CIRCUIT CITY UNPLUGGED: WHY DID CHAPTER 11 FAIL TO SAVE 34,000 JOBS?

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

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CIRCUIT CITY UNPLUGGED: WHY DID CHAPTER 11 FAIL TO SAVE 34,000 JOBS?

WEDNESDAY, MARCH 11, 2009

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:08 p.m., in room 2141, Rayburn House Office Building, the Honorable Steve Cohen (Chairman of the Subcommittee) presiding.

Present: Representatives Cohen, Delahunt, Watt, Maffei, Lofgren, Johnson, Scott, Franks, Jordan, Coble, Issa, and Forbes.

Staff present: Susan Jensen-Lachmann, Majority Counsel; Stewart Jeffries, Minority Counsel; and Adam Russell, Majority Professional Staff.

Mr. COHEN. This hearing of the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law will now come to order.

Without objection, the Chair will be authorized to declare a recess of the hearing.

I will now recognize myself for a short statement.

We are in the midst of an economic maelstrom that is hurting virtually every sector of our Nation's economy. From businesses to consumers, there is no one and nothing that hasn't been touched by our economic crisis.

While, in the past, this Subcommittee has concentrated solely on the impact of this crisis on the individual, it is important to examine the impact on businesses as well, which are also subject to the vagaries of the economic cycles and the bankruptcy process.

When businesses encounter financial distress, they may file for bankruptcy relief under Chapter 11 as a last resort to remaining in business, a form of bankruptcy relief intended to give companies a temporary cooling-off period during which they can reorganize their financial affairs.

Chapter 11, essentially, is like a hospital where sick businesses—under the careful scrutiny of a bankruptcy judge who wears white scrubs and a stethoscope, and creditors—are given a chance to rehabilitate themselves.

By promoting reorganization, Chapter 11 is supposed to benefit everyone. Employees' jobs should be, and, often, are preserved. Creditors have a greater chance of receiving payment, rather than liquidation value from a forced asset sale. And, vendors continue to have the company as a future customer. So vendors benefit, creditors benefit, employees benefit, the economy benefits, and the community benefits from having this rehabilitated tax-revenue source.

Clearly, Chapter 11 is not a panacea, but it is something that we need in our arsenal, to keep our economy moving. Just like sick individuals, some Chapter 11 businesses are too far gone too far for help, and they are beyond doctors' help.

The goal of Chapter 11 is to give businesses at least a fighting chance to reorganize so they can reenter the marketplace and save jobs.

Some of us feel, however, that Chapter 11 is no longer working as Congress intended it to, especially in light of the 2005 amendments to the Bankruptcy Code. This concern may very well be illustrated by the recent Chapter 11 case filing of Circuit City.

Before filing, Circuit City was one of the Nation's largest retailers, with more than 700 store locations, and more than 34,000 employees. In less than 4 months after filing for Chapter 11, however, Circuit City closed all of its doors, and virtually all of its employees are now without jobs, jobless.

What went wrong? Why didn't Chapter 11 work to save this business? If Chapter 11 couldn't save Circuit City, is it also failing to save other businesses? And with this economy, there are going to be a whole lot more Circuit Citys and businesses—not of that size, but of that size—and lesser and greater—who will need to be reorganized. And what will happen? And what should Congress do with this new economic plight and condition that didn't exist in 2005.

All of these are important questions we need to have answered. Accordingly, I look forward to receiving today's testimony and learning more about how we can adjust our laws to affect outcomes reflective of 2009.

I would now like to recognize my colleague, Mr. Franks, the distinguished Ranking Member of the Subcommittee, for his opening remarks.

Mr. FRANKS. Well, thank you, Mr. Chairman. And thank you for calling this hearing on this, the Subcommittee's first important hearing on the topic of bankruptcy.

Over the last couple of years, bankruptcy has been one of our busiest areas. And, indeed, it has included three hearings on Chapter 11 bankruptcy alone.

As our former colleague, and my esteemed predecessor, Chris Cannon, remarked last term, "Bankruptcy is so important, that the founding fathers explicitly listed it as one of the enumerated powers of the Congress, in Article 1, Section 8 of the Constitution."

Our current economic distress only serves to underscore further the importance of our bankruptcy laws.

In 2005, Congress passed a major overhaul of the bankruptcy code, through the Bankruptcy Abuse, Prevention and Consumer Protection Act of 2005. Four years on, in our current economic environment, it is not surprising that the Committee is taking a look at the laws—Chapter 11 provisions—to see how they are working.

We should all, however, be careful as we review this act. The 2005 reform capped off years of debate on how to revise the bankruptcy code. And, as with many long-considered, major pieces of legislation, the final product incorporated a self-reinforcing web of compromises made by all parties.

In our hearings last term, and, now, again, this term, some of those parties have come back to us, trying to strike a new deal on part or some other parts of the act.

That may be unsurprising, especially since political power at both ends of Pennsylvania Avenue have shifted from Republicans to Democrats. Nevertheless, partisan attempts to nibble at, or undermine, or begin to unravel, the 2005 reform, would be counterproductive and unfortunate.

Today's hearing, in fact, serves well to highlight the need for caution. The 2005 reform, for example, carefully struck a better balance in Chapter 11's provision affecting relations between retail vendors and their mall and shopping-center landlords.

Previously, it was too easy for vendors in Chapter 11 to squat in their already-leased space, holding landlords hostages, sometimes for years, as the vendors tried to work their way through Chapter 11. This was particularly problematic in the case of anchor-store bankruptcies, like those involving large department stores.

The excessive leniency toward vendors in the code's prior provisions too often enabled "ghost stores" like those to convert their hosts into "ghost malls." And, too often, it prevented vibrant, viable stores from coming into those malls and occupying space that they urgently needed.

None of us, of course, wants Chapter 11 to force vendors into liquidation too fast. But at the same time, none of us should want Chapter 11 to allow anchor stores and other companies in bankruptcy to slowly bleed landowners and landlords dry. That would only kill the companies on which all retail vendors rely for space, and choke our economy in a time in which it is already struggling for breath.

Accordingly, while some may partially ascribe Circuit City's eventual liquidation to problems with retail leases, we should be careful not to overreact to that charge. We should be careful to explore all of the issues that affected Circuit City's case, and consider whether they stem from problems inherent in the bankruptcy code, problems inherent to Circuit City, or—such as inadequate business model—or problems inherent in the current, highly unusual credit crisis.

Circuit City's liquidation will, of course, cost many jobs, as the title of this hearing suggests. But mistaken repeals of the 2005 reform could cost other jobs such as those held by Circuit City's competitor, other vendors, suppliers, financiers and landlords. Those jobs could, in the end, number even more, although their loss may be even harder to trace through the system.

This is a patter that we must be careful not to set in motion, whether in the electronic sector, the auto sector or the banking sector, or any other sector of our economy.

And, Mr. Chairman, with that, I yield back my time. Thank you, sir.

Mr. COHEN. I thank the gentleman for his statement.

I now recognize Mr. Delahunt, the unofficial Vice Chairman of this Subcommittee, distinguished Member from—a former Attorney

General and a man of many trades. And, yes—I can't go any further.

Mr. DELAHUNT. Don't stop there.

I think it is wise if we go and listen to those who are testifying.

I want to commend you, however, for these hearings. And I hope that you would consider having a series of hearings from the perspective of oversight, to determine how we got here.

You know, I think that we have an obligation, as a Subcommittee, to examine the causes of these bankruptcies that are going to multiply. We have had a debate on the floor, led by the gentlelady from California, Ms. Lofgren, who is a Member of this Committee.

I think it is important we really deeply delve into the causes. How did we get here? I suspect that there are—most of the reasons are outside of the Bankruptcy Code. But I think we have that obligation to make every effort that we can to avoid bankruptcy.

With that, I yield back.

Mr. COHEN. Thank you, sir.

Are there other Members that wish to make an opening statement?

I would like to now introduce the witnesses for today's hearing. And make note that our first witness is not under the Witness Protection Program, but had difficulty with his flight, and was unable to be present—Mr. Miller, who I have not had the pleasure of meeting, but I have heard great statements about his knowledge of this issue—had a problem with his flight cancellation and inclement weather in New York City.

It is unusual for a witness to participate telephonically, but we wanted him to do that. And with the indulgence of our Members, we will allow him to proceed in that fashion.

I thank Mr. Franks for his cooperation to allow us to do that. And I think that is the reason for this large screen, here.

The other witnesses we will have today—our first witness—do we have him as first? Mr. Pachulski is first. But I just wonder, is he going to be in front of a TV camera the whole time? Is he there now?

Why don't we go ahead and ask him to—we will have him first. But, in time, Mr. Richard Pachulski is an additional witness. He is a partner at Pachulski Stang Ziehl and Jones—extensive experience in business reorganizations, as well as debtor-creditor litigation—and, during the 1980's, was a well-known Chapter 7 and 11 trustee. He has represented numerous debtors and creditor committees, in both out-of-court workouts and in-court proceedings.

Mr. Pachulski has been cited by several publications as a leader in the legal community. During 2007 and 2008, he represented debtors' and creditors' committees in numerous industries, though, primarily, in the real estate business and retail industry.

A representative sampling of such matters include his current representation of the creditors committee of Circuit City and affiliates.

Our first witness, who will precede Mr. Pachulski, because of the need to go to this extra-terrestrial type of video—or testimony—will be Harvey Miller.

Mr. Miller is in the business, finance and restructuring department of Weil, Gotshal & Manges?

Mr. MILLER. Manges.

Mr. COHEN. Manges—thank you. Where did that come from?

He has played a leading role in many major business-organization cases, involving, among others, Lehman Brothers, Texaco, Donald Trump, Federated Department Stores, Macy's, Chase Manhattan Mortgage and Realty Trust, Best Products Company, Continental Airlines and Eastern Airlines.

Mr. Miller is a lecturer for the American Law Institute and American Bar Association, New York University Law Workshop on Bankruptcy and Reorganization, the New York State Bar Association, and various local bars and law schools.

He co-authored numerous bankruptcy texts, is a contributing editor of Collier on Bankruptcy and a Federal attorney-fee awards reporter, an adjunct professor of law at NYU School of Law, and a lecturer at Columbia School of Law.

Our third witness will be Mr. Daniel Hurwitz, who appears on behalf of the National Council of Shopping Centers. He is the former president and COO of Developers Diversified Realty. In May 2007, he previously served as senior executive vice president—chief investment officer since May 2005—and was executive vice president of DDR from June 1999 through April 2005.

He was on the company's board of directors from May 2002 to 2004. He is responsible for Developers Diversified's core-revenue departments, in addition to management of the various disciplines related to the day-to-day operations of the company. Moreover, he is a member of the company's executive management and investment committees.

