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Hearing Date: January 11, 2011
Hearing Time: 11:00 a.m.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	**Chapter 11**
JENNIFER CONVERTIBLES, INC.	:	**Case No. 10-13779 (ALG)**
Debtors.	:	**(Jointly Administered)**

OBJECTION OF ASHLEY HOMESTORES, LTD. TO DEBTOR'S MOTION PURSUANT TO 11 U.S.C. § 365 FOR APPROVAL OF THE ASSUMPTION OF EXECUTORY CONTRACTS WITH LICENSOR, EFFECTIVE AS OF THE EFFECTIVE DATE OF A PLAN OF REORGANIZATION

TO: THE HONORABLE ALLAN L. GROPPER,
UNITED STATES BANKRUPTCY JUDGE

Ashley HomeStores, Ltd. ("AHL") hereby respectfully submits this Objection to the Debtor's Motion Pursuant To 11 U.S.C. § 365 For Approval Of The Assumption Of Executory Contracts With Licensor, Effective As Of The Effective Date Of A Plan Of Reorganization

[Docket No. 362] (the "Motion")[1] filed by Jennifer Convertibles, Inc. and its affiliated debtors and debtors in possession in the above-captioned chapter 11 cases (collectively, the "Debtors"). In support of this Objection, AHL respectfully represents as follows:

INTRODUCTION

1. One of the Debtors (Hartsdale) operates six Ashley HomeStores pursuant to trademark usage agreements with AHL. Under applicable trademark law, Hartsdale's right to use Ashley's trademarks is personal to Hartsdale-- in order to maintain the value and quality of its trademarks, Ashley has the right (and even the obligation) to carefully assess and monitor the bona fides of any potential licensee of its trademarks. The trademark usage agreements provide Ashley with several protections to ensure that this evaluation process is ongoing and complete, including requirements for financial reporting by the licensee, confidentiality provisions, and provisions for an event of default based on any licensee action that impairs or detracts from the value of the trademarks or the goodwill associated therewith.

2. As these chapter 11 cases have progressed, Ashley has become increasingly concerned with the ongoing ability of Hartsdale to perform under the trademark usage agreements. Ashley has repeatedly requested that Hartsdale comply with its financial reporting obligations under the agreements in order to evaluate the Hartsdale HomeStore business, but to no avail. The Debtors have refused to provide specific financial information for the Hartsdale segment of their businesses. Moreover, the Debtors have now proposed a substantive consolidation plan that would saddle Hartsdale with over $10 million dollars in repayment obligations, including $6.5 million in secured debt to Mengnu, most (if not all) of which arose in connection with the Debtors' Jennifer Convertibles segment and not the Hartsdale HomeStore segment.

1 Capitalized terms used, but not defined, herein have the meaning set forth in the Motion.

3. Effective upon the effective date of this substantive consolidation plan, the Debtors now seek to assume the Hartsdale trademark usage agreements. However, as set forth below, the Debtors cannot satisfy the requirements of section 365 of the Bankruptcy Code because (a) section 365(c) prohibits the Debtors from assuming the TUAs without the consent of AHL, (b) the Debtors cannot satisfy their cure obligations under section 365(b)(1)(A)&(B), and (c) the Debtors cannot provide the adequate assurance of future performance required under section 365(b)(1)(C). Therefore, AHL respectfully requests that the Court honor AHL's rights under the trademark usage agreements and applicable law, and deny the Motion.

FACTUAL BACKGROUND

4. As of the commencement of these chapter 11 cases, AHL and debtor Hartsdale Convertibles, Inc. ("Hartsdale") were parties to seven separate Trademark Usage Agreements (the "TUAs"), each of which governs Hartsdale's use of certain Ashley trademarks (the "Trademarks") at a specific store location (collectively, the "HomeStores"). The TUAs contain terms and conditions regarding Hartsdale's use of the Trademarks.[2] The TUAs have five (5) year terms, commencing on October 27, 2006 (for the first location) through April 9, 2010 (for the most recently established location).

5. All seven of the HomeStores originally operated by Hartsdale are located in New York. Hartsdale closed its Manhattan HomeStore location postpetition, and the other six remain in operation.

