is Beautiful, but Should You Incorporate There?

A company can incorporate in any state it chooses. Most small businesses incorporate in the state in which they do business, while larger companies typically hunt around for the state or country that gives them the most favorable treatment (lower taxes, fewer restrictions). A growing number of U.S. companies are incorporating in Bermuda to lower their corporate income taxes while still enjoying the benefits of doing business in the United States. Does this seem right to you? Read these two articles and answer the questions that follow:

- "U.S. Corporations Are Using Bermuda to Slash Tax Bills," by David Cay Johnston, New York Times on the Web, February 18, 2002, http://query.nytimes.com/gst/fullpage.html?res=9901EEDB1E3FF93BA25751C0A9649C8B63
- "The Hidden Perils of Offshore Tax Havens," by Diane Brady, *BusinessWeek*, August 8, 2002, http://www.businessweek.com/bwdaily/dnflash/aug2002/nf2002088_9533.htm

Questions:

- What advantages do U.S. companies gain by incorporating in Bermuda?
- What disadvantages do U.S. companies incur by incorporating in Bermuda?
- Do you find the practice of incorporating in Bermuda unethical? Why, or why not?

TEAM-BUILDING SKILLS (AACSB)

Legally Speaking

Here's the scenario: You and your team serve as consultants to business owners who need help in deciding which legal form of ownership is best for them. You're currently working with three clients. For each client, you'll evaluate possible legal forms of organization, debate the alternatives, and make a recommendation. Then, you'll write a report to your client, presenting your recommendation and explaining why you arrived at your conclusion.

In addition to learning the basic facts about each company, you've gathered additional information by asking each client the following questions:

- How much control do you want?
- Do you want to share profits with others?
- How much liability exposure are you willing to accept?
- What are your financing needs?
- What are you willing to do to set up and operate your business?
- Should it be possible for the business to continue without you?

The following is the information that you've collected about each client, along with ownership options you should consider.

Client 1: Rainforest Adventures

Rainforest Adventures offers one-day and multiday tours of several locations in Australia. It works both with tourists and with study groups, and its clientele varies from people who want a relaxing experience away from hectic urban life to those who are keenly interested in the exotic environment. The business is dedicated to the preservation of Australia's tropical and wetland preserves. Its guides have many years of experience leading tourists through the rainforests, particularly at night when they come alive.

Rainforest Adventures was started three years ago by Courtney Kennedy, who has fifteen years of experience in the ecotourism industry. She runs the business as a sole proprietorship but is considering a partnership. (She doesn't want the cost or hassle of doing business as a corporation.) In questioning her, you found out the following: Kennedy is dedicated to preserving the Australian wetlands and sees her business as a way of encouraging people to support conservation efforts. However, her guides have displayed an "it's just-a-job" attitude, have become increasingly undependable, and are unwilling to share her commitment. Still, Kennedy has several trusted friends who not only have years of experience as guides, but who also share her enthusiasm for environmental preservation. She's optimistic that they'd be willing to join her in the business. She dreams of expanding her business to offer classes on the ecology of the rainforest but doesn't have enough cash, and she's afraid that a loan application will be turned down by the bank.

Options

Because Kennedy doesn't want to incorporate, she's left with two options: to continue doing business as a sole proprietorship or to find one or more individuals to join her in a partnership. After evaluating these two alternatives, you should recommend the one that you consider most appropriate. You should discuss the pros and cons of both options and explain how each applies to Kennedy's situation. If you recommend forming a partnership, you need to distinguish between a general partnership and a limited partnership, as well as explain what a partnership agreement is, what it covers, and why it's important.

Client 2: Scuffy the Tugboat

Scuffy the Tugboat is a family-run business that makes tugboats. It was formed as a partnership in 1996 by the three McLaughlin brothers—Mick (a naval architect), Jack (an accountant), and Bob (a marine engineer). Their first tugboat is still towing ships in Boston harbor, and over the years, success has allowed them to grow the company by plowing money back into it. Last year's sales were more than $7 million. Now, however, they want to double production by expanding their factory by five thousand square feet. They estimate a cost of about $1 million, yet a bigger facility would enable them to avoid late-delivery penalties that can run up to $2,000 a day. They're not sure, however, about the best way to raise the needed funds. None of the brothers has $1 million on hand, and because lenders are often hesitant to loan money to shipbuilders, even those with good performance records, local banks haven't been encouraging.

Unlike many partners, the three brothers get along quite well. They're concerned, though, about the risks of taking on personal debts for the business. In particular, they don't like being liable not only for their own actions, but also for the actions of all the partners.

Options

You should recommend that Scuffy the Tugboat either remain a partnership or become a privately-held corporation. State the pros and cons of both forms of organization, and explain how they apply to the brothers' situation.

Client 3: Dinner Rendezvous

For three years, owner Peggy Deardon has been operating Dinner Rendezvous, which gives individuals an opportunity to meet others and expand their social networks, in Austin, Texas. Interested clients go to the company's Web site and fill out applications and privacy statements. There's an annual membership fee of $125 and a $15 charge for each dinner attended (plus the cost of dinner and drinks). Deardon sets up all dinners and is onsite at the restaurant to introduce guests and serve complimentary champagne. While the company has a steady clientele, it's not a big moneymaker. If Deardon didn't have a regular full-time job, she couldn't keep the business running. She stays with it because she enjoys it and believes that she provides a good service for Austin residents. Because it's run out of her home, and because her biggest cost is the champagne, it's a low-risk business with no debts. With a full-time job, she also appreciates the fact that it requires only a few hours of her time each week.

Options

Since your client wants advice on whether to incorporate, you should evaluate two options—remaining a sole proprietorship or forming a corporation. In addition to your recommendation, you should state the pros and cons of both forms of organization and explain how they apply to Deardon's situation.

THE GLOBAL VIEW (AACSB)

America for Sale

Our U.S. companies continue to expand by merging with or acquiring other companies. This is acceptable business practice. But what happens when our U.S. companies and other assets are bought up by firms and individuals outside the United States? Is this acceptable business practice or something we should be concerned about? Learn how this is happening by reading this article by Geoff Colvin:

- "America for Sale," *Fortune*, CNNMoney.com, February 6, 2008, http://money.cnn.com/2008/01/30/news/economy/Colvin_recession.fortune/index.htm?postversion=2008020609

Questions:

- Why are foreigners buying U.S. assets?
- Is the current trend in foreign investments in U.S. assets positive or negative for the United States? Whom does it help? Whom does it hurt? Explain.
- What, if anything, can the United States do to stop this trend?
- If you were able, would you limit foreign investment in U.S. assets? Why, or why not?

How to Choose the Best Legal Structure for Your Business

Joshua Stowers
Staff Writer

Business News Daily Staff
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Choosing the right legal structure is a necessary part of running a business. Whether you're just starting out or your business is growing, it's crucial to understand the options.

- Your business's legal structure determines your tax rates, management and paperwork requirements, fundraising abilities, and more.
- Sole proprietorships and partnerships are relatively easy to start, but they lack liability protection.
- Corporations may take more work to start, but they offer liability protection and, in some cases, more favorable tax rates.
- **This article is for business owners looking to learn more about the different small business legal structures.**

Your business's legal structure has many ramifications. It can determine how much liability your company faces during lawsuits. It can put up a barrier between your personal and business taxes – or ensure this barrier doesn't exist. It can also determine how often your board of directors must file paperwork – or if you even need a board. **[Related article: What to Do if Your Business Gets Sued]**

We'll explore business legal structures and how to choose the right structure for your organization.

What is a business legal structure?

A business legal structure, also known as a business entity, is a government classification that regulates certain aspects of your business. On a federal level, your business legal structure determines your tax burden. On a state level, it can have liability ramifications.

Why is a business legal structure important?

Choosing the right business structure from the start is among the most crucial decisions you can make. Here are some factors to consider:

- **Taxes:** Sole proprietors, partnership owners and S corporation owners categorize their business income as personal income. C corporation income is business income separate from an owner's personal income. Given the different tax rates for business and personal incomes, your structure choice can significantly impact your tax burden.
- **Liability:** Limited liability company (LLC) structures can protect your personal assets in the event of a lawsuit. That said, the federal government does not recognize LLC structures; they exist only on a state level. C corporations are a federal business structure that includes the liability protection of LLCs.
- **Paperwork:** Each business legal structure has unique tax forms. Additionally, if you structure your company as a corporation, you'll need to submit articles of incorporation and regularly file certain government reports. If you start a business partnership and do business under a fictitious name, you'll need to file special paperwork for that as well.
- **Hierarchy:** Corporations must have a board of directors. In certain states, this board must meet a certain number of times per year. Corporate hierarchies also prevent business closure if an owner transfers shares or exits the company, or when a founder dies. Other structures lack this closure protection.
- **Registration:** A business legal structure is also a prerequisite for registering your business in your state. You can't apply for an employer

identification number (EIN) or all your necessary licenses and permits without a business structure.
- **Fundraising:** Your structure can also block you from raising funds in certain ways. For example, sole proprietorships generally can't offer stocks. That right is primarily reserved for corporations.
- **Potential consequences for choosing the wrong structure:** Your initial choice of business structure is crucial, although you can change your business structure in the future. However, changing your business structure can be a disorganized, confusing process that can lead to tax consequences and the unintended dissolution of your business.

Did you know?: If you have to expand your business to another state, you won't have to create a new company or structure, but you may have to register it as a "foreign entity."

Types of business structures

The most common business entity types are sole proprietorships, partnerships, limited liability companies, corporations and cooperatives. Here's more about each type of legal structure.

Sole proprietorship

A sole proprietorship is the simplest business entity. When you set up a sole proprietorship, one person is responsible for all a company's profits and debts.

"If you want to be your own boss and run a business from home without a physical storefront, a sole proprietorship allows you to be in complete control," said Deborah Sweeney, vice president and general manager of business acquisitions at Deluxe Corp. "This entity does not offer the separation or protection of personal and professional assets, which could prove to become an issue later on as your business grows and more aspects hold you liable."

Proprietorship costs vary by market. Generally, early expenses will include state and federal fees, taxes, business equipment leases, office space, banking fees, and any professional services your business contracts. Some examples of these businesses are freelance writers, tutors, bookkeepers, cleaning service providers and babysitters.

A sole proprietorship business structure has several advantages.

- **Easy setup:** A sole proprietorship is the simplest legal structure to set up. If you – and only you – own your business, this might be the best structure. There is very little paperwork since you have no partners or executive boards.
- **Low cost:** Costs vary by state, but generally, license fees and business taxes are the only fees associated with a proprietorship.
- **Tax deduction:** Since you and your business are a single entity, you may be eligible for specific business sole proprietor tax deductions, such as a health insurance deduction.
- **Easy exit:** Forming a proprietorship is easy, and so is ending one. As a single owner, you can dissolve your business at any time with no formal paperwork required. For example, if you start a day care center and wish to fold the business, refrain from operating the day care and advertising your services.

The sole proprietorship is also one of the most common small business legal structures. Many famous companies started as sole proprietorships and eventually grew into multimillion-dollar businesses. These are a few examples:

- eBay
- JCPenney
- Walmart
- Marriott Hotels

Partnership

A partnership is owned by two or more individuals. There are two types: a general partnership, where all is shared equally, and a limited partnership, where only one partner has control of operations and the other person (or persons) contributes to and receives part of the profits. Partnerships can operate as sole proprietorships, where there's no separation between the partners and the business, or limited liability partnerships (LLPs), depending on the entity's funding and liability structure.

"This entity is ideal for anyone who wants to go into business with a family member, friend or business partner – like running a restaurant or agency together," Sweeney said. "A partnership allows the partners to share profits and losses and make decisions together within the business structure. Remember that you will be held liable for the decisions made as well as those actions made by your business partner."

General partnership costs vary, but this structure is more expensive than a sole proprietorship because an attorney should review your partnership agreement. The attorney's experience and location can affect the cost.

A business partnership agreement must be a win-win for both sides to succeed. Google is an excellent example of this. In 1995, co-founders Larry Page and Sergey Brin created a small search engine and turned it into the leading global search engine. The co-founders met at Stanford University while pursuing their doctorates and later left to develop a beta version of their search engine. Soon after, they raised $1 million in funding from investors, and Google began receiving thousands of visitors a day. Having a combined ownership of 11.4% of Google provides them with a total net worth of nearly $226.4 billion.

Business partnerships have many advantages.

- **Easy formation:** As with a sole proprietorship, there is little paperwork to file for a business partnership. If your state requires you to operate under a fictitious name ("doing business as," or DBA), you'll need to file a Certificate of Conducting Business as Partners and draft an Articles of Partnership agreement, both of which have additional fees. You'll usually need a business license as well.
- **Growth potential:** You're more likely to obtain a business loan with more than one owner. Bankers can consider two credit histories rather than one, which can be helpful if you have a less-than-stellar credit score.

- **Special taxation:** General partnerships must file federal tax Form 1065 and state returns, but they do not usually pay income tax. Both partners report their shared income or loss on their individual income tax returns. For example, if you opened a bakery with a friend and structured the business as a general partnership, you and your friend are co-owners. Each owner brings a certain level of experience and working capital to the business, affecting each partner's business share and contribution. If you brought the most seed capital for the business, you and your partner may agree that you'll retain a higher share percentage, making you the majority owner.

Partnerships are one of the most common business structures. These are some examples of successful partnerships:

- Warner Bros.
- Hewlett-Packard
- Microsoft
- Apple
- Ben & Jerry's
- Twitter

Limited liability company

A limited liability company (LLC) is a hybrid structure that allows owners, partners or shareholders to limit their personal liabilities while enjoying a partnership's tax and flexibility benefits. Under an LLC, members are shielded from personal liability for the business's debts if it can't be proven that they acted in a negligent or wrongful manner that results in injury to another in carrying out the activities of the business.

"Limited liability companies were created to provide business owners with the liability protection that corporations enjoy while allowing earnings and losses to pass through to the owners as income on their personal tax returns," said Brian Cairns, CEO of ProStrategix Consulting. "LLCs can have one or more members, and profits and losses do not have to be divided equally among members."

According to TRUiC, the cost of forming an LLC comprises the state filing fee and can range from $40 to $500, depending on your state. For example, if you file an LLC in New York, you must pay a $200 filing fee and a $9 biennial fee, according to LLC University, and file a biennial statement with the New York Department of State.

Although small businesses can be LLCs, some large businesses choose this legal structure. The structure is typical among accounting, tax, and law firms, but other types of companies also file as LLCs. One example of an LLC is Anheuser-Busch, one of the leaders in the U.S. beer industry. Headquartered in St. Louis, Anheuser-Busch is a wholly owned subsidiary of Anheuser-Busch InBev, a multinational brewing company based in Leuven, Belgium.

Here some other well-known examples of LLCs:

- Pepsi-Cola
- Sony
- Nike
- Hertz Rent-a-Car
- eBay
- IBM

Tip: To learn more about LLCs, read our LLC tax guide, our comprehensive overview of starting an LLC, and our guide to creating an LLC operating agreement.

Corporation

The law regards a corporation as separate from its owners, with legal rights independent of its owners. It can sue, be sued, own and sell property, and sell the rights of ownership in the form of stocks. Corporation filing fees vary by state and fee category.

There are several types of corporations, including C corporations, S corporations, B corporations, closed corporations, and nonprofit corporations.

- **C corporations:** C corporations, owned by shareholders, are taxed as separate entities. JPMorgan Chase & Co. is a multinational investment bank and financial services holding company listed as a C corporation. Since C corporations allow an unlimited number of investors, many larger companies – including Apple, Bank of America and Amazon – file for this tax status.
- **S corporations:** S corporations were designed for small businesses. They avoid double taxation, much like partnerships and LLCs. Owners also have limited liability protection. Widgets Inc. is an example of an S corporation that operates very simply: Employee salaries are subject to FICA tax (as are all employee salaries), while the distribution of additional profits from the S corporation does not incur further FICA tax liability. **[Learn more about FICA taxes for small businesses.]**

- **B corporations:** B corporations, otherwise known as benefit corporations, are for-profit entities committed to corporate social responsibility and structured to positively impact society. For example, skincare and cosmetics company The Body Shop has proven its long-term commitment to supporting environmental and social movements, resulting in an awarded B corporation status. The Body Shop uses its presence to advocate for permanent change on issues like human trafficking, domestic violence, climate change, deforestation and animal testing in the cosmetic industry.
- **Closed corporations:** Closed corporations, typically run by a few shareholders, are not publicly traded and benefit from limited liability protection. Closed corporations, sometimes referred to as privately held companies, have more flexibility than publicly traded companies. For example, Hobby Lobby is a closed corporation – a privately held, family-owned business. Stocks associated with Hobby Lobby are not publicly traded; instead, the stocks have been allocated to family members.
- **Open corporations:** Open corporations are available for trade on a public market. Many well-known companies, including Microsoft and Ford Motor Co., are open corporations. Each corporation has taken ownership of the company and allows anyone to invest.
- **Nonprofit corporations:** Nonprofit corporations exist to help others in some way and are rewarded by tax exemption. Some examples of nonprofits are the Salvation Army, American Heart Association and American Red Cross. These organizations all focus on something other than turning a profit.

Corporations enjoy several advantages.

- **Limited liability:** Stockholders are not personally liable for claims against your corporation; they are liable only for their personal investments.
- **Continuity:** Corporations are not affected by death or the transferring of shares by their owners. Your business continues to operate indefinitely, which investors, creditors and consumers prefer.
- **Capital:** It's much easier to raise large amounts of capital from multiple investors when your business is incorporated.

This structure is ideal for businesses that are further along in their growth, rather than a startup based in a living room. For example, if you've started a shoe company and have already named your business, appointed directors and raised capital through shareholders, the next step is to become incorporated. You're essentially conducting business at a riskier, yet more lucrative, rate. Additionally, your business could file as an S corporation for the tax benefits. Once your business grows to a certain level, it's likely in your best interest to incorporate it.

These are some popular examples of corporations:

- General Motors
- Amazon
- Exxon Mobil Corp.
- Domino's Pizza
- JPMorgan Chase

Learn more about how to become a corporation.

Cooperative

A cooperative (co-op) is owned by the same people it serves. Its offerings benefit the company's members, also called user-owners, who vote on the organization's mission and direction and share profits.

Cooperatives offer a couple main advantages.

- **Increased funding:** Cooperatives may be eligible for federal grants to help them get started.
- **Discounts and better service:** Cooperatives can leverage their business size, thus obtaining discounts on products and services for their members.

Forming a cooperative is complex and requires you to choose a business name that indicates whether the co-op is a corporation (e.g., Inc. or Ltd.). The filing fee associated with a co-op agreement varies by state.

An example of a co-op is CHS Inc., a Fortune 100 business owned by U.S. agricultural cooperatives. As the nation's leading agribusiness cooperative, CHS reported a net income of $422.4 million for fiscal year 2020. These are some other notable examples of co-ops:

- Land O'Lakes
- Navy Federal Credit Union
- Welch's
- REI
- Ace Hardware

Key takeaway: The five types of business structures are sole proprietorship, partnership, limited liability company, corporation and cooperative. The right structure depends mainly on your business type.

Factors to consider before choosing a business structure

For new businesses that could fall into two or more of these categories, it's not always easy to decide which structure to choose. Consider your startup's financial needs, risk and ability to grow. It can be challenging to switch your legal structure after registering your business, so give it careful analysis in the early stages of forming your business.

Here are some crucial factors to consider as you choose your business's legal structure. You should also consult a CPA for advice.

Flexibility

Where is your company headed, and which type of legal structure allows for the growth you envision? Turn to your business plan to review your goals and see which structure best aligns with those objectives. Your entity should support the possibility for growth and change, not hold it back from its potential. **[Learn how to write a business plan with this template.]**

Complexity

When it comes to startup and operational complexity, nothing is more straightforward than a sole proprietorship. Register your name, start doing business, report the profits and pay taxes on it as personal income. However, it can be difficult to procure outside funding. Partnerships, on the other hand, require a signed agreement to define the roles and percentages of profits. Corporations and LLCs have various reporting requirements with state governments and the federal government.

Liability

A corporation carries the least amount of personal liability since the law holds that it is its own entity. This means creditors and customers can sue the corporation, but they can't gain access to any personal assets of the officers or shareholders. An LLC offers the same protection but with the tax benefits of a sole proprietorship. Partnerships share the liability between the partners as defined by their partnership agreement.

Taxes

An owner of an LLC pays taxes just as a sole proprietor does: All profit is considered personal income and taxed accordingly at the end of the year.

"As a small business owner, you want to avoid double taxation in the early stages," said Jennifer Friedman, principal at Rivetr. "The LLC structure prevents that and makes sure you're not taxed as a company, but as an individual."

Individuals in a partnership also claim their share of the profits as personal income. Your accountant may suggest quarterly or biannual advance payments to minimize the effect on your return.

A corporation files its own tax returns each year, paying taxes on profits after expenses, including payroll. If you pay yourself from the corporation, you will pay personal taxes, such as those for Social Security and Medicare, on your personal return.

Tip: To simplify payroll complexities and taxation issues, consider using a payroll service. Check out our reviews of the best payroll services to find a partner that fits your needs and budget.

Control

If you want sole or primary control of the business and its activities, a sole proprietorship or an LLC might be the best choice. You can negotiate such control in a partnership agreement as well.

A corporation is constructed to have a board of directors that makes the major decisions that guide the company. A single person can control a corporation, especially at its inception, but as it grows, so does the need to operate it as a board-directed entity. Even for a small corporation, the rules intended for larger organizations – such as keeping notes of every major decision that affects the company – still apply.

Capital investment

If you need to obtain outside funding from an investor, venture capitalist or bank, you may be better off establishing a corporation. Corporations have an easier time obtaining outside funding than sole proprietorships.

Corporations can sell shares of stock and secure additional funding for growth, while sole proprietors can obtain funds only through their personal accounts, using their personal credit or taking on partners. An LLC can face similar struggles, although, as its own entity, it's not always necessary for the owner to use their personal credit or assets.

Licenses, permits and regulations

In addition to legally registering your business entity, you may need specific licenses and permits to operate. Depending on the type of business and its activities, it may need to be licensed at the local, state and federal levels.

"States have different requirements for different business structures," Friedman said. "Depending on where you set up, there could be different requirements at the municipal level as well. As you choose your structure, understand the state and industry you're in. It's not 'one size fits all,' and businesses may not be aware of what's applicable to them."

The structures discussed here apply only to for-profit businesses. If you've done your research and you're still unsure which business structure is right for you, Friedman advises speaking with a specialist in business law.

Max Freedman and Matt D'Angelo contributed to the writing and reporting in this article. Source interviews were conducted for a previous version of this article.

Image Credit:Shutterstock/Africa Studios

Joshua Stowe

Joshua Stowers
Business News Daily Staff

Joshua Stowers is a business.com and Business News Daily writer who knows firsthand the ups and downs of running a small business. An entrepreneur himself, Joshua founded the fashion and art publication Elusive Magazine. He writes about the strategic operations entrepreneurs need to launch and grow their small businesses. Joshua writes about choosing the choosing and building business legal structures, implementing human-resources services, and recruiting and managing talent.

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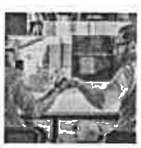

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Choose a business structure

The business structure you choose influences everything from day-to-day operations, to taxes and how much of your personal assets are at risk. You should choose a business structure that gives you the right balance of legal protections and benefits.

Content

Your business structure affects how much you pay in taxes, your ability to raise money, the paperwork you need to file, and your personal liability.

You'll need to choose a business structure before you register your business with the state. Most businesses will also need to get a tax ID number and file for the appropriate licenses and permits.

Choose carefully. While you may convert to a different business structure in the future, there may be restrictions based on your location. This could also result in tax consequences and unintended dissolution, among other complications.

Consulting with business counselors, attorneys, and accountants can prove helpful.

Review common business structures

A sole proprietorship is easy to form and gives you complete control of your business. You're automatically considered to be a sole proprietorship if you do business activities but don't register as any other kind of business.

Sole proprietorships do not produce a separate business entity. This means your business assets and liabilities are not separate from your personal assets and liabilities. You can be held personally liable for the debts and obligations of the business. Sole proprietors are still able to get a trade name. It can also be hard to raise money because you can't sell stock, and banks are hesitant to lend to sole proprietorships.

Sole proprietorships can be a good choice for low-risk businesses and owners who want to test their business idea before forming a more formal business.

Partnership

Partnerships are the simplest structure for two or more people to own a business together. There are two common kinds of partnerships: limited partnerships (LP) and limited liability partnerships (LLP).

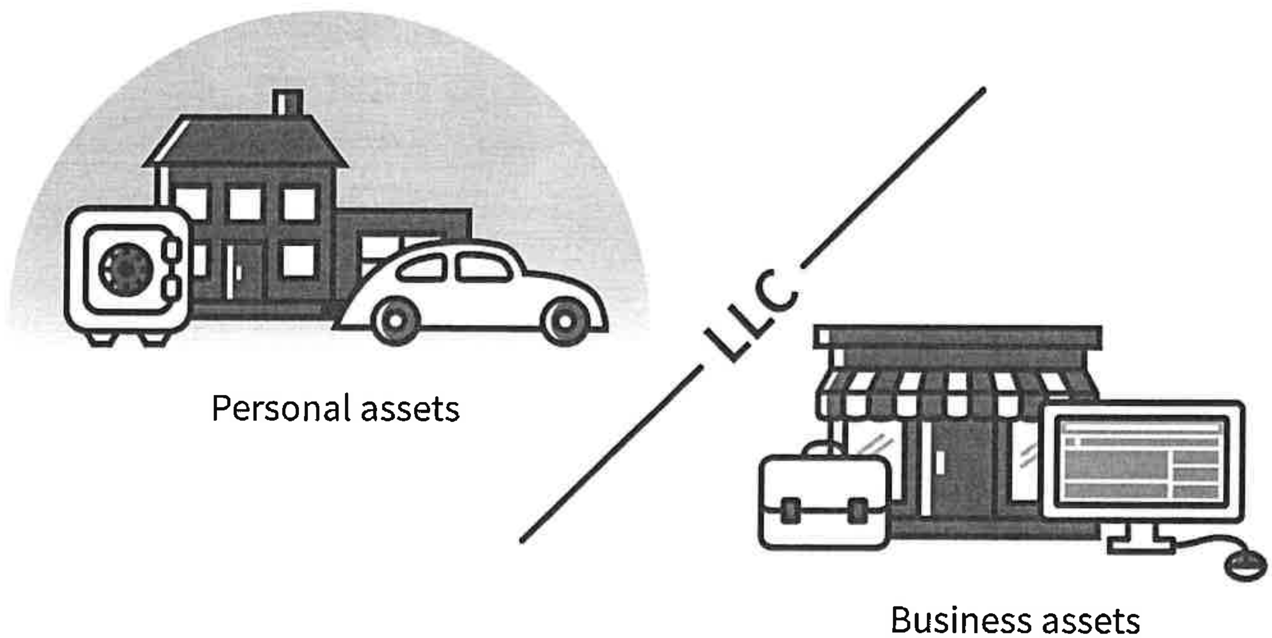
Limited partnerships have only one general partner with unlimited liability, and all other partners have limited liability. The partners with limited liability also tend to have limited control over the company, which is documented in a partnership agreement. Profits are passed through to personal tax returns, and the general partner — the partner without limited liability — must also pay self-employment taxes.

Limited liability partnerships are similar to limited partnerships, but give limited liability to every owner. An LLP protects each partner from debts against the partnership, they won't be responsible for the actions of other partners.

Partnerships can be a good choice for businesses with multiple owners, professional groups (like attorneys), and groups who want to test their business idea before forming a more formal business.

An LLC lets you take advantage of the benefits of both the corporation and partnership business structures.

LLCs protect you from personal liability in most instances, your personal assets — like your vehicle, house, and savings accounts — won't be at risk in case your LLC faces bankruptcy or lawsuits.



Profits and losses can get passed through to your personal income without facing corporate taxes. However, members of an LLC are considered self-employed and must pay self-employment tax contributions towards Medicare and Social Security.

LLCs can have a limited life in many states. When a member joins or leaves an LLC, some states may require the LLC to be dissolved and re-formed with new membership — unless there's already an agreement in place within the LLC for buying, selling, and transferring ownership.

LLCs can be a good choice for medium- or higher-risk businesses, owners with significant personal assets they want protected, and owners who want to pay a lower tax rate than they would with a corporation.

Corporation

Corporations can make a profit, be taxed, and can be held legally liable.

Corporations offer the strongest protection to its owners from personal liability, but the cost to form a corporation is higher than other structures. Corporations also require more extensive record-keeping, operational processes, and reporting.

Unlike sole proprietors, partnerships, and LLCs, corporations pay income tax on their profits. In some cases, corporate profits are taxed twice — first, when the company makes a profit, and again when dividends are paid to shareholders on their personal tax returns.

Corporations have a completely independent life separate from its shareholders. If a shareholder leaves the company or sells his or her shares, the C corp can continue doing business relatively undisturbed.

Corporations have an advantage when it comes to raising capital because they can raise funds through the sale of stock, which can also be a benefit in attracting employees.

Corporations can be a good choice for medium- or higher-risk businesses, those that need to raise money, and businesses that plan to "go public" or eventually be sold.

S corp

An S corporation, sometimes called an S corp, is a special type of corporation that's designed to avoid the double taxation drawback of regular C corps. S corps allow profits, and some losses, to be passed through directly to owners' personal income without ever being subject to corporate tax rates.

Not all states tax S corps equally, but most recognize them the same way the federal government does and tax the shareholders accordingly. Some states tax S corps on profits above a specified limit and other states don't recognize the S corp election at all, simply treating the business as a C corp.

S corps must file with the IRS to get S corp status, a different process from registering with their state.

S corps also have an independent life, just like C corps. If a shareholder leaves the company or sells his or her shares, the S corp can continue doing business relatively undisturbed.

S corps can be a good choice for a businesses that would otherwise be a C corp, but meet the criteria to file as an S corp.

B corp

A benefit corporation, sometimes called a B corp, is a for-profit corporation recognized by a majority of U.S. states. B corps are different from C corps in purpose, accountability, and transparency, but aren't different in how they're taxed.

B corps are driven by both mission and profit. Shareholders hold the company accountable to produce some sort of public benefit in addition to a financial profit. Some states require B corps to submit annual benefit reports that demonstrate their contribution to the public good.

There are several third-party B corp certification services, but none are required for a company to be legally considered a B corp in a state where the legal status is available.

Close corporation

Close corporations resemble B corps but have a less traditional corporate structure. These shed many formalities that typically govern corporations and apply to smaller companies.