Prior to joining Developers Diversified, he served as senior vice president and director of real estate and corporate development for Boscov's Department Store, Inc. Prior to that, he served as development director for Shopco Group, a New York City based developer and acquirer of regional and super-regional shopping malls.

He is a member of the ICSC board of trustees, co-chair of its open-air centers committee, and a proud alumnus of the Wharton School.

Our fourth witness is Todd Zywicki. Professor Zywicki teaches in the areas of bankruptcy and contract law at George Mason University School of Law. Previously, he taught at Mississippi College School of Law, where he has held a faculty position since 1996—or he had held one.

During 2003-2004 academic year, he served as director of the Office of Policy Planning at the Federal Trade Commission. Professor Zywicki is the author of more than 30 articles in leading law reviews—economics journals.

And our fifth witness is Isaac Pachulski, who appears on behalf of the National Bankruptcy Conference. Currently, he is a senior shareholder of Stutman Treister & Glatt professional corporation and specializes in corporate reorganization and solvency in bankruptcy law.

He has been with the firm since 1974, and became a shareholder in 1980. He is the NBC's co-vice chair of the Chapter 11 committee, and a member of the executive committee. He is also a member of the American College of Bankruptcy and the International Insolvency Institute.

In his more than three decades of practice as an insolvency attorney, Mr. Pachulski has represented both debtors and creditors, as well as other parties and interest in major reorganization cases around the country.

He has been a lecturer on topics such as appellate practice, intellectual property licenses, security interests, and bankruptcy.

And our final witness will be Mr. Jack Williams, who appears on behalf of the American Bankruptcy Institute. Professor Williams serves as the American Bankruptcy Institute residential scholar. As such, he assists the ABI with its educational programming and its role as the authoritative source of bankruptcy information for the Congress, media and the public.

He teaches at Georgia State College of Law, where he instructs on a broad array of courses. He also teaches at the New York Law School Masters Program in Taxation, the NYU School of Law Continuing Professional Education Program for the IRS, and the Federal Law Enforcement Training Center.

I want to thank all of our witnesses for participating in today's hearing. Without objection, your written statements will be placed in the record. And we would ask you limit your oral remarks to 5 minutes.

There are systems in front of all of you, except for Mr. Harvey Miller, who has no buzzer in front of him. But we will let you know when the lights would have changed, if you would have been present.

When the light turns yellow, it means you have a minute left. Then, you need to hurry your remarks or stretch them out, if you are close to the end. And when it gets to red, you are finished.

After each witness has presented his testimony, Subcommittee Members will be—after each witness has presented his or her testimony, at the end of the panel—Subcommittee Members are free to ask questions, subject to the 5-minute limit.

And, now, if we can go to the video screen, we would like Mr. Miller to start his 5-minute remarks. And we thank you for making yourself available through this unusual process.

Mr. Miller, are you there?

TESTIMONY OF HARVEY R. MILLER, WEIL, GOTSHAL & MANGES, LLP

Mr. MILLER. Thank you, Mr. Chairman.

I deeply appreciate the opportunity to participate in this hearing telephonically. And I apologize for my inability to get to Washington this morning.

It has been almost 30 years since the bankruptcy code now in effect, became effective. And in that 30-year period, we have had seismic changes in the way financial markets operate, and the way business is conducted, which is very different from the environment which existed in 1978, when the Bankruptcy Reform Act was passed.

Among those changes has been the changes in creditor constituencies. At the time that the bankruptcy code was enacted, those changes—the code addressed itself to constituencies primarily made up of unsecured creditors; generally, in most cases, with a large trade-creditor community, particularly in the retail area, where supply has made up a good portion of the creditor constituency.

Today, we find, in our cases, that the major creditors are secured creditors. And that has changed the dynamic of reorganization very significantly. In addition, there has been a change in the business practice for retailers, in particular, where suppliers are generally offshore, and their transactions are accomplished through letters-of-credit transactions. And, essentially, that becomes secured financing.

So the vendor-supplier community is not really the major force in retailing anymore. And that was the group of creditors that were very interested in seeing the retail organizations survive, because they wanted a customer in the future.

In addition to a major change in retailing—is back in 1990 and 1991 and 1992, when Federated Department Stores and R.H. Macy went into bankruptcy code, and other retailers—in those cases, generally the merchandise inventory was not subject to liens and encumbrances, and the retailer would tell its lender that, “We cannot give you a lien on the inventory, because, if we do that, we will not be able to get credit from our suppliers.”

With the change in the business practice of suppliers coming offshore, that argument no longer was accepted by lenders. And the consequence is most merchandise inventories are liened in favor of a secured creditor, a bank syndicate.

That bank syndicate, today, has a different view of rehabilitation and reorganization, because banking relationships are no longer what they were in 1978 and 1979. A secured lender looks at the merchandise inventory and sees it as being a liquid asset that is easily convertible into cash.

Because of the changes in the 2005 amendments to the bankruptcy code, which put a 210-day cap on the ability to assume or reject an unexpired lease of non-residential real property, the retail-store locations, the secured lender is always thinking about, “If this case is going to convert into a liquidation, I have to have sufficient time to have that inventory liquidated so that I can realize the outstanding amounts on my loans.”

That has been a dramatic change in retailing. And, basically, within a period sometimes no more than 60 days, the retailer really had to demonstrate refinancing of the existing secured debt or a plan of reorganization, which it can’t really do in 60 days. The result is that the debtor is forced to start the liquidation process.

I know the process was somewhat different in Circuit City, because of the nature of its own business. But that is a dramatic change.

The other big change which I would think the Committee ought to take into account is, in 1978, everybody agreed that rehabilitation and reorganization was a desired objective—that there was a virtue to reorganization.

As the code was being applied over the years, starting in 1979, there was a second principle which became evident, which was the maximization of creditor recoveries.

Now, those two objectives may be in competition with each other and, sometimes, upset the balance of the administration of a Chapter 11 case.

At this point in time, the goal of rehabilitation and reorganization is—does not appear to be the primary goal. As you look at Chapter 11 cases—and, particularly, since 2005 amendments—more and more of those cases are turning into liquidation cases because, one, debtor-in-possession financing is very hard to get in the current credit crunch.

Two, most of the assets are liened-up, and it is virtually impossible to prime a secured creditors. So the only source of debtor-in-possession financing turns out to be the existing secured creditor. And, generally, those are the defensive—debtor-in-possession financings—but they carry with them very coercive provisions.

They impose upon the debtor in possession dates, as to which a plan of reorganization must be filed. Very often, they give consent rights to the secured creditors.

What has happened is the balancing of equities before—the balancing of interests that was incorporated into the 1978 Bankruptcy Reform Act is no longer in place. The balance has been skewed very much in favor of the creditors, so that rehabilitation turns out not to be the primary objective of a Chapter 11 case.

Chapter 11, in effect, has become a process for the sterilization of liquidation sales to buyers for liquidation of the assets. And very few of these cases currently are turning out to be rehabilitation reorganization.

As a consequence of that, there are a great deal of jobs that are being lost. And the 34,000 jobs of Circuit City is compounded by—I am told that, over the last year, we have eliminated approximately 240,000 jobs in the retail sector. The retail sector is the employer of last resort.

I am also told that there are only about 479,000 jobs left in retailing. If you read the papers today, you will see retailing is going to have a pretty bad 2009.

The question is: How can we rehabilitate and reorganize these companies? We have to deal with the issue that debtor-in-possession financing, under this Code, is generally not available.

Can there be some provisions that are put into an amendment to the code, that will make debtor-in-possession financing more accessible, even if it may cause secured creditors to have to wait a longer period of time to get recoveries? Are we going to reinstate the objective of rehabilitation and reorganization, rather than liquidation of assets in Chapter 11?

These are among the problems that are occurring now. And one more, which I will add in the last minute, I think, is that——

Mr. COHEN. Thank you, sir. I have been——

I think we are beyond the last minute, so if you can close——

Mr. MILLER. I will close with this statement——

Mr. COHEN. Thank you.

Mr. MILLER [continuing]. If I may, Mr. Chairman.

Claims trading has also become a big problem in Chapter 11 cases. In 1991, when the rules of bankruptcy procedure were amended to allow, basically, free trading of claims against the debtor, a whole market opened up.

Now, buyers of claims buy them in at a substantial discount. Their entry fee is much lower. Their objectives are much different. They have a much shorter horizon. They are particularly concerned about expeditious recoveries and big recoveries. Their objective is not so much the rehabilitation of the debtor. This has changed the dynamic.

So, finally, my last sentence, sir, would be: The dynamic that was contemplated in 1978 is not the dynamic that is playing in Chapter 11 today. With all of the restrictions which were imposed in the 2005 amendment—they have had the effect of stopping the rehabilitation process, and leading cases, more often, into the sale of assets.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Miller follows:]

PREPARED STATEMENT OF HARVEY R. MILLER

Testimony of

Harvey R. Miller [1]

before the

Subcommittee on Commercial and Administrative Law

of the

House Judiciary Committee

111th Congress, 1st Session

for Hearings on

"Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?"

March 11, 2009

I greatly appreciate the opportunity to testify in these oversight hearings as to why chapter 11 of the Bankruptcy Code has been seriously impaired and may no longer be an effective process to preserve jobs through the rehabilitation and reorganization of distressed businesses.

I am a practicing attorney and senior member of the international law firm of Weil, Gotshal & Manges, LLP (WGM) that maintains its principal office in New York City. For

[1] Senior Partner, Weil, Gotshal & Manges LLP, New York, New York. The views expressed in this testimony are expressed solely on behalf of myself and not on behalf of any other person or entity.

the past 50 years[2], I have specialized in the laws relating to debtor-creditor relationships with an emphasis on restructuring, rehabilitating and reorganizing distressed business entities. I created the Business Finance and Restructuring group at WGM. I have represented debtors, secured and unsecured creditors, trustees, creditors' committees, and served as a trustee in cases under the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.)[3].

I am currently an Adjunct Professor of Law at the New York University School of Law, where I have taught a seminar on chapter 11 bankruptcy and reorganization law since 1975. I also am an Adjunct Lecturer in Law at the Columbia University School of Law, where I have taught a course on Corporate Reorganization and Bankruptcy Law, for the past eight years.

It is my understanding that the Subcommittee is concerned as to why it appears that chapter 11 of title 11 of the United States Code (Bankruptcy Code) is no longer serving the objective of enabling the rehabilitation and reorganization of distressed businesses that would preserve jobs, the interests of the communities in which each business operates and serve the national interest. A concern that is crystallized by the recent failure of the retail store chain of Circuit City to reorganize with the attendant loss of over 34,000 jobs and other consequences yet to be realized.