[2] The TUAs reference, contain and/or constitute confidential information that is protected from disclosure by the agreement of the parties and applicable law. Accordingly, to the extent that it becomes necessary or relevant for the Court to review the TUAs, AHL will seek to have the TUAs filed or introduced under seal.

6. Ashley Furniture Industries, Inc. ("AFI" and together with AHL, "Ashley") is the primary vendor to Hartsdale for the HomeStores. AFI also supplies a limited amount of product to the Jennifer Convertibles locations operated by the other Debtors.

OBJECTION

A. Section 365(c) of the Bankruptcy Code Prohibits The Debtors From Assuming The TUAs Without The Consent Of AHL.

7. Section 365(c)(1) of the Bankruptcy Code prohibits a debtor from assuming or assigning an executory contract if:

> (A) applicable law excuses a party, other than the debtor, to such contract . . . 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.

11 U.S.C. § 365(c).

8. Under the Lanham Act and applicable federal authority, a non-exclusive license to use a trademark is not assignable without the consent of the licensor. See Tap Publs. v. Chinese Yellow Pages, 925 F. Supp. 212, 218 (S.D.N.Y. 1996) (citing authorities and quoting treatises for proposition that "unless the license states otherwise, the licensee's right to use the licensed mark is personal and cannot be assigned to another" because "since the licensor-trademark owner has the duty to control the quality of goods sold under its mark, it must have the right to pass upon the abilities of new potential licensees").

9. The TUAs provide for a non-exclusive license of the Trademarks, and they explicitly forbid assignment of the TUAs and the right to use the Trademarks without AHL's written consent. Therefore, section 365(c) indisputably preserves this prohibition and prevents Hartsdale from assuming and assigning the TUAs without AHL's written consent. See, e.g.,

N.C.P. Mktg. Group v. Blanks (In re N.C.P. Mktg. Group), 337 B.R. 230, 237 (D. Nev. 2005); Wellington Vision, Inc. v. Pearle Vision, Inc. (In re: Wellington Vision, Inc.), 364 B.R. 129, 134 (S.D. Fla. 2007).

10. Moreover, a majority of circuit level decisions hold that the plain meaning of section 365(c) prohibits a debtor from assuming an executory contract if the contract is not assignable under applicable law. See RCI Tech Corp. v. Sunterra Corp. (In re Sunterra Corp.), 361 F.3d 257 (4th Cir. 2004); Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.), 165 F.3d 74 (9th Cir. 1999); In re West Elecs., Inc., 852 F.2d 79 (3d Cir. 1988). This approach is referred to as the "hypothetical test" in contrast to the "actual test" (also referred to by the Debtors as the "Footstar Approach"). See, e.g., Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir.), cert. denied, 521 U.S. 1120, 138 L. Ed. 2d 1014, 117 S. Ct. 2511 (1997); In re Footstar, Inc., 323 B.R. 566, 573-74 (Bankr. S.D.N.Y. 2005); In Adelphia Communications Corp., 359 B.R. 65, 72 (Bankr. S.D.N.Y. 2007). Under the "hypothetical test," the Debtors cannot assume the TUAs without AHL's consent because the TUAs are not assignable without AHL's consent. See, e.g., In re N.C.P. Mktg. Group, 337 B.R. at 237; In re: Wellington Vision, Inc., 364 B.R. at 134 (S.D. Fla. 2007).

11. In order to avoid the consequences of the "hypothetical test," the Debtors argue that (i) they are not seeking to assign the TUAs, only to assume them, (ii) the Court should apply the "actual test" to its analysis of section 365(c), and (iii) application of the "actual test" permits the Debtors to assume the TUAs because "the entity performing under the contracts (the Debtors/Hartsdale) will be the same entity that existed prepetition." Motion at 8 (¶23). The Debtors are wrong on all three counts for the same reason-- by the Debtors' own admission, the

entity seeking to assume the TUAs is not the same entity that originally entered into the TUAs with AHL.