State rules vary, but shares are usually barred from public trading. Close corporations can be run by a small group of shareholders without a board of directors.

Nonprofit corporation

Nonprofit corporations are organized to do charity, education, religious, literary, or scientific work. Because their work benefits the public, nonprofits can receive tax-exempt status, meaning they don't pay state or federal income taxes on any profits it makes.

Nonprofits must file with the IRS to get tax exemption, a different process from registering with their state.

can't distribute profits to members or political campaigns.

Nonprofits are often called 501(c)(3) corporations — a reference to the section of the Internal Revenue Code that is most commonly used to grant tax-exempt status.

Cooperative

A cooperative is a business or organization owned by and operated for the benefit of those using its services. Profits and earnings generated by the cooperative are distributed among the members, also known as user-owners. Typically, an elected board of directors and officers run the cooperative while regular members have voting power to control the direction of the cooperative. Members can become part of the cooperative by purchasing shares, though the amount of shares they hold does not affect the weight of their vote.

Combine different business structures

Designations like S corp and nonprofit aren't strictly business structures — they can also be understood as a tax status. It's possible for an LLC to be taxed as a C corp, S corp, or a nonprofit. These arrangements are far less common and can be more difficult to set up. If you're considering one of these non-standard structures, you should speak with a business counselor or an attorney to help you decide.

Compare business structures

Compare the general traits of these business structures, but remember that ownership rules, liability, taxes, and filing requirements for each business structure can vary by state. The following table is intended only as a guideline. Please confer with a business tax specialist to confirm your specific business needs.

Ownership	One person
Liability	Unlimited personal liability
Taxes	Self-employment tax Personal tax

Business structure	**Partnerships**
Ownership	Two or more people
Liability	Unlimited personal liability unless structured as a limited partnership
Taxes	Self-employment tax (except for limited partners) Personal tax

Business structure	**Limited liability company (LLC)**
Ownership	One or more people
Liability	Owners are not personally liable
Taxes	Self-employment tax

Business structure	Corporation - C corp
Ownership	One or more people
Liability	Owners are not personally liable
Taxes	Corporate tax

Business structure	Corporation - S corp
Ownership	One or more people, but no more than 100, and all must be U.S. citizens
Liability	Owners are not personally liable
Taxes	Personal tax

Business structure	Corporation - B corp
Ownership	One or more people
Liability	Owners are not personally liable
Taxes	Corporate tax

Business structure	Corporation - Nonprofit
Ownership	One or more people

Taxes	Tax-exempt, but corporate profits can't be distributed

Need help? Get free business counseling.

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Next

Choose your business name

Tax Consequences of Choice of Entity

Entity Options

- Sole Proprietor (Schedule C)-Single Taxation
  - Income taxed at Individual Level.
  - Payroll taxes on Form 1040, Schedule SE (Self-Employment Taxes).

- Partnership (Form 1065)-Single Taxation
  - Flow-through. Income taxed at Individual Level through issuance of Schedule K-1s by Partnership.
  - Payroll taxes on Form 1040, Schedule SE (Self-Employment Taxes).

- C Corporation (Form 1120)-Double Taxation
  - Income taxed at Corporate Entity level.
  - Shareholder and Officers' income taxed at individual level through issuance of Form 1099-DIV and Form W-2.
  - Payroll taxes as per Form W-2, with reporting on Form 1040. Considered an employee of Corporation.

- S Corporation (Form 1120S)-Single Taxation
  - Flow-through. Income taxed at Individual Level through issuance of Schedule K-1s by S Corporation. Timely file Form 2553, Election by a Small Business Corporation to get Flow-through treatment.
  - Payroll taxes as per Form W-2, with reporting on Form 1040. Considered an employee of Corporation.

Limited Liability Company ("LLC") Considerations

- LLCs exist only at the State level through filing "Articles of Organization" with NYS Secretary of State.

  - A one-member LLC defaults to "Sole Proprietorship" tax treatment at Federal Level.
  - A two or more member LLC defaults to "Partnership" tax treatment at Federal Level.
  - An entity can instead elect to be subject to "Corporation" tax treatment by timely filing Form 8832 Entity Classification Election with the IRS.

Federal Business Taxes to Consider When Starting a New Business

- Income Tax
- Employment Taxes:
  - Social Security and Medicare (FICA); Self-Employment Tax if Sole Proprietorship
  - Unemployment Tax (FUTA)
- Excise Taxes
  - Environmental taxes, Communications and air transportation taxes, Fuel taxes, Retail tax, Ship passenger tax, and Manufacturers Taxes

New York State Business Taxes to Consider When Starting a New Business

- Business Income Tax
- Sales and Use Tax
- Property Taxes
- NYC Commercial Rent Tax
- Employment Requirements/Taxes:
  - Unemployment Insurance, State Disability Insurance (SDI), Re-Employment Tax, Temporary Disability Insurance, Workers' Compensation Insurance, Metropolitan Commuter Transit Mobility Tax (MCTMT)

Payroll Tax Audit Issue: Employee vs Independent Contractor

(W-2 vs 1099)

Definitions

- **EMPLOYEE**: Employer has the right to direct and control the worker. This worker is an employee and must be issued a Form W-2 annually and the employer is responsible for employment/payroll taxes.
- **INDEPENDENT CONTRACTOR**: In business for themselves, and offers their services to the general public. This worker is an independent contractor who would be issued a Form 1099-NEC annually and would be responsible for their own employment taxes.
- New York State and the Federal Government have different tests. Both tests look at multiple factors together with no one factor being conclusive.

NYS “Direction and Control Test”

- Factors relevant to assessing direction and control:
  - (1) Worker worked at his own convenience;
  - (2) Worker was free to engage in other employment;
  - (3) Worker received fringe benefits;
  - (4) Worker was on the employer’s payroll; and,
  - (5) Worker was on a fixed schedule.
    - <u>Byrog v. Cipriani Group</u>, 770 N.Y.S.2d 692 (N.Y. 2003)

Federal "Economic Reality" Test

- Under this test, the relevant factors include whether:
  - (1) Employer had the power to hire and fire the employee;
  - (2) Employer supervised and controlled employee work schedules or conditions of employment;
  - (3) Employer determined the rate and method of payment; and,
  - (4) Employer maintained employment records.
    - Carter v. Dutchess Community College, 735 F.2d 8(2nd Cir. 1984)
  - No one of these factors by themselves is dispositive. This test encompasses the totality of circumstances.
    - Herman v. RSR Sec. Services Ltd., 172 F.3d 132 (2nd Cir. 1999)

Penalties for Misclassification of Employees

- If found to be in violation, the Employer could be ordered to pay:
  - Back wages, overtime and benefits owed to the employee;
  - Penalties and interest; and,
  - Payroll taxes owed on both the federal and NYS levels.

  - *Important Note*: Even after a business closes, the employer may still be found personally liable for misclassification under state and federal law.
    - Irizarry v. Catsimatidis, 722 F.3d 99 (2nd Cir. 2013)

Corporation Audit Issue: Compensation of Officers

Corporation Audit Issue: Officers' Compensation

- Corporate officers are generally also shareholders. The temptation is to reduce officers' compensation in order to avoid payroll taxes by characterizing an income payment as either a dividend (lower individual tax rate) or a loan (tax-free treatment).
- If the amount issued as salary is not "reasonable", a dividend may be disallowed and characterized as "disguised compensation".
- "Loans to Shareholder". If not properly documented as a loan (in writing, due date, market rate interest and payment history, etc.), the government views this as "disguised compensation".

"Reasonableness" of Officers' Compensation

- Factors looked at in determining whether amounts paid were reasonable compensation, include:
  - (1) Qualifications for employment;
  - (2) Nature, extent, and scope of person's work;
  - (3) Size and complexities of the business;
  - (4) Comparison of salaries paid with gross income and net income;
  - (5) Prevailing general economic conditions;
  - (6) Comparison of salaries with distributions made to shareholders;
  - (7) Prevailing rates of compensation for comparable positions in similar industries;
  - (8) Compensation paid to person in prior years (S Corporation); and,
  - (9) Whether the corporation provided pension or profit-sharing plans.
    - Brewer Quality Homes, Inc. v. Commissioner, 86 T.C.M. 29 (T.C. 2003)
    - *See also, IRS Fact Sheet 25, Wage Compensation for S Corporation Officers, FS-2008-25, August 2008*

Additional Resources

- www.irs.gov
  - Publication 15 (Circular E): Employer's Tax Guide
  - Publication 334: Tax Guide for Small Business
  - Publication 509: Tax Calendars
  - Publication 541: Partnerships
  - Publication 542: Corporations
  - Publication 583: Starting a Business and Keeping Records
- www.tax.ny.gov
  - Publication 16 (PUB-16): New York Tax Status of Limited Liability Companies and Limited Liability Partnerships
  - Publication 20 (PUB-20): New York Tax Guide for New Businesses
  - NYS-50: Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax

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T.C. Memo. 2003-200

Brewer Quality Homes, Inc.
v.
Commissioner.

Docket No. 8222-99.

United States Tax Court.

Filed July 10, 2003.

R. Cody Mayo, Jr., for the petitioner.

Mary Beth Calkins and Joseph Ineich, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

CHABOT, Judge:

Respondent determined deficiencies in Federal corporate income tax against petitioner as follows:

Year	*Deficiency*
1995	$123,602
1996	144,411

After concessions by respondent,[1] the issue for decision is the extent to which amounts that

[86 T.C.M. 30]

petitioner paid to Jack are deductible as reasonable compensation under section 162(a)(1).[2]

FINDINGS OF FACT[3]

Some of the facts have been stipulated; the stipulations and the stipulated exhibits are incorporated herein by this reference.

Petitioner was incorporated in Louisiana on August 1, 1977. When its petition in the instant case was filed, petitioner's principal place of business was in Bossier City, Louisiana. Bossier City is in northwest Louisiana, on the east side of the Red River, across from Shreveport. Petitioner is located on Rte. US 80.

Petitioner is engaged in the business of retail selling of manufactured homes, also known as mobile homes, trailers, or trailer homes, hereinafter sometimes collectively referred to as mobile homes. At all relevant times, Jack and Mary each owned 50 percent of petitioner's stock. Petitioner's stock was not publicly traded.

A. *Jack's Background*

Jack served in the U.S. Marine Corps for 3 years. In 1954, he left the Marine Corps and moved to Dallas, Texas, where he began a career in the automobile business. Jack served as the sales, finance, and insurance manager for several General Motors dealerships. In 1973, he left the automobile business to pursue a career in the mobile home business.

B. *Petitioner's Origin and Economic Development*

Jack began his mobile home retailing business with capital raised from the $8,000 of equity that he had in his home and a $50,000 bank loan. He used this capital to establish an inventory of about six mobile homes. Jack increased his inventory by buying distressed merchandise at a discount—new mobile homes that lenders had repurchased from retailers who were going out of business. He attributed the failures of other retailers' businesses to an economic downturn that began in 1973.

Jack did not employ anyone in his mobile home retailing business during its first year.

During the 1980s, the mobile home retailing business in petitioner's region of the country (Texas, Louisiana, and Oklahoma) endured another economic downturn, because of the oil industry. More than 45,000 mobile homes were repossessed in Texas alone. In petitioner's basic trade area, 21 mobile home retailers either went out of business or filed for bankruptcy. Petitioner was one of only two mobile home retailers located within 1 mile of petitioner that survived the 1980s' economic downturn.

During 1992 and 1993, the mobile home retailing business in petitioner's basic trade area endured another economic downturn. Although petitioner survived this downturn, many other mobile home retailers did not. Nine of the mobile home retailers that did not survive this downturn were located within 1 mile of petitioner on the US 80 corridor. Petitioner again took advantage of the situation by buying at distress sale prices mobile homes that lenders had repossessed and selling these mobile homes at regular retail prices.

Petitioner had about 16 employees during the early 1990s. In 1996, petitioner had 22 employees, 7 of whom were in sales.

Petitioner's business was operated as a sole proprietorship from 1973 until petitioner's incorporation, in 1977. Petitioner elected S corporation status as of January 1, 1987. Petitioner was a C corporation for 1988. Petitioner elected S corporation status as of January 1, 1989, and remained in that status through 1993. Petitioner was a C corporation for 1994 through 1996.

[86 T.C.M. 31]

Petitioner reported gross sales, total income, and taxable income for 1986 through 1996 as shown in table 1.

Table 1

Year	*Gross Sales*	*Total Income*[1]	*Taxable Income (Loss)*
1986	$2,528,724	$ 530,635	$ 36,429
1987	3,022,585	657,051	19,819
1988	3,569,197	843,645	15,816
1989	3,380,615	771,252	(18,214)
1990	3,526,171	884,275	(1,791)
1991	2,888,775	716,812	(6,976)
1992	2,732,920	728,845	118,987
1993	4,197,494	1,015,976	337,405
1994	6,559,036	1,383,467	97,840
1995	9,006,092	2,029,979	167,758
1996	9,920,208	2,326,709	151,566

[1] Total income includes gross profit, interest income, and other income.

Jack and Mary personally guaranteed all loans by banks to petitioner.

C. *Jack's Duties*

Jack exercised complete control over petitioner's business since it was founded (1973) and over petitioner since it was incorporated (1977), including the years in issue. He served as petitioner's president, chief financial officer, chief executive officer, general manager, sales manager, loan officer, credit manager, purchasing officer, personnel manager, advertising manager, insurance agent, real estate manager, and corporate legal affairs liaison. With the exception of sales manager—Jack promoted a sales administrator to sales manager in mid-1996— Jack has always held these positions.

In his capacity as general sales manager, Jack oversaw petitioner's daily sales operations, worked with salespeople on all transactions, appraised trade-ins, negotiated with buyers, and approved all closings. In his capacity as advertising manager, Jack directed petitioner's advertising efforts: He met with all media, wrote ad copies for television, radio, and newspaper advertisements, prepared the advertising budgets, and approved all advertising costs. In his capacity as loan officer, Jack approved the underwriting for all in-house loans and personally worked delinquent accounts. In his capacity as licensed general insurance agent, Jack was responsible for petitioner's book of insurance; petitioner had more than 400 insurance customers. Petitioner insured 60 percent of its sales. The commissions earned for Jack's work as the licensed general insurance agent went to petitioner and were reported on petitioner's tax return. As the personnel manager, Jack was responsible for hiring, firing, supervising, training, and evaluating all of petitioner's employees. In his capacity as purchasing officer, Jack ordered all of petitioner's inventory, lot supplies, and office supplies. He also bought all company vehicles and approved all invoices for payment. In his capacity as corporate legal affairs liaison, Jack reviewed legal contracts between petitioner and third parties.

In addition to the foregoing, Jack supervised the in-house bookkeeper; reviewed vendor invoices; maintained inventory records; gathered the necessary information to prepare petitioner's financial statements and tax returns; planned and monitored petitioner's cashflow; signed checks; negotiated lines of credit, advances, and loans; and directed the investment of petitioner's cash reserve. Jack extensively reviewed petitioner's quarterly financial reports.

Jack brought enthusiasm, dedication, and energy to petitioner. He made a point of being willing to meet every customer at some point in the sales process. He worked 6 to 7 days per week, and often worked long into the night. He opened and closed the business each day. If there were delinquent accounts, then Jack went out at night and collected on them. In petitioner's early years, Jack worked about 70 hours per week; during the years in issue, Jack worked about 60 hours per week. His duties also involved frequent travel.

At all times relevant to the instant case, Mary has been either petitioner's vice president, secretary, or secretary-treasurer.

D. *Compensation Practices*

1. *General*

Petitioner did not maintain a written salary policy or bonus plan for its employees. To attract "top-notch" people it paid compensation that was equivalent to or greater than the compensation paid by other mobile home retailers. Since its incorporation, petitioner has paid all the cost of health insurance for all its employees. It has also provided paid sick and vacation leave for all its employees, except Jack (and, presumably, Mary). Although petitioner established

[86 T.C.M. 32]

a profitsharing plan with Commercial National Bank in January of 1985, the plan was terminated in late 1987. In addition, petitioner's resolution on February 5, 1996, to adopt a 401(k) retirement plan was aborted on February 7, 1997, because of excessive administrative costs.

Table 2 sets forth the compensation petitioner paid to its key employees, other than Jack, for 1994, 1995, and 1996.

Table 2

Name	Position	1994	1995	1996
John Atkinson	Sales Person	$60,053	$75,407	$72,209
Garry Hood	Sales Person	NA	21,777	74,551
Kurt Ley	Sales Manager	NA	21,000	71,424
Patsy K. Watson	Bus. Manager	31,428	37,946	40,250
Larry Gill	Service Manager	51,161	56,827	62,523
Dale Hughes	Sales Person	26,823	45,210	27,635
Tony Lewis	Sales Person	42,763	55,434	41,445
Mary Brewer	Bookkeeper/Decorator	21,765	21,744	18,000

2. *Jack's Compensation*

During the years in issue, petitioner never had a compensation, defined benefit, or profit-sharing plan for Jack. Jack analogized petitioner's compensation policy for him to that of a farmer's: If petitioner had a good year, then Jack had a good year; if petitioner had a bad year, then Jack took "minimum wages."

Table 3 shows, for each of the years 1986 through 1996, (1) petitioner's claimed compensation payment to Jack, (2) that claimed compensation as a percentage of gross sales (*supra* table 1), and (3) that claimed compensation as a percentage of taxable income before deduction of that claimed compensation, *supra* table 1 as adjusted by adding back the claimed compensation to Jack.

Table 3

Year	Claimed compensation	Claimed compensation as % of gross sales	Claimed compensation as % of Taxable income before deduction of Jack's compensation
1986	$ 24,195	1.0	39.9
1987	79,413	2.6	80.0
1988	164,292	4.6	91.2
1989	84,581	2.5	127.5
1990	175,164	5.0	101.0
1991	129,828	4.5	105.7
1992	25,174	0.9	17.5
1993	25,818	0.6	7.1
1994	398,638	6.1	80.3
1995	762,186	8.5	82.0
1996	863,559	8.7	85.1

In 1995, petitioner paid $62,186 in salary to Jack over the course of the year. On December 31, 1995, petitioner paid an additional $700,000 to him as a bonus. In 1996, petitioner paid $63,559 in salary to Jack over the course of the year. On December 31, 1996, petitioner paid an additional $800,000 to him as a bonus. Jack determined the amount of his bonus each year after he and J. Michael Sledge (hereinafter sometimes referred to as Sledge) examined petitioner's financial situation. Sledge, a certified public accountant, has been petitioner's accountant since its incorporation and Jack's accountant since 1975. Sledge prepared petitioner's tax returns for both of the years in issue, and signed those tax returns as paid preparer. He represented petitioner and Jack during the audit stage that led to the instant case. He met with Jack at least quarterly every year to review the financial performance of the company and another 20-30 times a year on an ad hoc basis. He has attended most of the meetings of petitioner's board of directors since 1977.

In determining the amount of a bonus for Jack, Jack and Sledge considered petitioner's profit situation and the amount of retained earnings necessary to satisfy an investor in petitioner. Jack discussed with Sledge the possibility that the amounts of the 1995 and 1996 bonuses might be viewed as "unreasonable compensation in eyes of the Commissioner" of Internal Revenue. Jack was aware that there were risks involved with petitioner's payment of the bonuses on the last day of the year.

Petitioner's corporate board minutes for 1995 and 1996 do not reflect any intent to increase Jack's compensation in those years to make up

[86 T.C.M. 33]

for Jack's earlier years' undercompensated services.

E. *Distribution and Dividend History*

Petitioner distributed $116,100 in 1993, as an S corporation. Petitioner distributed $320,949 dividends in 1994, as a C corporation. This was done in accordance with Sledge's recommendation. The 1993 and 1994 distributions are the only ones petitioner ever made, through the end of 1996. Petitioner did not have any agreements with any banks or financial institutions with which it dealt that prohibited it from declaring dividends for the years in issue.

F. *Business Practices*

1. *Products*

Over the years, petitioner has been a dealer of about 20 different brands of mobile homes. In 1995 and 1996, petitioner carried the Fleetwood line of mobile homes as its primary product offering. Fleetwood manufactures price-competitive, high quality mobile homes. Fleetwood dealerships generally are very successful.

During the years in issue, petitioner did not have a franchise agreement with Fleetwood, nor did petitioner receive any market protection from it. Indeed, there was another Fleetwood retailer located "almost next door" to petitioner.

For 1995-1996, petitioner was ranked number 36 of Fleetwood retailers in the nation. For 1996-1997, petitioner was ranked (1) the top Fleetwood retailer in Louisiana, and (2) number 13 in the nation.

2. *Financing*

Since 1991, petitioner has offered financing to customers who Jack describes as "people that do not conform to the average lending institution." Jack managed this loan portfolio for petitioner and also served as the underwriter for each of the loans. Petitioner has extended more than 200 loans as part of its financing endeavors. Of this number, only three failed, and only one resulted in a loss to petitioner. Petitioner's mobile home loan portfolio produced $87,974 interest for 1995 and $89,357 interest for 1996.

3. *Insurance Underwriting*

Before petitioner could install a mobile home on a buyer's location, the buyer had to insure the mobile home. As a licensed fire and casualty insurance agent, Jack wrote insurance policies for 60 percent of petitioner's sales. These policies were then attached to their corresponding notes, which were sold to banks. The commissions earned from the insurance sales went to petitioner. Petitioner reported "Part. & Insurance Income" of $58,019 and $44,566, respectively, on its 1995 and 1996 tax returns.

G. *Conclusions*

Table 4 sets forth the parties' and the Court's positions with respect to claimed compensation payments by petitioner to Jack for the years in issue. Petitioner contends that all of the amounts paid meet the requirements for deductibility, and that greater payments, unspecified in amount, also would be deductible. Respondent's determinations and contentions, and the Court's redeterminations, are in terms of the maximum amounts that meet the requirements for deductibility.

Table 4

	1995	1996
Petitioner:		
Paid, deducted, and stands by tax returns	$762,186	$863,559
Respondent Allows:		
Notice of deficiency	[1]423,245	[2]2465,800
After concessions	[3]604,117	485,966
Court Finds:	610,000	630,000

[1] In the notice of deficiency, respondent allowed a deduction of $444,989 of the amount petitioner paid to both Jack and Mary. Because respondent concedes that the entire $21,744 paid to Mary is deductible, this leaves $423,245 as the amount petitioner paid to Jack that respondent determined to be deductible.

[2] In the notice of deficiency, respondent allowed a deduction of $483,800 of the amount petitioner paid to both Jack and Mary. Because respondent concedes that the entire $18,000 paid to Mary is deductible, this leaves $465,800 as the amount petitioner paid to Jack that respondent determined to be deductible.

[3] This is the sum of $599,117, derived by Hakala's formulaic approach, plus "additional compensation of $5,000.00 to Mr. Brewer for providing his personal guarantee to secure a short-term working capital line of credit in 1995." *Infra* OPINION, C. Analysis, 1. Reasonableness, (d) Amount of Reasonable Compensation, (2) Loan Guarantee.

Petitioner did not intend in 1995 and did not intend in 1996 to compensate Jack for his earlier services to petitioner.

OPINION

A. *Parties' Positions*

Petitioner maintains that the amounts it paid to Jack as compensation were reasonable in

[86 T.C.M. 34]

amount, within the meaning of section 162(a)(1), and so these amounts are fully deductible.

Respondent "agrees that Mr. Brewer brought enthusiasm, dedication[,] and energy to the Petitioner, and that the company experienced great growth during the mid 1990s; however," respondent contends that any amounts paid to Jack in excess of $604,117 for 1995 and $485,966 for 1996 were not intended as payments purely for personal services,[4] and even if they were so intended, they were unreasonable in amount for the services he rendered. Respondent argues that these excess amounts are not deductible under section 162(a)(1).

B. *Summary; Conclusions*

In determining the maximum reasonable compensation for Jack's services for the years in issue, we have considered the relevant factors listed in *Owensby & Kritikos, Inc. v. Commissioner* [87-2 USTC ¶ 9390], 819 F.2d 1315, 1323 (5th Cir. 1987), affg. [Dec. 42,133(M)] T.C. Memo. 1985-267. Both parties presented expert witness reports and testimony on the applicability of the relevant factors to the instant case. While we do not find the experts' conclusions particularly helpful, we do use some of the data and analyses they provide in reaching our decision.

We first consider the Robert Morris Associates (hereinafter sometimes referred to as RMA) report for the industry on financial ratios, which provides data on, among other things, executive compensation as a percentage of sales for companies comparable to petitioner. Based on petitioner's and the mobile home retail industry's financial performances in 1995 and 1996, we conclude that Jack's compensation as a percentage of sales should be compared to those of executives in comparable companies at around the 90th percentile. By multiplying petitioner's sales by the appropriate RMA factor for each year, we determine that payments to Jack, as compensation for the services he performed for petitioner, would have been about $520,000 in 1995 and $600,000 in 1996. We add $5,000 to the 1995 amount on account of Jack's guaranty of a bank loan to petitioner.

We also consider the fact that petitioner did not provide Jack with retirement benefits. Based on comments by respondent's expert, we conclude that an amount of about 5 percent of Jack's compensation would be sufficient to compensate him for the absence of retirement benefits. This brings reasonable compensation to about $550,000 in 1995 and $630,000 in 1996.

In light of respondent's willingness to allow what Hakala recommends for 1995, plus correction of Hakala's mathematical errors, we round the 1995 amount to $610,000.

We conclude that all of the amounts that would have been reasonable compensation to Jack were intended by petitioner to be compensation and not dividends.

C. *Analysis*

Section 162(a)(1)[5] allows a deduction for the payment of compensation, but only if the compensation is both (1) reasonable in amount and (2) paid for personal services rendered. *Paula*

[86 T.C.M. 35]

Construction Co. v. Commissioner [Dec. 31,555], 58 T.C. 1055, 1058 (1972), affd. without published opinion [73-1 USTC ¶ 9283] 474 F.2d 1345 (5th Cir. 1973); sec. 1.162-7(a), Income Tax Regs. The question of reasonableness is one of fact which must be resolved on the basis of all the facts and circumstances in the case. *Owensby & Kritikos, Inc. v. Commissioner* [87-2 USTC ¶ 9390], 819 F.2d at 1323; *Pepsi-Cola Bottling Co. of Salina, Inc. v. Commissioner* [76-1 USTC ¶ 9107], 528 F.2d 176, 179 (10th Cir. 1975), affg. [Dec. 32,435] 61 T.C. 564, 567 (1974); *Estate of Wallace v. Commissioner* [Dec. 46,977], 95 T.C. 525, 553 (1990), affd. [92-2 USTC ¶ 50,387] 965 F.2d 1038 (11th Cir. 1992); *Home Interiors & Gifts, Inc. v. Commissioner* [Dec. 36,842], 73 T.C. 1142, 1155 (1980).

In addition to multifactor tests (see *Owensby & Kritikos, Inc. v. Commissioner* [87-2 USTC ¶ 9390], 819 F.2d at 1323), courts have also used independent investor tests to determine whether payments to an employee-shareholder exceeded reasonable compensation. See, e.g., *Dexsil Corp. v. Commissioner* [98-1 USTC ¶ 50,471], 147 F.3d 96, 100-101 (2d Cir. 1998), vacating and remanding [Dec. 50,552(M)] T.C. Memo. 1995-135, on remand [Dec. 53,372(M)] T.C. Memo. 1999-155. Generally, courts have described independent investor tests as a lens through which the entire analysis should be viewed. *Dexsil Corp. v. Commissioner, id.* at 101. In *Owensby & Kritikos, Inc. v. Commissioner* [87-2 USTC ¶ 9390], 819 F.2d at 1327, the Court of Appeals for the Fifth Circuit stated: "The so-called independent investor test is simply one of the factors a court should consider, and in certain cases it may be a substantial factor." In discussing the significance of a corporation's dividend practices, that Court also stated: "The prime indicator of the return a corporation is earning for its investors is its return on equity." *Id.* at 1326-1327.

Discerning the intent behind the payments also presents a factual question to be resolved within the bounds of the individual case. *Nor-Cal Adjusters v. Commissioner* [74-2 USTC ¶ 9701], 503 F.2d 359, 362 (9th Cir. 1974), affg. [Dec. 30,930(M)] T.C. Memo. 1971-200; *Paula Construction Co. v. Commissioner* [Dec. 31,555], 58 T.C. at 1059.

Where officer-shareholders who are in control of a corporation set their own compensation, careful scrutiny is required to determine whether the alleged compensation is in fact a distribution of profits. *Rutter v. Commissioner* [88-2 USTC ¶ 9500], 853 F.2d 1267, 1270-1271 (5th Cir. 1988), affg. [Dec. 43,316(M)] T.C. Memo. 1986-407; *Owensby & Kritikos, Inc. v. Commissioner* [87-2 USTC ¶ 9390], 819 F.2d at 1324; *Estate of Wallace v. Commissioner* [Dec. 46,977], 95 T.C. at 556; sec. 1.162-7(b)(1), Income Tax Regs.

We will consider first whether (and, if so, then to what extent) the payments to Jack exceeded reasonable compensation, and then whether (and, if so, then to what extent) any part of the payments that survive the first test should nevertheless be nondeductible because they were not intended to be compensation. Compare *Owensby & Kritikos, Inc. v. Commissioner* [87-2 USTC ¶ 9390], 819 F.2d at 1325 (payments made in the form of compensation), with *Paula Construction Co. v. Commissioner* [Dec. 31,555], 58 T.C. at 1057, 1059-1060 (payments made in the form of distributions), and *King's Court Mobile Home Park v. Commissioner* [Dec. 48,173], 98 T.C. 511, 514-515 (1992) (corporation's unreported income diverted to shareholder).

1. *Reasonableness*

Many factors are relevant in determining whether amounts paid to a person were reasonable compensation, including the following: The person's qualifications; the nature, extent, and scope of the person's work; the size and complexities of the business; a comparison of salaries paid with gross income and net income; the prevailing general economic conditions; a comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all persons; in the case of small corporations with a limited number of officers the amount of compensation paid to the particular person in previous years; and whether the corporation provided the person with a pension or profit-sharing plan. *Owensby & Kritikos, Inc. v. Commissioner* [87-2 USTC ¶ 9390], 819 F.2d at 1323, and cases there cited. No single factor is decisive; rather, we must consider and weigh the totality of the facts and circumstances in arriving at our decision. *Idem.*

Before we apply the relevant factors to the instant case, we note that petitioner presented evidence of three offers to buy petitioner. The parties devoted substantial efforts to analyze the direct and indirect (i.e., regarding return on investment) significance of these offers. Indeed, respondent's expert opined: "The single best evidence of reasonable compensation can be found in the three subsequent offers to acquire the assets and business of [petitioner]". However, none of the offers is sufficiently detailed to enable us to determine what Jack's services would be worth under that offer. (Petitioner contends that one offer would justify a 1996 compensation level higher than petitioner paid, while respondent contends that, using the same methodology that petitioner used, one of the other offers, would lead to a conclusion that the

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maximum 1996 reasonable compensation would be only $79,103.) Also, the parties do not assist us in deciding how to adjust for the difference in time between the offers' presentations and the years in issue. Finally, we do not even know when one of the offers was made. Under these circumstances, we conclude that the offers are not to be given any weight in determining the amounts of reasonable compensation for Jack's services for the years in issue.