I commend the Subcommittee for its concern. The nation is engulfed in an economic crisis the likes of which have not occurred since the Great Depression of the 1930s. Bold action is necessary to protect and preserve the nation's economic foundation. In a credit-intensive world, it is essential to have a means to deal with excess credit and the resultant failures

[2] During the period of September 1, 2002 to March, 2007, I was a Vice Chairman and Managing Director of Greenhill & Co., LLC, an investment banking firm located in New York City.

[3] Since approximately 1973, I have been a conferee and member of the National Bankrutpcy Conference and I also am a fellow of the American College of Bankruptcy.

of distressed businesses. Bankruptcy reorganization had served as that means. In 1978, with the support of the financial community, Congress recognized the need for an effective bankruptcy reorganization process and enacted the Bankruptcy Reform Act of 1978, that included a new chapter to deal with business reorganizations. Chapter 11 of the Bankruptcy Code was conceived to implement the objective of saving businesses while balancing the needs of the debtors and the rights of creditors and interest holders.

Unfortunately, the balancing of interests that was enacted in 1978 has been upset through a series of amendments of the Bankruptcy Code, culminating in the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (BAPCPA), that have clawed back Bankruptcy Code protections that had been enacted to assist and enable a debtor to rehabilitate and reorganize its business.

The Erosion Of The Chapter 11 Paradigm

The world of restructuring and reorganization has dramatically changed from that which existed in 1978. This change has been precipitated by globalization, the expansion and predominance of secured creditors, claims trading, technological advances in all areas, particularly communications and access to information, a shift from a manufacturing to a service economy, and major business consolidations. The change was accentuated by the very robust economy that the United States enjoyed during the period from 2003 to mid-2007. Unprecedented low interest rates and overwhelming liquidity radically diminished the fear of loss and enhanced greed for higher and higher returns. The result was reckless spending and highly risky lending and investing. The availability of easy credit provided by financial institutions and the entry of hedge funds into the lending market enabled weak companies to increase their leverage without taking necessary actions to correct deficiencies in their operations and potential financial problems.

Starting in the beginning of 2008, the crack in the economy that had emerged as the subprime crisis increased, began to widen. The first victims of this growing financial instability were retail organizations. However, during the interim period, there had been a continuing decline in major restructuring and reorganization cases, largely due to the excessive liquidity in the marketplace and the easy access to covenant-free or low-covenant borrowing. The top five bankruptcy cases in 2006 totaled only $13 billion in assets, compared with $101.3 million in 2005. In a twelve-month period ending September, 2006, chapter 11 cases filed by businesses rose in number to slightly over 6,000 cases, continuing the lowest level since the mid-1990s. Corporate default rates, likewise, declined significantly to an unprecedented low level in 2007, approximately 0.51%.

Thus, in the context of the changes in the economic environment and the declining use of chapter 11, the question arose as to whether the chapter 11 paradigm that had originated in the railroad reorganization cases that followed the Civil War, had any continued viability. Professors Douglas G. Baird and Robert K. Rasmussen boldly stated:

> To the extent we understand the law of corporate reorganizations as providing a collective forum in which creditors and their common debtor fashion a future for a firm that would otherwise be torn apart by financial stress, we may safely conclude that its era has come to an end.[4]

Today, chapter 11 is not a process in which a debtor and creditors work together to rehabilitate a debtor. Why has this occurred? The answer is multi-faceted. In the legislative process that occurred from 1973 to the passage of the Bankruptcy Reform Act of 1978, the goal

[4] See Douglas G. Baird and Robert K. Rasmussen, "The End of Bankruptcy," 55 Stan. L. Rev., 751, 753 (2002).

of rehabilitation of distressed debtors was the primary rationale to support the need for business reorganization reform legislation. Subsequent to the enactment of the Bankruptcy Reform Act, and during the mid to late 1980s, a new and often conflicting theme began to emerge in response to the belief of special interest groups that chapter 11 cases were weighted in favor of debtors. This theme emphasized as a prime objective of chapter 11, the maximization of creditor recoveries. While it could be argued that the objectives are not mutually exclusive, the effort to give primacy to creditor recoveries has given rise to confusion in the chapter 11 process. Thus, chapter 11, more often than not, is used as a means to validate and sterilize the sale of a debtor's assets. This is accomplished by the use of section 363(b) of the Bankruptcy Code to effect a expeditious sale of all or substantially all of the debtor's assets, early in the case, to expedite distributions, essentially, to secured creditors. The process provides early gratification of the secured creditors and gives buyers the benefit of asset sales that are blessed by a court and, often, are free and clear of liens, encumbrances and claims pursuant to section 363(f) of the Bankruptcy Code.

The chapter 11 process, as contemplated in 1978, has been overwhelmed by marginalization of the debtor in possession, expansion of creditor (particularly secured creditor) control, the increasing imposition of creditor-designated chief restructuring officers (CROs), claims trading, more complex debt and organizational structures, and short-term profit motivation. Resultantly, an objective of a successful rehabilitation, the preservation of going-concern value and the emergence of a rehabilitated stand-alone debtor, has been eclipsed in most cases.[5]

[5] Of course, there are always exceptions that prove the rule. Those exceptions involve cases dealing with sick, old-line asset-based industries or businesses beset by mass tort litigation or organized labor issues, and pension and employee benefits liabilities.

The 1978 Bankruptcy Code was intended to be flexible legislation to meet the needs of a debtor confronting economic distress and default, as well as serve the interests of all those affected by business failure, including the debtor, creditors, employees, the community in which the debtor operated, and the public interest. The reorganization provisions of the Bankruptcy Code were enacted to deal with the reluctant debtor by providing inducements to initiate formal reorganization cases before the debtor's assets had been dissipated and the possibility of reorganization minimized, as had occurred under the former Bankruptcy Act. To achieve that objective, Congress enacted the administrative provisions of the Bankruptcy Code, which provided protections for the debtor, including the automatic stay, the ability to use, sell or lease property, including cash collateral and other collateral security of a secured creditor, the ability to assume or reject executory contracts and unexpired leases of non-residential real property, and, importantly, the ability to obtain credit and offer to lenders material enhancements for lending to a debtor in possession.

In 1978, Congress intended that the debtor in possession would be the driving force of a chapter 11 reorganization. Supported by a fair but sympathetic bankruptcy court, the debtor/debtor in possession did become the leading actor in the chapter 11 reorganization scenario during the 1980s, to a point that it created a backlash from creditors. The hue and cry went out that bankruptcy courts were debtor-oriented and every benefit of the doubt went to the debtor. That situation did not prevail for very long. The drive to make chapter 11 more inviting to distressed debtors was inadequate to eliminate all special interest legislation. Despite valiant efforts by reformers, section 1110 of the Bankruptcy Code carried forward from the former Bankruptcy Act, special protections for sellers, financiers and lessors of certain types of equipment relating to aircraft and vessels. Using that piece of special interest legislation as a foundation, other creditor groups pressed Congress for legislative containment of the bankruptcy court and the powers of the debtor/debtor in possession. Congress responded generously to the "needs" of these special interest groups.

The clawback of debtor protection provisions began. Virtually every group with an effective lobbyist came forward and was able to obtain special interest legislation that included protections for personal property equipment lessors, commercial property owners, shopping center owners and lessors, financial institutions, government agencies, unions, and retirees, to name just a few.

The biggest special interest victory is the ill-conceived BAPCPA. While it is primarily directed at consumer bankruptcies, BAPCPA contains provisions relating to chapter 11 reorganizations and affects the delicate balance between the interests of debtors and creditors that are the essence of reorganization. Among them are the mandatory cap on a debtor's exclusive period to file a plan of reorganization; enhanced protections for trade and reclamation creditors; a mandatory cap on the period within which to assume or reject unexpired leases of non-residential real property; expanded protection for utilities; and the mandatory appointment of a chapter 11 trustee in certain circumstances as well as the relaxation of the ability to recover voidable preferences, among others.

BAPCPA fulfilled a long-standing desire on the part of special interest groups to limit the discretion of the bankruptcy court and thereby reduce the flexibility of the court to meet the needs of rehabilitation and reorganization of a debtor. Complimenting the extended adoption of special interest legislation has been the emergence of coercive debtor in possession financing under section 364 of the Bankruptcy Code, that has been aggravated by the current credit crunch.

The Effect Of The Changing Economic Environment And The Bankruptcy Code Amendments On Circuit City That Doomed Its Reorganization

The contraction of unsecured credit.

The retail reorganization cases of the 1980s and 1990s, including those of Federated Department Stores and R.H. Macy & Co., among others, involved the restructuring of large amounts of unsecured credit. A good portion of unsecured credit represented the claims of vendor/suppliers who populated the creditors' committees in those cases. Such creditors had an abiding interest in the reorganization of the retail chain so that they would have a continuing customer. As globalization progressed and the search for cheaper production costs drove production of goods offshore, the nature of the supplier chain changed. More and more domestic producers went out of business. The vendor/supplier community was offshore and merchandise inventory increasingly came from foreign sources that required letter of credit financing. The result was (a) the diminishment of the long-standing vendor/supplier relationship that actively supported the survivorship of its customer, and (b) the loss of a large creditor constituency favoring reorganization over liquidation.

The emergence of secured inventory financing.

In the retail reorganization cases of the 1980s and 1990s, the retailers' merchandise inventories, generally, were unencumbered and represented a major tangible asset to enable the retailer to obtain attractive credit terms from its vendor suppliers. Retailers rejected requests by lenders for liens against their merchandise inventory on the grounds that if the liens were granted, they would not be able to get adequate vendor supplier credit. As the effects of globalization and the changes in the supply chain occurred, *supra*, that argument fell on deaf ears, particularly as retailers increased their borrowings and leverage ratios to support expansion.

As a consequence, by the beginning of the instant economic crisis for retailers, starting in 2007, generally retailers had granted liens and encumbrances against their merchandise inventories to their lenders. This changed the dynamic in the relationship between the lender, usually a syndicate of financial institutions, and the retailer. Customer/banker relationships had likewise changed. Many financial institutions that had previously worked with a debtor in the effort to rehabilitate and reorganize a retail customer no longer maintained that type of relationship and support, and were often compelled to write down the value of distressed loans and, sometimes, dispose of the loans.

As secured lenders, the financial institutions and the members of lender syndicates adopted a more distant and shorter term relationship with the retail debtor, they became more focused upon realizing recoveries from their collateral security. Most financial institutions look at a retailer's merchandise inventory as being liquid, i.e., easily convertible into dollars. In that context, the financial institutions are not interested in a long chapter 11 reorganization case. They are interested in a quick recovery and exit from the chapter 11 process. Because the financial institutions, generally, have liens against the merchandise inventory and all other assets of the borrower, such as Circuit City, the ability of the borrower to obtain alternative financing to support a rehabilitation process under chapter 11 is extremely limited. The ability to prime the existing secured creditor under section 364(d) of the Bankruptcy Code is more illusory than real.