12. AHL entered into the TUAs with Hartsdale. At the time the TUAs were entered into, Hartsdale was a wholly-owned subsidiary of Jennifer Convertibles, Inc., the stock of which was publicly traded and owned by various companies and individuals. Hartsdale's only business was and is to operate the HomeStores that are the subject of the TUAs. In contrast, the Motion seeks approval for assumption of the TUAs by the Debtors. See, e.g., Motion at 1, 3 (¶ 10), 5 (¶ 16) , 8 (¶¶ 21-22), 9 (¶¶ 24-25), 15 (¶ 39). The Debtors collectively operate more than sixty (60) Jennifer stores in addition to the six remaining HomeStores. And the Motion seeks approval for this assumption "effective as of the effective date of a chapter 11 plan of reorganization," which means that the proposed assumption actually would be by the Reorganized Debtors. Motion at 2. See also Motion at 3 (¶ 10), 5 (¶ 17), 9 (¶ 24), 15 (¶ 39).

13. Under the Plan, the Debtors would be substantively consolidated. See Plan at 18-19 (§ 2.01). Post-confirmation, each of the Reorganized Debtors would be liable for all of the payment obligations imposed by the Plan. Thus, although the Plan purports to qualify the extraordinary remedy of substantive consolidation by limiting it "solely for purposes of voting, confirmation and making distributions to Holders of Allowed Claims," Plan at 19 (§ 2.01), the Plan would inextricably tie the fortunes of Hartsdale (and therefore, the HomeStores) to the fortunes of the other Debtors and their scores of Jennifer stores.

14. On and after the effective date of the proposed Plan, Hartsdale would be liable for repayment of the Tranche A Note ($1.4 million due in one year), the Tranche B Note ($2.6 million due in two years), the Tranche C Note ($950,000 due in three years), the Tranche D Note ($1.8 million due in four years) and the Tranche E Note ($3.9 million due in five years). See

Disclosure Statement at 15. Hartsdale's assets would be encumbered by a security interest in favor of Mengnu to secure repayment of the Tranche B Note and Tranche E Note. See id. Thus, the Plan would subject Hartsdale to liability for over $10.5 million in debt, $6.5 million of which would be secured by a blanket lien on Hartsdale's assets. This is a wholesale change to the capital structure that Hartsdale exhibited prepetition. See, e.g., Hartsdale Schedule of Assets and Liabilities [Case No. 10-13783 (ALG); Docket No. 5] (Hartsdale shown to have zero secured debt and only $1.6 million in unsecured debt-- the majority of which is owed to Ashley).

15. In addition to this radically different capital structure, the control and effective ownership of Hartsdale also would undergo a very significant change upon the effective date of the Plan. As noted in the Motion, Mengnu would receive 90.1% of the equity of reorganized Jennifer Convertibles, Inc. See Motion at 9. The Debtors attempt to brush away this momentous shift with the glib observation that "ownership of Hartsdale post-bankruptcy remains the same." Id. While this may be technically true, it ignores the serious implications that would arise from the Debtors (including Hartsdale) being controlled by Mengnu, which is (i) owed more than $6.5 million in debt under the Plan secured by all of the assets of all of the Debtors, and (ii) an off-shore furniture manufacturer with the potential to be in direct competition with AHL's affiliated furniture vendor, AFI.

16. Confronted with a similar situation, a bankruptcy court in the Western District of Tennessee found that section 365(c) prohibited a debtor from assuming a patent license pursuant to a chapter 11 plan where the reorganized debtor's stock would be transferred to a new owner. See In re Alltech Plastics, Inc., 1987 Bankr. LEXIS 2259, 25-26 (Bankr. W.D. Tenn. 1987). In doing so, the court refused to elevate form over substance, determining that "the proposed reorganized Debtor is in reality a different entity than the pre-petition Debtor or the Chapter 11

debtor." Id. at 24. The court based its ruling on specific facts in the case, which included the debtor's lack of other assets, employees or operations, and the previous conversion of the debtor's case to chapter 7 before it was converted back to chapter 11. See id. at 24-25. These facts led the court to conclude that it would not be equitable to expose the licensor to the risks posed by what amounted to a "de facto assignment." See id. at 25, 29 (citing court's equitable powers under section 105 of the Bankruptcy Code).