The following indicia of relatively high reasonable compensation are present in the instant case:

(1) Jack has been involved in every aspect of petitioner since its inception. Through his enthusiasm, hard work, and dedication, he built petitioner into a successful enterprise. He served as its president, chairman, chief executive officer, general manager, chief financial officer, credit manager, purchasing officer, personnel manager, advertising manager, insurance agent, real estate manager, and corporate legal affairs liaison. He worked 60 hours per week, 6 to 7 days per week.

(2) Petitioner grew rapidly between 1991 and 1996. In 1995, it was ranked number 36 of Fleetwood mobile home retailers in the nation; in 1996, it climbed to number 13 in the nation.

(3) Jack personally guaranteed the working capital lines of credit of petitioner.

(4) Petitioner did not provide a defined benefit or profitsharing plan to Jack. The only nonsalary benefit that petitioner provided to Jack was health insurance; Jack (and, presumably, Mary) was the only employee who did not receive paid sick and vacation leave.

(5) Under Jack's control, petitioner survived several economic downturns when many other mobile home retailers went out of business.

The following indicia of relatively low reasonable compensation are present in the instant case:

(1) The claimed compensation petitioner paid to Jack in 1995 and 1996 constituted 8.5 percent and 8.7 percent, respectively, of petitioner's gross sales, and 82 percent and 85 percent, respectively, of petitioner's taxable income. These percentages exceed those of most similar companies.

(2) Petitioner did not maintain a compensation policy for Jack. Because Jack controlled the corporation, he was able to set his own compensation.

(3) The bonus amounts were not set in accordance with any formula or other detailed arrangement agreed upon in advance. Rather, they were determined and paid at the end of the year, when petitioner knew its profitability for that year. Thus, Jack's compensation was set on an ad hoc basis.

(4) Petitioner did not pay dividends in 1995 or 1996, even though it had made a distribution in 1993 and paid dividends in 1994, and profitability before officer's compensation was greater in 1995 and 1996 than it was in the two earlier years.

(5) Petitioner's average return on equity, which measures the percent of profit before taxes as a percentage of tangible net worth, was below that of comparable companies for the years in issue.

At trial, both parties presented the reports and testimony of expert witnesses. Petitioner's experts were Sledge and Mae Lon Ding, hereinafter sometimes referred to as Ding. Respondent's expert was Scott D. Hakala, hereinafter sometimes referred to as Hakala.

Before admitting expert testimony into evidence, the trial judge is charged with the gatekeeping obligation of ensuring that the testimony is both relevant and reliable. *Kumho Tire Co. v. Carmichael*,526 U.S. 137, 147 (1999); *Daubert v. Merrell Dow Pharmaceuticals, Inc.*,509 U.S. 579, 589 (1993); *Caracci v. Commissioner* [Dec. 54,747], 118 T.C. 379, 393 (2002), on appeal (5th Cir. Oct. 15, 2002). This gatekeeping obligation applies to all expert testimony, including testimony based on technical and other specialized knowledge. *Kumho Tire Co. v. Carmichael*, 526 U.S. at 141; see Fed. R. Evid. 702.

As trier of fact, we are not bound by the opinion of any expert witness and will accept or reject expert testimony, in whole or in part, in the exercise of sound judgment. *Lukens v. Commissioner* [91-2 USTC ¶ 50,517], 945 F.2d 92, 96 (5th Cir. 1991) (and cases there cited), affg. [Dec. 46,394(M)] T.C. Memo. 1990-87.

The three experts agree on some aspects of elements that should be taken into account in determining what would be reasonable compensation for Jack's services to petitioner, but even there they do not agree on what numbers those aspects should lead us to. Each expert does a much better job of explaining why the other side is wrong than why his or her analysis is correct. To that extent, each expert has been helpful. To put it another way, the experts have provided substantial assistance to the trier of fact (Fed. R. Evid. 702) in identifying and winnowing out the chaff; they have provided far less assistance in identifying and keeping the wheat. See *United States v. Mastropieri* [82-2 USTC ¶ 9484], 685 F.2d 776, 786 (2d Cir. 1982).

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(a) *Hakala*

Hakala is a principal in Business Valuation Services, Inc. He had academic training in compensation theory and was awarded the degree of Ph.D. in Economics by the University of Minnesota. He has testified as an expert witness in reasonable compensation cases.

Table 5 shows the amounts that Hakala concluded were maximum reasonable compensation for Jack's services to petitioner in 1994, 1995, and 1996, per Hakala's expert witness report (Ex. 60-R) and Hakala's rebuttal expert witness report (Ex. 61-R).

Table 5

	Ex. 60-R	*Ex. 61-R*
1994	$381,608	$410,626
1995	544,419	599,117
1996	448,620	485,966

The task of calculating a maximum amount of reasonable compensation ordinarily, and in the instant case, involves judgment calls, generalizations, and very rough approximations. We are mindful of Judge Tannenwald's observation that in valuation disputes (and reasonable compensation disputes are essentially a subset of valuation disputes) there is often "an overzealous effort, during the course of the ensuing litigation, to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise". *Messing v. Commissioner* [Dec. 28,532], 48 T.C. 502, 512 (1967); see *Estate of Jung v. Commissioner* [Dec. 49,387], 101 T.C. 412, 446 (1993).

Hakala acknowledges that the correction of but one set of inconsistencies in his expert witness report assumptions results in changes of 7 to 10 percent in his conclusions. Ex. 61-R, pp.6-7, IV-3. We are struck by the fact that Hakala has so much confidence in the combination of accuracy and precision of his numbers and analysis that, even after the humbling exercise of making the gross corrections he describes, he claims to be able to come to conclusions to six significant figures. *Supra* table 5. Respondent urges us to follow in Hakala's footsteps—to six significant figures. We respond that, neither Hakala's nor respondent's continued presentation of six-significant-figure conclusions causes us to have any confidence that the *precision of those conclusions is an indication that those conclusions are accurate.*[6] Indeed, Hakala's efforts to persuade us to walk that road serve only to cause us to doubt his judgment. When we doubt the judgment of an expert witness on one point, we become reluctant to accept that expert's conclusions on other points.[7]

When the Court asked Hakala if he was "confident" in his conclusion that reasonable compensation for 1996 should be substantially below reasonable compensation for 1995 (see *supra* tables 4 and 5), he responded as follows:

> THE WITNESS: No, and I think they have a valid point that there was more income, and what I missed was that in the other income was the rebate from Fleetwood. When you factor the rebate from Fleetwood in, the compensation for '96 should go up. If you do that, then you have to adjust the compensation for '95 downward. So, you know, I would agree that I think intuitively, '96 should probably be higher than '95.

Notwithstanding this testimony, Hakala did not change his report recommendations, and respondent's posttrial briefs still urge us to adopt Hakala's report recommendations, with substantially lower reasonable compensation for 1996 as compared to 1995.[8]

(b) *Sledge*

Sledge is a C.P.A. in private practice in his own firm. He was awarded the degree of B.S. in Industrial Psychology by Louisiana State University and took postgraduate work to prepare himself for the C.P.A. examination. He has testified as an expert witness in business valuation cases, and other matters involving officer compensation issues.

Sledge did not determine what was maximum reasonable compensation for Jack's services to petitioner in the years in issue, but concluded that "it is my opinion that the salary paid to Mr. Brewer during 1995 and 1996 is reasonable."

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As a result, we can agree with much of what Sledge says, and still have little or no guidance from his expert witness report as to what numbers to set for reasonable compensation.

Before the trial, respondent moved in limine to exclude Sledge's expert witness report and to not allow Sledge to testify as an expert witness. Respondent pointed to Sledge's obvious conflict of interest and contended that Sledge "is unable to provide the degree of objectivity required of an expert witness." We concluded that, in the instant case, it was better to (1) take Sledge's conflict of interest into account in weighing his expert witness report and expert testimony, and (2) not exclude Sledge and his report. In retrospect, we conclude that we made the right decision on this matter; i.e., we conclude that Sledge's expert witness report, his rebuttal report, and his expert witness testimony did assist us, as trier of fact, in understanding concepts involved in determining reasonable compensation, and in understanding matters raised by Hakala. See *Koch Refining Co. v. Jennifer L. Boudreau MV*, 85 F.3d 1178, 1182-1183 (5th Cir. 1996).

(c) *Ding*

Ding is president of Personnel Systems Associates. She was awarded the degree of M.B.A. by the University of Southern California, and the degree of B.A. in Industrial Psychology from UCLA. She has testified as an expert witness in reasonable compensation cases.

Ding did not conclude what was maximum reasonable compensation for Jack's services to petitioner in the years in issue, but she concluded that "Mr. Brewer was compensated at a rate in 1995 and 1996, which we believe an investor in an arm's-length transaction would have thought to be reasonable". Nevertheless, Ding's presentation of the data from RMA enables us to make our own evaluation and to start the process of redetermining reasonable compensation numbers for Jack's services.

(d) *Amount of Maximum Reasonable Compensation*

(1) RMA Ratios

Both Hakala and Ding direct our attention to RMA surveys of companies that specialize in mobile home retailing. None of the expert witnesses was able to identify any published surveys of the *amounts* of executive compensation for the mobile home retailing industry. However, it was noted that the RMA's surveys provided financial ratios, including a ratio for executive compensation to company sales.

In her analysis of the RMA data, Ding stated that petitioner's—

> average compensation [total executive compensation, including what petitioner paid to Mary] to sales ratio for the period 1986-1996 was 4.6%, which was slightly above the RMA 75th percentile of 4.2% and considerably below our [i.e., Ding's] projection of the 90th percentile average of 5.9% (Exhibit F).

Ding regarded the following considerations as being among those leading to her conclusion that Jack "achieved exceptional financial performance" at petitioner, "justifying a comparison of compensation above the 75th percentile and as high as the 90th percentile":

> Petitioner's sales grew at an average annual rate of 17 percent while the industry grew at an average annual rate of only 10.8 percent.
>
> Petitioner's inventory turnover rate, "a key measure of efficient use of capital and inventory management", was more than one-third higher than the mobile home retail industry as a whole.
>
> Petitioner "has very high capitalization relative to industry norms which reduce risk to the shareholder in the event of a downturn in business, saves interest costs on loans, enables faster growth, and causes ROE [returns on equity] ratios to understate true profit performance."

From the foregoing and other matters, Ding concluded as follows:

> When all the above factors are taken into consideration, it is apparent that Brewer Quality Homes' performance is among the best in the industry. CEOs who achieve top performance in their industry receive top pay, therefore it is reasonable to expect that Jack Brewer would receive compensation above the 75th percentile and as high as the 90th percentile.

Hakala, on the other hand, stated that for 1995 and 1996 Jack's "compensation level * * * [as a percentage of sales] was significantly higher than the third quartile levels of the RMA comparable firms." He stated that this high compensation level resulted in a drop in profitability which, together with an elimination of dividends, provided "low returns to its [petitioner's] shareholder."

In his rebuttal report, Hakala presented several criticisms of Ding's use of RMA data. We consider these criticisms seriatim.

Ding used average percentages over time, while Hakala focused on year-by-year figures for 1994 through 1996. Table 6 compares petitioner's total officer compensation (Jack's plus Mary's, in the case of petitioner) as a percentage of mobile home sales, on the one hand, to

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Ding's and Hakala's different approaches as to the RMA 75th percentile data.

Table 6	*Petitioner*	*RMA—Ding*	*RMA—Hakala*
1994	6.4	4.2	5.4
1995	8.7	4.2	5.4
1996	8.9	4.4	3.4
Averages			
Ding (1986-1996)	4.6	4.2	--
Ding (1994-1996)	8.0	4.3	--
Hakala (1994-1996)	8.0	--	4.7

Ding's focus on 11-year averages led her to conclude that petitioner's 11-year average payment ratios are only a little higher than the RMA 75th percentile ratios (4.6 percent to 4.2 percent) and *much lower* than the estimated RMA 90th percentile ratios[9] (4.6 percent to 5.9 percent). Hakala, on the other hand, concluded that petitioner's 1-year payment ratios are *much higher* than the RMA 75th percentile ratios (8.0 percent to 4.7 percent). *Supra* table 6.

Hakala also criticized Ding's analysis, as follows:

> In the tax year 1986 through 1993, BQH [petitioner] elected S Corporation status. The owner-officer of an S Corporation has an incentive to minimize personal salary and bonus compensation and to recognize greater taxable corporate ncome due to payroll taxes on reported compensation.[10] This calls into question the appropriateness of an undercompensation analysis in the years 1986 through 1993.

Firstly, for 2 of the 8 years Hakala refers to (1986 and 1988), petitioner was a C corporation, not an S corporation. It is not clear whether these mistakes were merely "harmless error" or whether this affected Hakala's conclusions.

Secondly, if Hakala's thesis is correct, that this "incentive" affected petitioner's actions during the C corporation years, then it becomes relevant to determine whether (and to what extent) it also affected the similar-sized businesses that provided the underlying data for the RMA ratios. Until we know that, we do not know how to deal with the concern that Hakala has described.

Thirdly, Hakala does not: (a) Point to any evidence that would enable us to quantify the amount, if any, by which this potential gamesmanship actually diminished the compensation that petitioner paid to Jack in any year, (b) suggest any way of adjusting the ratio for petitioner to compensate for this potential gamesmanship, or (c) explain why petitioner and Jack would shift payments from compensation in 1993 but not use that device for 1989, 1990, and 1991, when presumably the same "incentives" were in play and when petitioner and Jack had the same tax adviser that they had in 1993.

Thus, Hakala's speculation is interesting but we do not find it helpful in analyzing the instant issue. See *infra* (3) Previous Underpayment.

Hakala also presents the following double-barreled attack on Ding's reliance on the RMA data:

> The Robert Morris Associates ("RMA") data requires more analysis than was provided by Ms. Ding. First, we don't know exactly how many officers, directors and affiliates are represented in the total officers' compensation in the RMA figures. For larger dealerships, our experience is that more than one officer is included and sometimes three or more persons may be represented in the total figures. Second,

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> we don't know the extent to which the officers' compensation is consistent with arm's length practices. The BVS Report summarized in Exhibits II-2 and II-3 [attachments to Exh. 60-R, Hakala's expert witness report] represents an attempt to address these issues. The suggested total compensation at the 75th percentile level is at most $324,219 in 1995 and $224,858 in 1996 for a single officer and $486,329 in 1995 and $337,287 in 1986 for two officers or more executive officers of BQH based on this information.

As to the multiple-officer concern, we are satisfied that Ding's approach is useful, in the absence of anything better. Ding determined appropriate total officer compensation, subtracted the agreed-upon compensation to Mary, and concluded that the remainder is appropriate compensation to Jack. In the material that Hakala cites, he assumed that, in a two-officer arrangement, the second officer was compensated at half the rate of the first officer, and concluded that the CEO's compensation was 67 percent of the total officer compensation. We agree that Hakala's conclusions follow, arithmetically, from his assumptions. However, Hakala does not give us any reason to conclude that Hakala's "attempt to address these issues" is any better than Ding's approach. In the absence of any hard information as to businesses of petitioner's size, other than the evidence of petitioner's own history, we are willing to follow Ding's approach.

Hakala's concern that the underlying RMA data may not be "consistent with arm's length practices" is the more serious attack.

However, Hakala does not provide anything to back up the suspicion that he voices. Also, the material to which Hakala directs our attention does not appear to address this issue at all. Finally, the numbers that Hakala finally commends to us ($599,117 for 1995, $485,966 for 1996, *supra* tables 4, 5) are substantially greater than the numbers that Hakala tells us would result from the RMA 75th percentile data that Hakala suggest are too great.

Hakala does not direct our attention to any other data that focus on the mobile homes retail sales industry.[11]

On this record, the RMA ratios leave much to be desired as a foundation for decision-making. We nevertheless use those ratios as a starting point, because they are the only statistical information we have that deals with mobile home retailers. In other words, the RMA ratios are "the only game in town". See, e.g., *United States v. Borum*, 584 F.2d 424, 434 (D.C. Cir. 1978) (MacKinnon, J., dissenting).

The years in issue, 1995 and 1996, were good years for the mobile home retailing industry and even better years for petitioner.[12]

Jack guided petitioner through the hard times when many of petitioner's competitors went out of business and into the breakout years of 1995 and 1996.[13] We are satisfied that Jack's long-term efforts leading up to 1995 and 1996, and Jack's spectacularly successful work in 1995 and 1996, justify ranking Jack with the leaders of his field for the latter years. To us, this means that reasonable compensation for 1995 and 1996 is to be determined by reference to the 90th percentile of officer compensation payments.

We note that the RMA ratios fluctuate greatly from year to year, and even the relative ratios (i.e., comparisons of the ratios for smaller companies with the ratios for larger companies) fluctuate greatly. None of the experts discusses the factors that led to the RMA ratio fluctuations. Ding attempted to "smoothen" the relevant ratios. See *supra* table 6 for 75th percentile numbers. For 90th percentile numbers, Ding used 6.0 for 1995 and 6.3 for 1996. Hakala did not discuss whether there should be a different approach to the smoothening process or whether the RMA ratio amounts should be used without any smoothening. In the absence of criticism by Hakala, we are willing to follow Ding's smoothening approach. We apply the RMA 90th percentile

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ratios to petitioner's 1995 and 1996 sales to obtain total shareholder-employee reasonable compensation. From the totals thus obtained, we subtract the amounts petitioner paid to Mary, which have been agreed to be reasonable compensation for Mary's services.

However, our willingness to follow Ding's analysis regarding Jack's 90th-percentile status, at least for 1995 and 1996, does not lead us to Ding's conclusions that all of Jack's compensation is reasonable for each of these years. As Ding acknowledged at trial, the compensation that petitioner paid to Jack for each of these years, as a percentage of petitioner's sales, was significantly higher than the 90th-percentile level shown by the RMA data for the same years.

Our acceptance of Ding's thesis, then, leads us to apply the RMA 90th-percentile ratios to petitioner's sales, which results in reasonable compensation amounts significantly less than petitioner's actual payments to Jack. This process leads us to initial calculations of $520,000 for 1995 and $600,000 for 1996 as reasonable compensation amounts for Jack's services.

(2) Loan Guaranty

Hakala opined, in his expert witness report, that Jack was entitled to an additional $5,000 reasonable compensation "for providing his personal guarantee to secure a short-term working capital line of credit in 1995". Respondent has conceded the allowability of this additional amount. Petitioner does not dispute this item; we accept it. *Owensby & Kritikos, Inc. v. Commissioner* [87-2 USTC ¶ 9390], 819 F.2d at 1325 n. 33.

Accordingly, we increase our 1995 reasonable compensation determination to $525,000.

(3) Previous Underpayment

Petitioner contends that Jack was underpaid in previous years, particularly 1992 and 1993. See *supra* table 3. Petitioner argues as follows:

> While there are no corporate minuets [sic] declaring any part of Mr. Brewer's compensation for 1995 and 1996 as make up salary, a good faith argument for extension of existing law can be made where it is apparent from the facts because of the extreme disparity between Mr. Brewer's compensation in 1992 and 1993 and his compensation in both previous and following years that the fact that he was being compensated for past performance is plainly apparent.

Respondent's rejoinder is twofold: (1) There is no indication of an intent to compensate Jack in 1995 or in 1996 on account of past undercompensation, and (2) Hakala concluded that Jack was adequately compensated for Jack's services to petitioner for 1986 through 1994.

Amounts paid in a later year for earlier years' services may be deducted when paid, if the services were undercompensated in the earlier years. *Lucas v. Ox Fibre Brush Co.* [2 USTC ¶ 522], 281 U.S. 115, 119 (1930); *Estate of Wallace v. Commissioner* [Dec. 46,977], 95 T.C. at 553; *Cropland Chemical Corp. v. Commissioner* [Dec. 37,413], 75 T.C. 288, 297-298 (1980), affd. without published opinion 665 F.2d 1050 (7th Cir. 1981); *R.J. Nicoll Co. v. Commissioner* [Dec. 31,566], 59 T.C. 37, 50-51 (1972). In order to be allowed the deduction, the taxpayer must establish (1) the amount of the undercompensation for the earlier years' services and (2) that the payment in the later year is intended as compensation for the earlier years' services. *Pacific Grains, Inc. v. Commissioner* [68-2 USTC ¶ 9536], 399 F.2d 603, 606 (9th Cir. 1968), affg. [Dec. 28,309(M)] T.C. Memo. 1967-7; *Perlmutter v. Commissioner* [67-1 USTC ¶ 9246], 373 F.2d 45, 48 (10th Cir. 1967), affg. [Dec. 27,434] 44 T.C. 382, 403 (1965); *Estate of Wallace v. Commissioner* [Dec. 46,977], 95 T.C. at 553-554.

In the instant case, petitioner has presented us with little more than the claim, and general conclusory testimony, that some amount was intended as compensation for Jack's earlier years' services. We are not told (1) how much of the 1995 payments or the 1996 payments was so intended; (2) how the intent was arrived at or formulated; or (3) what earlier years' services were being compensated for in 1995 or in 1996. For all we can tell, petitioner's "theory of compensation for prior services was only an afterthought developed at a time when the reasonableness of the compensation was already under attack." *Pacific Grains, Inc. v. Commissioner* [68-2 USTC ¶ 9536], 399 F.2d at 606.

Petitioner's plea that we overlook the absence of corporate minutes runs into the concern that it is precisely in situations such as the instant case, where one person's "controlling presence was on all sides of the negotiating table" (*Kean, Transferee v. Commissioner* [Dec. 45,046], 91 T.C. 575, 595 (1988)), that we "must carefully scrutinize the payments to ensure that they are not disguised dividends." *Owensby & Kritikos, Inc. v. Commissioner* [87-2 USTC ¶ 9390], 819 F.2d at 1324.

On the basis of Jack's and Sledge's testimony, as well as petitioner's failure to produce any relevant corporate minutes or any other contemporaneous paper trail (see *Wichita Terminal Elevator Co. v. Commissioner* [Dec. 15,171], 6 T.C. 1158, 1165 (1946), affd. [47-1 USTC ¶ 9253] 162 F.2d 513 (10th Cir. 1947)), we conclude that it is more likely than not that petitioner did not intend in 1995 and did not intend in 1996 to compensate Jack for his earlier services to petitioner. We have so found.

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Under these circumstances we need not, and we do not, determine whether Jack was undercompensated for his earlier services to petitioner.

(4) Nonsalary Benefits

Ding stated that petitioner's failure to provide nonsalary benefits (other than health insurance) to its executives should be taken into account in determining the maximum reasonable compensation for Jack. She regarded as particularly important the lack of "a defined benefit plan or deferred compensation plan." She relied on studies showing that (1) "Companies typically provide their executives with benefits representing 24.4% of compensation" and (2) "Sixty-one percent of retail and wholesale trade industries provide long-term incentive programs for their top managers".

In his rebuttal expert witness report, Hakala responded as follows:

> *Compensation for Poor Benefits*: This is an interesting issue. It is difficult to quantify. BQH is not a large, public company. Benefits are typically more limited for officers of manufactured home dealerships. It is our understanding that Mr. Brewer's benefits were consistent with the benefits realized by his top sales personnel. The data relied upon by Ms. Ding is not applicable for a company of the size and type of BQH. However, some elements for benefits might be considered appropriate in a market compensation analysis but not in the independent investor returns analysis.

On opening brief, petitioner contends as follows:

> Additionally, Mr. Brewer's compensation lacked the typical benefits package. Mr. Brewer's compensation package did not include, a retirement plan, a SEP, a 401(k), a Profit-sharing plan, a Defined benefits plan, a 205 plan, a 125 plan, sick leave, or paid vacation. (Trial Trans. Vol. 1 page 38) These types of benefits were customary in the industry and represent a substantial amount of money. This lack of customary benefits package justifies a larger salary. (Trial Trans. Vol. 2 pages 193-196) Typically, companies provide their executives with benefits representing 24.4% of compensation. (Exhibit 56-P page 7 and Exhibit X therein) If Mr. Brewer would have had a typical benefits package his cash compensation could have been 24% less and he still had the same total compensation.

On answering brief, respondent replies as follows:

> Petitioner's argument that Jack Brewer's compensation in 1995 and 1996 made up for the lack of company provided fringe benefits is unfounded. It was not necessary for Jack Brewer to participate in a company sponsored profit sharing plan because, in fact, Jack Brewer determined and allocated substantially all company profits to himself on December 31 of each year.

We analyze this matter as follows:

Firstly, if petitioner means to say that courts apply the reasonable compensation test to only "cash compensation", then petitioner is wrong.

> It has long been settled law that—
>
> The sum of all compensation, deferred as well as direct, must meet the requirement of § 162 that it be reasonable in amount. [*Edwin's, Inc. v. United States* [74-2 USTC ¶ 9669], 501 F.2d 675, 679 (7th Cir. 1974).]

To the same effect, see *LaMastro v. Commissioner* [Dec. 36,093], 72 T.C. 377, 381-382 (1979); *Bianchi v. Commissioner* [Dec. 33,833], 66 T.C. 324, 329-330 (1976), affd. without published opinion 553 F.2d 93 (2d Cir. 1977).

Secondly, the question of what courts do in fact requires an understanding of the effect of the limits of what is in the record before us. For example, if we knew that (1) the underlying data for the RMA ratios came from only those mobile home retailers who provided nonsalary benefits to their executives, (2) but this underlying data included only the cash compensation paid to the executives and not the value of (or current cost to buy) the nonsalary benefits, and (3) the value of (or current cost to buy) these benefits was, as Ding stated, 24.4 percent of total compensation (i.e., cash compensation plus nonsalary benefits), then we would adjust the cash compensation amount upward by about 32.3 percent to arrive at total equivalent compensation.[14] However, the record before us does not include any of the needed information as to the data underlying the RMA ratios. Also, the 24.4 percent in Ding's analysis comes from a report of a 1992 study of 297 employers. The record does not give us any characteristics of the participating employers that would enable us to make a useful judgment as to how that sample related to the RMA samples for 1995 and 1996. Petitioner's brief makes assumptions that are not stated in the brief and that appear to be neither supported by nor contradicted by the record. Respondent's brief on this issue seems to

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be totally irrelevant to a reasonable compensation analysis, even though it may be significant to an analysis of petitioner's intent.

We are left with Hakala's observation that some adjustment for nonsalary benefits "might be considered appropriate in a market compensation analysis". Because of Hakala's observation, and in light of the lack of foundation for the use of 24.4 percent for mobile home retailers of petitioner's size, we conclude that we should adjust upward by some amount the estimates derived from the RMA ratios. See *Kennedy v. Commissioner* [82-1 USTC ¶ 9186], 671 F.2d 167, 175 (6th Cir. 1982), revg. [Dec. 36,219] 72 T.C. 793 (1979). Doing the best we can with the record in the instant case, we increase our 1995 reasonable compensation determination to $550,000 and our 1996 reasonable compensation determination to $630,000.

(5) Independent Investor Returns

In reaching his reasonable compensation figures, Hakala "relied primarily our [on ?] investor return analysis as an indication of the upper bound on executive compensation such that an arm's-length investor in the Company is able to realize a fair return on equity."

a. *Fair Market Value Analysis*

In the first part of his analysis, Hakala valued petitioner based on two "rules of thumb": (1) three times "owners' discretionary cash flow" and (2) five times earnings before interest (the net of interest income and interest expense) and taxes (only Federal income taxes), or EBIT. Owners' discretionary cashflow is the sum of EBIT, Jack's compensation, and Mary's compensation. Hakala states that, because only the owners' discretionary cashflow measure is calculated before deduction of officers' compensation, the difference in value between the two measures provides an implied amount of excess compensation. For 1995 and 1996, Hakala calculated implied excess compensation of $356,942 and $412,625, respectively. By subtracting the amounts of implied excess compensation from the amounts that petitioner paid to Jack, Hakala determined an implied amount of reasonable compensation of $405,244 for 1995 and $450,934 for 1996.

In his expert witness reports, Hakala included tables showing how his fair market value analysis would apply if petitioner had paid to Jack only the amounts that Hakala concluded would be reasonable compensation. In his original report, in which he concluded that maximum reasonable compensation to Jack would be $544,419 for 1995[15] and $448,620 for 1996, Hakala's fair market value analysis shows that, what Hakala referred to as the implied amount of reasonable compensation would be only $418,290 for 1995, but would be $461,734 for 1996. In his rebuttal report, in which he concluded that maximum reasonable compensation to Jack would be $599,117 for 1995 (see *supra* note 15) and $485,966 for 1996, Hakala's fair market analysis shows that, what Hakala refers to as the implied amount of reasonable compensation still would be only $418,290 for 1995, and $461,734 for 1996.

Hakala's analysis seems to not make any further use of the implied amounts of reasonable compensation that he thus calculated.

As far as we can tell, Hakala uses the three times owners' discretionary cashflow only in calculating "Operating return [operating income] on FMV operating assets [which Hakala apparently equates to three times owners' discretionary cashflow]" both in terms of what the ratios actually were and what the ratios would have been under the method described *infra*

b. *Estimate of Petitioner's Discount Rate*.

As far as we can tell, Hakala uses the five times EBIT only in one table, which appears twice in Hakala's original report. In that table, Hakala uses interchangeably "5 times EBIT" and "FMV of BQH [petitioner]". Hakala does not appear to use the five times EBIT amount to derive anything.

Hakala has not explained, and we have not been able to discern, any role that Hakala's fair market value analysis played in producing Hakala's bottom-line reasonable compensation conclusions. Under these circumstances, we do not pause to consider the appropriateness of Hakala's choices of the three and five multipliers (why not 2 1/2 and 5 1/2, or some other sets of numbers), of Hakala's choices of things to multiply (owners' discretionary cashflow and EBIT), of Hakala's choices of equivalents (three times owners' discretionary cashflow is equivalent to the fair market value of petitioner's operating assets; five times EBIT is equivalent to the fair market value of petitioner), and of Hakala's method of deriving implied reasonable compensation from these multiplier rules of thumb.

