

Going Out of Business Sales and State Law:  
No More Mister Nice Guy<sup>1</sup>

“Going out of business sales,” liquidators advise, have a magical cachet, handily outdrawing the logically equivalent “store closing sale,” not to mention routine “clearance” or “best prices of the season” sales. Otherwise savvy shoppers are magnetically drawn to going out of business sales, even such sales often initially offer discounts far below those in normal sales, and even though one may need to stand in long lines to pay for these “bargains.”<sup>2</sup> Because of the potency of the “going out of business” and “store closing” labels, many states specifically regulate these sales. Absent those limits, a retailer may well hold a perpetual “going out of business” sale that not only harm consumers by enticing them to buy items that may be of lower quality and higher prices, but unfairly competes with other businesses that do not use the charged terms for their sales. These state laws often limit the length of such sales because a true going out of business sale can be completed in a relatively short period of time, that should be counted in weeks and not in months or years as with the proverbial Oriental rug merchant. In addition, laws typically bar or limit the amount and nature of goods that the retailer can add to its existing stock of merchandise during the sale. There are two primary rationales for this: first, the new merchandise may be of lesser quality, misleading consumers who expect to be buying the same items normally sold by that store. Second, adding new merchandise is what operating stores do – it is inherently misleading to advertise a “closing” sale while adding inventory that merely delays completion of the sale. Thus, merchandise limits merely supplement time limits on these sales.

In addition to these liquidation-specific laws, general consumer protection laws may also be implicated in going out of business sales. The Montgomery Wards bankruptcy was a prime example of this. Only fourteen months after its first Chapter 11, and after a disappointing Christmas season, Wards refiled without warning on December 28, 2000. Up to the day it filed, it continued to sell gift certificates, take deposits for layaways, and market service contracts to unsuspecting buyers. The very next day, it sought leave to begin a liquidation sale and to change its policies on those prepetition consumer obligations. In most cases, it would honor them only for transactions occurring after December 17, and only by giving vouchers that would be void after the end of January. Those actions certainly raise serious questions for state regulators since the company obviously knew of its dire finances while it continued to assume obligations that it knew it likely would not honor. Certainly, they resulted in a flood of consumer complaints that states would normally expect to resolve under their

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<sup>1</sup> The author is bankruptcy counsel for the National Association of Attorneys General, but the views expressed herein are solely those of the author. In addition, not all states have participated in the proceedings described herein, and the views ascribed to “the states” should not be taken as applying to any states beyond those that have joined in a specific action.

<sup>2</sup> As an example, when a local retail chain closed one unprofitable store in Washington, D.C. area and advertised a “40% off, going out of business sale,” the identical food processor was available in a regular sale at its other stores for a nickel *less* and without the hour-long lines in which eager purchasers were standing at the store that was closing.

existing consumer protection laws.

And, finally, while companies generally may change the terms on which they operate postpetition (at least so long as the new terms are clearly disclosed), there are minimum terms, such as implied warranties of merchantability, that many state laws do not allow to be disclaimed under any circumstance. Even if large signs proclaim that sales are “final” and “as is,” no one should be allowed to sell products where the defects cannot be discerned by the consumers. No matter how cheaply it is sold, consumers have a right to expect that a toaster will work and a CD will play – at least if they have no way of detecting a problem until they take the product home. Some defects make an item unsalable at *any* price and a general disclaimer is not enough to eliminate the unconscionability of selling such items. There are other examples of deceptive practices – anything from typical deceptive advertising to violations of weights and measures or product expiration date laws that must be obeyed by any retailer, liquidating or not.

The recent spate of retail bankruptcies have caused increasing concerns for states about the scope of the authorizations that debtors are seeking to carry out these sales. Again, Wards provides a striking example. It requested permission, under Section 363, to begin an immediate liquidation sale. It asserted that it needed emergency authorization because it had seasonal merchandise that needed to be sold promptly to maximize its value – yet so did every other retailer. Any avid shopper knows that stores are full of racks at 50 to 75% off after Christmas, so an inventory clearance sale by Wards would hardly be “out of the ordinary course of business.” The truth is that Wards just wanted its sale to stand out – and to have an excuse to override state law that might otherwise have limited its repudiation of its prepetition promises to consumers.