17. This Court should reach the same conclusion here, either by following the majority of circuit court decisions and applying the "hypothetical test" or by recognizing the specific facts in this case that strongly militate against exposing AHL to the inequitable risk of being made party to TUAs with the Reorganized Debtors. AHL did not license its Trademarks to an entity controlled and indirectly owned by an off-shore furniture manufacturer. AHL did not license its Trademarks to an entity saddled with \$10.5 million in debt under a substantive consolidation plan. AHL did not license its Trademarks to an entity whose assets are encumbered by a blanket lien to secure \$6.5 million in debt to its controlling indirect parent, which is also the exclusive vendor for sixty other stores in the enterprise's other business segment. Indeed, subjecting Hartsdale to the liabilities and liens provided under the Plan would constitute a *prima facie* case of constructive fraudulent transfer absent the Plan's artifice of substantive consolidation.

18. This Court should not permit the Debtors (and ultimately, Mengnu) to have their cake and eat it too. If the Debtors (and Mengnu) want to obtain the benefits of substantive consolidation, then they should also be required to accept its burdens. Regardless of how the Debtors have couched the effects of the Plan's substantive consolidation, the Plan would utterly transform the Hartsdale entity that currently is party to the TUAs. This transformation clearly

requires AHL's consent to any assumption of the TUAs by the Reorganized Debtors. Ashley cannot overstate the value of its Trademarks and the goodwill associated therewith-- that value should not be put at risk in furtherance of Mengnu's insistence on dictating the terms of the Debtors' reorganization. The Court should recognize the necessity under applicable law for AHL to exercise its discretion regarding licensees of its Trademarks by refusing to approve the assumption of the TUAs absent AHL's consent.

B. The Debtors Cannot Satisfy Their Cure Obligations Under Section 365(b)(1)(A)&(B) Of The Bankruptcy Code.

19. Even if section 365(c) did not prohibit the Debtors from assuming the TUAs without AHL's consent, the Debtors would still need to satisfy their cure obligations under section 365(b)(1) before the TUAs could be assumed. Hartsdale is in monetary and non-monetary default under the TUAs, and it cannot cure all of these defaults under the Debtors' current Plan structure.

20. Section 365(b)(1) provides that a debtor cannot assume an executory contract under which the debtor is in default unless the debtor:

> (A) cures, or provides adequate assurance that the [debtor] will promptly cure, such default . . . [and]
>
> (B) compensates, or provides adequate assurance that the [debtor] will promptly compensate, a party other than the debtor to such contract . . . for any actual pecuniary loss to such party resulting from such default . . . .

11 U.S.C. § 365(b)(1)(A)&(B). As the Debtor acknowledges, section 365(b)(1) requires a debtor to cure <u>all</u> defaults under a license agreement, monetary <u>and</u> non-monetary, before it can assume the agreement. <u>See</u> Motion at 14, n.4 (citing <u>In re Empire Equities Capital Corp.</u>, 405 B.R. 687, 690 (Bankr. S.D.N.Y. 2009) (current version of section 365(b)(1) provides "no room for the

contention that non-monetary defaults in non-lease executory contracts are exempt from the cure obligation")).

21. Hartsdale is in monetary default under the TUAs for failure to pay amounts due to AHL and AFI. As of the commencement of these cases, the Debtors collectively owed $1,262,896.95 to AFI for prepetition product purchases. In addition, AHL has incurred in excess of $50,000 in legal fees and expenses to enforce its rights under the TUAs in the Debtors' chapter 11 cases, for which the TUAs require Hartsdale to indemnify AHL. The Debtors do not specify in the Motion the cure amount that they concede would be payable upon assumption of the TUAs, but consistent with the foregoing the Debtors would need to promptly pay in excess of $1.3 million in order to satisfy their cure obligations under section 365(b)(1)(A).[3]

22. In addition, Hartsdale also is in non-monetary default under the TUAs on at least two grounds. First, Hartsdale closed the Manhattan HomeStore location. Especially because the Manhattan HomeStore was the most visible location operated by Hartsdale, its closing was not only a default under the Manhattan TUA, but also a default under all of the other TUAs as well. Each of the TUAs provides for an event of default if Hartsdale "commits any act that, in the judgment of [AHL] or [AFI] impairs or detracts from any one or more of the [Trademarks] or the goodwill associated with any of the [Trademarks]." Clearly, closing a very prominent HomeStore location, particularly during the key fall sale season, impairs or detracts from the Trademarks and the goodwill associate therewith. Indeed, the TUAs provide for a separate event of default if the licensee "fails or refuses to keep the [HomeStore] open for business during those business days when other furniture and retail stores within a 50-mile radius of the [HomeStore]