We have thought it appropriate to consider Hakala's fair market value analysis only because (1) Hakala presented it at the head of his independent investor returns analysis, and (2) it helps us in evaluating the complexities of the remaining portions of Hakala's independent investor returns analysis.[16] However, we conclude that this fair market value analysis in Hakala's expert witness report does not lead us to any

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answer in our quest for the maximum amount of reasonable compensation from petitioner to Jack.

b. *Estimate of Petitioner's Discount Rate*

Hakala's next step in his investor returns analysis was to estimate the discount rate, or "cost of capital". As Hakala uses the term, petitioner's cost of capital is the rate of return that an investor would expect to realize from an investment in a company such as petitioner, taking into account the appropriate risk and performance characteristics of petitioner.

From his pretax operating return on net operating assets percentages, Hakala determined an adjusted average required rate of return of 16.77 percent. In so doing, he assumed "inflation plus real growth will average approximately 4.0% per annum" and grossed up for taxes. Hakala then calculated reasonable compensation numbers for Jack such that the average required rate of return was 16.77 percent. The values of the variables (operating profit and three times owners' discretionary cashflow) that Hakala used to conclude that the average required rate of return equaled 16.77 percent are pretax values. The 16.77 percent, however, contemplates that the values will be after-tax values.

Hakala chose to use the Capital Asset Pricing Model (hereinafter sometimes referred to as CAPM) to estimate petitioner's cost of capital. He states that CAPM is "A standard method of estimating the cost of capital".

Petitioner contends that CAPM "has no application to closely held companies", citing *Furman v. Commissioner* [Dec. 52,679(M)], T.C. Memo. 1998-157. Neither Hakala nor respondent seeks to rebut petitioner's *Furman* contention. Hakala did not tell us (1) whether there are other standard methods, (2) whether CAPM has advantages over other standard methods, nor (3) why Hakala chose to use CAPM in this instance.

In *Estate of Heck v. Commissioner* [Dec. 54,639(M)], T.C. Memo. 2002-34, we commented as follows:

[11] In recent cases, we have criticized the use of both the capital asset pricing model (CAPM) and WACC as analytical tools in valuing the stock of closely held corporations. See *Furman v. Commissioner* [Dec. 52,679(M)], T.C. Memo. 1998-157. See also *Estate of Maggos v. Commissioner* [Dec. 53,846(M)], T.C. Memo. 2000-129, and *Estate of Hendrickson v. Commissioner* [Dec. 53,512(M)], T.C. Memo. 1999-278, which reaffirm that view, citing *Furman,* and *Estate of Klauss v. Commissioner* [Dec. 53,923(M)], T.C. Memo. 2000-191, where we rejected an expert valuation utilizing CAPM in favor of one utilizing the buildup method. In other recent cases, however, we have adopted expert reports which valued closely held corporations utilizing CAPM to derive an appropriate cost of equity capital. See *BTR Dunlop Holdings, Inc. v. Commissioner* [Dec. 53,624(M)], T.C. Memo. 1999-377; *Gross v. Commissioner* [Dec. 53,481(M)], T.C. Memo. 1999-254, affd. [2001-2 USTC ¶ 60,425] 272 F.3d 333 (6th Cir. 2001).

Because the parties have not developed this dispute and we conclude *infra* that Hakala's application of CAPM to petitioner in the instant case has significant flaws, we do not determine in the instant case the conceptual suitability of applying CAPM to the valuation of closely held companies such as petitioner.

The first step in CAPM involves calculating the cost of equity capital, which Hakala defined as "the expected (or required) rate of return on the firm's common stock" that an investor would "expect to realize from an investment in a company with the risk and performance characteristics" of petitioner. Hakala estimated the cost of equity capital to be 15.06 percent in 1995 and 15.75 percent in 1996.[17] Hakala then estimated the cost of debt, which he based on

[86 T.C.M. 45]

"the prevailing prime lending rate plus 1.0%." For 1995 and 1996, the costs of debt were 9.50 percent and 9.25 percent, respectively.

Next, Hakala applied the values determined in the preceding two steps to calculating the weighted average cost of capital, sometimes hereinafter referred to as WACC. Hakala determined that the WACC was 14.16 percent for 1995 and 14.76 percent for 1996.

In his expert witness report, Hakala described this process as "using weights reflecting the relative importance of debt and equity in the typical firm's capital structure." He multiplied the cost of equity capital by a fraction derived from the relative portion of total capital that consisted of equity; he multiplied the cost of debt capital by a fraction derived from the ratio of debt to equity (instead of the ratio of debt to total capital); and he added the two products together to produce his WACC amounts.

Sledge, in his rebuttal report, points out (correctly) that Hakala's debt multiplier should have been the ratio of debt to total capital; that the sum of the debt multiplier and the equity multiplier should be 1.000, while Hakala's sum was 1.0123; and that this error by Hakala resulted in Hakala's overstating the WACC and thereby understating the amount of reasonable compensation. (Sledge also has errors, discussed *infra.*)

Hakala has chosen to use 11.70 percent as the basic debtequity ratio. From this, he derives the equity multiplier of 0.8953 (this is one, divided by 1.117). It follows that the debt multiplier should be 1.0 minus 0.8953, or 0.1047, and not the 0.117 that Hakala used. If we correct this error and the abovenoted error of 15.06 percent rather than 15.03 percent for the cost of equity capital, then Hakala's CAPM approach should yield a 1995 WACC of 14.08, instead of Hakala's 14.16. Similar corrections would apply to the 1996 WACC. Because a lower WACC leads to higher reasonable compensation under Hakala's approach, these corrections in Hakala's numbers would result in an increase in the reasonable compensation numbers that Hakala recommends.

Hakala testified that correcting the WACC "caused the numbers in both years to go up" and stated in his rebuttal report that "The calculation of the weights for debt and equity in the BVS report [Hakala's expert witness report] was inconsistent with the assumed weights in the original Exhibit IV-2."

However, we are unable to determine exactly what corrections Hakala made in his WACC calculations that led to the substantial increases in his recommendations as to reasonable compensation. As a result, we do not know whether Hakala has already corrected for the above-noted errors.

In Sledge's rebuttal report, he pointed out that the combined debt and equity multipliers that Hakala used to determine the cost of debt and the cost of equity exceeded 1.0. He then proposed debt and equity multipliers that total 1.0, and he demonstrated the effect of the change by calculating the WACC for 1995, which he determined was 13.66 percent. Sledge presented this as follows:

> 3. This is the weighed [sic] average cost of capital, WACC, and is calculated as shown below.

```
Cost of debt                          9.50 × (1 - .38)      =  5.89
This is the cost of debt after taxes
Weighed [sic] cost of debt            5.89 × .1170          =  0.69

+ Weighed [sic] cost of equity       15.06 × (1/1 + .1170)  =

                 or,                 15.06 × .8953          = 13.48
                                                            ________
= WACC                                                 14.16 rounded
```

[86 T.C.M. 46]

DR. HAKALA HAS MADE AN ERROR IN THE CALCULATIONS OF WACC

> Refer to Exhibit Rebut-19.1 [an attachment in Sledge's rebuttal report] and you will see the correct formula for WACC. While Dr. Hakala has correctly written the formula on his p. 20, he does not compute it correctly.

```
                      CORRECT CALCULATIONS FOR WACC.

Cost of debt                          9.50 × (1 - .38)   =  5.89
This is the cost of debt after taxes
Weighed [sic] cost of debt            5.89 × .0928       =  0.55

+ Weighed [sic] cost of equity       15.06 × .9072         13.66
                                                         ________

= WACC                                                     13.66
```

As this excerpt shows, Sledge failed to add together the weighted cost of debt and the weighted cost of equity in his calculation. The corrected WACC, according to the values Sledge proposed, is 14.21 percent for 1995 and 14.82 percent for 1996, amounts greater than what Hakala had determined. Thus, while Sledge correctly noted one of Hakala's mathematical errors, Sledge's proposed solution leads to (or would have led to, if Sledge had carried the analysis out) reasonable compensation conclusions that are less than Hakala's conclusions.

As we noted *supra,* Hakala used 11.70 percent as the debtequity ratio in calculating the relative weights to be given to debt capital and equity capital. He did not give us any source for his statement that this is "the relative importance of debt and equity in *the typical firm's* capital structure." (Emphasis added.) However, elsewhere in his report he indicated that 11.70 percent is the *average* debt-equity ratio of four named firms.

These four firms had debt-equity ratios ranging from 0.8 percent to 33.6 as of June 30, 1996. We are not given any information that would lead us to conclude that the average of four firms' widely disparate capital structures happens to be precisely equal to "the typical firm's" capital structure.

All four firms are publicly traded, while petitioner is not. We do not find any information suggesting that this makes a difference or does not make a difference in what a reasonable independent investor would do with a firm like petitioner.

Hakala told us that "each of the four firms is a large manufacturer of * * * [mobile] homes with a large retail organization." Petitioner is entirely a retailer.

Hakala told us that the four firms had sales of $208 million to $862 million a year for 1995 and 1996, while petitioner's sales were only $9-10 million.

Hakala described the four firms as "billion dollar companies", while he regarded petitioner as worth only a few million dollars.

Hakala did not present to us any explanation (much less evidence supporting any explanation) as to whether or not adjustments should be made to this particular four-firm average debt-equity ratio to arrive at a typical debt-equity ratio that would be meaningful with regard to firms that are similar to petitioner. Because (1) Hakala's CAPM analysis makes reasonable compensation vary directly with the debt-equity ratio,[18] and (2) Hakala contends that his CAPM analysis enables him to determine Jack's maximum reasonable compensation to the dollar, it becomes important for us to have confidence in the correctness of Hakala's determination of 11.70 percent as the debt-equity ratio to use.

Because of the above-noted omissions, we have no idea what debt-equity ratio is appropriate to use in a CAPM analysis. This makes us reluctant to rely on a CAPM analysis based on the record in the instant case, whether or not CAPM analyses are viewed as conceptually appropriate for firms such as petitioner.

Finally, we note that, in his expert witness report, Hakala's arithmetic was inconsistent with his narrative description of the process of moving from WACC to pretax operating return on net operating assets. The arithmetic was consistent with an assumed combined State and Federal tax rate of about 41 percent, while the narrative states that Hakala used 38 percent. In his rebuttal report, Sledge pointed out the error and stated that "Correction of this error in math will raise the allowable compensation to Jack Brewer by about $94,000." In his rebuttal report, Hakala appears to have corrected this error[19] and has increased his recommended

[86 T.C.M. 47]

reasonable compensation amounts by a total of $92,044 for 1995 and 1996.

We note that Hakala did not make any change to his original WACC amounts, in correcting his expert witness report, and that his "bottom-line" determinations changed by almost the same amount that Sledge stated would be the case if Hakala were to make the corrections. Yet, when asked about this matter at trial, Hakala testified that his error was in the weighting of the two components of WACC, and not in the assumed tax rate.

We have described *supra* some mathematical errors that Hakala made in his WACC calculations. Hakala did not correct these errors. It appears that if these were corrected, then Hakala's "bottom-line" numbers would be greater, but we cannot tell by what amounts.

c. *Determination of Compensation Formula*

After Hakala determined a net required rate of return of 16.77 percent, he "conducted an analysis to determine a compensation formula to arrive at a reasonable range for officer's compensation such that an arm's-length investor could realize market rates of return on invested capital in * * * [petitioner]".[20]

Hakala calculated the "theoretically appropriate officers' compensation" by starting with a base salary of $207,000. He determined this amount by multiplying by 1.5 the median base salary shown in a survey for 1994 by Panel Publications of Aspen Publishing, hereinafter sometimes referred to as Panel/Aspen. Hakala did not explain why he multiplied the 1994 median base salary by 1.5, or why he used 1994 as a base year when he provided the data for 1995 and 1996—but not for 1994—in his report. Also, the data Hakala used was from both (1) the fabricated metal and wood products industry group and (2) the business services industry group. We are unclear as to how these industry groups are similar to petitioner. Hakala admitted that the comparability is somewhat limited and "not a very good fit". Nevertheless, he claimed that the data "provided information".[21]

[86 T.C.M. 48]

To determine the base salary for 1995 and 1996, Hakala increased the 1994 theoretical base salary of $207,000 by 4 percent per year. Thus, the base salary for 1995 and 1996 would have been $215,280 (207,000 x 1.04) and $223,891 (215,280 x 1.04), respectively. Hakala then determined the bonus amounts based on a percentage of the operating income before officers' compensation. In his expert witness report, Hakala explains as follows:

> The bonus percentage is solved based on the projected 4% per annum rate of growth, the expected operating expenses before officers' compensation in each future year and a required average net operating return on operating assets of 18.18%.
>
> Based on our analysis we calculate that the reasonable compensation for Mr. Brewer to achieve a 18.18% investor return is $544,419 in 1995 and $448,620 in 1996. This corresponds to a bonus of $329,568 in 1995, which would be 65.8% of theoretical operating income, and a bonus of $225,022 in 1996, which would be 31.9% of theoretical operating income.

In his rebuttal report, Hakala noted that his revised adjusted average required operating return on net operating assets (16.77 percent, rather than 18.18 percent) resulted in his increasing the recommended compensation level for each year, as described *supra*. However, he attributed this change entirely to recalculation of the weights for debt and equity.

Hakala's discussion of the Panel/Aspen data described *supra* does not seem to affect his conclusions at all, except as to how much of Jack's maximum reasonable compensation should be labeled base pay and how much should be labeled bonus. He apparently regarded this as so inconsequential that, in his rebuttal report, he did not bother to correct the bonus components when he revised the total compensation amounts. We cannot tell what function Hakala's discussion of base pay serves in Hakala's reaching, or explaining, his bottom-line conclusions.

Hakala's discussions of other comparisons, although eventually discarded, serve the appropriate function of demonstrating that those comparisons would have resulted in lower permissible amounts of reasonable compensation; they thereby make the CAPM approach appear to be more generous to petitioner than would be the case if the other methods had not been presented.

When "push came to shove", Hakala's conclusions rested entirely on CAPM, and respondent followed Hakala's conclusions to the dollar.

(6) Conclusion

Hakala has not presented us with a description of how his various analyses fit together to lead to the final numbers he reaches. He has not specified what points in his analyses are being corrected and how these corrections result in the changed numbers between his original expert witness report and his rebuttal report. As to the many different variables in CAPM, Hakala has not indicated why we should accept his choices in values rather than other choices, such as Sledge's.

Sledge, however, has not shown us how the changes in values result in his conclusions. Rather, he simply concludes that changing one of the variables to a value that is more favorable to petitioner results in a specified amount of greater maximum compensation. Without a thorough explanation or demonstration of why his changes result in the numbers that he reaches, we do not accept Sledge's conclusions. Further, we cannot tell from the information included in the expert reports whether a variation in any particular value is likely to cause a great or only slight change in the bottom line, and often it is not apparent whether a change is likely to increase the maximum amount of reasonable compensation or decrease the maximum amount of reasonable compensation.

In fact, Sledge conceded that it would be highly improbable for all of his suggested revisions to Hakala's CAPM numbers to be operable together. Adoption of some of his suggested revisions very likely would require that some other suggested revisions would have to be rejected, or might have to be revised in such a way as to result in the latter revisions undoing the effect of the former revisions.

We also note the paradox in Hakala's approach that the more successful Jack was in building up petitioner, the less the amount Hakala would say would be reasonable compensation. We find it difficult to justify an analysis that leads to such a counterintuitive result.

Under these circumstances, we conclude that (1) Hakala's application of CAPM on the record herein presents too many difficulties to justify using CAPM in the calculation of reasonable compensation for Jack, and (2) neither Hakala nor Sledge has explained CAPM sufficiently for us to be able to determine what would be the bottom-line effect of even correcting the arithmetic errors we have described, except that we perceive it is more likely than not that those corrections would produce reasonable compensation numbers somewhat greater than those that Hakala recommended.

[86 T.C.M. 49]

However, it appears from respondent's reactions on brief that respondent is willing to accept Hakala's recommendations even when the amounts exceed what had been determined in the notice of deficiency. Accordingly, we conclude: (1) Based on the foregoing analysis of Hakala's independent investor approach and the correction of Hakala's arithmetic errors (plus the allowance for Jack's loan guaranty), 1995 reasonable compensation for Jack's services is $610,000; and (2) based on the foregoing analysis of the RMA data (plus an amount for nonsalary benefits), 1996 reasonable compensation for Jack's services is $630,000.

2. *Intent*

Because of the comparatively subjective nature of the determination of a taxpayer's intent in making a payment to a shareholder-employee, courts have generally concentrated on the reasonableness prong rather than the intent prong in section 162(a)(2) cases. See, e.g., *Elliotts Inc. v. Commissioner* [83-2 USTC ¶ 9610], 716 F.2d 1241, 1243 (9th Cir. 1983), revg. [Dec. 37,110(M)] T.C. Memo. 1980-282. However, it is clear that if a payment was not intended to be compensation for personal services, then it will not be deductible under section 162(a)(2) even if the payment did not exceed reasonable compensation. See *King's Court Mobile Home Park v. Commissioner* [Dec. 48,173], 98 T.C. at 514-515; *Paula Construction Co. v. Commissioner* [Dec. 31,555], 58 T.C. at 1057, 1059-1060.

Having made determinations as to the maximum amounts of petitioner's payments to Jack that would be reasonable compensation for Jack's services, we now proceed to the second prong—whether any portions of those reasonable amounts are nevertheless not deductible by petitioner because they were not intended as compensation.

Respondent contends "that part of the payments [to Jack] deducted by petitioner are disguised dividends." In support of this contention, respondent directs our attention to the following: (1) Jack's testimony that if petitioner had a good year, then Jack had a good year, (2) the yearend ad hoc determination of Jack's bonuses and absence of any compensation plan for Jack are indicia of an intent to distribute earnings rather than pay compensation for services, and (3) the incentive to avoid one of the two layers of income taxation of dividends.

Petitioner contends that the issue is not properly before the Court in the instant case (see *supra* note 4), and devotes its efforts to the reasonable compensation prong.

We agree with respondent that (1) the issue is properly before us and (2) the evidence to which respondent draws our attention points toward an intent to distribute earnings.

However, in the instant case this agreement with respondent's position does not result in any disallowance of otherwise reasonable compensation.

In each year before us, substantially all of petitioner's payments to Jack were made by way of a bonus at the end of the year. There is no testimony or other evidence that indicates that the participants in the discussions—Jack and Sledge—had one intention with regard to a portion of each bonus and a different intention with regard to the remaining portion of each bonus. Thus, one might contend that a contaminating intention should result in disallowance of deductions for the entirety of each bonus, or alternatively that the contamination was not great enough to require disallowance of deductions for any part of each bonus.

Yet, from the notice of deficiency onward respondent clearly has not taken the all-or-nothing approach. Rather, even though respondent seems to regard the intent prong as more important than the reasonable amount prong, at each stage respondent has applied the intent argument only to so much of petitioner's payments to Jack as exceeds reasonable compensation.[22]

On the basis of the record in the instant case, consistent with the foregoing, we conclude that part of the amounts petitioner paid to Jack in each of the years in issue was not intended as compensation. The part that was not intended as compensation in each year is the amount by which the payments exceeded the amounts that we have held to be reasonable compensation. See *supra* table 4.

Thus, we hold, for petitioner, that all of the amounts petitioner paid to Jack that would not exceed reasonable compensation for Jack's services

[86 T.C.M. 50]

were in fact paid as compensation for Jack's services.

To take account of the foregoing,

Decision will be entered under Rule 155.

Notes:

1. In the notice of deficiency, respondent disallowed (1) $338,941 of the $783,930 of officer compensation that petitioner paid to Jack R. Brewer, Sr. (hereinafter sometimes referred to as Jack), and Mary L. Brewer (hereinafter sometimes referred to as Mary) in 1995, and (2) $397,759 of the $881,559 of officer compensation that petitioner paid to Jack and Mary in 1996.

Respondent concedes that (1) all payments of officer compensation to Mary are deductible, and (2) additional portions of the payments to Jack are deductible. After respondent's concessions, there remain in dispute only $158,069 of the original $338,941 disallowance for 1995, and only $337,593 of the original $397,759 disallowance for 1996.

2. Unless indicated otherwise, all section references are to sections of the Internal Revenue Code of 1986 as in effect for the taxable years in issue.

3. Respondent's counsel complied with the detailed requirements of Rule 151(e)(3) as to proposed findings of fact in opening briefs; petitioner's counsel did not. As a result, respondent was deprived of the opportunity to explain why petitioner's views of the facts were incorrect. In our determinations, we have taken the foregoing into account and have resolved many otherwise uncertain matters in favor of respondent's view of the facts.

Petitioner's counsel is put on notice that (1) the Rule is designed both to facilitate the work of the Court and also to provide a "level playing field" to the parties, and (2) the Court will be inclined to impose formal sanctions in the event of future similar violations.

Sec. 7491, which shifts the burden of proof to the Commissioner if the taxpayer meets certain conditions, is effective for court proceedings arising in connection with examinations beginning after July 22, 1998. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, sec. 3001(a), 112 Stat. 726. Respondent began examining petitioner's 1995 and 1996 Federal corporate income tax returns sometime in early 1997. Accordingly, sec. 7491 does not apply in the instant case.

Unless indicated otherwise, all Rule references are to the Tax Court Rules of Practice and Procedure.

4. On answering brief, petitioner contends as follows:

The Respondent contends that a portion of the payments are disguised dividends. * * *

The issue as to whether the payment of compensation was purely for services is not before the Court.

The Notice of Deficiency did not raise the issue of disguised dividends or the compensatory nature of the services, or assert that any portion of the payment was a disguised dividend. * * * It is unfair to the Petitioner after close of the trial to raise a new issue that being that the payment received by Mr. Brewer was for something other than the services he rendered. * * *

The Petitioner contends that only the amount of compensation the Court may find is in excess of a reasonable amount, if any, be declared to be a dividend, and that the Respondent not be allowed to dispute the compensatory nature of the payments to Mr. Brewer.

For the following reasons, we conclude that the issue of whether any part of petitioner's payments to Jack was disguised dividends, rather than intended compensation for personal services, is properly before the Court.

Firstly, the notice of deficiency explanation includes the alternative that disallowed amounts were not "expended for the purposes designated."

Secondly, the first sentence of respondent's opening statement before the trial is as follows:

OPENING STATEMENT BY COUNSEL ON BEHALF OF THE RESPONDENT

MS. CALKINS: Your Honor, this case presents two questions: whether a portion of payments made to Mr. Brewer in 1995 and 1996 and deducted as officer's compensation by the Petitioner are actually disguised dividends. * * *

The second question, respondent stated, was whether the deducted amounts "are reasonable in amount." The final sentence of respondent's opening statement is as follows:

It is Respondent's position that in spite of Mr. Brewer's contributions to Petitioner during the years at issue, the payments to him over and above what Respondent has allowed in the trial memorandum should be disallowed as disguised dividends.

Thirdly, our search of the transcript shows that, notwithstanding respondent's clear statements at the start of the trial, petitioner did not object, or otherwise comment on this matter, at that time or at any other time during the 3-day trial.

5. SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered * * *

6. A quotation from Shakespeare is perhaps apt:

Glendower: I can call spirits from the vasty deep.

Hotspur: Why, so can I, or so can any man; But will they come when you do call for them?

Henry IV, Part I, act 3, sc. 1.

7. For completeness, it should be noted that, when the Court asked Hakala "why it is that you believe it is appropriate to come up with a result to six significant figures", he responded that—

no one in a real compensation would round to six significant figures, that normally I would round to the nearest thousand or the nearest 5,000. In effect, if I was at 599, I'd round up to 600,000. If it was at 485, I might round to 485.

However, notwithstanding Hakala's concession that "no one" in a real situation would determine reasonable compensation to six significant figures, Hakala did not change his report recommendation, and respondent's posttrial briefs still urge us to adopt Hakala's six-significant-figure recommendations.

8. At trial, Hakala explained that, if he adjusted upward the maximum reasonable compensation for Jack for 1996, then he would have to make a corresponding downward adjustment for 1995. Neither Hakala at trial nor respondent on brief has explained why an upward adjustment for 1996 on account of the Fleetwood rebate would require a downward adjustment for 1995, except that at trial Hakala invoked the imagery of "squeezing on a balloon."

9. Hakala ignores Ding's estimates of RMA 90th percentile ratios; he neither disputes nor accepts the correctness of Ding's estimates. However, on brief, respondent accepts the correctness of Ding's estimates of RMA 90th percentile ratios, at least for the purpose of pointing out that petitioner's 1995 and 1996 ratios are far higher than the ratios that Ding applies.

10. In general, an S corporation shareholder is taxed on the shareholder's pro rata share of the corporation's income, regardless of whether the shareholder actually receives a distribution. Sec. 1366(a)(1). Where the shareholder is also an employee of the corporation, there is an incentive both for the corporation and for the employee-shareholder to characterize a payment to the employee-shareholder as a distribution rather than as compensation because only payments for compensation are subject to Federal employment taxes. See secs. 3111, 3301. In such instances, the Commissioner may recharacterize a distribution as compensation in order to reflect the true nature of the payment. See Rev. Rul. 74-44, 1974-1 C.B. 287 ("dividends" paid to S corporation shareholders treated as reasonable compensation for services rendered and subjected to Federal employment taxes); see also *Veterinary Surgical Consultants, P.C. v. Commissioner* [Dec. 54,527], 117 T.C. 141, 145-146 (2001), affd. sub nom. *Yeagle Drywall Co. v. Commissioner* [2003-1 USTC ¶ 50,141], 54 Fed. Appx. 100 (3d Cir. 2002).

Although Hakala argued that petitioner may have practiced tax gamesmanship in one or more of the years before 1995, the record does not disclose that respondent made a determination on this matter, nor can we tell from the record whether petitioner did distort the situation.

11. In his rebuttal report, Hakala states as follows:

The single best evidence of reasonable compensation can be found in the three subsequent offers to acquire the assets and business of BQH [petitioner] found in the exhibits to Ms. Ding's report.

However, Hakala relies on these offers only to the extent of contending that, in reality, the offers amount to less compensation for Jack than the approach that Hakala uses. In effect, then, Hakala rejects the lessons of the evidence that he describes as "The single best evidence".

12. Petitioner's sales increased proportionately more than the industry's sales, as shown by the following table:

Year	*Petitioner's Sales see supra Table 1*	*Industry Sales*	*Petitioner's Sales as a % of Industry Sales*
1986	$2,528,724	$ 5,480,384,000	0.046
1987	3,022,585	5,512,572,600	0.055
1988	3,569,197	5,482,567,900	0.065
1989	3,380,615	5,392,508,800	0.063
1990	3,526,171	5,231,181,600	0.067
1991	2,888,775	4,728,750,100	0.061
1992	2,732,920	5,986,350,800	0.046
1993	4,197,494	7,755,418,000	0.054
1994	6,559,036	10,181,722,000	0.064
1995	9,006,092	12,327,516,300	0.073
1996	9,920,208	13,954,982,400	0.071

13. Hakala stated, in his rebuttal report:

BQH [petitioner] was a well run and successful dealership with an established franchise and presence. Mr. Brewer clearly deserves substantial credit for this success in 1995 and 1996.

14. If nonsalary benefits are 24.4 percent of total compensation, then cash compensation constitutes the remaining 75.6 percent of the total compensation. Thus, total compensation is

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100 percent    of cash compensation, or 132.3 percent of
75.6 percent   cash compensation.
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15. For these calculations, Hakala ignored, without explanation, the additional $5,000 discussed *supra (2) Loan Guaranty.*

16. In Gilbert and Sullivan's "Patience", the character Bunthorne extols obscurity and complexity as the route to creation of an impressive persona, as follows:

If you're anxious for to shine in the high aesthetic line as a man of culture rare,

You must get up all the germs of the transcendental terms, and plant them everywhere.

You must lie upon the daisies and discourse in novel phrases of your complicated state of mind,

The meaning doesn't matter if it's only idle chatter of a transcendental kind.

And every one will say,

As you walk your mystic way,

"If this young man expresses himself in terms too deep for *me,*

Why, what a very singularly deep young man this deep young man must be!"

"Patience", The Complete Plays of Gilbert and Sullivan, pp. 199-200 (New York: Modern Library).

Under Fed. R. Evid. 702, the justification for the expert witness is that the expert witness "will assist the trier of fact to understand the evidence or to determine a fact in issue". It is not enough that the expert can communicate with other experts. The expert should be enough of a teacher or explainer so that the nonexpert trier of fact can understand the steps in the expert's analysis. The nonexpert trier of fact should not have to be a detective, discovering clues in odd places in the expert's report, in order to understand how the expert proceeded from one step to the next.

17. Hakala's report shows the arithmetic as follows:

1995: "15.06% = 5.96% plus (7.40% times 1.09) plus 1.00%"

1996: "15.75% = 6.65% plus (7.40% times 1.09) plus 1.00%"

Sledge's supplemental report adds the same components for 1995 as follows:

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  Long-Term Risk Less [sic] Rate        5.96
+ Market Risk × Beta 7.4 × 1.09    =    8.07
+ Non-systematic risk                   1.00
                                       _____
= Required return on equity            15.06 rounded
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Sledge then uses the 15.06 percent in his calculations.

When we perform the indicated arithmetic, we get 15.026, rounded to 15.03 percent for 1995, and 15.716, rounded to 15.72 percent for 1996.

18. Under Hakala's approach, the cost of debt capital is substantially less than the cost of equity capital. Thus, a greater debt-equity ratio leads to a lesser weighted average cost of capital (WACC). This means that under the CAPM, the greater the debt-equity ratio, the less the net profit that an independent investor would require, and so the independent investor could afford to pay more compensation.

19. We say "appears to", because Hakala's final numbers are not precisely the same as Sledge's numbers. We suspect that the differences are due to rounding at earlier stages of the computation, but we cannot be sure, because Hakala does not present a clear explanation of what he did.

20. This 16.77 percent (18.18 percent in Hakala's first expert witness report) is determined as an average of the information for 1995 and for 1996. Hakala has not explained how there could be a plausible scenario in which an "arm's-length investor" would take into account 1996 information, including 1996 interest rates, in agreeing to compensation payments in 1995.

21. Hakala's justification at trial for use of the Panel/Aspen data from the "Fabricated Metal and Wood Products Industry Group" and the "Business Services Industry Group" to determine a base salary for Jack was as follows:

[Q. by Calkins, on direct] Now, Dr. Hakala, we're going to Exhibit 57-P, which is Ms. Ding's rebuttal to your report.

A Okay

Q Ms. Ding assigns a number of errors in her report, and we'll briefly go through each of these errors.

At page 2, error number one, she addresses the use of the Penell [Panel/Aspen] Publishing Survey, criticizing the data and the size of the company.

Could you comment on that?