Consequently, the only source of financing is the pre-chapter 11 lender. In the case of Circuit City, the lenders' syndicate led by the Bank of America. From the perspective of the Bank of America syndicate, as stated, its objective was to get paid, with interest, costs and fees. The primary source for its quick recovery was the proceeds from the merchandise inventory. Therefore, the bank had to consider how that merchandise inventory could be converted into dollars. The inventory-secured lender does not want the merchandise inventory. It wants dollars. To obtain dollars, the inventory has to be liquidated in place, i.e., in the store locations. Pursuant to section 365(d)(4)(B) of the Bankruptcy Code, Circuit City had a maximum of 210 days from the filing date of its chapter 11 case to assume or reject the unexpired leases of non-residential real property, i.e., the approximately 700-800 retail store locations. The liquidation of the merchandise inventory takes a substantial amount of time. As a result, the Bank of America and other similarly situated secured lenders want to be sure that there is adequate time to use the store locations to liquidate the merchandise inventory and obtain the full recovery of their loans.

In those situations, lenders such as the Bank of America who become debtor in possession financiers often impose conditions of that financing that require refinancing by date certain or the commencement of liquidation of the borrower's assets and, particularly, the merchandise inventory to ensure that such is completed before the retailer must reject or otherwise vacate the retail store locations.

Debtor In Possession (DIP) Financing.

Major chapter 11 cases require debtor in possession financing. The ability to use cash collateral under section 363(c) is limited and often vigorously opposed. Section 364 was incorporated into the Bankruptcy Code to induce lenders to extend credit to a debtor in possession or a trustee. Since 1978, secured financing has become predominant. As a consequence, a debtor's options for financing are limited. In the case of Circuit City, essentially, there was only one source of debtor in possession financing, i.e., the Bank of America syndicate. Generally, the financing of a chapter 11 case by the pre-chapter 11 secured creditors is characterized as "defensive DIP financing." The term is a misnomer. Financings by pre-chapter 11 secured creditors have become offensive.

Negotiations over DIP agreements tend to be one-sided, with lenders structuring agreements to enhance influence and control. Most DIP agreements take the form of a revolving credit facility and, currently, more usually a term loan. The agreements will include regular reporting requirements to allow the lenders to frequently evaluate the debtor in possession's performance and to determine whether the financing should be terminated.

Despite some resistance by bankruptcy courts, DIP loan agreements may contain:

- Provisions requiring the debtor in possession to hire a CRO. CROs typically are vested with executive decision-making power, not responsible to the CEO, direct and exclusive access to a debtor's board of directors, and the ability to talk to lenders without reporting back to the debtor. CRO candidates, generally, are recommended by the lenders and must be acceptable to the lenders.

- Cash-flow covenants that are so restrictive that they can compel the sale of assets or downsizing. For example, it was argued that the management of United Airlines was compelled to terminate a good portion of its workforce and renegotiate its collective bargaining agreements in order to comply with the cash-flow requirements of its DIP agreement.

- Provisions giving the lender control over disposition of the debtor's assets.

- Drop-dead dates or terms that provides for successively lowered advances to encourage liquidation.

- Restrictive negative covenants that constrain management flexibility, as well as low threshold events of default.

- Provisions that provide for the sale of the debtor or its assets within the limited period of time.

- Provisions that subject the debtor's plan of reorganization to some form of lender control. Examples include not allowing the debtor to file a plan of reorganization without lender consent, conditioning debtor exclusivity on lender consent, requiring the file of a plan by a day certain, or specifying the contents of the plan.

- General release of all potential claims against the lender and payment of all fees and expenses of the lender.
- The payment of substantial fees and expenses, including the continuing obligations to pay the fees and expenses of the lenders' professionals without any requirement for bankruptcy court oversight.

In the cases of retailers, the control provisions are particularly troublesome because of the interaction between the DIP financing and the 210-day cap on the assumption or rejection of unexpired leases of non-residential real property. Such control provisions enable the secured creditor to take control of the reorganization process and replace the judgment and decision-making that was to be exercised by the debtor in possession with the power of domination of a self-interested creditor who uses the process to protect its interests.

The Bankruptcy Court in *In re Tenney Village Co., Inc.*, 104 B.R. 562, 567-68 (Bankr. D.N.H. 1989) was prescient. In rejecting a proposed DIP financing arrangement, it wrote:

> Under the guise of financing a reorganization, the Bank would disarm the Debtor of all weapons usable against it for the bankruptcy estate's benefit, place the Debtor in bondage working for the Bank, seize control of the reins of reorganization, and steal or margin other creditors in numerous ways. The financing agreement would pervert the reorganization process from one design to accommodate all classes of creditors and equity interests to one specifically craft for the benefit of the Bank and the Debtor's principals who guaranteed its debt. It runs roughshod over numerous sections of the Bankruptcy Code. Under its rights of approval and supervision, the Bank would in effect operate the Debtor's business.

Finally, the costs of DIP financing are prohibitive. In the case of Circuit City, it appears that the DIP financing, which included a roll-up of the pre-chapter 11 outstanding loan balance, only provided Circuit City with a very limited amount of new money, probably in the area of $200 million, despite a face amount of the DIP financing of approximately $1.2 billion. The approximately $800 million of pre-chapter 11 indebtedness was simply rolled into the DIP financing to become a cost and expense of the chapter 11 administration that would have to be satisfied at confirmation of any plan of reorganization. In addition, the DIP loan agreement restricted the extent to which Circuit City could draw on the loan facility. Nonetheless, Circuit City was required to pay fees based upon the face amount of the DIP loan facility, probably at an enhanced interest rate on that amount. Generally, DIP financing imposes an interest rate based upon LIBOR plus 1,000 bps. Usually a floor is stated for LIBOR, e.g. 3%. As a result, the effective interest rate will be in the teens. Interestingly, DIP financings are viewed as low-risk loans, yet they carry the highest interest rates, which together with additional costs and fees may preclude rehabilitation and reorganization. It has been reported that the fees and expenses paid by Circuit City for the approximately $200 million of new money, totaled approximately $44 million. The potential new money likely was inadequate to support the reorganization effort of Circuit City.

Claims Trading.

In 1991 the Federal Rules of Bankruptcy Procedure were amended to eliminate any meaningful restriction on the trading of claims against a debtor. The rationale was to provide liquidity to the holders of claims. The result has been a very active market in bankruptcy claims by distressed debt traders and hedge funds. In major cases, claims change hands with great rapidity. Debt is a saleable commodity.

Distressed debt traders and hedge funds have different objectives than those of vendor/suppliers. They are motivated by quick and sizeable returns on their investment. Because their entry price usually is much lower than the face amount of the acquired debt, they are more apt to favor the sale and dismemberment of a debtor, if it will yield faster and greater recoveries based upon the costs of purchasing claims. Unless they are extending loans to own the debtor, a process that gained some favor in the mid-2000s, there is little or no interest in the rehabilitation of the debtor. In the case of Circuit City, it well may be that claims of the Bank of America syndicate were traded and, perhaps, acquirors took aggressive actions to have the Bank of America compel or influence the early termination of operations and the abandonment or the reorganization effort.

Conclusions

It is unfortunate that over 34,000 jobs have been lost as a result of the failure of Circuit City. Retailers are often the employer of last resort for a significant portion of the working population. I have been told that approximately 223,000 retail jobs were lost during 2008. I believe there only remain about 479,000 retail jobs in the United States. Undoubtedly, given the current economic circumstances, there will be more retail restructurings and, probably, retail chapter 11 cases. They will not be successful unless Congress takes remedial action to:

- Amend section 365(d)(4)(B) to remove the limit on the period within which a debtor in possession may assume or reject unexpired leases of non-residential real property. The Bankruptcy Code requires the lessee during the period to comply with the terms and provisions of the lease and to pay the rents required under the lease. Removal of the 210-day limitation will not prejudice lessors. Bankruptcy courts have been considerate and receptive to lessors who require early decisions as to assumption or rejection when necessary.
- Explore the enactment of enabling legislation during this economic crisis to provide debtor in possession financing for distressed businesses on reasonable terms and provisions while limiting the exercise of remedial rights by existing secured creditors.
- Explore means to limit the negative effects of excessive claims trading that hinder the ability to reorganize distressed businesses.
- Revisit the provisions of BAPCPA that tend to drain operating capital out of retail debtors in possession, such as section 366 (utility deposits), sections 503(b)(9) and 546(c) of the Bankruptcy Code.

- Restore to bankruptcy courts discretion to consider extensions of the time within which to assume or reject executory contracts and unexpired leases of non-residential real property and the exclusivity of a debtor to file a proposed plan of reorganization.

I appreciate the opportunity extended by the Subcommittee to testify in this hearing. I also subscribe to the testimony of Isaac M. Pachulski on behalf of the National Bankruptcy Conference.

Mr. COHEN. Thank you, sir. And I appreciate your making yourself available through the telephonic communication. If you can stay with us, we are going to have the other witnesses testify. And then we will, at some point—I think we have to go have votes, and return. And if you could stay with us for questions, that would be great.

Mr. MILLER. I would be happy to, sir.

Mr. COHEN. Thank you.

I would now like to recognize Mr. Richard Pachulski, for his statement.

TESTIMONY OF RICHARD M. PACHULSKI, PACHULSKI STANG ZIEHL & JONES, LLP

Mr. RICHARD PACHULSKI. Mr. Chairman and Members of the House Subcommittee, I first want to thank each of you for the opportunity for me to participate in this hearing, and to present my personal views regarding the factors that led to the liquidation of Circuit City, and the loss of over 34,000 jobs.

While I am presently lead counsel to the creditors—to the Circuit City Creditors' Committee—all positions I present here are my own personal views, and not of the Creditors' Committee, or any client of the firm of which I am a law partner.

In my almost 30 years as a restructuring attorney, with this being the fourth recessionary cycle that I have been a witness to, in that professional career, in no prior recessionary cycle have I seen such hopelessness in reorganizing financially troubled companies, particularly in the retail industry.

As presented in my written testimony, while I could come up with many factors that ultimately led to Circuit City's liquidation, three factors are the most dominant: First, the general downturn of the United States economy; second, the unbelievable tight credit market, with specific emphasis on the lack of virtually any debtor-in-possession financing; and, third, Section 503(b)(9) of the bankruptcy code.

For a simple background, as of mid-2008, Circuit City operated 712 superstores and nine outlet stores, providing over 40,000 jobs. In addition, Circuit City also operated under a Canadian subsidiary known as InterTAN, with 700 retail stores and dealer outlets in Canada.

As of calendar year 2007, Circuit City represented 8.1 percent of the United States' consumer-electronics retail market. And during Circuit City's fiscal year ending February 29, 2008, Circuit City had sales of approximately $11.7 billion.