[3] The Debtors may seek to distinguish between prepetition amounts owed by Hartsdale and prepetition amounts owed by any of the other Debtors for purposes of calculating the cure amount for the TUAs. The Court should not give credence to any such attempt given that (i) the Motion seeks approval for "the Debtors" to assume the TUAs, and (ii) the proposed assumption of the TUAs is pursuant to, and conditioned upon, the effectiveness of the proposed Plan, which provides for the Debtors to be substantively consolidated.

are open for business." Therefore, the closing of the Manhattan HomeStore is a non-monetary default that would need to be cured (or waived by AHL) before the Debtors could assume the TUAs.

23. Second, Hartsdale has failed to provide satisfactory financial reporting to AHL. The TUAs require Hartsdale to provide quarterly financial reports, including balance sheets and income statements in the form and content required by AHL. The TUAs also require Hartsdale to prepare and submit to AHL any additional reports requested by AHL. From the very beginning of these cases Ashley, has been concerned with the financial health and integrity of Hartsdale and its HomeStores (as distinct from the Jennifer Convertibles stores operated by the other Debtors). Ashley raised these concerns in written responses filed with respect to the Debtors' "first day" cash management motion and the Debtors' postpetition financing. See [Docket Nos. 110 and 350]. Ashley also specifically articulated its concerns in a letter from its counsel to counsel for the Debtors dated August 17, 2010, a copy of which is attached hereto as Exhibit "A" (the "August 17 Letter"). As set forth in the August 17 Letter, Ashley informed the Debtors that (i) it was focused on the performance of the Hartsdale HomeStores, (ii) in order to assess the performance of these HomeStores, Ashley required specific financial reporting for the Hartsdale HomeStore segment of the Debtors' businesses, and (iii) this reporting was necessary for Ashley to evaluate any proposed assumption of the TUAs.

24. Neither the Debtors nor their counsel provided a substantive response to the requests in the August 17 Letter. The Debtors have not provided Ashley with the requested specific financial reporting for the Hartsdale HomeStore segment of the Debtors' businesses. The Debtors' counsel eventually sent an email to Ashley's counsel, which is not quoted or discussed in detail here because it was couched as a settlement communication subject to

protection under Federal Rule of Evidence 408. Suffice it to say that Debtors' counsel indicated the requested financial information would not be forthcoming.[4]

25. As noted in the August 17 Letter, specific financial reporting for the Hartsdale HomeStore segment of the Debtors' businesses is crucial for Ashley to assess the financial performance of the stores and to evaluate the proposed assumption of the TUAs. The need for this information has become even more acute now that the Debtors propose to saddle Hartsdale with over $10 million dollars in debt ($6.5 million of which would be secured by a blanket lien on Hartsdale's assets) under the five Tranches of notes under the Plan. Yet the Debtors continue to provide financial information on a consolidated basis for all of their operations, including in the financial projections that accompany the Disclosure Statement. The Debtors' failure to comply with their financial reporting obligations under the TUAs is a separate, material and ongoing non-monetary default that prevents the TUAs from being assumable under section 365(b)(1)(A).

C. The Debtors Cannot Provide The Adequate Assurance Of Future Performance Required Under Section 365(b)(1)(C) Of the Bankruptcy Code.