A There's some validity to the limitations on the use of the Penell, since I used fabricated metal wood products and business services.

I did pick the right types of industries, but the survey is too broad to probably be as applicable as I would like.

It's informative, but it's certainly not determinative of my ultimate opinion in the case.

Q So, when she says this data is not valid—

A It's valid. It's used all the time in the real world to sort of condition what you'd make in a small, closely-held company, but the issue is that you have to sort of condition the data for what industry and sector you're in, and that element of her criticism I think has some validity, a lot of validity.

* * * * * * *

Q [By Mayo, on cross] Okay. The first thing you did was you went to a survey called Pennell [Panel] Aspen Publishing Survey.

A Yes.

Q And that was a survey of compensation of CEO's.

A Yes.

Q And the first industry you looked at was wood products manufacturing?

A Fabricated metal and wood products.

Q Yeah, fabricated metal, that's not really very closely related to Mr. Brewer's business, though, is it?

A It's not a very good fit. It—he's selling products that might —

Q Small, low tech components, you know, pegs and brackets and that kind of stuff.

A Not always. Exacto Spring fell in there, but anyway.

Q How about Business Services? What was Business Services?

A It's so broad. It's also not a very good fit. I think some are—yeah, on page 13, I say thus, the comparability is somewhat limited.

Q Yeah, but that was what you used.

A It provided information.

Q I want to point out to the Court that there are some weaknesses in this analysis.

A I agree.

Q You agree that there are some weaknesses?

A Agree, and it provides some information, but the analysis is limited.

Q Right, and there are some weak—because it's wood products and business services, neither one are kind of directly related to Mr. Brewer?

A Correct.

22. For example, in the opening statement at trial, respondent's counsel described respondent's position as follows:

It is Respondent's position that in spite of Mr. Brewer's contributions to Petitioner during the years at issue, the payments to him over and above what Respondent has allowed in the trial memorandum should be disallowed as disguised dividends.

The trial memorandum reference is as follows:

Respondent's expert witness opinion (as modified by revised Exhibit IV-3 in the rebuttal report) provides for reasonable compensation for services rendered to petitioner by Mr. Brewer of $599,117.00 for 1995 and $485,966 for 1996. Further, the report allows additional compensation of $5,000.00 to Mr. Brewer for providing his personal guarantee to secure a short-term working capital line of credit in 1995. It is respondent's position that the stated amounts represent the reasonable compensation to Mr. Brewer and will be sustained by the Court as such.

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1 N.Y.3d 193
802 N.E.2d 1090
770 N.Y.S.2d 692

SHYRON BYNOG et al., Appellants-Respondents,
v.
CIPRIANI GROUP, INC., et al., Respondents-Appellants, et al., Defendants. (And Another Action.)

Court of Appeals of the State of New York.

Argued October 21, 2003.

Decided December 2, 2003.

[1 N.Y.3d 194]

Robert K. Erlanger, New York City, for appellants-respondents.

Robinson Brog Leinwand Greene Genovese & Gluck P.C., New York City (*Christy L. Reuter, John D. D'Ercole* and *Marshall E. Bernstein* of counsel), for respondents-appellants.

[1 N.Y.3d 195]

Proskauer Rose LLP, New York City (*Stephen Rackow Kaye* and *Aaron J. Schindel* of counsel), for The Fireman Group-Café Concepts, Inc., amicus curiae.

Eliot Spitzer, Attorney General, New York City (*Caitlin J. Halligan, Michelle Aronowitz, M. Patricia Smith, Jean Lin* and *Seth Kupferberg* of counsel), and *Jerome Tracy,* Albany, for State of New York, amicus curiae.

Judges CIPARICK, ROSENBLATT, GRAFFEO and READ concur; Chief Judge KAYE taking no part.

[1 N.Y.3d 196]

OPINION OF THE COURT

G.B. SMITH, J.

The primary issue before this Court is whether plaintiffs, professional banquet waiters, are entitled to recover, pursuant to Labor Law § 196-d, certain payments, alleged to be gratuities, made as part of catering contracts. We conclude that because plaintiffs were independent contractors and not employees of the defendants, they are not entitled to recover the payments. Accordingly, we modify the order of the Appellate Division insofar as it concludes that plaintiffs are employees of the Cipriani defendants, and thus dismiss the cause of action under Labor Law § 191 and the associated claim under Labor Law § 198.

Plaintiffs allege that they are professional banquet waiters employed by the Cipriani defendants at various catering facilities in New York City and that the Alexander defendants (M.J. Alexander & Co., Inc. [MJA] and Michael J. Alexander, individually) were the disclosed agents of the Cipriani defendants. Plaintiffs allege that as employees, they were entitled to receive, pursuant to Labor Law § 196-d, a mandatory 22% service charge paid by Cipriani's customers under various banquet contracts, in addition to the $20-28 flat hourly rate paid by the Alexander defendants.[1]

Plaintiffs also allege a violation of Labor Law § 191 in that they were not paid within seven days after work was performed

[1 N.Y.3d 197]

and a violation of Labor Law § 193 in that the defendants improperly withheld a portion of their pay for workers' compensation premiums.

Cipriani Fifth Avenue, LLC owns and operates both a banquet facility and two restaurants at 30 Rockefeller Plaza in New York City known as the "Rainbow Room." Cipriani 42nd Street, LLC owns and operates a banquet facility in New York City known as "Cipriani 42nd

Street." Cipriani 55 Wall Street, LLC owned and operated a banquet facility in New York City known as "Cipriani 55 Wall" but is no longer in business.

In contrast to plaintiffs who are temporary workers pursuant to catering contracts, the Rainbow Room employs a unionized permanent wait staff pursuant to a negotiated collective bargaining agreement. Union waiters are comprised of two groups, union banquet waiters and union restaurant waiters. All unionized waiters are permanent employees of the Rainbow Room and work exclusively for them. Under their collective bargaining agreement, the union banquet waiters receive a salary plus a portion of the catering food and beverage contract charge as a gratuity.

At the Rainbow Room, banquet service is provided by the union banquet waiters. If business needs require, the collective bargaining agreement expressly permits the Rainbow Room to supplement the banquet staff, first by using union restaurant waiters, and then by hiring outside temporary banquet waiters. The Rainbow Room paid MJA $20 per hour for each temporary waiter, plus a $15 fee for each waiter regardless of the number of hours worked. Cipriani 42nd Street paid $20-22 per hour for each waiter and $28 per hour for each captain plus a $15 fee for each waiter or captain regardless of the number of hours worked. The Cipriani defendants never took deductions, including payroll taxes, from the amounts invoiced by MJA.

Cipriani 42nd Street is not bound by the collective bargaining agreement and does not have a unionized wait staff. For banquets there, Cipriani 42nd Street hires outside temporary banquet waiters.

One of the places from which the Cipriani defendants obtain temporary waiters is MJA, a temporary personnel agency. When the defendants have a particular need, they contact MJA with the time and location of the need, as well as the number of waiters needed.

The Cipriani defendants moved for summary judgment. Supreme Court granted the motion on the ground that the

[1 N.Y.3d 198]

plaintiffs were independent contractors. The court also dismissed the plaintiffs' Labor Law §§ 196-d and 191 claims against Alexander, individually.[2]

The Appellate Division modified Supreme Court's order, on the law, by reinstating the plaintiffs' Labor Law §§ 191 and 198 claims against the Cipriani defendants, holding that summary judgment should not have been granted "on the ground that plaintiffs were not employees of" the Cipriani defendants. (298 AD2d 164, 165 [2002].) The Appellate Division affirmed the dismissal of the Labor Law § 196-d claims, holding that the contractual 22% service charge was not "in the nature of a voluntary gratuity presented by the customer in recognition of the waiter's service, and therefore need not be distributed to the waiters pursuant to Labor Law § 196-d, notwithstanding that the customer might believe that the charge is meant to be so distributed." (*Id.*) The Appellate Division granted the separate motions of the plaintiffs and defendants for leave to appeal to this Court and certified the question of whether the Appellate Division order was "properly made."

On this appeal plaintiffs, supported by the New York State Attorney General, continue to argue that they were employees of the Cipriani defendants and therefore entitled to the relief sued for. We disagree.

Article 6 of the Labor Law governs employers' payment of wages and benefits to employees. The parties agree that the critical inquiry in determining whether an employment relationship exists pertains to the degree of control exercised by the purported employer over the results produced or the means used to achieve the results (*see Matter of Ted Is Back Corp. [Roberts],* 64 NY2d 725, 726 [1984]; *Matter of 12 Cornelia St. [Ross],* 56 NY2d 895, 897 [1982]; *see also Matter* *of Morton,* 284 NY 167 [1940]). Factors relevant to assessing control include whether the worker (1) worked at his own convenience, (2) was free to engage in other employment, (3) received fringe benefits, (4) was on the employer's payroll and (5) was on a fixed schedule (*see Lazo v Mak's Trading Co.,* 84 NY2d 896, 897 [1994] [applying standard in tort context]; *see also Bhanti v Brookhaven Mem. Hosp. Med. Ctr.,* 260 AD2d 334, 335 [2d Dept 1999]).

As stated by Supreme Court, plaintiffs were not employees of the Cipriani defendants because they (1) worked at their own

[1 N.Y.3d 199]

discretion, (2) worked for other caterers, including Cipriani's competitors, without restriction, and (3) were under the exclusive direction and control of MJA, the temporary service agency that interviewed, hired and compensated the plaintiffs and from whom the plaintiffs received federal tax form 1099.[3] The Cipriani defendants did not provide uniforms (tuxedos) or any other necessary apparatus (wine bottle openers, etc.) to the temporary waiters from MJA.

Based upon the undisputed facts before us, MJA conducts interviews and hires temporary professional waiters. MJA furnishes each person it hires with an MJA handbook which tells them how they are to conduct themselves. Additionally, MJA provides any needed training of the individuals it hires. MJA pays each waiter directly and furnishes 1099's for tax purposes.

In most cases Alexander attends the banquets and supervises the temporary waiters personally. If he is not in attendance, one of the temporary waiter captains supervises the others.

If a problem does arise, the MJA handbook states that the temporary waiter should inform either Michael Alexander, if he is present, one of his appointed captains if he is not, or simply wait until after the event and report the problems to Alexander. The handbook instructs the temporary waiters not to contact the "client" directly.

After the banquets, MJA sends an invoice to the Cipriani defendants for services rendered. The Cipriani defendants would not pay any of the temporary waiters directly. Instead, they would send a check to MJA, payable to MJA, to settle the accounts.

The only involvement that the Cipriani defendants have with the waiters is to meet with them on the day of the banquet to discuss the particular customer menu and the timing of the various courses being served. In sum, it is clear the plaintiffs, temporary waiters, were not employed by the Cipriani defendants but were independent contractors.[4]

[1 N.Y.3d 200]

We also reject plaintiffs' attempt to cast themselves as special employees of the Ciprianis. Even if we were to conclude that the special employment doctrine is applicable in this context and that plaintiffs were the general employees of MJA, the fact remains that the Ciprianis did not exert sufficient control over plaintiffs' performance of their work to render them the special employer of plaintiffs (*see Thompson v Grumman Aerospace Corp.,* 78 NY2d 553, 557 [1991]).

Accordingly, the order of the Appellate Division should be modified, with costs to defendants, in accordance with this opinion and, as so modified, affirmed. The certified question should be answered in the negative.

Order modified, etc.

Notes:

1. Subsequent to the filing of an individual action, Bynog filed a putative class action complaint against Cipriani and MJA asserting the identical Labor Law § 196-d claims. The Supreme Court dismissed the class action. The Appellate Division affirmed and granted leave to appeal to this Court. The principles above govern this action as well.

2. The claim against MJA was withdrawn prior to a decision by the Supreme Court on the motion for summary judgment.

3. Form 1099 reports to the Internal Revenue Service amounts paid as compensation to persons such as independent contractors when withholding tax is not applicable.

4. Although we hold that the MJA waiters were not Cipriani employees, we reserve judgment as to whether those waiters would be entitled to a share of Cipriani's service charge under Labor Law § 196-d if they were employees.

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735 F.2d 8
26 Wage & Hour Cas. (BN 1239, 101 Lab.Cas. P 34,540,
17 Ed. Law Rep. 1031
Louis CARTER, Plaintiff-Appellant,
v.
DUTCHESS COMMUNITY COLLEGE, et al., Defendants-Appellees.
No. 778, Docket 83-2053.
United States Court of Appeals, Second Circuit.
Argued Feb. 17, 1984.
Decided May 14, 1984.

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Claudia J. Flynn, New York City (Parker Auspitz Neesemann & Delehanty P.C., New York City, on the brief), for plaintiff-appellant.

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Stephen J. Wing, County Atty., Poughkeepsie, N.Y., for defendants-appellees Dutchess Community College and F. Kennon Moody.

Nancy Miller Lerner, Asst. Atty. Gen., New York City (Robert Abrams, Atty. Gen. of State of N.Y., Melvyn R. Leventhal, Deputy First Asst. Atty. Gen., Barbara Butler and Brenda S. Spears, Asst. Attys. Gen., New York City, on the brief), for defendants-appellees Walter Chattman and Patrick J. Fish.

Before TIMBERS, KEARSE and PIERCE, Circuit Judges.

TIMBERS, Circuit Judge:

This is an appeal from a summary judgment entered January 11, 1983 on the motions of defendants in the Southern District of New York, Robert L. Carter, District Judge. The court granted the motions based on the report and recommendation of Magistrate Naomi Reice Buchwald, dated December 13, 1982. The magistrate recommended that, because plaintiff Louis Carter, as a state inmate, is under the "ultimate control" of the New York State Department of Correctional Services, he cannot be an employee of defendant Dutchess Community College within the meaning of the Fair Labor Standards Act (FLSA), 29 U.S.C. Sec. 201 et seq. (1982). We reverse and remand.

I.

At the time this Sec. 1983 action was commenced on February 25, 1981, Carter was an inmate at the Fishkill Correctional Facility (FCF) in New York. He alleged that he was participating in a program at FCF conducted by Dutchess Community College (DCC), pursuant to which, in conjunction with the several college level courses offered by DCC to inmates at FCF, DCC "employ[ed] several inmates in [the] institution (using only those who have actually graduated from a four-year college program) to act as teaching assistants to our regular staff." In his amended complaint filed December 5, 1981, Carter alleged that he was compensated at a level well below the federal minimum wage, in violation of the FLSA.

The origins of the inmate-teaching assistant program at FCF can be traced to a letter dated March 25, 1978 from defendant F. Kennon Moody, a former Coordinator of Inmate Education at DCC, to defendant Walter Chattman, who at the time was the Director of Educational Services for the New York State Department of Correctional Services (DCS). In that letter Moody first proposed the program. The duties of the inmate-teaching assistants would include meeting with DCC teachers, attending class meetings, and tutoring inmate-students outside of classroom hours. Moody requested the permission of DCS to supplement the inmates' prison wages so that a total day's salary would amount to between $3 and $4, five days a week. Moody also suggested that DCC send a check on a monthly basis to the prison's Office of Inmates Accounts to cover the supplementary wages.

The inquiry regarding the payment of supplementary wages to inmates was referred to defendant Patrick J. Fish, an attorney with DCS. According to Chattman's memorandum of April 20, 1978 to a deputy superintendent of programs, Fish advised that he saw "no legal impediment" to the supplementary compensation plan.

DCC then conducted a screening process to find inmates it considered to be qualified for the teaching assistant positions. Eligibility criteria were determined solely by DCC. DCC then submitted to DCS a list of inmates who it recommended be permitted by DCS to participate in the teaching assistant program. It is not clear from the record how many inmates were proposed by DCC, and consequently how many, if any, were rejected by DCS. What is clear is that Carter was among the eight inmates selected during the Fall of 1980. He was selected to conduct twenty tutorial classes in business math, all of which were held within the prison. Each session lasted 2 1/2 hours. He was paid a total of $60, which breaks down to $3 per class, or $1.20 per

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hour. The federal minimum wage at the time was $3.10 per hour.

At some point during or after his participation in the teaching assistant program, Carter learned that student tutors at the campus of DCC earned at least the federal minimum wage, which DCC was required to pay by law. On February 4, 1981, Carter wrote letters to the Director of Education at DCS and the Director of Financial Aid at DCC, inquiring about the disparate compensation scheme. He referred in both letters to the fact that the current Coordinator of Inmate Education at DCC had told Carter that DCS did not permit DCC to pay any more than $3 per day.

Carter received a prompt response on February 10 from the DCC Director of Financial Aid, Daniel Sistarenik, who informed Carter that indeed DCS did restrict the maximum amount of compensation that could be paid to the inmate tutors. Sistarenik advised Carter to state his concerns to DCS. By the time Carter commenced his Sec. 1983 pro se action on February 25, he had received no response from DCS. He attached the response he finally did receive, dated April 9, to his affidavit in opposition to defendants' motions to dismiss. This letter told Carter to direct his concerns to DCC.

In his pro se complaint, Carter named DCS and DCC as defendants. He alleged that he had been denied the equal protection of the laws, in violation of the Fourteenth Amendment, and had been subjected to involuntary servitude in violation of the Thirteenth Amendment. He sought back wages in amount of $107.50, plus interest, punitive damages in amount $150,000, and an injunction requiring defendants to begin paying all tutors the same compensation.

After DCS was dismissed from the action by an order entered June 17, 1981, Carter filed an amended complaint on November 23, 1981. The amended complaint added the individual defendants Moody, Chattman and Fish and alleged that defendants' actions violated the labor laws by compensating him at a rate less than the minimum wage.

On July 20, 1982, defendants DCC and Moody filed a motion to dismiss the complaint pursuant to Fed.R.Civ.P. 12(b)(6). On July 21, 1982, defendants Chattman and Fish filed a similar motion to dismiss. The motions were referred to the magistrate in accordance with a prior order referring the entire case to her.

In her well reasoned report and recommendation to Judge Carter, the magistrate rejected both constitutional arguments made by plaintiff. These arguments are not pressed on appeal.

In stating the alleged FLSA violation, the magistrate framed the issue as follows:

"In order to determine whether such an employment relationship exists the court must look to the 'economic reality' of the situation and determine whether DCC has 'ultimate control' over plaintiff."

The magistrate then applied the following standard to the facts before her:

"Although DCC does have discretion in the selection of inmates for positions in the teaching assistant program, these inmates nevertheless remain under the supervision and control of prison officials. It was the prison administrators that initially approved the program, and inevitably it is these same officials who retain the authority to disqualify an inmate or discontinue the program as they see fit. The fact that DCC was responsible for initiating the program and paying the inmates' wages does not compel a contrary result. Rather, the college's control over the inmates is 'qualified,' that is, 'subject to the ultimate control of prison administrators.' ... In short, inmates who participate in the teaching assistant program nevertheless retain their status as inmates under the control of New York State's correctional facilities, rather than becoming 'employees' of DCC."

In a footnote, the magistrate added that it was "unlikely that Congress intended that the FLSA's minimum wage protection be extended to prisoners." She recommended that defendants' motions, which

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she correctly treated as motions for summary judgment because the parties had conducted some discovery and relied on matters outside the pleadings, be granted.

The magistrate's report and recommendation was accepted and adopted by Judge Carter as the opinion of the court. From the judgment entered thereon, plaintiff has taken this appeal on which he has been represented by competent counsel. He argues (1) that the court applied an improper legal standard under the FLSA; (2) that defendants failed to sustain their burden under Rule 56; (3) that the court resolved factual disputes against him, the non-moving party; and (4) that the court did not allow sufficient discovery. For the reasons set forth below, we reverse the judgment of the district court and remand the case to that court for further proceedings.

II.

In our view, the issues in this case really boil down to one question: whether prisoners ever may be considered employees for the purposes of the minimum wage provisions of the FLSA. We frame the question in this way because, upon close examination, the only issue of fact considered material by defendants in their moving papers was Carter's inmate status. Moreover, the practical effect of the district court's decision is an absolute preclusion of FLSA coverage for prisoners. The court acknowledged that DCC exercised some control over the inmate-teaching assistants, but held that, since prison officials "inevitably" had "ultimate control" over the inmates, DCC could not be considered to be the inmates' employer.

It is common ground that courts, in determining whether an employment relationship exists for purposes of the FLSA, must evaluate the "economic reality" of the relationship. [1] Such an evaluation was first applied in the FLSA context in Goldberg v. Whitaker House Cooperative, Inc., 366 U.S. 28 (1961). The "economic reality" test since has been refined and now is understood to include inquiries into:

"whether the alleged employer (1) had the power to hire and fire the employees, (2) supervised and controlled employee work schedules or conditions of employment, (3) determined the rate and method of payment, and (4) maintained employment records."

Bonnette v. California Health and Welfare Agency, 704 F.2d 1465, 1470 (9 Cir.1983). The power to control a worker clearly is a crucial factor in determining whether an employment relationship exists. The district court here was correct in considering it.

The point at which we believe the court below erred was in giving undue weight to the control factor alone. More specifically, the court created a two-tiered analysis of control, recognizing that DCC had "qualified control" and that DCS had "ultimate control". Based on this distinction, as in Alexander v. Sara, Inc., 559 F.Supp. 42 (M.D.La.), aff'd per curiam, 721 F.2d 149 (5 Cir.1983), the court here held that Carter was not an employee within the meaning of the FLSA.

We do not agree that an entity's control over a worker must be "ultimate" in order to justify a finding of an employer-employee relationship. The statute is a remedial one, written in the broadest possible terms so that the minimum wage provisions would have the widest possible impact in the national economy. It runs counter to the breadth of the statute and to the Congressional intent to impose a qualification which permits an employer who exercises substantial control over a worker, but whose hiring decisions occasionally may be subjected to a third party's veto, to escape compliance with the Act. Indeed, in Falk v. Brennan, 414 U.S. 190 (1973), the Supreme

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Court held that a real estate management partnership, for FLSA minimum wage purposes, was an employer of maintenance workers at various apartment complexes. The workers were hired and supervised by the partnership, but at all times were considered employees of the owners of the apartment buildings. The Court referred to the amount of control exercised by the partnership over the workers as "substantial". The fair inference is that ultimate control was exercised by the apartment owners. It follows that the fact that control over a worker may be qualified is not a sufficient factor, in and of itself, to place an employment relationship beyond the scope of the FLSA.

Defendants argue, however, and the district court essentially agreed, that in the specific area of inmate labor, the ultimate control exercised by prison officials over inmates is a dispositive consideration that precludes a finding of an employee-employer relationship between an inmate and some outside entity. Aside from language in Alexander v. Sara, Inc., supra, defendants claim support from the stated purposes behind the FLSA. The argument here begins by pointing out that the FLSA was enacted to improve the living conditions, bargaining strength vis-a-vis employers, and general well-being of the American worker. 29 U.S.C. Sec. 202 (1982). In light of that, they contend that the FLSA has no application to imprisoned persons such as Carter, whose living conditions are determined as a matter of state policy, and who have no need for bargaining strength since their right to work in the first place is a matter of legislative grace.

Despite the surface appeal of this logic, we reject it for three reasons. First, there are purposes behind the FLSA other than those set forth above, among which is the establishment of minimum standards in the workplace. Mitchell v. Robert DeMario Jewelry, Inc., 361 U.S. 288 (1960). This results in the elimination of unfair competition, not only among employers, but also among workers looking for jobs. We believe that courts should refrain from exempting a whole class of workers, based on technical labels, from the coverage of the FLSA, because such action would have the potential for upsetting the desired equilibrium in the workplace.

Second, in Sec. 13 of the FLSA, 29 U.S.C. Sec. 213 (1982), Congress has set forth an extensive list of workers who are exempted expressly from FLSA coverage. The category of prisoners is not on that list. It would be an encroachment upon the legislative prerogative for a court to hold that a class of unlisted workers is excluded from the Act. Congress must be presumed to be aware of and to approve of the use by the courts of the economic reality test, which involves a case-by-case factual analysis. We decline defendants' invitation to depart from that analysis here.

Third, the cases relied upon by defendants--even those with language suggesting a bright-line rule of exemption for prisoners--in fact have undertaken a particularized inquiry into the facts of each case. In Alexander v. Sara, Inc., supra, a district court in Louisiana described in detail the blood plasma program in the Louisiana State Penitentiary at Angola, at which the plaintiffs worked. In ruling that the inmates were not employees of the defendant (an outside company), the court acknowledged that the facts were nearly identical to those of another Louisiana district court case, Hudgins v. Hart, 323 F.Supp. 898 (E.D.La.1971). While the court in Alexander did state that FLSA coverage for prison inmates was not contemplated by Congress, that strikes us as dictum in view of the factual analysis of the case.

Similarly, in Sims v. Parke Davis & Co., 334 F.Supp. 774 (E.D.Mich.), aff'd per curiam, 453 F.2d 1259 (6 Cir.1971), cert. denied, 405 U.S. 978 (1972), the court carefully analyzed all the facts of the case before concluding that the economic reality of the inmate-manufacturer relationship was that it was not employment, and not covered by the FLSA. Accord, Huntley v. Gunn Furniture Co., 79 F.Supp. 11 (W.D.Mich.1948).

We hold that it was error to have granted defendants' motions on the basis of "ultimate

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control"--whether viewed as one factor of the economic reality test or as an independent ground. A full inquiry into the true economic reality is necessary. We hold only that an inmate may be entitled under the law to receive the federal minimum wage from an outside employer, depending on how many typical employer prerogatives are exercised over the inmate by the outside employer, and to what extent.

III.

There remains to be determined whether, based on the record before us, we can affirm the summary judgment in favor of defendants on the ground that the economic reality test discloses no employment relationship between Carter and DCC. We can do so only if there is no genuine issue as to any material fact, the burden of establishing that being on defendants as the moving parties. American International Group, Inc. v. London American International Corp., 664 F.2d 348, 351 (2 Cir.1981). Any ambiguities must be resolved in favor of the non-moving party. Id.

In applying the economic reality test, the material facts are whether the alleged employer could hire and fire the worker, control work schedules and conditions of employment, determine the rate and method of payment, and maintain employment records. Carter's amended complaint alleges that he was employed by DCC pursuant to a proposal made by Moody of DCC to Chattman of DCS. The complaint also alleges that DCC was to pay the inmate-tutors directly, and that the wages eventually paid to Carter were substantially below the minimum wage and the compensation paid to on-campus student tutors. Attached to the complaint were Moody's letter (which says, "We propose to employ several inmates"), a response from the deputy superintendent of program services at Green Haven, [2] a letter from the same deputy superintendent to Chattman asking for advice on the legality of DCC's paying inmates, and Chattman's answering memorandum that, on the advice of counsel, there was no legal impediment to DCC's paying the inmates.

In support of the motion to dismiss by DCC and Moody, there was attached an affidavit by the Chief Assistant County Attorney for Dutchess County. His affidavit did not address any of the facts that are material under the economic reality test. His ground for urging dismissal was solely that Carter was an inmate at a state prison. We have held above that that is an insufficient reason to have granted summary judgment for defendants.

In support of the motion to dismiss by Chattman and Fish, there was attached an affidavit by an Assistant Attorney General. His affidavit likewise was devoid of any material facts and rested solely on the fact that Carter was an inmate. In paragraph 10, the affidavit stated as a conclusion that "[i]nmates in the New York State

Correctional System are not entitled to receive minimum wage." Attached to the affidavit were the Moody letter, the letter to Chattman from the deputy superintendent of program services, and Chattman's memorandum relaying counsel's advice, all of which had been attached to the complaint. In addition, there was attached a certificate of approval from the office of the Commissioner of Correctional Services setting forth daily allowance rates paid by the prison system to the inmates. The certificate did not disclose that money paid to inmates by outside "employers" was subject to a DCS-imposed maximum.

In short, defendants' affidavits simply failed to demonstrate that all material facts under the economic reality test were undisputed.

Carter filed opposing papers, including an affidavit. He restated the facts as originally alleged in the complaint. He added, however, that he had received a letter from a Petrita Hernandez, dated April 9, 1981 (after the filing of Carter's original complaint). This letter was in response to Carter's letter to DCS of February 4, 1981 which had been attached to Carter's original

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complaint. In her letter, Ms. Hernandez, who was Director of Education at DCS, informed Carter that "this issue [regarding compensation for tutoring] should be addressed to Dutchess Community College for whom you tutor." This letter certainly suggests a genuine issue as to a very material fact, namely, who determines the rate of pay for inmate-tutors. While it is the position of defendants that DCS imposes a maximum on money payable to inmates, Ms. Hernandez' letter at least gives rise to a contrary inference.

Despite the sparse record before us, this case strikes us as quite different from the typical case in which prisoners seek FLSA coverage. E.g., Wentworth v. Solem, 548 F.2d 773 (8 Cir.1977) (per curiam) (inmate working in prison bookbindery not an employee of the state prison); Alexander v. Sara, Inc., supra (no contractual relationship between inmates and outside company; "compensation" paid to State of Louisiana, not to inmates; no right on part of outside company to reject an inmate assigned to work in the plasma program); Sims v. Parke Davis & Co., supra (no contractual relationship between inmates and outside company; outside company relinquished to prison officials the normal rights of an employer to determine whether more or less manpower was needed, who the workers would be, and to discharge those found unsatisfactory); Hudgins v. Hart, supra (no contractual relationship between outside company and inmates; prison officials assigned inmates to work for defendant; money was sent to prison, which decided how much to pay the inmates); Huntley v. Gunn Furniture Co., supra, (same; sole control was with prison officials).

In the instant case, accepting the facts and all reasonable inferences favorable to Carter as the non-moving party, DCC made the initial proposal to "employ" workers; suggested a wage as to which there was "no legal impediment"; developed eligibility criteria; recommended several inmates for the tutoring positions; was not required to take any inmate it did not want; decided how many sessions, and for how long, an inmate would be permitted to tutor; and sent the compensation directly to the inmate's prison account.

While perhaps not the full panoply of an employer's prerogatives, this may be sufficient to warrant FLSA coverage. We do not hold one way or the other on that ultimate issue. We hold only that Carter has demonstrated genuine issues regarding material facts as to whether he is covered by the FLSA, and we emphatically hold that the fact that he is a prison inmate does not foreclose his being considered an employee for purposes of the minimum wage provisions of the FLSA.

The judgment of the district court is reversed, and the case is remanded to that court for further proceedings consistent with this opinion, including appropriate discovery proceedings. [3]

Costs to appellant on this appeal.

The mandate shall issue forthwith.

Reversed and remanded.

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1 A case by case analysis is required because the statute's definitions are stated in only the broadest terms. Section 3(e) defines "employee" as "any individual employed by an employer." 29 U.S.C. Sec. 203(e) (1982). "Employ" is defined as "to suffer or permit to work." Id. Sec. 203(g). An "employer" is one who acts "directly or indirectly in the interest of an employer in relation to an employee." Id. Sec. 203(d).