I now would like to spend a moment discussing each of the three factors that I previously alluded to, that contributed to Circuit City's liquidation.

As to the effect of the economic downturn on Circuit City, as with so many retailers in 2008, Circuit City suffered a significant decrease in customer traffic. Simply put, as consumers were limited in their borrowing from credit cards and equity loans, household and consumer-electronic products suffered a dramatic reduction in sales. For instance, it certainly didn't help that 75 percent of Circuit City sales were generated through credit card purchases.

The next issue that so dramatically constrained Circuit City's ability to reorganize and to avoid liquidation and the loss of jobs was its relationship with its pre-Chapter 11 bank group. In fact, just weeks before the case commenced, the bank group reduced Circuit City's borrowing availability by over $50 million.

Upon filing Circuit City's Chapter 11 petition, the bang group provided what it termed as "DIP financing." But when all was said and done, the bank group effectively gave back to Circuit City the $50 million it took away pre-petition, at a remarkable cost.

In evaluating the bank group's DIP-financing package, for essentially $50 million in available credit, Circuit City had to pay $30 million in fees, had to consent to a forced timeline for the sale of the business, cram down immunity and the ability to call a default at almost any time, once the Christmas season ended. The very banking institutions that have received substantial bailout money effectively squeezed Circuit City to liquidation.

If the economy and the bank group's DIP financing did not destroy any chance of Circuit City having sufficient time to achieve an internal reorganization by downsizing or selling Circuit City's businesses, bankruptcy code Section 503(b)(9) was the final death knell.

What Section 503(b)(9) provided upon its enactment in 2005 was that goods received by a debtor within 20 days before the date of the commencement of the Chapter 11 case would be provided administrative-claim status. In order to confirm a plan of reorganization, administrative claims must be paid in full on the effective date of a plan of reorganization.

Accordingly, certain pre-position trade claims were elevated from unsecured-creditor status to administrative-claim status upon the enactment of Section 503(b)(9).

In the case of Circuit City—filed Section 503(b)(9) claims of approximately $359 million. Circuit City's management estimates those claims will be allowed in an amount in excess of $215 million. In the event allowed Section 503(b)(9) claims were, for example, $215 million, at least that amount would have to have been available on the effective date of any Circuit City plan of reorganization, to pay Section 503(b)(9) claims, instead of those monies being used for distribution to similarly situated creditors who gave trade credit more than 20 days before the petition date for needed capital expenditures, labor upgrades and other necessary costs to effectuate a successful reorganization.

In conclusion, while Circuit City may have been bigger than any other retailer to have been forced to liquidate in 2008, the major factors that caused the liquidation are presently inherent in all retail bankruptcies: A difficult economy; risk-averse lenders, facing their own financial struggles; and Section 503(b)(9) claims, making virtually any Chapter 11 more problematic.

Again, I thank the Subcommittee for the opportunity to present my personal views regarding Circuit City's liquidation, and the likely causes of future retail-company liquidations, unless the economy corrects itself and other measures are taken by Congress to correct the increasingly difficult environment to restructure financially challenged retail businesses.

Thank you, again.

[The prepared statement of Mr. Richard Pachulski follows:]

PREPARED STATEMENT OF RICHARD M. PACHULSKI

Testimony of

Richard M. Pachulski

before the

Subcommittee on Commercial and Administrative Law

of the

House Judiciary Committee

111th Congress, 1st Session

for Hearings on

"Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?"

March 3, 2009

I appreciate being given the opportunity to participate in this hearing regarding Circuit City's pending chapter 11 case and the effect the Bankruptcy Code (the "Code" or the "Bankruptcy Code") has had on companies in the retail industry, such as Circuit City, that attempt to reorganize. I commend the Subcommittee for focusing on how the provisions of the Bankruptcy Code relating to chapter 11 can be improved and for trying to better understand the reasons so many retailers, including Circuit City, have had to liquidate in the past year, causing the loss of hundreds of thousands of jobs. I present the following comments in my capacity as a restructuring lawyer for almost 30 years, specializing in the representation of corporate debtors and creditors' committees of such debtors. In that regard, I am presently lead counsel to the creditors' committee (the "Creditors' Committee") of Circuit City Stores, Inc. and affiliates ("Circuit City" or "Debtor" or the "Company"), though I am here providing this testimony on my own behalf and not on behalf of the firm[1] of which I am a partner, my partners, any client of the firm, or in any way Circuit City, any of its creditors or the Creditors' Committee. Additionally all information provided herein is derived from publicly available sources.

Background Information

Circuit City was founded in 1949 and headquartered in Richmond, Virginia. Prior to its chapter 11 filing Circuit City was a specialty retailer of consumer electronics, operating 712 superstores and 9 outlet stores. Circuit City also owns a Canadian subsidiary, InterTAN that operates 770 retail stores and dealer outlets in Canada. InterTAN also commenced reorganization proceedings in Canada.

In the fiscal year ending February 29, 2008, Circuit City recognized an operating loss of $319 million on sales of $11.7 billion. From March 1 – August 31, 2008, Circuit City

[1] Pachulski Stang Ziehl & Jones LLP (the "Firm"). The Firm is the largest legal restructuring boutique in the United States with over sixty-five lawyers collectively in four cities specializing in the restructuring area.

experienced an operating loss of more than $400 million (or approximately $67 million per month).

During 2008, Circuit City was in 153 U.S. media markets, 44 states and Puerto Rico. Circuit City's category of products included video, information technology, audio, entertainment, warranty and other associated services. In the calendar year 2007, Circuit City represented 8.1% of the United States' consumer electronics retail market.

On November 2, 2008, Circuit City announced it would close 155 stores, and as a consequence thereof, on November 7, 2008 laid off approximately 1300 employees. On November 10, 2008, Circuit City filed for chapter 11 protection in the Eastern District of Virginia. The Circuit City cases were assigned to the Honorable Kevin R. Huennekens. As of the chapter 11 petition date (the "Petition Date"), Circuit City's workforce consisted of approximately 39,600 full and part-time employees (with an anticipated addition of 11,000 part-time employees during the Christmas season.)

As has been the case with so many companies in so many industries, the major factor that caused Circuit City's chapter 11 filing and the ultimate liquidation of its business is the economic downturn in the United States and its specific effects on the retail industry. In addition to discussing below the effects of the economy causing the ultimate liquidation of Circuit City, I believe there are two other factors that need to be described to understand why Circuit City liquidated and so many other similarly situated retailers who commenced chapter 11 cases in 2008 suffered a similar fate. First, the stranglehold the Circuit City lenders negotiated when they provided debtor-in-possession financing ("DIP Financing") and, second, the effect of § 503(b)(9) of the Code enacted in 2005 that established administrative claim status for trade creditors providing product on credit to companies within 20 days of a chapter 11 filing.

The Economic Downturn and Tightening of Vendor Credit

As was the case with so many retailers in 2008, Circuit City suffered a significant decrease in customer traffic. As a result of consumers being limited in their borrowings from credit cards and equity loans, household and consumer electronic products suffered a dramatic reduction in sales. For example, 75% of Circuit City sales were generated through credit card purchases. Additionally, just prior to Circuit City's chapter 11 filing, many of Circuit City's vendors began restricting Circuit City's available trade credit and reduced payment terms, including that many vendors required that Circuit City pay cash in advance. Such vendor trade restrictions significantly limited Circuit City from maintaining adequate product inventory and supply level. Aside from vendors' general fear of supplying to a troubled retailer such as Circuit City, Circuit City's lenders (the "Bank Group") decreased the availability under Circuit City's revolving credit facility. The vicious cycle began with vendors realizing that their source of payment (i.e., bank credit availability) was being constrained, so vendors tightened credit more and the Bank Group tightened more and on and on.

Circuit City faced the perfect storm that so many retailers are facing today: reduced customer traffic, causing vendors to become nervous, resulting in more restrictive bank lending terms, causing vendors to completely restrict credit, with companies such as Circuit City facing a virtual unmanageable credit squeeze that can best be remedied through a well-planned chapter 11 filing. Since the perfect storm that the retail industry faces today can occur so quickly, such thoughtful planning is nearly impossible in today's economic environment.

To make matters worse in Circuit City's case, Circuit City anticipated a $75 million refund from the Internal Revenue Service. Circuit City believed that such a refund could address its liquidity needs and allow it to pursue an out-of-court restructuring alternative. While I believe that $75 million in November 2008 might have provided Circuit City additional "runway" before having to file a chapter 11 petition, I believe that Circuit City's desire to achieve a restructuring out-of-court was completely unrealistic.

Upon filing its chapter 11 petition, Circuit City announced its intention to emerge from chapter 11 by closing a subset of unprofitable stores and enacting certain cost-savings measures. If the measures proved unworkable, Circuit City hoped to sell at minimum a majority of its business to continue operating as a going concern. Management was clear throughout the early stages of the chapter 11 process that saving as many jobs as possible while reorganizing as much of Circuit City as was viable were management's priorities. In addition to the harsh economic environment, and as more fully described below, with Circuit City's Bank Group providing extremely tight DIP Financing and the existence of certain Code provisions (e.g., Bankruptcy Code § 503(b)(9)), there was little prospect of selling and/or reorganizing Circuit City and saving up to almost 40,000 jobs.

The Bank Group's DIP Financing

In addition to the United States' generally struggling economy, an additional factor that resulted in the eventual liquidation of Circuit City was a severe tightening of the credit markets and in particular by the Bank Group.

As of the Petition Date, Circuit City had formulated a turnaround business plan which management hoped would grow revenue and reduce expenses. However, due to the very poor retail environment and the depth and breadth of the required turnaround, Circuit City's business plan reflected that Circuit City would at best operate at a break-even EBITDA for fiscal year ending February 2010. Accordingly, the Company would need to generate additional cash to cover debt service and necessary capital expenditures to maintain and to improve its stores and operating systems.

In addition to funding interest payments and capital improvements, Circuit City would require substantial capital to fund over $100 million of operating losses during the first 11 months of 2009 until the business was projected to recoup some of its losses during the 2009 holiday season.

For many of the participants in Circuit City's Bank Group, rather than increasing their lending to Circuit City, they curtailed it because one could only surmise that in the Bank Group's view, a Circuit City liquidation was the cheapest, the fastest, and easiest way to reduce their risk and for many participants in the Bank Group, raise much needed cash. For those reasons, the Bank Group was simply unwilling or unable to lend the funds required by Circuit City to bridge the gap to a normalized retail environment.

Many of the country's larger banking institutions were already members of the Bank Group. That left few other institutions large enough to finance a facility of the size Circuit City needed and even fewer to enter into a DIP arrangement with a new client in late fall of 2008. This left Circuit City without any options other than to negotiate with the Bank Group and to accept an unreasonable package of DIP financing terms.