Its December 28 motion promised that all Attorneys General would be served by overnight mail. Had it done so, they might have had enough time to object by the January 11 deadline. In fact, though, the certificate of service shows that notice not sent until *January 8* by *regular* mail. As a result, most Attorneys General did not receive the motion by the deadline, much less have time to assign it to counsel, have it analyzed, a response prepared, and local counsel hired to oppose it. As a result, there was no organized state response opposition to the startlingly broad scope of relief that was sought. Wards claimed in its motion that it wanted to eliminate liquidation-specific laws because it would be too burdensome to figure out what they were, much less to bother to comply with them. (It conceded that many such laws exempt court-ordered sales, but argued that it should not be required to determine what laws were left, much less how much burden they actually imposed). It further asserted that it did not intend to enjoin other state laws, such as health and safety laws, but ignored general consumer protection laws.

Yet, as bad as the motion was, the actual order was far worse. It enjoined governments from “(a) interfering in any way with, or otherwise impeding, the conduct of the Store Closing Sales or (b) instituting any action or proceeding . . . seeking an order or judgment that might in any way directly or indirectly interfere with or adversely affect the conduct of the Store Closing Sales” and allowed the sale to proceed “notwithstanding (i) any local, state, or federal law or ordinance . . . purporting to restrict, limit or otherwise regular such sales [other than] in accordance with the Store Closing Sales Protocol.” While the Store Closing Protocol referenced *shopping center* guidelines on health and safety, it

contained no exception for state health and safety laws. The order was broad enough to bar the fire marshal from enforcing occupancy limits if this would adversely affect the sale and was entered without hesitation by the court.

The Attorney General's office in Ohio happened to get notice of the proceeding early enough to file an objection so the final order did incorporate a health and safety exception, but otherwise continued to broadly preempt all other state law. The court did not explain on what basis it could enter an injunction against states that had done nothing to waive their sovereign immunity.<sup>3</sup> Nor did it discuss the legal basis for preempting state law even if immunity was not at issue. The debtor argued that the court's power derived from Section 363, 105, and that 28 U.S.C. 959 did not apply.<sup>4</sup> The states disagreed strongly with the debtor's arguments (see below), but the order was a *fait accompli* and an appeal probably could not have been completed before the sale was over. Moreover, the states were busy dealing with the specific consumer problems that continued to crop up. As a result, the order was not further contested in this case, but the states began reviewing the issues further as several other small cases were filed in late 2001 and early 2002, including Service Merchandise and Bugle Boy. As with Wards, these motions were usually filed with little or no notice to the states and generally only the state in which the bankruptcy was located managed to object, and obtain some state-specific relief. Matters came to a head with the KMart bankruptcy. Although it was reported that KMart would be closing stores, the states were still hampered when the motion was filed, because there was *no* effort to serve Attorneys General with the motion, even though, the proposed relief was almost as broad as in the Wards motion. One state, however, noticed the filing and alerted NAAG. In turn, NAAG advised state contacts and many states indicated an interest in challenging the order.

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<sup>3</sup> While the order was sought by way of a motion, it asked for injunctive relief which the Rules explicitly require be sought through an adversary proceeding. That procedural irregularity obscured, but did not change, the essential nature of the court's actions. "A judicial proceeding is considered brought against the sovereign if the result could serve 'to restrain the Government from acting, or to compel it to act.'" *U.S. E.P.A. v. General Elec. Co.*, 197 F.3d 592, 597 (2nd Cir. 1999) *amended on other grounds*, 212 F.3d 689 (2nd Cir. 2000), quoting *Dugan v. Rank*, 372 U.S. 609, 620 (1963). Cf. *In re Pacific Gas & Electric Company*, 273 B.R. 795, 818-819 (Bankr. N.D. Cal. 2002) (language in plan which barred state from enforcing its laws violated Eleventh Amendment; immaterial that Rules allow such relief without adversary complaint since critical issue is relief sought, not form of action) and *Idaho v. Coeur d'Alene Tribe of Idaho*, 521 U.S. 261, 270 (1997) ("The real interests served by the Eleventh Amendment are not to be sacrificed to elementary mechanics of captions and pleading.")