2 After commencement of the action, Carter was transferred out of the Fishkill Correctional Facility.

3 Since the district court did not reach the issues, and because the record before us is inadequate, we do not pass on the merit of defendants' arguments regarding the Eleventh Amendment, qualified immunity or the exemption from FLSA coverage based upon National League of Cities v. Usery, 426 U.S. 833 (1976).

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Alexis M. HERMAN, Secretary of Labor, United States
Department of Labor, Plaintiff-Appellee,
v.
RSR SECURITY SERVICES LTD., Michael A. Stern, Individually
and as President, and Frank Watkins, Individually
and as Vice President, Defendants-Appellees,
Murray Portnoy, Individually and as Chairman of the Board
and former Secretary of RSR Security Services,
Ltd., Defendant-Third-Party-Plaintiff-Appellant,
v.
Marilyn J. Stern, Third-Party-Defendant-Appellee.

Docket No. 97-6255.
United States Court of Appeals,
Second Circuit.
Argued Sept. 3, 1998.
Decided March 19, 1999.

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Alan B. Pearl, Syosset, New York (Alan B. Pearl & Associates, P.C., Syosset, New York, of counsel), for Defendant-Third-Party-Plaintiff-Appellant Murray Portnoy.

Paul L. Frieden, Washington, D.C. (U.S. Department of Labor, Washington, D.C., of counsel), for Plaintiff-Appellee Alexis M. Herman.

Bryan C. Skarlatos, New York, New York (Brian C. Wille, William F. Cuozzi, Kostelanetz & Fink, LLP, New York, New York, of counsel), for Defendants-Appellees RSR Security Services Ltd. and Michael A. Stern and Third-Party-Defendant-Appellee Marilyn J. Stern.

Before: NEWMAN, CARDAMONE, and PARKER, Circuit Judges

CARDAMONE, Circuit Judge:

The victor at Waterloo, when asked to undertake a task, reputedly responded: "The Duke of Wellington declines to interfere in circumstances over which he has no control." Appellant here interfered in business affairs where, the record reveals, he had considerable control over employees. Under the Fair Labor Standards Act, such control of employees is central to deciding whether appellant should be deemed an employer and therefore liable to his employees for unpaid wages.

Murray Portnoy (Portnoy or appellant) appeals from a judgment entered on March 31, 1997 in the United States District Court for the Eastern District of New York following a bench trial before Chief Judge Charles P. Sifton. The trial court found appellant, who served as chairman of the Board of RSR Security Services, Ltd. (RSR), was an employer under the Fair Labor Standards Act of 1938 (FLSA), 29 U.S.C. §§ 201-19 (1994), and thus was liable for RSR's violations of the FLSA's minimum wage, overtime, and recordkeeping requirements. Portnoy also appeals from an order dated March 17, 1996 from the same court dismissing his third-party complaint against Marilyn J. Stern and his cross-claims against defendants Michael A. Stern and Frank Watkins seeking contribution and/or indemnity from them. The latter appeal raises the issue--one of first

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impression in this Court--of whether there is a right to contribution or indemnity under the FLSA.

BACKGROUND

A. Facts

In late 1987 Michael Stern, Marilyn Stern (Michael's wife), and Murray Portnoy incorporated RSR to provide security guard, pre-employment screening, polygraph, patrol, and undercover services to corporate clients. Portnoy, a principal in the labor relations firm of Portnoy, Messinger & Pearl, became involved in the corporation's formation in late 1987 when Marilyn Stern--the daughter of a deceased friend--asked him for help in locating a job for her husband, Michael. Portnoy responded to this request by providing the financing necessary to start RSR, of which he and Marilyn Stern each owned 50 percent.

This arrangement seemed suitable since Michael Stern had knowledge of the security business from his previous ownership of two other security guard companies. But, because one of his security companies had been investigated by the IRS, resulting in an outstanding judgment against him, Michael Stern was not made a stockholder in the newly formed corporation. In addition, both of Stern's previous security guard companies had been investigated by the Department of Labor for minimum wage and overtime violations of the FLSA. Subsequent violation claims arising from these investigations were resolved without litigation.

The record does not clearly indicate whether Portnoy was aware of Michael Stern's alleged FLSA violations prior to organizing RSR and the institution of the present litigation. In any event, Stern was elected president of RSR, and Portnoy served as chairman of the Board and held various other positions from time to time. Prior to 1988 when Frank Watkins was hired as vice president, Portnoy and Stern were the company's only officers. RSR's main office was located in Long Island City, New York, and its branch office was maintained in the Westbury, New York offices of Portnoy, Messinger & Pearl. The majority of RSR's operations, including those involving the security guards, were conducted at the Long Island City office.

Michael Stern managed the security guard operations. He hired and fired guards, set the rates for their services, assigned them to job locations, monitored their performance, prepared the payroll, and maintained the company's files. In late fall 1988 Stern and Portnoy hired Frank Watkins as a vice president to assist Stern in the daily operation of the business. His duties included overseeing the security guards and the undercover investigators, conducting pre-employment screenings for clients, and maintaining company files. After a year, Watkins also became involved in sales and marketing, preparing the guards' payroll, and assisting Stern in hiring and firing decisions.

1. Portnoy's Participation in RSR

Although Portnoy exercised broad authority over RSR operations while working out of the Westbury office, he was not directly involved in the daily supervision of the security guards. Inasmuch as he was the only principal who had bank credit, he exercised financial control over the company. Thus, he had authority over Stern and Watkins; in his testimony, he asserted he could have unilaterally dissolved RSR, had Stern not followed his instructions. Portnoy's financial activities included the signing of RSR loans, approving purchases, and leasing vehicles for RSR employees on his personal credit. Watkins also testified that a raise he received came from Portnoy.

In addition, Portnoy frequently gave Stern and Watkins instructions on conducting RSR business. On one occasion, for example, he became aware, through RSR's accountant, that security guard employees were being illegally included as

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independent contractors on IRS 1099 forms. Subsequently, Portnoy instructed Stern and Watkins to cease the practice and later checked with other employees of the company to ensure the practice had been terminated.

Portnoy kept himself apprised of RSR operations by receiving periodic reports from employees in the Long Island City office. Watkins sent him faxes, work orders, memos, investigation reports, and invoices concerning the business operations, as well as weekly timesheets of his duties. Brian Serotta, an RSR accountant, reported to Portnoy with respect to company finances and, on at least one occasion, informed him about improprieties regarding the compensation of security guards. Appellant also requested that Bonni McGuirk, an RSR salesperson, be his "eyes and ears" in the company. Following this request, McGuirk gave him verbal briefings and sent him copies of letters and work orders. Another former RSR salesperson, Karen Goodman, testified she forwarded client complaints to Portnoy. Further, appellant telephoned the Sterns "reasonably frequently." Portnoy also participated in hiring and recruiting some RSR employees. He hired Bonni McGuirk to market security guard services and assisted in the hiring of Karen Goodman.

Portnoy took part more directly in the security guard operations. He referred a few individuals to RSR as potential security guard employees. He assigned guards to cover specific clients, sometimes set the rates clients were charged for those services, gave Watkins instructions about guard operations, and forwarded complaints about guards to Watkins. He also directed Watkins to show RSR's employment application forms to Alan Pearl of Portnoy, Messinger & Pearl for revisions.

Moreover, Portnoy was involved in some aspects of the compensation of the guards. For instance, he signed payroll checks on at least three occasions when, due to illness, Stern was unable to do so. Further, Portnoy established a payment system by which clients who wanted undercover operatives would pay Portnoy, Messinger & Pearl, which then forwarded the payments to RSR. In addition, John Thompson testified that Portnoy resolved a complaint about a work-related problem regarding Thompson's son, whom RSR employed as a security guard.

Because of his participation in company business, Portnoy was viewed by others as having control over RSR operations. Employees, including Watkins and several security guards, testified they viewed him as the "boss" of RSR. Portnoy did not discourage this view and in fact represented himself to outside parties as having such authority by allowing his name to be used in sales literature, by representing to potential clients that he was a principal with control over company operations--one who demanded nothing less than the highest legal, ethical, and quality services from the company--by using his reputation with Portnoy, Messinger & Pearl clients to obtain and refer clients to RSR, and by giving Watkins instructions with respect to those clients' security needs.

2. Portnoy's Knowledge of the FLSA

Describing the FLSA as his "passion," Portnoy testified that he had extensive knowledge of the FLSA and its requirements during the dates in question. He first became familiar with this law in 1939 and has kept up with it ever since, often advising clients of Portnoy, Messinger & Pearl how to comply with FLSA provisions. An investigator for the Department of Labor confirmed these statements when she testified that she had dealt with Portnoy for the past ten to 15 years because of his expertise regarding the FLSA. She stated that one of the specific areas of Portnoy's expertise was determining when and whether employees were entitled to overtime compensation.

3. The FLSA Violations

RSR employees were paid hourly wages starting at the minimum wage. RSR deducted

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from a guard's first or second paycheck a $40 or $45 fingerprint processing fee. The fingerprinting was required under state law, and the deductions were recorded on the payroll records as "state fees." Payroll records reflect that during the weeks these deductions were made, the guards received less than the minimum wage--a clear violation of the FLSA. See 29 U.S.C. §§ 206, 215(a)(2) (1994).

In addition, RSR security guards frequently worked over 40 hours, with some employees logging an average of 70 to 80 hours per week. The actual hours worked were recorded on timesheets and logbooks. However, Stern or Watkins recorded different numbers on payroll records, in order to reflect one-third less overtime worked per week than each guard actually had worked. Thus, although RSR's payroll records indicated that RSR was compensating guards for overtime at one and one-half times their regular pay, RSR was in fact paying its employees the same rate for all hours worked, including overtime, and deliberately concealing this practice by falsifying its payroll records. These practices also violated the FLSA. See 29 U.S.C. §§ 207, 211(c), 215(a)(2), 215(a)(5) (1994).

B. Prior Proceedings

This conduct came to light in 1993 when the Department of Labor began investigating RSR. On December 7, 1993 the Secretary of Labor (Secretary) filed a complaint charging defendants RSR, Michael Stern, and Frank Watkins with willfully violating the minimum wage, overtime, and recordkeeping requirements of the FLSA from January 1991 through March 1994. The Secretary sought back wages and liquidated damages on behalf of RSR's employees, as well as a permanent injunction preventing defendants from committing future violations of the FLSA. See 29 U.S.C. §§ 216(c), 217 (1994). Later, the Secretary amended her complaint to add Portnoy as a defendant, claiming that he was an employer under the FLSA. Appellant answered the complaint and amended his answer on June 26, 1995 to assert cross-claims for indemnity and contribution against Watkins and against both Michael and Marilyn Stern.

Both the Secretary and Portnoy moved for summary judgment on the issue of whether Portnoy was an employer under the FLSA, and the district court denied the motions in an order dated March 17, 1996. In that same order, the court granted the application to dismiss the Secretary's claim against Watkins. That order also dismissed Portnoy's cross-claims against Michael Stern and Watkins, as well as Portnoy's third-party complaint against Marilyn Stern.

A bench trial was held the last week of September 1996 on the remaining issues. Because on September 24 defendants RSR and Stern consented to the entry of a default judgment and stipulated to the amounts they owed the government, the only defendant contesting liability at the bench trial was Portnoy.

Six months later by order dated March 31, 1997 the district court ruled that Portnoy was an employer under the FLSA, that he had willfully violated the FLSA, and ordered him to pay $78,878.02 in back wages. Appellant was, in addition, found liable for liquidated damages in the same amount because of his failure to show good faith and objectively reasonable grounds for his asserted belief that RSR had been acting in conformity with the FLSA. Judgment was entered against appellant for $157,756.04.

Portnoy brought post-trial motions pursuant to Federal Rules of Civil Procedure 52(b) and 59(a), seeking amended or new findings of fact, a new trial, and an order directing entry of judgment in his favor. In an order dated August 12, 1997 the district court denied all the post-trial motions, ruling that nothing had been raised that warranted changing the factual findings or legal conclusions of the March 31, 1997 order. Portnoy appeals from the

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March 31, 1997 and August 12, 1997 orders and from the interlocutory order of March 17, 1996. We affirm.

DISCUSSION

I Standard of Review

On appeal from a bench trial, the district court's underlying findings of fact are reviewed for clear error, and its ultimate conclusions of law are reviewed de novo. See Lopresti v. Terwilliger, 126 F.3d 34, 38-39 (2d Cir.1997) (citing Fed.R.Civ.P. 52(a)); see also Reich v. Waldbaum, Inc., 52 F.3d 35, 39 (2d Cir.1995) (reviewing the willfulness of an FLSA violation as a mixed question of law and fact under this standard);

Brock v. Superior Care, Inc., 840 F.2d 1054, 1059 (2d Cir.1988) (same for employee status under the FLSA); Bonnette v. California Health & Welfare Agency, 704 F.2d 1465, 1469 (9th Cir.1983) (same for employer status under the FLSA).

II Qualifying as an "Employer" Under the FLSA

A. Statutory Definitions

To be held liable under the FLSA, a person must be an "employer," which § 3(d) of the statute defines broadly as "any person acting directly or indirectly in the interest of an employer in relation to an employee." 29 U.S.C. § 203(d) (1994). The Supreme Court has emphasized the "expansiveness" of the FLSA's definition of employer. Falk v. Brennan, 414 U.S. 190, 195, 94 S.Ct. 427, 38 L.Ed.2d 406 (1973). Above and beyond the plain language, moreover, the remedial nature of the statute further warrants an expansive interpretation of its provisions so that they will have "the widest possible impact in the national economy." Carter v. Dutchess Community College, 735 F.2d 8, 12 (2d Cir.1984).

B. Economic Realities

Because the statute defines employer in such broad terms, it offers little guidance on whether a given individual is or is not an employer. In answering that question, the overarching concern is whether the alleged employer possessed the power to control the workers in question, see Carter, 735 F.2d at 12, with an eye to the "economic reality" presented by the facts of each case, Goldberg v. Whitaker House Coop., 366 U.S. 28, 33, 81 S.Ct. 933, 6 L.Ed.2d 100 (1961). Under the "economic reality" test, the relevant factors include "whether the alleged employer (1) had the power to hire and fire the employees, (2) supervised and controlled employee work schedules or conditions of employment, (3) determined the rate and method of payment, and (4) maintained employment records." Carter, 735 F.2d at 12 (quoting Bonnette, 704 F.2d at 1470).

No one of the four factors standing alone is dispositive. See Superior Care, 840 F.2d at 1059. Instead, the "economic reality" test encompasses the totality of circumstances, no one of which is exclusive. Since economic reality is determined based upon all the circumstances, any relevant evidence may be examined so as to avoid having the test confined to a narrow legalistic definition. See Rutherford Food Corp. v. McComb, 331 U.S. 722, 730, 67 S.Ct. 1473, 91 L.Ed. 1772 (1947) (whether an employer-employee relationship exists does not depend on isolated factors but rather "upon the circumstances of the whole activity").

Yet, such status does not require continuous monitoring of employees, looking over their shoulders at all times, or any sort of absolute control of one's employees. Control may be restricted, or exercised only occasionally, without removing the employment relationship from the protections of the FLSA, since such limitations on control "do[ ] not diminish the significance of its existence." Donovan v. Janitorial Servs., Inc., 672 F.2d 528, 531 (5th Cir.1982); see Superior Care, 840 F.2d at 1060; Carter, 735 F.2d at 12-13.

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C. Application

Using this "economic reality" test, we must decide whether Portnoy is an employer under the FLSA. Evidence in the record supports at least three of the four factors. First, appellant had the authority to hire employees as evidenced by his hiring of Stern, Watkins, Brian Serotta, and Bonni McGuirk. Although this hiring involved mainly managerial staff, the fact that he hired individuals who were in charge of the guards is a strong indication of control. See Donovan v. Grim Hotel Co., 747 F.2d 966, 972 (5th Cir.1984) (noting as important evidence that defendant "personally selected the manager of every hotel").

Second, the proof suggests that Portnoy, on occasion, supervised and controlled employee work schedules and the conditions of employment. For example, he was involved in the assignment of guards to some work locations and, in addition, instructed Watkins to have Alan Pearl of Portnoy, Messinger & Pearl review and revise RSR's employment application forms.

The third factor asks whether the alleged employer determined the rates and method of payment to employees. Little evidence suggests Portnoy was involved with determining the rate of payment to the security guard employees. But he did participate in the method of payment when he ordered a stop to the illegal pay practice of including security guards on 1099 forms as independent contractors. The record further reflects that appellant signed security guard payroll checks on at least three occasions. Appellant contends that such cannot be the basis for liability because two of those three occasions occurred before the period giving rise to liability, but this contention is not a relevant consideration in determining his status as an employer. The key question is whether Portnoy had the authority to sign paychecks throughout the relevant period, and he did.

Fourth, there is no evidence that Portnoy was involved in maintaining employment records. But that this fourth factor is not met is not dispositive. See Superior Care, 840 F.2d at 1059.

In determining that Portnoy was an employer, the trial court also looked at several additional circumstances evidencing his control over RSR employees. Particularly in point was the exercise of authority over both Stern and Watkins, as demonstrated by the frequency with which he gave them instructions on running RSR. Because he controlled the company financially, it was no idle threat when he testified that he could have dissolved the company if Stern had not followed his directions.

D. Resolving Portnoy's Contentions

In challenging the trial court's conclusion that he was an employer for FLSA purposes, appellant raises a number of arguments, several of which require comment. Portnoy contends that evidence showing his authority over management, supervision, and oversight of RSR's affairs in general is irrelevant, and that only evidence indicating his direct control over the guards should be considered. Such a contention ignores the relevance of the totality of the circumstances in determining Portnoy's operational control of RSR's employment of the guards. In addition, other circuits have held that operational control is relevant in determining whether an individual is an employer under the FLSA. See Dole v. Elliott Travel & Tours, Inc., 942 F.2d 962, 965 (6th Cir.1991) (employer includes person who has "operational control" of day-to-day functions); Donovan v. Agnew, 712 F.2d 1509, 1511 (1st Cir.1983) (employer includes person who has "operational control"); Donovan v. Sabine Irrigation Co., 695 F.2d 190, 194-95 (5th Cir.1983) (employer includes person who "effectively dominates its administration or otherwise acts, or has the power to act, on behalf of the corporation vis-a-vis its employees").

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Appellant also insists the district court's decision conflicts with holdings from other courts of appeals. But the cases he cites to support this proposition are readily distinguished. In Wirtz v. Pure Ice Co., 322 F.2d 259, 262-63 (8th Cir.1963), stock ownership, in and of itself, was held insufficient to give rise to employer status. And in Sabine, 695 F.2d at 195, the court held that stock ownership is not necessary to a finding of employer status. Portnoy was, of course, not only a 50 percent stockowner; he had direct involvement with the security guard operations from time to time and was generally involved with all of RSR's operations.

Moreover, appellant declares that some evidence should be disregarded because the Department of Labor encouraged Watkins and others to testify falsely, for instance, by dismissing Watkins as a defendant in exchange for his allegedly false testimony against Portnoy. However, Portnoy offers no proof that Watkins' testimony was false, or that this quid pro quo ever existed. Other arguments raised in a similar vein, e.g., Portnoy's entitlement to notes from a meeting between Watkins and the Department and, to have his lawyer present at the meeting, accusations that two witnesses testified falsely because they would personally benefit from a verdict against Portnoy, were just that--conclusory arguments, with no support in legal theory and, therefore, without merit.

Finally, appellant urges that some of the factual findings upon which the trial court's decision is based are clearly erroneous. Because, as documented above, persuasive evidence in the record supports the trial court's factual findings, we see no reason to hold those findings clearly erroneous. In light of the totality of all the circumstances and proof before the district court, its factual findings and legal conclusion that Portnoy qualifies as an employer under the economic realities test must be affirmed.

III The Statute of Limitations and Willful Violations of the FLSA

The FLSA generally provides for a two-year statute of limitations on actions to enforce its provisions, but allows a three-year limitations period for "a cause of action arising out of a willful violation." 29 U.S.C. § 255(a) (1994). Thus, in this case, if Portnoy is found to have willfully violated the FLSA, he will be liable for the pay violations of the past three years, instead of just the past two years.

The district court found that Portnoy willfully violated the FLSA. Appellant asserts this finding is erroneous. The accepted standard for determining willful behavior, for which plaintiff bears the burden of proof, was enunciated by the Supreme Court in McLaughlin v. Richland Shoe Co., 486 U.S. 128, 133, 108 S.Ct. 1677, 100 L.Ed.2d 115 (1988), "that the employer either knew or showed reckless disregard for the matter of whether its conduct was prohibited by the statute."

Conflicting testimony was presented as to Portnoy's actual knowledge of the FLSA violations. Watkins testified he told Portnoy that the guards were being cheated. Witness Amatulli, a security guard, also testified he told Portnoy he was not being paid time and a half for his overtime hours. On appeal, Portnoy denies these conversations occurred and maintains that Watkins and Amatulli testified falsely. As the district court correctly determined, however, it is unnecessary to decide whether the conversations actually occurred, because the "reckless disregard" prong was satisfied even discounting this evidence.

The trial court reasoned that although Portnoy may not have had actual knowledge of the violative practices, the proof demonstrated he recklessly disregarded the possibility that RSR was violating the FLSA. Several reasons support this conclusion. First, when he agreed to form RSR, the trial court found, Portnoy was

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aware that one of Stern's previous security guard companies had been the subject of an Internal Revenue Service investigation, which led to the filing of an outstanding judgment against Stern. Hence, Portnoy knew Stern had conducted his earlier business activities in an illegal manner. With this background, when appellant subsequently learned that RSR guards were illegally included on 1099 forms as independent contractors--an indication of unlawful activity--he made no effort to ascertain RSR's compliance with the FLSA.

In response, appellant avers he had no independent knowledge that security guards were not being paid overtime, or even that the security guards were being paid minimum wages and therefore subject to the requirements of the FLSA. And, Portnoy further states, he repeatedly checked with Michael Stern, Marilyn Stern, and Watkins in order to ensure that RSR was complying with the law. But, for Portnoy to rely on information from Stern and Watkins in this context was reckless because Portnoy already knew of Stern's prior illegal activities and that some of RSR's own pay practices, which had come to his attention, violated the law. Moreover, appellant had independent means of determining the rates at which guards were paid since he was in regular contact with various RSR employees, including RSR's accountant; he could easily have inquired into the pay rates for the security guards. Portnoy was, after all, an expert in this field who had extensive knowledge of the FLSA and its requirements.

Under the circumstances, the district court was correct to rule that for Portnoy to rely upon the promises of Stern and Watkins was a reckless disregard of the risk that RSR was not in compliance with the FLSA. Such reckless disregard constituted a willful violation of the statute.

IV Liquidated Damages

The FLSA states that an employer who violates the Act's minimum wage or overtime provisions "shall be liable to the ... employees affected in the amount of their unpaid minimum wages, or their unpaid overtime compensation, as the case may be, and in an additional equal amount as liquidated damages." 29 U.S.C. § 216(b) (1994). Liquidated damages are not a penalty exacted by the law, but rather compensation to the employee occasioned by the delay in receiving wages due caused by the employer's violation of the FLSA. See Overnight Motor Transp. Co. v. Missel, 316 U.S. 572, 583-84, 62 S.Ct. 1216, 86 L.Ed. 1682 (1942).

Courts have discretion to deny an award of liquidated damages where the employer shows that, despite the failure to pay appropriate wages, the employer acted in subjective "good faith" and had objectively "reasonable grounds" for believing that the acts or omissions giving rise to the failure did not violate the FLSA. 29 U.S.C. § 260 (1994). The employer bears the burden of proving good faith and reasonableness, but the burden is a difficult one, with double damages being the norm and single damages the exception. See Reich v. Southern New England Telecommunications Corp., 121 F.3d 58, 71 (2d Cir.1997). To establish good faith, the employer must take active steps to ascertain the dictates of the FLSA and then act to comply with them. See id.

Portnoy failed to prove good faith. The scenario in this case is somewhat different from the ordinary one because Portnoy had extensive knowledge of the FLSA's requirements, but utterly failed to take the steps necessary to ensure RSR's pay practices complied with the Act. Many of the cases in this area of the law address situations where the employer has knowledge of his pay practices but is ignorant of the requirements of the FLSA. See, e.g., Brock v. Wilamowsky, 833 F.2d 11, 19 (2d Cir.1987). Nor did appellant, for reasons already discussed, demonstrate objectively reasonable grounds for believing that RSR

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was in compliance with the FLSA. [1] Because appellant failed to prove both subjective good faith and objective reasonableness, liquidated damages were properly assessed against him.

V The FLSA and the Right to Contribution

Finally, we turn to the question of whether there is a right to contribution or indemnification under the FLSA. This issue, as noted earlier, is one of first impression in this Court. Following the methodology of Northwest Airlines, Inc. v. Transport Workers Union, 451 U.S. 77, 101 S.Ct. 1571, 67 L.Ed.2d 750 (1981), the district court concluded there was no right to such relief under the FLSA and therefore dismissed Portnoy's claim asserting such rights against both of the Sterns and Watkins.

In Northwest the issue of contribution arose after Northwest Airlines was found liable for paying female flight attendants less than similarly positioned male flight attendants in violation of Title VII and the Equal Pay Act. See 451 U.S. at 81, 101 S.Ct. 1571. Northwest Airlines sought contribution from the flight attendants' union that had negotiated the unequal pay rates for its members. See id. at 82, 101 S.Ct. 1571. To determine whether either statute provided for a right of contribution, the Supreme Court focused its inquiry on traditional tools of statutory interpretation, looking at the language of the statute, examining its purpose and structure, and reviewing its legislative history.

The Court held that neither the Equal Pay Act nor Title VII by its express terms created a right of contribution in favor of employers. See id. at 91, 101 S.Ct. 1571. Despite this omission such a right may still exist if the statute was "enacted for the special benefit of a class of which petitioner is a member." Id. at 92, 101 S.Ct. 1571. But, the Court concluded, the purpose of both statutes was to benefit employees, and employers were not members of the class for whose special benefit either statute was enacted. See id. It further observed that the comprehensive nature of the remedial schemes in both statutes strongly evidenced a congressional purpose not to authorize additional remedies. See id. at 93-94, 101 S.Ct. 1571. Moreover, the legislative history of each statute was silent on the issue of contribution. See id. at 94, 101 S.Ct. 1571. In light of this analysis, the Supreme Court held that there was no right to contribution under either Title VII or the Equal Pay Act. See id. at 95, 101 S.Ct. 1571.

Portnoy maintains that the present action may be distinguished from Northwest because his claims of contribution and indemnification against co-employers comport with the purpose and policy of the FLSA, more than Northwest Airline's claim for contribution against an employee union comported with the purpose and policy of either Title VII or the Equal Pay Act. To the contrary, in Northwest, the Supreme Court assumed for the purposes of its analysis that the union bore "significant responsibility for discriminatory practices that these statutes were designed to prohibit," and that all the elements of contribution were met. 451 U.S. at 88, 90, 101 S.Ct. 1571. And, even assuming that the union was as culpable as a co-employer, the Court ruled that "[n]one of these assumptions ... provides a sufficient basis for recognizing the right" to contribution absent statutory authority. Id. at 90, 101 S.Ct. 1571. As the district court correctly held, Portnoy's status as an employer places him outside of the statute's intended protection, regardless of the status of the party from whom he seeks contribution.

Applying the Northwest analysis to the FLSA leads us to the same conclusion:

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There is no right of contribution or indemnification for employers found liable under the FLSA. The reasons are readily apparent. First, the text of the FLSA makes no provision for contribution or indemnification. Second, the statute was designed to regulate the conduct of employers for the benefit of employees, and it cannot therefore be said that employers are members of the class for whose benefit the FLSA was enacted.

Third, the FLSA has a comprehensive remedial scheme as shown by the "express provision for private enforcement in certain carefully defined circumstances." Northwest, 451 U.S. at 93, 101 S.Ct. 1571. Such a comprehensive statute strongly counsels against judicially engrafting additional remedies. Fourth, the Act's legislative history is silent on a right to contribution or indemnification. See Joint Hearings on H.R. 7200 and S. 2475 Before the Senate Comm. on Educ. and Labor and the House Comm. on Labor, 75th Cong. (1937), reprinted in 4 American Landmark Legislation: The Fair Labor Act of 1938, at 37-116 (Irving J. Sloan ed., 2d series, 1984) [hereinafter American Landmark Legislation]; S.Rep. No. 75-884 (1937), reprinted in American Landmark Legislation at 117-24; H.R.Rep. No. 75-1452 (1937); H.R.Rep. No. 75-2182 (1938); 83 Cong. Rec. 6894-6895, 7274-7326, 7373-7451, 7648-7673, 7720-7751, 7770, 7778-7813, 7863-7900, 7918-7957, 9158-9180, 9246-9267, 9615-9616 (1937-38), reprinted in part in American Landmark Legislation at 125-470. Accordingly, we hold that there is no right to contribution or indemnification for employers held liable under the FLSA.

Cases from other circuits support this conclusion. Several have followed Northwest 's reasoning in similar situations. See Martin v. Gingerbread House, Inc., 977 F.2d 1405, 1408 (10th Cir.1992) ("a third party complaint by an employer seeking indemnity from an employee is preempted" by the FLSA); Lyle v. Food Lion, Inc., 954 F.2d 984, 987 (4th Cir.1992) (court should not "engraft an indemnity action upon this otherwise comprehensive federal statute," i.e., the FLSA); LeCompte v. Chrysler Credit Corp., 780 F.2d 1260, 1264 (5th Cir.1986) (same).

Yet, even if the FLSA does not authorize contribution or indemnification, appellant declares these claims may nonetheless be prosecuted under New York law. This view of the law is flawed because the FLSA's remedial scheme is sufficiently comprehensive as to preempt state law in this respect. In addition, federal courts recognize a right to contribution under state law only "in cases in which state law supplie[s] the appropriate rule of decision." Northwest, 451 U.S. at 97 n. 38, 101 S.Ct. 1571. Here, federal law, not state law, supplies the appropriate rule of decision because the instant claim has been brought solely pursuant to the FLSA.

CONCLUSION

As a consequence, and for the foregoing reasons, we affirm the judgment and order of the district court.

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1 The district court mistakenly said "[Portnoy] was well aware that other RSR practices had violated the FLSA." However, from the rest of the court's discussion, we believe it clear that the district court meant to comment on Portnoy's knowledge of RSR's illegal practice concerning the 1099 forms.