As of the Petition Date the face amount of Circuit City's pre-petition revolving facility with the Bank Group was $1.3 billion (the "Pre-Petition Facility"). Only $900 million, however, was owing as of the Petition Date. The $400 million difference was the result of a highly subjective, liquidation-based borrowing cap designed by the Bank Group to ensure that the Bank Group was always comfortably oversecured. Also just a few weeks before the case commenced the Bank Group reduced Circuit City's borrowing availability by over $50 million. The Bank

Group's decision could not have come at a worse time for Circuit City. Circuit City was faced with very tight liquidity heading into their most profitable season. Circuit City then turned in desperation to a familiar funding source – the Bank Group. The Bank Group, who had just choked Circuit City off was now available to "help." The Bank Group now agreed to advance essentially the same funds that the Bank Group had refused to advance only a few weeks previous. The difference, of course, was that the renewed availability would now be styled as "DIP financing," and the cost would be exorbitant.

The face amount of the "new" DIP Financing offered by the Bank Group was $1.1 billion - $200 million less than the face amount of the Pre-Petition Facility. To make matters worse, Circuit City's "Borrowing Base" was reduced based on appraised liquidation value of the Company's inventory and receivables. Amazingly, under the "DIP Financing" Circuit City was required to use 95% of the DIP Financing simply to pay off the pre-petition debt owing to the Bank Group themselves.

At the first day hearing on the interim DIP Financing, Circuit City's counsel advised the Bankruptcy Court that when all was said and done there would be $50 million of actual, additional availability to Circuit City until Christmas, as compared to what would have been available under the constricted Pre-Petition Facility. Effectively the Bank Group simply relabeled their pre-petition loan as "DIP Financing" and engaged in a controlled liquidation. In order to receive the additional $50 million of availability, Circuit City had to give up and/or give to the Bank Group, among other things, the following:

- $30 million in fees and expenses (for $50 million of availability);
- Circuit City effectively surrendered plan exclusivity to the Bank Group – Circuit City was required to file a plan of reorganization that had to be acceptable to the Bank Group by March 1, 2009, or less than 4 months after it filed for Chapter 11 protection. If the plan were unacceptable to the Bank Group, in their sole discretion the Bank Group could

simply foreclose on their fully secured claims. As such, the Bank Group would receive cram-down immunity.

- The Bank Group also mandated that Circuit City had to ready their businesses for sale by early March 2009. A default would arise otherwise.
- Circuit City was prohibited from seeking to prime the Bank Group's claims.
- The DIP Financing would fall into default unless a $75 million "Term Loan" was put in place junior to the DIP Financing by January 17, 2009. While this term was contained in the agreement negotiated between Circuit City and the Bank Group, the term was withdrawn by the Bank Group at the Final Hearing on the DIP Financing because of the vigorous objection by the Creditors' Committee that it was preposterous to believe that in the present economic environment, any junior loan could be obtained within sixty days after the Petition Date, let alone a junior loan subordinate to approximately $900 million of senior Bank Group debt.

In summary, the Bank Group's package of benefits for $50 million of availability included $30 million in loan fees, a forced timeline for sale of the company, cram-down immunization and the ability to call a default at almost any time once the Christmas season ended. The sad fact is that while bailout money is being consumed by banking institutions like Bank Group members Bank of America and Wells Fargo Bank, little, if any of those monies are going to the benefit of financially challenged businesses, particularly in the retail industry. Not surprisingly, prior to the end of February, 2009 (less than three and a half months from the Petition Date) the Bank Group's debt had been paid in full and well over 30,000 jobs had been lost.

Bankruptcy Code § 503(b)(9)

If the economy and the Bank Group's "DIP Financing" did not destroy any chance of Circuit City having sufficient time to achieve an internal reorganization by downsizing or selling Circuit City's businesses, Bankruptcy Code § 503(b)(9) was the final death knell. As part of the Bankruptcy Abuse and Consumer Protection Act of 2005 ("BAPCPA"), Congress amended the Bankruptcy Code to add § 503(b)(9). Specifically, § 503(b)(9) provides that:

> "after notice and a hearing, there shall be allowed administrative expenses... including ... the value of any goods received by the debtor within 20 days before the date of commencement of the case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business."

Effectively, such administrative claims are afforded priority in terms of payment in bankruptcy cases. More importantly, in order to confirm a plan of reorganization the Bankruptcy Code requires that administrative claims be paid up in cash, in full on the effective date of a debtor's plan of reorganization.

For a company like Circuit City, inventory is key to providing customers, for instance, with current, state-of-the-art technology and new DVD/CD releases. Simply put, if the shelves are not well stocked in terms of selection and quantity, the customer will go elsewhere. At the Petition Date, Circuit City had over 6500 vendors delivering a variety of goods to its stores daily such as TVs, home theater systems, computers, camcorders, furniture, software, imaging and telecommunications products and other audio and video electronics.

Given the nature of Circuit City's business and the value of its deliveries, it should come as no surprise that the amount of goods received by it in the 20 days prior to the Petition Date amounted to a staggering sum. The total amount of § 503(b)(9) claims filed by creditors on or before the December 18, 2009, bar date for filing such claims in the case was $349,825,685.09. For a cash-strapped business relying on tight credit markets, having sufficient monies to confirm a chapter 11 plan of reorganization would be virtually impossible if the actual amount of § 503(b)(9) claims approached even a fraction of the approximate $350 million filed claim number.

When Circuit City recently filed its motion seeking to extend its exclusivity period to file a plan of reorganization by 180 days, that pleading stated that "close to $500 million alone is attributable to claims arising under § 503(b)(9) of the Bankruptcy Code. Preliminary reconciliation efforts suggest that such claims may amount to over $215 million." Circuit City went on to state in the exclusivity pleading that the process of evaluating both § 503(b)(9) administrative claims that would need to be paid in full by any plan of reorganization and other claims were in the early stages of review and would literally take months to reconcile.

In the event attempts had been made to reorganize Circuit City and to confirm a plan of reorganization, as referenced by Circuit City, no less than $215 million would have to have been set aside for payment of the § 503(b)(9) claims instead of those monies being used for distributions to similarly situated creditors who gave trade credit more than 20 days before the Petition Date (or frankly other credit at any time before the Petition Date), capital expenditures, labor upgrades and other necessary costs to effectuate a successful reorganization and prove feasibility[2] during the plan confirmation process.

The problem is that in a chapter 11 case where a debtor is unable to pay administrative expense claims, including § 503(b)(9) claims, such a case is "administratively insolvent" and cannot be confirmed under chapter 11. These companies simply do not have the option to reorganize and emerge from bankruptcy. Even in cases where the debtor may be able to sell enough assets or raise cash through other means and pay § 503(b)(9) claimants, the company must often go through protracted litigation on a claim-by-claim basis to determine which are and are not valid § 503(b)(9) claims. For instance, as noted in the Plastech[3] case, before the debtor confirmed its plan of reorganization it filed sixteen omnibus objections to § 503(b)(9) claims.

[2] Section 1129(a)(11) of the Code requires as a condition of confirmation that the Bankruptcy Court find that confirmation "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan unless such liquidation or reorganization is proposed in the plan." In a case like Circuit City where hundreds of millions of dollars would need to be paid to § 503(b)(9) creditors on the effective date of any plan of reorganization, the ability to prove such feasibility for Circuit City would have been extremely difficult, if not impossible.

[3] *In re Plastech Engineered Products, Inc.* 394 B.R. 147 (Bankr. E.D. Mich. 2008).

The following is only a partial list of litigation issues that arise when analyzing § 503(b)(9) claims:

- The "value of goods". How are the "value of goods" calculated? Is it based on a contract price, the invoice price, or the going market rate? At what point in time are the goods valued? When shipped, received, or at some other point in time? What is a "good" as opposed to a "service" which is not covered by the language of § 503(b)(9)? What if the creditor has delivered a good that has been improved by a service?
- "Received by the debtor within 20 days" before the bankruptcy filing. The calculation of goods received within 20 days of the filing often means that the debtor must be able to track, on an invoice-by-invoice basis, the exact date on which goods were received to validate that the goods were received in the requisite time frame. In a case with a high volume of goods received this could be an incredibly time-consuming process. In addition, there has been litigation of what constitutes 20 days. What if the 20^{th} day falls on a weekend or holiday?
- "In the ordinary course of the debtor's business" – what constitutes the ordinary course of business? Is it ordinary as between the parties, or is ordinary dictated by industry standards?
- Can the debtor offset § 503(b)(9) claims against preference claims? For instance, under § 502(d) of the Bankruptcy Code, if the creditor owes the debtor money, the corresponding portion of the creditor's claim against the debtor is disallowed. In Plastech[4] the Bankruptcy Court ruled that § 502(d) was inapplicable to offset § 503(b)(9) claims. It ruled that § 502(d) only applied to pre-petition general unsecured claims arising under § 501. Therefore, the debtor had to pay a valid § 503(b)(9) claim to the creditor and separately seek to recover on its preference judgment against the creditor, which can lead to inefficient results. The setoff issue will be repeatedly faced by bankruptcy courts across the country.

A company that seeks to avoid tangible costs (e.g., professional fees[5]) and intangible costs (e.g., customer fears of a company liquidating and losing, for instance, valid warranty coverage) may not find that feasible in a chapter 11 context because of § 503(b)(9). In and of itself, the time necessary to litigate the validity of § 503(b)(9) claims may result in the inability to timely confirm a plan of reorganization and avoid the liquidation of a going concern business.

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[4] *In re Plastech Engineered Products, Inc.* 394 B.R. 147 (Bankr. E.D. Mich. 2008).

[5] Aside from the significant cost of administering a chapter 11 case until confirmation of a plan of reorganization, the United States Trustee's office has begun, in certain instances, appointing official committees to represent holders of §503(b)(9) claims, thus adding an additional layer of administrative expense to the estate. *See, e.g., In re Empire Beef Co., Inc.,* (Bankr. W.D.N.Y. 2007).

In addition to the reasons cited above, § 503(b)(9) creates several other impediments for a debtor to achieve a successful sale and/or reorganization and the avoidance of a liquidation and loss of jobs:

- Many § 503(b)(9) creditors are not willing to risk losing their 100 cent on the dollar recovery on their § 503(b)(9) claims in return for the possibility of maintaining a customer, such as Circuit City, as an outlet for distribution of their goods. The § 503(b)(9) claims, therefore, set a floor at liquidation value that is difficult to surpass with a going concern sale or reorganization. Vendors weigh the relative costs/benefits of trying to help save an outlet to sell product through, against the potential negative impact on their § 503(b)(9) claims in delaying a decision to liquidate. The cost/benefit analysis in many cases reduces a vendor's willingness to extend trade credit. In the pre-section 503(b)(9) environment, a trade creditor may have extended trade credit in exchange for a second lien on available collateral. Post enactment of § 503(b)(9) and the existence of that administrative claim section, unsecured creditors are discouraged from providing trade credit on even a second lien basis since they are essentially depleting their own § 503(b)(9) claims. Because of vendors' lack of incentive to provide trade credit, there is an increased need for presently unavailable outside funding to pay trade creditors.