<sup>4</sup> The reference to Section 959 is a red herring. While many courts hold that it does not apply in a liquidation, many of these sales, are not true liquidations but merely restructuring and downsizing of the sort that are carried out by operating companies in or out of bankruptcy. And, in any event, the question is not whether Section 959 applies; but rather whether there is any Code provision that *bars* application of state law. Generally applicable laws apply to *all* issues unless there is a specific exception and, as shown below, there is no such exception in the Code.

In the states' view, the arguments advanced by KMart (and other retail debtors who all use the same form motion and order) fall far short of justifying the relief sought. Those motions assert the truism that federal law preempts conflicting state law and then assert the wholly different proposition that state law is also preempted when it merely conflicts with a federal "policy." The motions also assert that Section 363 "requires" the debtor to maximize recoveries for creditors, even though there is no such language in the Section.<sup>5</sup> They end, by arguing, in essence, that debtors may preempt these laws whenever it is convenient to do so and whenever they can make more money by doing so. Those arguments, of course, go too far. It would be more convenient for debtors if they did not have to apply the varying sales tax laws of each community, or pay the local minimum wage. If the debtor could stay open when all other businesses are closed under local "blue laws," it could undoubtedly sell more goods. Yet, debtors recognize that they must obey these laws and the laws at issue here stand on no different legal footing.

Contrary to the position of these debtors, Section 363 does not provide the broad preemption that they argue for. Preemption of state law is disfavored and one must show a "clear and manifest" intent on the part of Congress. *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 544 *reh'g denied*, 114 S.Ct. 2771 (1994); *Building & Trades Council v. Assoc. Builders*, 507 U.S. 218, 224 (1993); *Dept. of Revenue of Oregon v. ACF Industries*, 510 U.S. 332, 345 (1994); *English v. General Elec. Co.*, 496 U.S. 72, 87 (1990); *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 255 (1984). While there is a limited preemption provision in Section 363(l), there is no broad preemption language in the rest of Section 363, clear or otherwise.

The courts agree. In *Integrated Solutions, Inc. v. Service Support Specialties, Inc.*, 124 F.3d 487, 493-94 (3rd Cir. 1997) the court held that the court could not use Section 363 to allow the debtor to sell an asset at all if that sale would violate state law (a far more intrusive provision than the state regulations at issue here). It rejected the debtor's assertions that Sections 363 and 704 **"demonstrate that the 'overriding purpose of the Bankruptcy Code is the expeditious and equitable distribution of the assets of the debtor's estate.'" and that the trustee is required to "maximize the potential return to creditors," even if this would violate state law. To the contrary, the court held:**

{N}either 363(b)(1) nor § 704(1) expressly authorizes the trustee to sell property in violation of state law transfer restrictions. Moreover, Integrated points to nothing in the legislative history that would even raise an inference that Congress intended to give the trustee such authority under these provisions. The clear lack of Congressional intent to preempt state law restrictions on transferring property of the estate is even more telling given the explicit language that Congress uses when it intends to displace state nonbankruptcy law in other provisions of the

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<sup>5</sup> The closest the section comes is the provision that the amount received from a collusive sale may be attacked.

Bankruptcy Code. . . [citing to 363(l)]. Because both Code provisions relied upon by Integrated fail to explicitly express Congress's intent to supersede state law restrictions on the transfer of estate property, Integrated's preemption claim is rendered wholly unconvincing, especially in light of our strong presumption against inferring Congressional preemption in the bankruptcy context.