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Bobby IRIZARRY, Ruben Mora, Joselito Arocho, Joseph Crema, Alfred Croker, Frank Deleon, Mario Dipreta, William Helwig, Robert Misuraca, Robert Pastorino, Victor Phelps, Daniel Salegna, Gilberto Santiago, Plaintiffs–Appellees, Carlos Torres, on behalf of himself and all others similarly situated, Lewis Chewning, Plaintiffs–Counter–Defendants–Appellees,
Raymond Allen, Llanos Blas, Nabil Elfiky, Mohammed Dabash, Carlos Martinez, Luis Morales, Steve Grossman, Franklyn Collado, David Adler, Dino A. Zaino, Patrick Labella, Robert Mastronicola, Anthony Brooks, Victor Bennett, Candido Morel, Jose Martinez, Wayne Hendricks, Harold Horn, Troy Miller, Ousmane Diatta, Elliot Stone, Tina Rodriguez, Gabriel Karamanian, Brian Homola, Anna Garrett, Nelson Betancourt, Jose Delacruz, Yuri Lamarche, Michael Groseclose, Rodolfo Delemos, Pio Morel, Abigail Claudio, Malick Diouf, David Otto, Alejandro Morales, Victor Diaz, Paul Petrosino, Eduardo Gonzalez, Jr., Jose Bonilla–Reyes, Vincent Perez, Martin Gonzalez, Calvin Adams, William Fritz, Katherine Halpern, Christian Tejada, Edward Stokes, Plinio Medina, Towana Starks, Lawson Hopkins, Ruben M. Aleman, Eugene Rybacki, Earl Cross, Manolo Hiraldo, Robert Hairston, Plaintiffs,
v.
John CATSIMATIDIS, Defendant–Appellant.
Gristede's Operating Corp., Gristede's Foods Ny, Inc., Namdor, Inc., Gristede's Foods, Inc., City Produce Operating Corp., Defendants–Counter–Claimants, Gallo Balseca, James Monos, Defendants.[*]

Docket No. 11–4035–cv.

United States Court of Appeals, Second Circuit.

Argued: Dec. 13, 2012.
Decided: July 9, 2013.

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Jonathan D. Hacker (Walter Dellinger, Brianne J. Gorod, Joanna Nairn, on the brief), O'Melveny & Myers LLP, Washington, D.C., for Appellant.

Deepak Gupta, Gupta Beck PLLC, Washington, D.C. (Gregory A. Beck, Jonathan E. Taylor, Gupta Beck PLLC, Washington, D.C.; Adam T. Klein, Justin M. Swartz, Molly A. Brooks, Outten & Golden LLP, New York, NY, on the brief) for Appellees.

Rachel Goldberg, Attorney, Office of the Solicitor (M. Patricia Smith, Solicitor of Labor, Jennifer S. Brand, Associate Solicitor, Paul L. Frieden, Counsel for Appellate Litigation, on the brief), for Amicus Curiae Secretary of Labor.

Tsedeye Gebreselassie, Catherine K. Ruckelshaus, National Employment Law Project, New York, NY, for Amicus Curiae Make The Road New York, Brandworkers International, Restaurant Opportunities Center New York, Chinese Staff and Workers Association, National Mobilization Against Sweatshops, National Employment Law Project, Legal Aid Society of New York, Urban Justice Center, Asian American Legal Defense and Education Fund.

Before: WESLEY and HALL, Circuit Judges, GOLDBERG, Judge.[**]

WESLEY, Circuit Judge:

After the failure of a settlement in a wage-and-hour case brought by a group of employees of Gristede's supermarkets, the

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plaintiff employees moved for partial summary judgment on the issue of whether John Catsimatidis, the chairman and CEO of Gristede's

Foods, Inc., could be held personally liable for damages. The case turns on whether Catsimatidis is an “employer” under the Fair Labor Standards Act (“FLSA”), 29 U.S.C. § 203(d), and the New York Labor Law (“NYLL”), N.Y. Lab. Law §§ 190(3), 651(6). The United States District Court for the Southern District of New York (Crotty, *J.)* granted partial summary judgment for the plaintiffs on the issue, establishing that Catsimatidis would be held jointly and severally liable for damages along with the corporate defendants. *See Torres v. Gristede's Operating Corp.,* No. 04 Civ. 3316(PAC), 2011 WL 4571792 (S.D.N.Y. Sept. 9, 2011) (“ *Torres III*”). Catsimatidis appeals. We affirm the district court's decision so far as it established that Catsimatidis was an “employer” under the FLSA; we vacate and remand the grant of partial summary judgment on plaintiffs' NYLL claims.

Background

Catsimatidis is the chairman, president, and CEO of Gristede's Foods, Inc., which operates between 30 and 35 stores in the New York City metro area and has approximately 1700 employees. Although a series of mergers and acquisitions has complicated the question of which companies are responsible for the Gristede's business and supermarkets, the parties have not made corporate structure the focus of this case. They essentially agree that Catsimatidis is the owner and corporate head of all implicated companies, but they dispute the manner and degree of his control over the stores and employees.

In 2004, a group of then-current and former employees of Gristede's supermarkets sued several companies involved in operating the stores. The employees also sued three individual defendants: Catsimatidis, Gristede's District Manager James Monos, and Gristede's Vice President Gallo Balseca. The district court certified a class composed of “[a]ll persons employed by defendants as Department Managers or Co–Managers who were not paid proper overtime premium compensation for all hours that they worked in excess of forty in a workweek any time between April 30, 1998 and the date of final judgment in this matter (the ‘class period’).” *Torres v. Gristede's Operating Corp.,* No. 04 Civ. 3316(PAC), 2006 WL 2819730, at *11 (S.D.N.Y. Sept. 29, 2006) (“ *Torres I* ”) (quotation marks omitted). In this decision, the court noted that the parties disputed the duties of co-managers and department managers, though the scope of plaintiffs' duties are not at issue in this appeal.

After two-and-a-half years of litigation, the district court granted summary judgment for the plaintiffs on their FLSA and NYLL claims, which concerned reduction of hours, withholding of overtime, misclassification as exempt employees, and retaliation. *See Torres v. Gristede's Operating Corp.,* 628 F.Supp.2d 447, 461–63, 475 (S.D.N.Y.2008) (“ *Torres II*”). The court held that plaintiffs were entitled to liquidated damages, the amount of which would be determined in future proceedings. *Id.* at 462 n. 14, 465. Plaintiffs reserved the right to move separately for a determination that the individual defendants were individually liable as joint employers. *Id.* at 453 n. 2.

Following the summary judgment order, the parties reached a settlement agreement, which the district court approved. The corporate defendants later defaulted on their payment obligations under the agreement. Defendants sought to modify the settlement, but the district court denied their request. Plaintiffs then moved for partial summary judgment on Catsimatidis's personal liability as an employer.

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The district court granted the motion for reasons both stated on the record at the conclusion of oral argument on the motion, *see* Special App'x at 43–46, and memorialized in a written decision, *see Torres III*. The reasons included the fact that Catsimatidis “hired managerial employees,” “signed all paychecks to the class members,” had the “power to close or sell Gristede's stores,” and “routinely review[ed] financial reports, work[ed] at his office in Gristede's corporate office and generally preside[d] over the day to day operations of the company." *Torres III,* 2011 WL 4571792, at *2. According to the district court, "[f]or the purposes of applying the total circumstances test, it does not matter that Mr. Catsimatidis has delegated powers to others [; w]hat is critical is that Mr. Catsimatidis has those powers to delegate." *Id.* (citation omitted). The court concluded that "[t]here is no area of Gristede's which is not subject to [Catsimatidis's] control, whether [or not] he chooses to exercise it," and that, therefore, Catsimatidis "had operational control and, as such, [ ] may be held to be an employer." *Id.* at *3.[1]

Discussion[2]

I. Definition of "employer" under the FLSA

The Supreme Court has recognized "that broad coverage [under the FLSA] is essential to accomplish the [statute's] goal of outlawing from interstate commerce goods produced under conditions that fall below minimum standards of decency." *Tony & Susan Alamo Found. v. Sec'y of Labor,* 471 U.S. 290, 296, 105 S.Ct. 1953, 85 L.Ed.2d 278 (1985). Accordingly, the Court "has consistently construed the Act liberally to apply to the furthest reaches consistent with congressional direction." *Id.* (quotation marks omitted). "The common law agency test was found too restrictive to encompass the broader definition of the employment relationship contained in the [FLSA]." *Frankel v. Bally, Inc.,* 987 F.2d 86, 89 (2d Cir.1993). Instead, the statute "defines the verb 'employ' expansively to mean 'suffer or permit to work.' " *Nationwide Mut. Ins. Co. v. Darden,* 503 U.S. 318, 326, 112 S.Ct. 1344, 117 L.Ed.2d 581 (1992) (quoting 29 U.S.C. § 203(g)). Unfortunately, however, the statute's definition of "employer" relies on the very word it seeks to define: " 'Employer' includes any person acting directly or indirectly in the interest of an employer in relation to an employee." 29 U.S.C. § 203(d). The statute nowhere defines "employer" in the first instance.

The Supreme Court noted early on that the FLSA contains "no definition that solves problems as to the limits of the

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employer-employee relationship under the Act." *Rutherford Food Corp. v. McComb,* 331 U.S. 722, 728, 67 S.Ct. 1473, 91 L.Ed. 1772 (1947). The Court has also observed "that the 'striking breadth' of the FLSA's definition of 'employ' 'stretches the meaning of 'employee' to cover some parties who might not qualify as such under a strict application of traditional agency law principles' in order to effectuate the remedial purposes of the act.' " *Barfield,* 537 F.3d at 141 (quoting *Darden,* 503 U.S. at 326, 112 S.Ct. 1344) (internal citation omitted).

"Accordingly, the Court has instructed that the determination of whether an employer-employee relationship exists for purposes of the FLSA should be grounded in 'economic reality rather than technical concepts.' " *Id.* (quoting *Goldberg v. Whitaker House Coop., Inc.,* 366 U.S. 28, 33, 81 S.Ct. 933, 6 L.Ed.2d 100 (1961)). The "economic reality" test applies equally to whether workers are employees and to whether managers or owners are employers. *See Herman v. RSR Sec. Servs. Ltd.,* 172 F.3d 132, 139 (2d Cir.1999).

"[T]he determination of the [employment] relationship does not depend on such isolated factors" as where work is done or how compensation is divided "but rather upon the circumstances of the whole activity." *Rutherford,* 331 U.S. at 730, 67 S.Ct. 1473. Some early cases concerned managerial efforts to distance themselves from workers in an apparent effort to escape the FLSA's coverage. For example, in *Goldberg,* the Supreme Court considered whether a manufacturing cooperative was an "employer" of "homeworker" members who created knitted and embroidered goods in their homes and were paid by the month on a rate-per-dozen basis. 366 U.S. at 28–29, 81 S.Ct. 933. The Court concluded that this constituted an employer-employee relationship because management's authority made "the device of the cooperative too transparent to survive the statutory definition of 'employ' and the Regulations governing homework." *Id.* at 33, 81 S.Ct. 933. "In short, if the 'economic reality' rather than 'technical concepts' is to be the test of employment, these homeworkers are employees." *Id.* (internal citations omitted). Similarly, the Court noted in *Rutherford* that "[w]here the work done, in its essence, follows the usual path of an employee, putting on an 'independent contractor' label does not take the worker from the protection of the Act." 331 U.S. at 729, 67 S.Ct. 1473.

The Second Circuit "has treated employment for FLSA purposes as a flexible concept to be determined on a case-by-case basis by review of the totality of the circumstances"; we have "identified different sets of relevant factors based on the factual challenges posed by particular cases." *Barfield,* 537 F.3d at 141–42.

In *Carter v. Dutchess Community College,* 735 F.2d 8 (2d Cir.1984), we identified factors that are likely to be relevant to the question of whether a defendant is an "employer." In that case, prison inmates teaching classes in a program that was managed by a college claimed the college was their employer. The district court rejected this assertion because "the college had only qualified control over the inmate instructors; the Department of Correctional Services always maintained ultimate control." *Barfield,* 537 F.3d at 142 (describing *Carter*) (quotation marks omitted). This Court, however, concluded that the "ultimate control" rule "would not comport with the 'remedial' purpose of the FLSA, which Congress intended to 'have the widest possible impact in the national economy.' " *Id.* (quoting *Carter,* 735 F.2d at 12). Instead, we established four factors to determine the "economic reality" of

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an employment relationship: "whether the alleged employer (1) had the power to hire and fire the employees, (2) supervised and controlled employee work schedules or conditions of employment, (3) determined the rate and method of payment, and (4) maintained employment records." *Id.* (quoting *Carter,* 735 F.2d at 12).[3]

Barfield also discusses the factors this court has used "to distinguish between independent contractors and employees," 537 F.3d at 143 (citing *Brock v. Superior Care, Inc.,* 840 F.2d 1054, 1058–59 (2d Cir.1988)), and "to assess whether an entity that lacked formal control nevertheless exercised functional control over a worker," *id.* (citing *Zheng v. Liberty Apparel Co.,* 355 F.3d 61, 72 (2d Cir.2003)).[4] None of the factors used in any of these cases, however, comprise a "rigid rule for the identification of an FLSA employer." *Id.* "To the contrary, ... they provide 'a nonexclusive and overlapping set of factors' to ensure that the economic realities test mandated by the Supreme Court is sufficiently comprehensive and flexible to give proper effect to the broad language of the FLSA." *Id.* (quoting *Zheng,* 355 F.3d at 75–76).

a. Individual liability

None of the cases above dealt specifically with the question we confront here: whether an individual within a company that undisputedly employs a worker is personally liable for damages as that worker's "employer." The only case from our Circuit to confront the question squarely is *RSR,* 172 F.3d 132. RSR provided guards, pre-employment screening, and other security services. It was sued for FLSA violations with regard to its security guards. Its chairman of the board, Portnoy, was found by the district court after a bench trial to be an "employer" under the statute. We affirmed, in a decision that both applied the four-factor test from *Carter* and noted other factors bearing upon the "overarching concern [of] whether the alleged employer possessed the power to control the workers in question." *Id.* at 139.

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As background, we noted that "[a]lthough Portnoy exercised broad authority over RSR operations ..., he was not directly involved in the daily supervision of the security guards." *Id.* at 136. Nonetheless, because "he was the only principal who had bank credit, he exercised financial control over the company." *Id.* "Thus, he had authority over" the operations manager, who directly supervised the guards. *Id.* "Portnoy kept himself apprised of RSR operations by receiving periodic reports [including] work orders, memos, investigation reports, and invoices concerning the business operations, as well as weekly timesheets of [a manager's] duties." *Id.* at 137. He also "referred a few individuals to RSR as potential security guard employees," "assigned guards to cover specific clients, sometimes set the rates clients were charged for those services, gave [a manager] instructions about guard operations, and forwarded complaints about guards to" a manager. *Id.*

Portnoy also "signed payroll checks on at least three occasions" and "established a payment system by which clients who wanted undercover operatives would pay" Portnoy's separate labor-relations firm. *Id.* Additionally, Portnoy "represented himself to outside parties as" being "the 'boss' of RSR" by "allowing his name to be used in sales literature, by representing to potential clients that he was a principal with control over company operations ... and by giving [a manager] instructions with respect to [ ] clients' security needs." *Id.*

We determined that at least three of the four *Carter* factors applied. First, Portnoy had hired employees, and although this "involved mainly managerial staff, the fact that he hired individuals who were in charge of the guards [was] a strong indication of control." *Id.* at 140. Second, Portnoy had, "on occasion, supervised and controlled employee work schedules and the conditions of employment." *Id.* Third, he had "participate[d] in the method of pay[ing]" the guards, even though he was not involved in determining their salaries, because he had previously "ordered a stop to the illegal pay practice of including security guards on 1099 forms as independent contractors," and he "had the authority to sign paychecks throughout the relevant period." *Id.* Although there was no evidence that Portnoy had been involved in maintaining employment records, we confirmed that the fact that "this fourth factor is not met is not dispositive." *Id.* The " 'economic reality' test encompasses the totality of circumstances, no one of which is exclusive." *Id.* at 139. In sum, we determined that Portnoy was "not only a 50 percent stockowner; he had direct involvement with the security guard operations from time to time and was generally involved with all of RSR's operations." *Id.* at 141.

RSR also highlighted two legal questions relevant here. The first concerns the scope of an individual's authority or "operational control" over a company—at what level of a corporate hierarchy, and in what relationship with plaintiff employees, must an individual possess power in order to be covered by the FLSA? The second inquiry, related but distinct, concerns hypothetical versus actual power: to what extent and with what frequency must an individual actually use the power he or she possesses over employees to be considered an employer?

i. Operational control

In addition to applying the *Carter* test, *RSR* noted the district court's recognition that Portnoy exercised direct authority over the two persons most responsible for managing the security guards, as well as the fact that "[b]ecause [Portnoy] controlled

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the company financially, it was no idle threat when he testified that he *could have* dissolved the company if [one of the managers] had not followed his directions." *Id.* at 140 (emphasis added). Accordingly, we emphasized that we rejected Portnoy's argument "that evidence showing his authority over management, supervision, and oversight of RSR's affairs in general is irrelevant, and that only evidence indicating his direct control over the guards should be considered." *Id.* We concluded that this formulation "ignores the relevance of the totality of the circumstances in determining Portnoy's operational control of RSR's employment of the guards." *Id.* We also noted that "operational control" had been cited as relevant by other circuits considering the question of individual liability under the FLSA. *See id.*

"Operational control" is at the heart of this case. Catsimatidis's core argument is that he was a high-level employee who made symbolic or, at most, general corporate decisions that only affected the lives of the plaintiffs through an attenuated chain of but-for causation. Although Catsimatidis undisputedly possessed broad control over Gristede's corporate strategy, including the power to decide to take the company public, to open stores, and to carry certain types of merchandise, he contends that a FLSA "employer" must exercise decision-making in a "day-to-day" capacity. Appellant's Br. at 3. By this, he appears to mean decisions about individual store-level operations, close to, if not actually including, the particular working conditions and compensation practices of the employees themselves. Plaintiffs counter that many cases have found individuals with "operational control" on a more general level to be employers. Appellees' Br. at 28–31.

Most circuits to confront this issue have acknowledged—and plaintiffs do not dispute—that a company owner, president, or stockholder must have at least some degree of involvement in the way the company interacts with employees to be a FLSA "employer." Many cases rely on *Wirtz v. Pure Ice Co.,* 322 F.2d 259, 262 (8th Cir.1963), for this proposition. In *Wirtz,* the court concluded that the individual defendant was not an employer even though he was the "controlling stockholder and dominating figure" because although he "could have taken over and supervised the relationship between the corporation and its employees had he decided to do so," he did not. *Id.* (quotation marks omitted). The defendant visited the facility at issue a few times per year but "had nothing to do with the hiring of the employees or fixing their wages or hours," and he "left the matter of compliance with the Fair Labor Standards Act up to the various managers of the businesses in which he had an interest." *Id.* at 262–63. The court noted, however, that if it were to consider "a combination of stock ownership, management, direction and the right to hire and fire employees, then a contrary conclusion would be well supported." *Id.* at 263.

In *RSR,* we cited three cases with holdings in accordance with *Wirtz* in resolving the "operational control" issue. First, in *Donovan v. Sabine Irrigation Co.,* 695 F.2d 190, 194–95 (5th Cir.1983), the Fifth Circuit determined that an individual without an interest in the employer corporation could be held liable if he "effectively dominates its administration or otherwise acts, or has the power to act, on behalf of the corporation vis-a-vis its employees"—or if he lacked that power but "independently exercised control over the work situation." The *Sabine* court found the individual defendant liable because he "indirectly controlled many matters traditionally handled by an employer in relation to an employee (such as payroll, insurance, and income tax matters)," noting also that the defendant's

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"financial gymnastics directly affected Sabine's employees by making it possible for Sabine to meet its payroll and keep its employees supplied with the equipment and materials necessary to perform their jobs." *Id.* at 195. (quotation marks omitted).

Second, in *Dole v. Elliott Travel & Tours, Inc.,* 942 F.2d 962, 966 (6th Cir.1991), the Sixth Circuit was unmoved by the protestations of an individual defendant who testified that he "made major corporate decisions" but "did not have day-to-day control of specific operations." The court found that the defendant's responsibilities, which included determining employee salaries, constituted "operational control of *significant aspects* of the corporation's day to day functions." *Id.* (quotation marks omitted) (emphasis in original).

Finally, in *Donovan v. Agnew,* 712 F.2d 1509, 1511 (1st Cir.1983), the First Circuit imposed liability on individual defendants "who together were President, Treasurer, Secretary and sole members of the Board" of the defendant company. One of the defendants had been "personally involved in decisions about layoffs and employee overtime hours," *id.,* and the defendants together had "operational control of significant aspects of the corporation's day to day functions, including compensation of employees, and [ ] personally made decisions to continue operations despite financial adversity during the period of nonpayment," *id.* at 1514.

Plaintiffs in our case place particular emphasis on the statement by the *Agnew* court that "[t]he overwhelming weight of authority is that a corporate officer with operational control of a corporation's covered enterprise is an employer along with the corporation, jointly and severally liable under the FLSA for unpaid wages." [5]*Id.* at 1511. Although this appears to suggest that any amount of corporate control is sufficient to establish FLSA liability, the First Circuit warned against taking the FLSA's coverage too far, noting that "the Act's broadly inclusive definition of 'employer' " could, if "[t]aken literally and applied in this context[,] ... make any supervisory employee, even those without any control over the corporation's payroll, personally liable for the unpaid or deficient wages of other employees." *Id.* at 1513.

Drawing on this language, the First Circuit later concluded that individuals who had "exercised some degree of supervisory control over the workers" and been "responsible for overseeing various administrative aspects of the business" but had not demonstrated other important characteristics— "in particular, the personal responsibility for making decisions about the conduct of the business that contributed to the violations of the Act"— were not personally liable under the FLSA. *Baystate Alternative Staffing, Inc. v. Herman,* 163 F.3d 668, 678 (1st Cir.1998). The court rejected an "expansive application of the definition of an 'employer' " that would find that "the significant factor in the personal liability determination is simply the

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exercise of control by a corporate officer or corporate employee over the 'work situation.' " *Id.* at 679. No other decision has gone as far as *Baystate;* most courts have endeavored to strike a balance between upholding the broad remedial goals of the statute and ensuring that a liable individual has some relationship with plaintiff employees' work situation.

For example, in *Gray v. Powers,* 673 F.3d 352, 354–57 (5th Cir.2012), the court found that the co-owner of a company that owned a nightclub was not a bartender's "employer" despite being a signatory on the corporate account and "occasionally sign[ing] several pages of preprinted checks." The individual defendant had little control over the bar and its employees except to direct a bartender to serve certain customers on several occasions when he was at the bar. *Id.* at 354. Similarly, in *Patel v. Wargo,* 803 F.2d 632, 638 (11th Cir.1986), the Eleventh Circuit held that an individual who was both president and vice president of a corporation, as well as a director and principal stockholder, was not an employer because he did not "have operational control of significant aspects of [the company's] day-to-day functions, including compensation of employees or other matters 'in relation to an employee.' "

By contrast, in *Reich v. Circle C. Investments, Inc.,* 998 F.2d 324, 329 (5th Cir.1993), the court found that a non-owner of a company that had invested in a nightclub had exercised sufficient "control over the work situation" as the "driving force" behind the company. The court cited evidence that the individual hired employees, gave them instructions (including specific songs for dancers' routines), and signed their payroll checks. *Id.* He had also removed money from corporate safes, "ordered one employee to refrain from keeping records of the tip-outs," and "spoke[n] for [the company] during the Secretary's investigation of possible FLSA violations." *Id.*

These cases reaffirm the logic behind our holding in *RSR,* which focused on defendant Portnoy's "operational control *of RSR's employment of the guards," see RSR,* 172 F.3d at 140 (emphasis added), rather than simply operational control of the company. Evidence that an individual is an owner or officer of a company, or otherwise makes corporate decisions that have nothing to do with an employee's function, is insufficient to demonstrate "employer" status. Instead, to be an "employer," an individual defendant must possess control over a company's actual "operations" in a manner that relates to a plaintiff's employment. It is appropriate, as we implicitly recognized in *RSR,* to require some degree of individual involvement in a company in a manner that affects employment-related factors such as workplace conditions and operations, personnel, or compensation—even if this appears to establish a higher threshold for individual liability than for corporate "employer" status.

The fundamental concern in the initial cases construing the FLSA was preventing a business entity from causing workers to engage in work without the protections of the statute. It was an "economic reality" that the "homework" cooperative in *Goldberg* functioned as the workers' employer because it paid them to create clothing, even if the compensation structure technically circumvented agency-law concepts of formal employment. *See Goldberg,* 366 U.S. at 31, 81 S.Ct. 933 (stating that the Court would be "remiss ... if we construed the Act loosely so as to permit this homework to be done in ways not permissible under the Regulations"); *see also United States v. Rosenwasser,* 323 U.S. 360, 363, 65 S.Ct. 295, 89 L.Ed. 301 (1945) ("A worker is as much an employee

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when paid by the piece as he is when paid by the hour."). This concern is not as pressing when considering the liability for damages of an individual within a company that itself is undisputedly the plaintiffs' employer.

Even in the individual-liability context, however, "the remedial nature of the [FLSA] ... warrants an expansive interpretation of its provisions so that they will have 'the widest possible impact in the national economy.' " *RSR,* 172 F.3d at 139 (quoting *Carter,* 735 F.2d at 12). Nothing in *RSR,* or in the FLSA itself, requires an individual to have been personally complicit in FLSA violations; the broad remedial purposes behind the statute counsel against such a requirement. The statute provides an empty guarantee absent a financial incentive for individuals with control, even in the form of delegated authority, to comply with the law, and courts have continually emphasized the extraordinarily generous interpretation the statute is to be given. Nor is "only evidence indicating [an individual's] direct control over the [plaintiff employees] [to] be considered." *RSR,* 172 F.3d at 140. Instead, "evidence showing [an individual's] authority over management, supervision, and oversight of [a company's] affairs in general" is relevant to "the totality of the circumstances in determining [the individual's] operational control of [the company's] employment of [the plaintiff employees]." *Id.*

A person exercises operational control over employees if his or her role within the company, and the decisions it entails, directly affect the nature or conditions of the employees' employment. Although this does not mean that the individual "employer" must be responsible for managing plaintiff employees—or, indeed, that he or she must have directly come into contact with the plaintiffs, their workplaces, or their schedules—the relationship between the individual's operational function and the plaintiffs' employment must be closer in degree than simple but—for causation. Although the answer in any particular case will depend, of course, on the totality of the circumstances, the analyses in the cases discussed above, as well as the responsibilities enumerated in the *Carter* factors, provide guidance for courts determining when an individual's actions rise to this level.

ii. Potential power

In *RSR,* we noted that "operational control" need not be exercised constantly for an individual to be liable under the FLSA:

[Employer] status does not require continuous monitoring of employees, looking over their shoulders at all times, or any sort of absolute control of one's employees. Control may be restricted, or exercised only occasionally, without removing the employment relationship from the protections of the FLSA, since such limitations on control do not diminish the significance of its existence.

172 F.3d at 139 (quotation marks and alteration omitted). The district court in this case appears to have relied on this language in stating that "[w]hat is critical is that Mr. Catsimatidis has [certain] powers to delegate" and that "[t]here is no area of Gristede's which is not subject to his control, whether [or not] he chooses to exercise it." *Torres III,* 2011 WL 4571792, at *2–3. The parties also dispute the importance of evidence indicating that Catsimatidis only rarely exercised much of the power he possessed.

Employer power that is "restricted or exercised only occasionally" does not mean "never exercised." In *Donovan v. Janitorial Services, Inc.,* 672 F.2d 528, 531 (5th Cir.1982), the Fifth Circuit noted that the

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company owner's "considerable investment in the company gives him ultimate, if latent, authority over its affairs," and the fact that he had "exercised that authority only occasionally, through firing one employee, reprimanding others, and engaging in some direct supervision of Johnson Disposal drivers, does not diminish the significance of its existence." In *Superior Care,* this court noted that although representatives of the defendant business, a nurse-staffing company, visited job sites only infrequently, the company had "unequivocally expressed the right to supervise the nurses' work, and the nurses were well aware that they were subject to such checks as well as to regular review of their nursing notes." 840 F.2d at 1060. "An employer does not need to look over his workers' shoulders every day in order to exercise control." *Id.* Similarly, in *Carter,* we rejected the proposition that the community college was not employing prison inmates solely because the prison had "ultimate control" over the prisoners, reasoning that the community college also made decisions that affected the prisoners' work. 735 F.2d at 13–14.

The Eleventh Circuit has squarely held that even when a defendant "could have played a greater role in the day-to-day operations of the [ ] facility if he had desired, ... unexercised authority is insufficient to establish liability as an employer." *Alvarez Perez v. Sanford–Orlando Kennel Club, Inc.,* 515 F.3d 1150, 1161 (11th Cir.2008). The *Alvarez* court found that an officer in a company that owned a kennel club was not an employer, in part because even though he might have had the authority to do so, he "had not taken part in the day-to-day operations of the facility, had not been involved in the supervision or hiring and firing of employees, and had not determined their compensation." *Id.*

Unlike *Alvarez, RSR* does not state unambiguously that unexercised authority is insufficient to establish FLSA liability, and we see no need to do so here in light of the evidence of the authority that Catsimatidis *did* exercise. Nonetheless, all of the cases discussed indicate that the manifestation of, or, at the least, a clear delineation of an individual's power over employees is an important and telling factor in the "economic reality" test. Ownership, or a stake in a company, is insufficient to establish that an individual is an "employer" without some involvement in the company's employment of the employees.

II. Catsimatidis as "employer"

"Using this 'economic reality' test, we must decide whether [Catsimatidis] is an employer under the FLSA." *See RSR,* 172 F.3d at 140. Is there "evidence showing his authority over management, supervision, and oversight of [Gristede's] affairs in general," *see id.,* as well as evidence under the *Carter* framework or any other factors that reflect Catsimatidis's exercise of direct control over the plaintiff employees?

a. Catsimatidis's overall authority

Catsimatidis is the chairman, president, and CEO of Gristede's Foods, Inc. Joint App'x 1016.[6] He does not report to anyone else at Gristede's. *Id.* at 1794. Catsimatidis personally owns the building in which Gristede's headquarters is located. *Id.* at 1789–90. His office is in that building, shared with Charles Criscuolo, Gristede's COO. *Id.* at 1793–94. Catisimatidis was "usually there for part of the day, at least [four] days a week." *Id.* at 1334. The human resources and payroll department

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is located in the same building. *Id.* at 1794–5. Regarding his duties, Catsimatidis testified: "I do the banking. I do the real estate. I do the financial.... I come up with concepts for merchandising.... I'm there every day if there is a problem," including problems with buildings, problems with the "Department of Consumer Affairs, governmental relations," and "[p]roblems with vendors, relationships with vendors, it takes up most of the time." *Id.* at 1800–01.