26. In addition to being unable to cure existing defaults, the Debtors cannot provide assurance that they will be able to perform under the TUAs post-confirmation. Section 365(b)(1)(C) expressly conditions assumption of an executory contract on the debtor providing "adequate assurance of future performance under such contract." 11 U.S.C. § 365(b)(1)(C). Adequate assurance is required whenever the non-debtor party to the contract has "reasonable ground for insecurity with respect to the debtor's ability to fully perform its obligations under the

[4] In fact, as early as August 4, 2010, counsel for the Debtors stated on the record (in response to Ashley's request for separate Hartsdale segment financial information) that the Debtors were unable to comply with this obligation See Transcript of August 4, 2010 Hearing at 35:12-13 ("Mr. Fox: We are operating. We're one company. [Ashley] wants separate dat[a]. They want something that we can't do.") (emphasis added). A copy of the relevant pages of the August 4, 2010 hearing are attached hereto as Exhibit "B".

contract" and is not contingent on the existence of a technical default In re Metromedia Fiber Network, Inc., 335 B.R. 41, 50 (Bankr. S.D.N.Y. 2005). The debtor has the burden to prove that adequate assurance has been provided. See In re Westview 74th Street Drug Corp., 59 B.R. 747, 755 (Bankr. S.D.N.Y. 1986).

27. The Debtors do not provide any evidence or basis in the Motion upon which a finding of adequate assurance of future performance could be made. The Debtors refer to their go forward financial projections, but (as noted above) these projections were made on a consolidated basis to cover the entire enterprise. See §B, supra. And despite the substantive consolidation provisions of the proposed Plan that expose Hartsdale to liability for all five Tranches of notes in excess of $10.5 million, the Plan carefully advises that it will not affect the "legal and corporate structure of the Reorganized Debtors." Plan at 18-19 (§ 2.01). Thus, Hartsdale would jointly bear the overwhelming burden of legacy debt from the Jennifer business segment, but would obtain no corresponding benefit in terms of asset or liquidity support.

28. As a wholly-owned subsidiary of Jennifer Convertibles, Inc., Hartsdale would be subject to having its working capital drained to fund operations of the Jennifer stores in addition to having its balance sheet overloaded with repayment obligations under the Plan. Yet despite the Motion's reference to several concrete examples of adequate assurance, such as the presence of a guarantee, the presence of a security deposit, money earmarked for the counterparty, etc., the Debtors offer nothing more than a general endorsement of the "continued operation and growth of both the Jennifer and Ashley segments" to support their ability to perform under the TUAs. See Motion at 14-15 (¶¶ 37-38). Regardless of whether the Debtors' consolidated projections are sound (something that will not be determined until the Plan confirmation hearing),[5] the Debtors

[5] For this reason, even if section 365(c) did not prohibit the assumption of the TUAs without AHL's consent as a matter of law for the reasons set forth herein, proceedings to develop the factual record regarding adequate

have not provided any (much less sufficient) proof of Hartsdale's ability to perform under the TUAs. To the contrary, the proposed Plan puts Hartsdale at immediate and perilous risk of future payment defaults, having to close one or more of the remaining HomeStore locations, and otherwise impairing or detracting from the value of the Trademarks in breach of the TUAs. See In re Alltech Plastics, Inc., 1987 Bankr. LEXIS 2259, 25-26 (Bankr. W.D. Tenn. 1987) (alternatively holding that patent license agreement could not be assumed under plan providing for transfer of stock in reorganized debtor because debtor could not provide adequate assurance of future performance).

29. Moreover, the Debtors have had nearly five months since receiving the August 17 Letter to prepare specific financial information for the Hartsdale HomeStore segment, but have failed to produce anything. See §(B), supra. In addition to constituting an ongoing default under the TUAs, the Debtors' failure to comply with reporting requirements under the TUAs provides affirmative evidence that the Debtors cannot or will not comply with this requirement going forward. The TUAs also contain key confidentiality provisions, which are particularly important in this context due to the involvement of Mengnu. Unless and until the Debtors can provide specific financial information for the Hartsdale HomeStore segment of their businesses and ensure the preservation of confidentiality under the TUAs, there is no basis for the Court to evaluate (much less find) whether AHL would be adequately assured of future performance under the TUAs as required by section 365(b)(1)(C) of the Bankruptcy Code.

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assurance (or the other requirements under section 365(b)) should be deferred to the confirmation hearing in the interests of judicial economy and preventing the parties from having to prepare the same evidentiary material for two separate hearings.

CONCLUSION

WHEREFORE, Ashley respectfully requests that the Court: (i) sustain this Objection; (ii) deny the Motion; and (iii) grant such other and further relief as the Court deems to be just and proper.

Dated: January 4, 2011
Santa Monica, California

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