- Unsecured trade vendors that have § 503(b)(9) claims now, in effect, are similarly situated to secured lenders. Both groups of creditors are primarily interested in maximizing the distributions on their claims. Because secured creditors – particularly when the pre-petition lender obtains additional collateral as a DIP lender – attempt to ensure that they are over-collateralized, the additional collateral that was once often available to fund the reorganization is now carefully monitored by § 503(b)(9) claimants unwilling to risk funding a plan at their own detriment through a depletion in the value of their § 503(b)(9) claims.

- With the extension of administrative claim treatment granted to § 503(b)(9) claims, there are fewer true unsecured trade creditors. Trade creditors with both § 503(b)(9) and general unsecured claims now have the expectation they will receive significant distributions on their § 503(b)(9) claims as long as they pursue the risk-averse path with the debtor, which is almost always an early liquidation. Circuit City was no different. As time went on trade creditors with a § 503(b)(9) claim knew that operating losses would be funded to the detriment of distributions on their § 503(b)(9) claims. Because of the seasonality and timing of Circuit City's chapter 11 filing, there was pressure to liquidate sooner than later to preserve value to its creditors. Not only were the inventory liquidation values likely to decline after the 2008 Christmas season, but further delay in the liquidation process would simply result in additional substantial operating losses.

- Had Circuit City's § 503(b)(9) claims not been so large, there would have been a larger pool of unsecured creditors that would have borne the risk associated with delaying the decision to liquidate. Instead of a smaller subset of § 503(b)(9) claimants with concentrated claims in Circuit City risking their distributions, the unsecured creditor body as a whole would have borne the risk and would have been more willing to wait and determine whether the retail environment would improve until a sale or reorganization could have been consummated.

In summary, for certain companies such as retailers or manufacturers the value of goods received in any 20-day period can easily amount to a significant portion of the outstanding trade debt at any given point in time. Thus, it can reasonably be said that the enactment of § 503(b)(9) changed the face of bankruptcies and put into question whether companies in certain industries, particularly the auto and retail industries, can be successfully reorganized under chapter 11 of the Bankruptcy Code.

In the case of Circuit City, § 503(b)(9) made Circuit City's emergence from chapter 11 more difficult. If Circuit City had filed under pre-BAPCPA laws, the burden of administrative claims would have been greatly reduced, making the capital required to confirm a plan of reorganization hundreds of millions of dollars less. Trade creditors likely would have been more willing to take a risk to allow Circuit City additional time to reorganize around a downsized company or sell some or all of its businesses as a going concern because they would not have been as concerned with the loss of value to their § 503(b)(9) claims. Instead the risk would have been borne by a larger pool of unsecured creditors. Trade creditors would also have been more willing to extend essential trade credit post-petition because they could have been granted a second lien to the Bank Group that was not just directly displacing their own claims. Additionally, monies that were required to pay § 503(b)(9) claims could have been used to extend the turnaround "runway," which may have provided enough time for the economy to improve.

Conclusion

While Circuit City may have been bigger than any other retailer to liquidate in 2008, the major factors that caused the liquidation presently are inherent in all retail bankruptcies: a difficult economy, risk-averse lenders facing their own financial struggles and § 503(b)(9) claims making exiting any chapter 11 more problematic. Again, I thank the Subcommittee for the opportunity to present my personal view of the factors that openly caused Circuit City's liquidation and likely will cause future retail company liquidations unless the economy corrects itself and other measures are taken by Congress to correct the increasingly difficult environment to restructure financially challenged retail businesses.

Mr. COHEN. Thank you, Mr. Pachulski.

And, now, I recognize Mr. Hurwitz, for his testimony.

TESTIMONY OF DANIEL B. HURWITZ, PRESIDENT AND COO, DEVELOPERS DIVERSIFIED REALTY CORPORATION, ON BEHALF OF INTERNATIONAL COUNCIL OF SHOPPING CENTERS

Mr. HURWITZ. Good afternoon, Mr. Chairman, and Ranking Member Franks.

My name is Daniel Hurwitz, and I am president and Chief Operating Officer of Developers Diversified Realty Corporation. I am pleased to testify today on behalf of the International Council of Shopping Centers.

I have a unique perspective on the topic of the effect of Chapter 11 bankruptcy laws in the Circuit City bankruptcy filing, as my company was the largest landlord of Circuit City, with 50 leases, $38 million in unsecured claims, and as a member of the Creditors' Committee in that case.

I look forward to sharing our direct experience with the Subcommittee.

Mr. Chairman, Circuit City's liquidation can be directly traced to three principal factors: The company's poor financial results; its inability to obtain realistic credit terms from trade vendors; and the devastating reality that the U.S. financial markets are mired in such profound turmoil that financing is nearly impossible to secure.

From our vantage point, Developers Diversified witnessed firsthand the collapse of this once-respected American brand. While the failure of Circuit City is a loss on many levels, to suggest that the company liquidated because of the current Chapter 11 process, or the deadline to assume or reject its leases, overlooks the complex set of factors which actually led to the company's demise.

First, the 210-day period to assume or reject leases is only a deadline if the landlords will not agree to an extension. The vast majority of Circuit City landlords, led by my company, would have granted an extension, as was done in recent bankruptcy cases filed by Hancock Fabrics, Linens-N-Things and Movie Gallery.

Circuit City entered bankruptcy with a post-petition lending facility that required the company to file a plan of reorganization, or close on a sale transaction, by January 31, 2009, less than 90 days after the filing date.

The post-petition loan that Circuit City obtained from its lenders provided the company with a mere $50 million in additional liquidity at a cost of $30 million in fees.

In light of the company's dismal post-bankruptcy sales results, its lenders were unwilling to extend the deadlines imposed by the lending facility, without clear support and participation from Circuit City's suppliers, which it simply could not achieve.

Based on this recent experience, what lessons can we learn about retail bankruptcies in the current economic environment?

First, we are experiencing an unparalleled business cycle that is testing even the best retail operators. Bank credit continues to tighten, debtor-in-possession financing has become specifically onerous, and trade vendors are reluctant to extend credit, except on the most egregious of terms. Without access to credit, even the best retailers will not be able to survive.

Second, the current retail liquidations have little to do with the Chapter 11 process. This is particularly true as to the lease assumption-or-rejection deadline of 210 days.

It is telling that, when the attorney for Circuit City explained to the bankruptcy court the reason why Circuit City was forced to liquidate, he never mentioned the 210-day deadline as a cause.

In fact, he specifically told the court that the reason for the liquidation was, in his words, "Due to the fact that financing in this market is extremely difficult." This is the hard truth, and it in no way implicated shopping-center landlords or the current Chapter 11 process.

Third, a retail bankruptcy can have serious negative effects on the shopping centers and on other retailers. The 2005 amendments that created more certainty for shopping-center owners now provides an important firewall which prevents the failure of one retailer from cascading to other businesses.

It would be unwise to revert to a standard which gives tenants an unlimited amount of time to make decisions about assuming or rejecting a shopping-center lease, and therefore places the other tenants, and its employees within the shopping center at risk.

My experience with the retail bankruptcies in recent years proves that the 210-day period has not been a factor in the fate of retailers who file for Chapter 11 protection. The catalyst for recent job losses and business liquidations is the poor economy and the lack of credit from vendors and lenders.

In conclusion, Mr. Chairman, the relationship between a tenant and a landlord is one of partnership. We share customers, invest side-by-side, and work in the communities we serve together. We need each other to exist, and our interests are aligned.

While some may paint a picture to the contrary, let there be no mistake that landlords thrive with healthy tenants, and tenants thrive with successful landlords.

There is no incentive for landlords to put additional stress on tenants having operating difficulty. The 210-day provision ensures that all interested parties come together in a timely manner to listen, and be heard, in the best interest of the operating company and its employees.

It is an honor to testify before you today, and I look forward to answering any questions you or other Members of the Subcommittee may have. Thank you, sir.

[The prepared statement of Mr. Hurwitz follows:]

PREPARED STATEMENT OF DANIEL B. HURWITZ

Good morning, Mr. Chairman and Ranking Member Franks, my name is Daniel Hurwitz and I am President and COO of Developers Diversified Realty Corporation. I am pleased to testify today on behalf the International Council of Shopping Centers. Founded in 1957, ICSC is the premier global trade association for the shopping center industry. Its more than 70,000 members in over 90 countries include shopping center owners, developers, investors, lenders, retailers and other professionals as well as academics and public officials. I have a unique perspective on the topic of the effect of Chapter 11 bankruptcy laws in the Circuit City bankruptcy filing as my company was the largest shopping center landlord of Circuit City and we were members of the Creditors Committee in that case. I look forward to sharing our direct experience with the Subcommittee. I will also discuss more generally the perspective of shopping centers on the current round of retail bankruptcy filings. I have several attachments to my statement and I would ask that they be included in the record.

THE CIRCUIT CITY BANKRUPTCY

Mr. Chairman, Circuit City's liquidation can be directly traced to three principal factors: the company's poor financial results, its inability to obtain realistic credit terms from trade vendors, and the devastating reality that the US financial markets were mired in such profound and unprecedented turmoil that financing—both debtor-in-possession and exit financing—was impossible to secure. Indeed, from our vantage point, Developers Diversified witnessed firsthand the collapse of this once respected and iconic American brand. I feel we are uniquely qualified to speak to the factors which led to that collapse.

DDR was Circuit City's largest landlord, with approximately 50 leases and at least $38 million in potential unsecured claims. DDR's business representatives had met with Circuit City's management prior to the bankruptcy filing and assured them that DDR stood ready to assist with what was then an out-of-court restructuring plan.

As it does in any bankruptcy case where it has a significant number of leases and potential exposure, DDR actively participated in Circuit City's bankruptcy proceedings. From the outset, our goal—for broader purposes as well as admittedly self-interested ones—was to see Circuit City survive. In fact, DDR proactively expressed a desire to extend the deadline to assume or reject leases. Further, along with other shopping center landlords, DDR agreed not to immediately press for post-petition rent in the amount of $25 million. DDR played a significant role in Circuit City's efforts to reorganize, not only in its capacity as Circuit City's largest landlord, but also as a vice chair of the Official Committee of Unsecured Creditors.