A series of subordinate managers reported to Catsimatidis but did not appear to have an extensive amount of interaction with him. Catsimatidis spoke to Criscuolo every day because they shared an office. *Id.* at 1797. Catsimatidis testified that Vice President Gallo Balseca "runs operations" and was "in the stores every day," and that the district managers reported to Balseca. *Id.* at 1796. Balseca reported to Criscuolo, but Catsimatidis rarely spoke directly to Balseca. *Id.* at 1794, 1797. Catsimatidis testified that the company's director of security "reports to the chief operating officer on a day-to-day basis, but if there is something he thinks I should know about, he would call and tell me." *Id.* at 1809. Catsimatidis occasionally sat in on merchandising and operations meetings. *Id.* at 1799.

Catsimatidis stayed apprised of how Gristede's was doing, reviewing the overall profit and loss statements as well as the "sales to purchases" statements of particular stores. He received "weekly gross margin reports from all the perishable departments" and "a comprehensive P[rofit] and L[oss] report on a quarterly basis" that he studied in depth and sometimes used to make general recommendations. *Id.* at 1849. As Executive Director of Human Resources and Asset Protection Renee Flores stated, "if there is a store that buys more than they sell, and it's a consistent thing, he may say, 'You know what, you might want to take a look at that, because they're buying more than they're selling.' " *Id.* at 1450–51.

Catsimatidis testified that he made "big picture" "merchandising decisions, like do we, for the next six months, push Coca–Cola or push Pepsi–Cola?" and "the decisions on having pharmacies in the stores." *Id.* at 1815. He testified that after making this sort of decision, he would tell Criscuolo or "yell it out when they have the [merchandising meeting]" in their shared office. *Id.* at 1816. He might also "yell out to go out and do more sales." *Id.* at 1817.

In general, employees agreed, as Executive Vice President Robert Zorn testified, that Catsimatidis "has whatever privileges an owner of a company has" to "make ultimate decisions as to how the company is run," and that there was "no reason to believe that if he chose to make a decision anybody there has the power to override him." *Id.* at 1329. They also agreed that Catsimatidis has the power to "shut down a store" or "sell a store if he felt that was the appropriate thing to do." *Id.* at 1370.[7]

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b. Involvement with stores

Although Catsimatidis did not exercise managerial control in stores on the day-to-day level of a manager, the evidence demonstrates that he exercised influence in specific stores on multiple occasions. For example, he made suggestions regarding how products are displayed in stores. In general, he testified that he focused on "driv[ing] sales, driv[ing] product, get[ting] more sales out of the stores" through techniques such as "buying a Coca–Cola at [the] right price, and [ ] put[ting] it on a front end display at the right price." *Id.* at 1819.

Catsimatidis testified specifically that "when [he] used to go around the stores, [he] used to make comments to the store managers about displays," telling them, for example, "if you put up this product, you might sell $100 a week." *Id.* at 1828. He would make visits to "five or ten" stores on Saturday mornings, staying about ten minutes in each one. *Id.* He referred to these as "just [ ] goodwill visit[s], merchandising, sales, what are we doing right, what are we doing wrong, what can we do better." *Id.* at 1831–32. His deposition also contained the following exchange:

Q: Why did you want to visit every store?

A: To check the merchandising.

Q: Can't the store managers take care of that themselves?

A: If the store managers did it perfectly, then I wouldn't have to visit the stores.

Q: But you have a level of trust in the store managers, right?

A: You hope so, yes.

Q: Why do you think it was necessary for the president of the company to go around to all these stores?

A: For the same reason Sam Walton went and visited his stores.

Q: What reason is that?

A: You just get a better feeling for merchandising. Sam Walton was a great merchandiser.

Q: On the Saturday morning visits to the stores, what did you do?

A: I walked in, introduced myself to the manager, most of them I knew, and just we would talk about merchandising. I would say is this selling, is this not selling, are you missing any products that you think you should have? And I would—I felt I would get input from store managers on merchandising problems.

Id. at 1829–30.

Catsimatidis would also address problems that occurred in individual stores. For example, he testified that if a vendor called him and said there was a problem, "[m]aybe that he was supposed to have a display and not have a display," he would not get involved personally but would refer the issue to Criscuolo. *Id.* at 1827. Catsimatidis testified that "if a store didn't look clean, or if it was very cluttered, [he] would make the comment about it ... to the store manager, and then follow up and say it to [Criscuolo]." *Id.* at 1831. On one occasion, he went to a store and was "annoyed" that a type of fish he tried to buy was not in stock, so he "sent an e-mail to the meat director, copy to his boss, ... sent one to the store manager, and sent one to the district manager." *Id.* at 1882. Catsimatidis commented that the emails were his attempt to "bring[ ] it to their

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attention that the department looked bad" and that he "would hope the supervisor or the merchandisers would fix it." *Id.* at 1883.

Additionally, Catsimatidis testified that the company's system automatically forwards him copies of any consumer complaints, which he then forwards by email "to the responsible parties ... with a comment of 'What the hell is happening?' " *Id.* at 1821. For example, he might forward a complaint about a store being dirty, and he sent a complaint about lids not fitting coffee cups to the deli director. *Id.* He testified, "I figured if they think I know about the problem, they'll work harder towards fixing it." *Id.* at 1822. When asked why this was, he said, "I guess they want to keep the boss happy, and I want to keep the consumers happy," and that "one of my jobs is how to get the consumers in our stores, and how to keep them in our stores." *Id.* at 1823. He has directed similar complaints to store managers. *Id.* at 1825.

Mitchell Moore, a former store manager, testified that Catsimatidis asked him to get involved with a "reset" at a particular store, meaning an effort to "change the store around, move items around the store, allocation, bring in new items." *Id.* at 1418. Moore also testified that Catsimatidis, while walking through a store, might "want me to change a display around or to make it fuller or to put a different variety in there," or to "put signs on certain items, give them a good deal on it" if he wanted Moore to "push a particular item." *Id.* at 1421–22. Zorn said that he had seen Catsimatidis go to stores for grand openings or reopenings, "walk up and down the aisles ... ask[ ] questions about—you know, he sees a product that is new and asks, you know—you know, who we buy that from and, you know, comments on the store decor," although Zorn noted that Catsimatidis was "there more in a PR capacity than a management type capacity." *Id.* at 1352–53.

c. The *Carter* factors

The first element of the *Carter* test considers whether the individual defendant "had the power to hire and fire employees." *Barfield,* 537 F.3d at 142 (quotation marks omitted). The evidence demonstrates that Catsimatidis possesses, but rarely exercises, the power to hire or fire anyone he chooses. He testified, "I guess I can fire the people that directly report to me," which he said would include "only maybe four or five" employees such as the COO and CFO. Joint App'x 1863. He testified in 2005 that he could not remember having fired anyone in five or six years. *Id.* at 1862. In *RSR,* we emphasized that the hiring and firing of "individuals who were in charge of [the plaintiff employees] is a strong indication of control." *RSR,* 172 F.3d at 140.

Zorn testified that Catsimatidis had hired him and "obviously would" have the authority to hire and fire others, "but he doesn't get involved in that." Joint App'x 1338. For example, when Zorn was "involved in letting go long-time employees for various reasons," he let Catsimatidis know "as a courtesy" and fired the employees even if Catsimatidis "wasn't happy about it." *Id.* at 1343. On one occasion when both Zorn and Catsimatidis interviewed a potential manager, Catsimatidis "was in favor of it but he left the decision to" Zorn. *Id.* at 1342. Catsimatidis promoted Deborah Clusan from director of payroll to director of payroll and human resources. *Id.* at 476. He promoted Moore to store manager from night manager. Moore testified that Catsimatidis "came to speak with me, asked me what my background was, ... and then the next day the vice president called me, and told

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me that I would be starting in the Store 504 the next day." *Id.* at 1412, 1415. Moore, like other employees, indicated that he "view[ed] Mr. Catsimatidis as [his] boss" and that Catsimatidis would have the power to fire a store employee. *Id.* at 1425–26.

The second *Carter* factor asks whether the individual defendant "supervised and controlled employee work schedules or conditions of employment." *Barfield,* 537 F.3d at 142 (quotation marks omitted). Plaintiffs overstate the importance of the two pieces of evidence on which they rely for this factor. Although they state in their brief that Catsimatidis said he "has handled complaints from Gristede's workers' union representatives 'every week for as long as I could remember,' " Appellees' Br. at 39, this mischaracterizes Catsimatidis's testimony; he stated that he had not been personally involved in union negotiations or discussions of problems, *see* Joint App'x 1802–03, 1812, 1876. Plaintiffs also assert that Catsimatidis "authorized an application for wage subsidies and tax credits on behalf of Gristede's employees." Appellees' Br. at 39. The evidence reflects only that Catsimatidis signed the application for tax credits to which Gristede's was entitled for employing people "coming off of Social Services, off of welfare." Joint App'x at 482–83. Moreover, plaintiffs do not indicate how this affected their "work schedules or conditions of employment." Although Catsimatidis's involvement in the company and the stores as discussed above demonstrates some exercise of operational control, it does not appear to relate closely to this factor of the *Carter* test.

The third factor asks whether the individual defendant "determined the rate and method of payment." *Barfield,* 537 F.3d at 142 (quotation marks omitted). The district court and plaintiffs emphasize the fact that Catsimatidis's electronic signature appears on paychecks. This—like all factors—is not dispositive. *See Gray,* 673 F.3d at 354. Nonetheless, we held in *RSR* that "[t]he key question is whether [the defendant] had the authority to sign paychecks throughout the relevant period, and he did." *RSR,* 172 F.3d at 140.

RSR also focused on the fact that the defendant "controlled the company financially." *Id.* It is clear that Catsimatidis possessed a similar degree of control. He testified that he keeps track of "payroll" as "a line item on accounting" and "a part of profit and loss," to know what percentage of Gristede's sales and expenses payroll comprises, but he does not get involved with individual salaries or schedules. Joint App'x at 1834–35. Although he did not speak to his managers "about people getting paid," *id.* at 1834, he knew that employees were paid on time "[b]ecause the unions would have come down on us real hard" if there was a problem. *Id.* at 1852. Catsimatidis explained that he might also learn about a problem "[i]f I walked down the aisle, and the employee saw me, they might complain," although the official procedure for such complaints involved the employees' union and store manager. *Id.* at 1866–67. Catsimatidis set up a meeting between lower-level managers and an outside payroll company, *id.* at 1452–53, and although he did not know specifically "if George Santiago in the store got a paycheck that week," his "rules are if somebody works, they get paid," *id.* at 469. The district court also noted that Catsimatidis stated "in open Court in this proceeding that he could shut down the business, declare bankruptcy, as well as provide the personal signature necessary for a bank letter of credit to be issued in favor of Gristede's," *Torres III,* 2011 WL 4571792, at *1, which further demonstrates the kind of financial control emphasized in *RSR*.

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The fourth *Carter* factor asks whether the individual defendant "maintained employment records." *Barfield,* 537 F.3d at 142 (quotation marks omitted). Plaintiffs offer only that "Catsimatidis works in the same office where employment records are kept" and promoted the payroll director, Appellees' Br. at 41, essentially admitting that Catsimatidis did not meet this factor. In sum, the evidence—much of it Catsimatidis's own testimony—indicates that Catsimatidis meets the first and third *Carter* factors.

d. Totality of the circumstances

There is no question that Gristede's was the plaintiffs' employer, and no question that Catsimatidis had functional control over the enterprise as a whole. His involvement in the company's daily operations merits far more than the symbolic or ceremonial characterization he urges us to apply. Unlike the defendant in *Wirtz,* who visited his company's facilities only a few times a year, Catsimatidis was active in running Gristede's, including contact with individual stores, employees, vendors, and customers. Catsimatidis dealt with customer complaints, in-store displays and merchandising, and the promotion of store personnel. That he may have done so "only occasionally" does not mean that these actions are irrelevant, *see RSR,* 172 F.3d at 139, especially when considered in the context of his overall control of the company.

Although there is no evidence that he was responsible for the FLSA violations—or that he ever directly managed or otherwise interacted with the plaintiffs in this case—Catsimatidis satisfied two of the *Carter* factors in ways that we particularly emphasized in *RSR:* the hiring of managerial employees, and overall financial control of the company. *See id.* at 136–37, 140 (finding that the individual defendant "exercised financial control over the company" and "frequently" gave instructions to subordinate managers); *see also Donovan v. Grim Hotel Co.,* 747 F.2d 966, 972 (5th Cir.1984) (noting that the individual defendant was the " 'top man' " in a hotel company who "held [the hotels'] purse-strings and guided their policies" and that the hotels "speaking pragmatically, ... functioned for the profit of his family"). This involvement meant that Catsimatidis possessed, and exercised, "operational control" over the plaintiffs' employment in much more than a "but-for" sense. His decisions affected not only Gristede's bottom line but individual stores, and the personnel and products therein.

We recognize that the facts here make for a close case, but we are guided by the principles behind the liquidated damages provision of the FLSA in resolving the impact of the totality of the circumstances described herein. The Supreme Court has noted that "liquidated damages as authorized by the FLSA are not penalties but rather compensatory damages 'for the retention of a workman's pay which might result in damages too obscure and difficult of proof for estimate other than by liquidated damages.' " *Republic Franklin Ins. Co. v. Albemarle County Sch. Bd.,* 670 F.3d 563, 568 (4th Cir.2012) (quoting *Brooklyn Sav. Bank v. O'Neil,* 324 U.S. 697, 707, 65 S.Ct. 895, 89 L.Ed. 1296 (1945)); *see also Marshall v. Brunner,* 668 F.2d 748, 753 (3d Cir.1982) (noting that liquidated damages "are compensatory, not punitive in nature").

As counsel for *amicus curiae* the Secretary of Labor explained at oral argument, the purpose of the FLSA is not to punish an employer but to remunerate aggrieved employees. Considered in the context of the expansive interpretation that courts have afforded the statute, this policy reasoning particularly counsels in favor of

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finding that Catsimatidis was an "employer" given the failure of the settlement between the corporate defendants and the plaintiff employees. Catsimatidis was not personally responsible for the FLSA violations that led to this lawsuit, but he nonetheless profited from them. And although the Gristede's Supermarkets business entity appears to have been larger than other businesses discussed in the cases that have considered this question, the company was not so large as to render Catsimatidis's involvement company is not public. Its stores actively exercised his influence, City metropolitan area, as are the where he worked almost daily. In sum, as the district court concluded, "it is pellucidly clear that he is the one person who is in charge of the corporate defendant." [8]*Torres III,* 2011 WL 4571792, at *3.

Although we must be mindful, when considering an individual defendant, to ascertain that the individual was engaged in the culpable company's affairs to a degree that it is logical to find him liable to plaintiff employees, we conclude that this standard has been met here. Catsimatidis's actions and responsibilities—particularly as demonstrated by his active exercise of overall control over the company, his ultimate responsibility for the plaintiffs' wages, his supervision of managerial employees, and his actions in individual stores—demonstrate that he was an "employer" for purposes of the FLSA.

III. New York Labor Law

The NYLL defines "employer" as "any person ... employing any individual in any occupation, industry, trade, business or service" or "any individual ... acting as employer." N.Y. Lab. Law. §§ 190(3), 651(6). The definition of "employed" under the NYLL is that a person is "permitted or suffered to work." *Id.* § 2(7).

The district court granted partial summary judgment in plaintiffs' favor on their NYLL claims, but neither its oral nor its written decision contained any substantive discussion of the issue. Plaintiffs assert that the tests for "employer" status are the same under the FLSA and the NYLL, but this question has not been answered by the New York Court of Appeals. Defendants respond that corporate officers cannot be held liable under the NYLL simply by virtue of their status, but plaintiffs are arguing that Catsimatidis should be held liable "not as [a] corporate officer[ ] or shareholder[ ], but as [an] employer [ ]." *See Chu Chung v. New Silver Palace Rest., Inc.,* 272 F.Supp.2d 314, 318 (S.D.N.Y.2003).

Plaintiffs also contend in their response brief that "there is no need to also establish [Catsimatidis's] status as an employer under state law" because the settlement agreement establishes that he will be personally liable " 'if the Court holds John Catsimatidis to be an employer'—period." Appellees' Br. at 41–42 (quoting Settlement Agreement § 3.1(H)). Defendants do not respond to this in their reply brief.

In light of the possible disagreement between the parties regarding the need for us to decide this issue of state law, and particularly in light of the absence of discussion of the issue in the district court's decision, we vacate the grant of summary judgment in plaintiffs' favor on the NYLL

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claims and remand to the district court. The case will return to the lower court in any event for a determination of damages in light of our holding today; in the process, the parties and the district court may determine (1) whether the NYLL question requires resolution, and (2) what that resolution should be.

Conclusion

We have examined all of Catsimatidis's arguments on appeal and find them to be without merit. For the foregoing reasons, the judgment of the district court granting partial summary judgment in favor of plaintiffs is **AFFIRMED IN PART, VACATED IN PART, AND REMANDED.**

Notes:

* The Clerk of Court is directed to amend the caption as listed above.

** The Honorable Richard W. Goldberg, of the United States Court of International Trade, sitting by designation.

1. In its oral ruling and accompanying order, the district court granted summary judgment finding Catsimatidis individually liable as an "employer" under the NYLL, but the court did not explain its reasons beyond what might be inferred from its discussion setting forth its reasoning in the FLSA context. *See Torres III,* 2011 WL 4571792, at *1; Special App'x at 46–47.

2. "We review an award of summary judgment *de novo,* and we will uphold the judgment only if the evidence, viewed in the light most favorable to the party against whom it is entered, demonstrates that there are no genuine issues of material fact and that the judgment was warranted as a matter of law." *Barfield v. NYC Health & Hosps. Corp.,* 537 F.3d 132, 140 (2d Cir.2008) (citing Fed R. Civ. P. 56(c); *Celotex Corp. v. Catrett,* 477 U.S. 317, 322–23, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986)). "The nonmoving party must set forth specific facts showing that there is a genuine issue for trial, and this Court must view the evidence in the light most favorable to the nonmoving party and draw all reasonable inferences in its favor." *Rubens v. Mason,* 527 F.3d 252, 254 (2d Cir.2008) (internal quotation marks and citation omitted).

3. Although the *Carter* court did not ultimately conclude that the prisoners were employees of the college, it noted that the following facts about the college "may be sufficient to warrant FLSA coverage" and certainly presented issues of material fact on the subject: the college "made the initial proposal to 'employ' workers; suggested a wage as to which there was 'no legal impediment'; developed eligibility criteria; recommended several inmates for the tutoring positions; was not required to

take any inmate it did not want; decided how many sessions, and for how long, an inmate would be permitted to tutor; and sent the compensation directly to the inmate's prison account." 735 F.2d at 15.

4. In *Zheng,* the court considered whether a garment manufacturer that contracted out the last phase of its production process to workers including the plaintiffs was an "employer" under the FLSA. It concluded that the relevant factors in such an instance were

> (1) whether [the manufacturer]'s premises and equipment were used for the plaintiffs' work; (2) whether the Contractor Corporations had a business that could or did shift as a unit from one putative joint employer to another; (3) the extent to which plaintiffs performed a discrete line-job that was integral to [the manufacturer]'s process of production; (4) whether responsibility under the contracts could pass from one subcontractor to another without material changes; (5) the degree to which the [manufacturer] or [its] agents supervised plaintiffs' work; and (6) whether plaintiffs worked exclusively or predominantly for [the manufacturer].

Zheng, 355 F.3d at 72. These factors highlight the flexible and comprehensive nature of the economic realities test in determining when an entity is an "employer" (in this case, whether the manufacturer was a "joint employer" along with another corporation) but are not directly implicated here.

5. This language was cited by our Circuit in a case concerning the meaning of the word "employer" in the context of the Employee Retirement Income Security Act ("ERISA"), in which we noted that "[i]n FLSA cases, courts have consistently held that a corporate officer with operational control who is directly responsible for a failure to pay statutorily required wages is an 'employer' along with the corporation, jointly and severally liable for the shortfall." *Leddy v. Standard Drywall, Inc.,* 875 F.2d 383, 387 (2d Cir.1989) (citing *Agnew,* 712 F.2d at 1511). Because *Leddy* did not require or contain any actual analysis of the FLSA, however, this statement does not constitute a holding that liability on the basis of "operational control" requires an individual to have been directly responsible for FLSA violations.

6. Although Catsimatidis's and other employees' functions within Gristede's appear to have shifted during the lengthy pendency of this lawsuit, all references are to the period relevant to the case.

7. At oral argument and in its written decision, the district court placed substantial reliance on an affidavit that Catsimatidis submitted in a separate lawsuit, a trademark action brought by Trader Joe's Company after it found out about a Gristede's plan to re-open a former Gristede's store under the name "Gristede's Trader John's." The district court emphasized that the affidavit, which discussed the process by which Catsimatidis had come up with the idea, indicated that Catsimatidis has the power to "set prices for goods offered for sale," "select the decor for the stores," and "control any store's signage and advertising." *Torres III,* 2011 WL 4571792, at *1. Although the parties dispute the significance and admissibility of the affidavit, it is not necessary to our decision. The affidavit indicates that Catsimatidis had the power to open a new store that was generally intended to offer "items at prices materially lower than comparable items in our other Gristede[']s stores." Joint App'x 3752. This only underscores the implication of the evidence we have already discussed: that Catsimatidis possessed the ability to control Gristede's operations at a high level.

8. The district court's decision indirectly referenced statements made by Catsimatidis in open court at a hearing on the settlement agreement to the effect that he was "here to speak

for 1,700 employees that [sic] their jobs ... on the line," that he "represent[ed] the 1,700 current employees," and that he was "their employer." Joint App'x 3594–95. We do not, of course, afford these statements weight as legal conclusions, but they are telling.

INTERNAL REVENUE SERVICE

IRS Fact Sheet

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Wage Compensation for S Corporation Officers

FS-2008-25, August 2008

Corporate officers are specifically included within the definition of employee for FICA (Federal Insurance Contributions Act), FUTA (Federal Unemployment Tax Act) and federal income tax withholding under the Internal Revenue Code. When corporate officers perform services for the corporation, and receive or are entitled to receive payments, their compensation is generally considered wages. Subchapter S corporations should treat payments for services to officers as wages and not as distributions of cash and property or loans to shareholders.

S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates.

The Internal Revenue Code establishes that any officer of a corporation, including S corporations, is an employee of the corporation for federal employment tax purposes. S corporations should not attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages.

This fact sheet clarifies information that small business taxpayers should understand regarding the tax law for corporate officers who perform services.

Who's an employee of the corporation?

Generally, an officer of a corporation is an employee of the corporation. The fact that an officer is also a shareholder does not change the requirement that payments to the corporate officer be treated as wages. Courts have consistently held that S corporation officer/shareholders who provide more than minor services to their corporation and receive or are entitled to receive payment are employees whose compensation is subject to federal employment taxes.

The Treasury Regulations provide an exception for an officer of a corporation who does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration. Such an officer would not be considered an employee.

What's a Reasonable Salary?

The instructions to the Form 1120S, U.S. Income Tax Return for an S Corporation, state "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

The amount of the compensation will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property or the right to receive cash and property did go the shareholder, a salary amount must be determined and the level of salary must be reasonable and appropriate.

There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of each case.

Some factors considered by the courts in determining reasonable compensation:

- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history
- Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements
- The use of a formula to determine compensation

Medical Insurance Premiums treated as wages.

The health and accident insurance premiums paid on behalf of the greater than 2 percent S corporation shareholder-employee are deductible by the S corporation as fringe benefits and are reportable as wages for income tax withholding purposes on the shareholder-employee's Form W-2. They are not subject to Social Security or Medicare (FICA) or Unemployment (FUTA) taxes. Therefore, this additional compensation is included in Box 1 (Wages) of the Form W-2, Wage and Tax Statement, issued to the shareholder, but would not be included in Boxes 3 or 5 of Form W-2.

A 2-percent shareholder-employee is eligible for an AGI deduction for amounts paid during the year for medical care premiums if the medical care coverage is established by the S corporation. Previously, "established by the S corporation" meant that the medical care coverage had to be in the name of the S corporation.

In Notice 2008-1, the IRS stated that if the medical coverage plan is in the name of the 2percent shareholder and not in the name of the S corporation, a medical care plan can be considered to be established by the S corporation if: the S corporation either paid or reimbursed the 2percent shareholder for the premiums and reported the premium payment or reimbursement as wages on the 2percent shareholder's Form W-2.

Payments of the health and accident insurance premiums on behalf of the shareholder may be further identified in Box 14 (Other) of the Form W-2.

Schedule K-1 (Form 1120S) and Form 1099 should not be used as an alternative to the Form W-2 to report this additional compensation.

Helen D'Eletto, Esq.

Presentation Questions

Factory Considerations:

1. Will this be the purchase of an existing factory business or just the assets (real estate, equipment, etc.)?
    a. Tax issues: Bulk Sale Transaction, Real Estate Transfer Tax.
    b. Sales Tax registrations are not transferable to new business.
    c. Any required licenses are not transferable to new business.

Form of Entity Considerations:

1. Will this be a sole proprietorship?
    a. Investor could make business loan to entity. Interest paid will be business deduction. Owner would report on Schedule C on Form 1040. Self-employment taxes are paid in on Form 1040 lieu of via separate Payroll tax forms.
2. Will this be a partnership?
    a. Investor would be a partner. There would be "profit-sharing".
    b. Partnership would submit Schedule K-1 to partners. US partner would report on Schedule E of Form 1040. Self-employment taxes are paid in on Form 1040 lieu of via separate Payroll tax forms.
3. Will this be a corporation?
    a. Double taxation concerns. Officers must draw a salary reported on Form W-2 with payroll tax liabilities for officers.
    b. NYS Corporate Franchise Tax.
    c. NYC Corporate Taxes (i.e., Commercial Rent Tax)
    d. S Corporation election. Non-resident foreigners cannot have direct ownership. Flow-through treatment for tax return purposes. Audit flags: reasonable compensation; Loans to shareholder.
4. Will this be an LLC (Limited Liability Company)?
    a. Number of Members determine federal tax treatment. One member: sole proprietorship; more than one member: partnership. Can elect Corporation treatment to override.

Tax Considerations

Purchasing or Acquiring a business or its assets:

1. Bulk Sale Transaction: Potential for NYS Sales tax liability in Asset purchase
2. Real Estate transfer Tax: Acquisition of business that has interest in real property, such as a deed or lease
3. License registrations and sales tax registrations are NOT transferable.

The form of the new entity:

<u>Sole Proprietorship</u>

1. Obtain Tax ID Number (EIN)
2. Directly Taxed to Owner on Schedule C on Form 1040
3. Self-Employment Tax

<u>Partnership</u>

1. Obtain Tax ID Number (EIN)
2. Profit Sharing, Not Salary
3. Share of Income/Deductions on Separate Form 1065 K-1
4. Schedule K-1 information reported on Schedule E on Form 1040
5. Self-Employment Tax

<u>Corporation</u>

1. NYS Certificate of Incorporation must be filed
2. Obtain Tax ID Number (EIN)
3. Double tax on income (Corporate and Shareholder)
4. W-2 payroll tax liability for officers
5. Corporate Franchise Tax (NYS)
6. Some NYC Corporate Taxes
7. If S Corporation (Subchapter S), treated as a partnership for most tax purposes

<u>LLC (Limited Liability Company)</u>

1. NYS Articles of Organization must be filed
2. Obtain Tax ID Number (EIN)
3. NYS Publication requirements must be satisfied
4. Only recognized as LLC for NYS purposes, no LLC at federal level.
    a. If one member, treated as Sole Proprietorship; of two of more members, treated as partnership. This can be overridden with election for Corporation Tax treatment.

FACT PATTERN

Elliot Baker, a New York City resident, claims he is the owner of his grandmother's secret cookie recipe, which combines cookies and nuts in a unique way: the Co-NUT. Baker, in his individual capacity, runs a small successful bakery from a sublet in an NYC coffee shop where he produces and recently started to sell Co-NUTs. The bakery has a large local customer base due to recent social media popularity. Customers line up out the door for the Co-NUT, which has also caused a boom in business for the coffee shop. A news station recently interviewed Baker regarding Co-NUT's popularity.

Due to the interview, Baker was approached by various investors looking to expand the bakery. Baker was particularly interested in Samantha Cash, a French investor. Cash has larger dreams for the Co-NUT rather than local manufacturing and sale. Cash and Baker have discussed Cash funding the purchase of a factory to mass produce the Co-NUT for sale across the country, possibly internationally, through licensing, franchising, or self-owned stores. Cash will fund the business endeavor and Baker will contribute the recipe, the good will of his current operation, and oversee the manufacturing process.

Cash is looking to purchase a specific factory ("Factory") out of the chapter 7 bankruptcy estate of Big Cookie. Big Cookie previously owned and operated a number of commercial bakeries but years ago decided to sell all the businesses and just focus on being a commercial landlord of the real properties from which they previously operated.

Big Cookie sold one of the bakery business locations to Cookie Crumble and took back a promissory note and first lien on all machinery and equipment, except certain machinery and equipment in which Big Cookie has a security interest subordinate to Cash. Big Cookie leased the Factory to Cookie Crumble. Significantly, and for reasons unknown, Big Cookie does not hold a collateral assignment of the lease for the Factory.

The Chapter 7 Trustee of Big Cookie published a Notice that he is selling his right, title and interest in everything that Big Cookie owns including the Factory, what remains due on the promissory note due, and the liens it has against the machinery and equipment, free and clear of liens with liens to attach to the proceeds of sale.

Cookie Crumble has 5 years remaining on a 10-year lease for the Factory. Cash learned about the sale of the factory because he is a secured creditor of Big Cookie. Cash also knows that Cookie Crumble is 6 months in arrears on its rent for the Factory and is also in default of the promissory note. Word on the street is that Cookie Crumble's business is not likely to survive. Cash wants to acquire the Factory and the machinery and equipment notwithstanding Cookie Crumbles tenancy at the Factory and that Cookie Crumble, and not Big Cookie, owns the machinery and equipment.

Baker has two kids who he hopes will one day take over his business. Cash is looking for the greatest return on her investment.

Baker and Cash have come to the Great Law Firm to discuss forming, arranging, and conducting their potential business for the manufacturing and sale of the Co-NUT, including the type of entity to form, tax repercussions, intellectual property concerns, personal liability, and other relevant issues.