The Third Circuit also cited to *In re Schauer*, 835 F.2d 1222, 122/ (8th Cir.1987), which similarly concluded that there is no conflict between the Code and state law defining the debtor's property rights. "Sections 363(b)(1) and 704 are . . . *simply enabling statutes that give the trustee the authority to sell or dispose of property if the debtors would have had the same right under state law.* (Emphasis added). See also *In re Crossman*, 259 B.R. 301 (Bankr. N.D. Ill. 2001) *In re Lauriat's Inc.*, 219 B.R. 648 (Bankr. D. Mass. 1998); *In re White Crane Trading Company, Inc.*, **170 B.R. 694 (Bankr. E.D. Cal. 1994)**

Accordingly, some 25 states authorized the filing of an objection to KMart's sale. After extended negotiations, the debtor agreed to several substantial revisions of its orders. Rather than preempting state laws, the order provided for a simple presumption that the debtor's sale procedures (as revised in the negotiations) did not violate liquidation laws<sup>6</sup> with a process for challenges to be raised to that presumption if governmental entities felt there was an issue as to their specific law. It also explicitly recognized that all other state laws would remain in effect and that states could move to enforce them in their own home courts instead of returning to the bankruptcy court. A number of other provisions were worked out to deal with the treatment of prepetition obligations (such as gift certificates and layaway deposits) and how postpetition sales would be conducted. Augmenting the existing store merchandise with any additional items that were not already owned by Kmart was also barred.<sup>7</sup> Accordingly, the objection was not filed.

In two other cases, arising shortly after KMart – Florsheim and the Museum Company – the states raised similar questions and actually filed objections to the proposed orders. Both orders used virtually identical language to that in KMart and the states' objections were also similarly worded. On the other hand, because each sale differed somewhat in terms of the numbers of stores at issue, the proportion of the business that was being closed and the proposed terms of the sales, the negotiated final orders differed somewhat. In each case, though, the order as entered differed substantially from that proposed by the debtor and had a much reduced impact on the states' ability to enforce their laws.

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<sup>6</sup> Keeping in mind that most such laws have an exception for court-ordered sales.

<sup>7</sup> That agreement was not as strong as it could have been since it only became clear at the last minute that the debtor' expressed intention of "fully stocking its stores to begin the sale" would cover some \$750 million of merchandise – fully 60% of all of the goods already in the stores. Moreover, the debtor also advertised for several weeks that "new merchandise was arriving daily." The states will be alert to those problems in future cases.

The states who have been contesting these orders intend to continue doing so, while looking at proactive steps to deal with these issues. One of their biggest problem is the lack of notice so they intend to react aggressively to future failures to serve them and to alert the United States Trustees to their concerns in this area. Hopefully the latter may be willing to raise the issue with the court if they see that adequate notice is not provided so that this problem can be resolved when the motions are filed, not when objections are being dealt with. The states also expect that their objections will put liquidators on notice of these issues. There are only a handful of such entities and they have extensive knowledge of the laws applicable to their sales. It should be possible to agree on whether, and to what extent, laws are applicable to a given sale. If there are none, or if compliance is only a minimal issue, then it there is no need to stir up trouble with the states by trying to preempt a law that doesn't even apply

By the same token, if liquidators and debtors are aware of the operational concerns that the states perceive, it should be possible to structure the sales procedures to meet those concerns – and to do so, *before* the bids are taken rather than afterwards. In the recent cases the debtors argued that they were limited in making changes to their sale orders because the bid process had already begun and certain methods of operation were presumed to apply. Changing those terms in mid-stream, the states were informed, would be unduly disruptive and costly. While the states are less than impressed by the legal merits of the argument that, “we’ve already contracted away the applicability of your laws,” the reality is that most courts would be reluctant to upset those arrangements. Thus, it is critical to put all parties on notice *before* the fact as to the likelihood that they will face objections if they continue proposing overreaching orders. This article is that warning.