At their first joint meeting in Washington in November 2008, we advised the other members of the Creditors' Committee, as well as Circuit City's management and retained professionals, that DDR would proactively seek to extend the 210-day period to assume or reject DDR's leases, even though the actual deadline was not until June 2009. DDR further proposed that it would advocate for extensions from other landlords. We repeated this proposal to counsel for the Committee and Circuit City on several occasions during the first two months of the case. In each instance, the company responded that its critical issues with other stakeholders took priority and would have to be resolved before it could turn to the extensions of time to assume or reject its leases.

Eventually, these other issues—financing, trade credit and business results—overwhelmed and ultimately capsized the company, mooting any discussion of lease assumption deadlines.

While the imminent absence of Circuit City as a fixture on the American retail landscape, coupled with the resulting loss of 34,000 jobs, is an undeniable tragedy, to suggest that the company was forced out of business because of Chapter 11 or the deadline to assume or reject its leases wildly misses the point and overlooks a complex set of factors which actually led to the company's demise.

First, the 210-day period to assume or reject leases is only a deadline if the landlords will not agree to an extension. As I stated, the vast majority of Circuit City's landlords, led by DDR, would have granted an extension, as they had done in the recent retail bankruptcy cases filed by Hancock Fabrics, Linens 'n Things and Movie Gallery.

In Circuit City's case, as we have seen, the deadline was irrelevant. Even without landlord consent, the 210-day period would not expire until June 2009 and the liquidation of the company is already nearly complete as of early March.

We do not deny for a moment that amended Section 365(d)(4) has changed the dynamic of retail bankruptcy cases. However, without sufficient liquidity to make post-bankruptcy payments to vendors, landlords, utility providers, and employees, a retailer simply cannot reorganize.

The Subcommittee should note that the last reorganization of a significant post-amendment retail bankruptcy was Goody's, a regional department store which emerged from bankruptcy in October 2008, only to file a second Chapter 11 bankruptcy case less than four months later, citing restrictive financial covenants and lack of liquidity due to its exit financing which essentially ended the possibility of reorganization. Goody's is presently liquidating through its second case.

We have also seen first-hand that some lenders refuse to permit the use and disposition of their collateral, or to extend additional financing, unless they have confidence in a debtor's ability to reorganize effectively without diminution in the value of their collateral. Not surprisingly, lenders have little incentive to participate in a reorganization process that will not result in a repayment of their indebtedness, which in most cases includes significant pre-petition borrowings.

The debtor-in-possession financing product has significantly—and negatively—altered the course of recent retail bankruptcies and this is a fundamental cause of

Circuit City's liquidation. Lenders are generally willing to provide only enough financing to position a debtor for a liquidation in the first few months of the case, and then impose restrictive conditions in post-petition financing agreements that either direct an immediate liquidation of the company, or include covenants or borrowing reserve rights that effectively allow the lender to "pull the plug" on the retailer only a few months into the case. Few debtors can survive these conditions. In fact, no recent significant retail debtor has.

Circuit City entered bankruptcy in November 2008, with a post-petition lending facility that required the company to file of a plan of reorganization or close on a sale transaction by January 31, 2009, less than 90 days after the filing date. The post-petition loan that Circuit City obtained from its lenders provided the company with a mere $50 million in additional liquidity at a cost of $30 million in fees. In light of the company's poor post-bankruptcy performance, its lenders were unwilling to extend the deadlines imposed by the post-petition lending facility (not the landlords' deadlines) without clear support and participation from Circuit City's suppliers, which it simply was not able to muster. In addition to this formal post-petition financing, the Subcommittee should be aware that Circuit City essentially borrowed $25 million dollars from its landlords, without paying interest, fees or providing any collateral. Circuit City took the position that it would not pay landlords post-petition rent ("stub rent") due from the date it filed for bankruptcy on November 10, 2008, until the end of the month.

LESSONS FROM RECENT RETAIL BANKRUPTCY CASES

So, after these recent experiences, what lessons can be learned about retail bankruptcies in the current economic conditions?

First, we are experiencing a catastrophically difficult business environment that will challenge even the best-run retailers. Bank credit has tightened generally; bankruptcy debtor in possession ("DIP") lending has specifically tightened and trade vendors are reluctant to provide credit, except on the most onerous of terms. Consumer spending and confidence are at all-time lows and unemployment has reached levels not seen since the early 1980s. This is a perfect storm. Reduced consumer spending reduces retailer profits, which in turn makes lenders reluctant to lend. Without access to credit, even otherwise well-run retail operations may not be able to survive.

Second, the current retail liquidations have little to do with the Chapter 11 process. This is particularly true as to the lease assumption or rejection deadline of 210 days enacted in 2005. When retailers have asked for extensions, shopping owner owners have overwhelmingly granted those extensions. In fact, in the Circuit City case, landlords agreed not to pursue post-petition or stub rent in an effort to provide additional liquidity to the company. It is telling that when the attorney for Circuit City explained to the bankruptcy court in Richmond, Virginia, on January 16, 2009, the reason why Circuit City was forced to liquidate, he never mentioned the 210-day deadline as a cause. In fact, he specifically told the court that the reason for the liquidation was, in his words, due to "the fact that financing in this market is extremely difficult." This is the hard truth, and it in no way implicates shopping center landlords or Chapter 11.

It is clear that what is pushing retailers into liquidation relates to credit availability and vendor willingness to ship consumer products on reasonable terms. Nothing in the bankruptcy law can change this unfortunate reality.

Third, a retail bankruptcy can have serious negative effects on shopping centers and on other retailers. The 2005 amendments that created more certainty for shopping center owners now provide an important "firewall" which prevents the failure of one retailer from cascading to other businesses. Under the prior law, lingering uncertainty caused neighboring stores to suffer from reduced traffic and sales while potential new tenants were reluctant to rent space in a shopping center with an uncertain future. Also the bankrupt retailer has an unfair competitive advantage over other retailers in the same center. It would be unwise, to say the least, to revert to a bankruptcy standard which gives tenants an unlimited amount of time to make decisions about assuming or rejecting a shopping center lease. Such a change would do nothing to make vendors ship products on friendly terms. The only effect is to put others at risk.

CONCLUSION

In conclusion, Mr. Chairman, my experience with multiple retail bankruptcies in recent years plainly shows that the 210-day period for assuming or rejecting leases has not been a factor in the fate of retailers who file Chapter 11. The cause of recent job losses and business liquidations is quite simply the poor economy and tight credit. Troubled retailers will only be able to reorganize successfully when these negative market conditions change. No reform of Chapter 11 would have induced trade creditors in Korea to ship consumer electronics to Circuit City. No reform of Chapter 11 would have lessened tight lending standards.

I want to finish my remarks by restating the obvious fact that the success of shopping center landlords depends on having tenants who pay rent. Shopping center owners have a vested interest in the financial success of the retail sector. Especially now, as the landlord conduct in the Circuit City case shows, landlords are taking extraordinary steps in order to assist our retail tenants. As I said earlier, we agreed not to immediately press for payment of post-petition "stub" rent amounting to $25 million. Shopping center owners want retailers to succeed. But repealing or revising the 210-day deadline will not help struggling retailers; it will only harm other retailers and shopping center owners.

I look forward to answering any questions you or other Members of the Subcommittee may have.

Mr. COHEN. You are welcome. Thank you, Mr. Hurwitz.

And, now, Professor Zywicki, if you would, proceed with your testimony.

TESTIMONY OF TODD J. ZYWICKI, PROFESSOR, GEORGE MASON UNIVERSITY SCHOOL OF LAW

Mr. ZYWICKI. Thank you, Mr. Chairman. It is a pleasure to be here.

When BAPCPA was being considered, I testified a number of times before this Subcommittee, and did a number of staff briefings. And right now, I am writing a book on BAPCPA. So what I am going to try to do today is remind this Subcommittee of why BAPCPA is written the way it is, and the goals that it was trying to accomplish.

But, first, let us keep in mind: The purpose of Chapter 11 is to allow financially-distressed firms to reorganize. It is not to try to save companies that are economically failed, or prop up companies whose time has passed.

This country used to have a lot of jobs in the typewriter-manufacturing industry, and the makers of typewriter accessories. But, obviously, we don't make typewriters anymore. Jobs were destroyed in the typewriter industry. But it is difficult to say that we should have tried to save the typewriter industry at all costs.

The goal is to try to efficiently distinguish between companies that should be reorganized, versus those companies whose time has passed.

The second thing to keep in mind is there are multiple constituencies in a bankruptcy case. BAPCPA was, quite plainly, a response to the need to rebalance a system that had gotten out of whack.

The system designed by 1978 was a system that was overly tilted toward debtor, and created undue hardships on a lot of other constituencies in the bankruptcy process. BAPCPA was a very well calibrated process to try to bring that system back into balance, and to try to restore some balance.

So let us familiarize ourselves to remember why it is that BAPCPA does what it does. First, consider the issue of leases in the 210-day deadline. Let me illustrate this by a story that draws on my own experience.

I live out in Northern Virginia, by Seven Corners. There is a strip mall in Seven Corners. There was a Montgomery Ward's in that strip mall. In 1997, Montgomery Ward's filed bankruptcy. It was a terrible, dingy store. Nonetheless, for 2 years, Montgomery Ward's sat in that strip mall, trying to reorganize. Finally, in 1999, Montgomery Ward's came out of bankruptcy. Soon thereafter, everybody realized that they should have been put to sleep, and not wasted 2 years.

As soon as they—while Montgomery Ward's was in bankruptcy, foot traffic through the mall just plummeted. It was a terrible store. Nobody wanted to shop there. The store became shabby. And it took down other stores with it.

Right next store to it was a PetSmart. The PetSmart finally had to close its door for, like, 6 to 9 months, because Montgomery Ward's wasn't generating enough foot traffic. Restaurants in the shopping mall were injured by the fact that the Montgomery Ward's, which was the anchor tenant in the mall, was not bringing in traffic.

Finally, we got rid of that terrible Montgomery Ward's. Soon thereafter, a Target store came in. The Target store is booming. I can say, as a consumer, I am much more happy with the Target store there. The PetSmart is reopening. The other stores in the strip mall are booming.

The point, here, is that by trying to save that Montgomery Ward's by that long, drawn-out process of 2 years, we tried to save a store that couldn't be saved. And we put off the entry of a new Target; a growing store with better jobs, that was creating benefits for the other stores in the strip mall, the restaurants, and everything else.

That is what the 210-day deadline was designed to do—is to bring about a more swift reconciliation of these situations, like Montgomery Ward's, so that we wouldn't have stores sitting there for 2 years, bringing down all the other stores in the strip mall, with it.

What about the administrative priority for vendors? The reason why we put in the—why the 20-day administrative priority for vendors was put in—was because, in fact, it was not the case that, prior to BAPCPA—that vendor claims were treated as unsecured claims.

In fact, what was happening is that courts, on an ad hoc, case-by-case basis, were turning some of these unsecured claims into what were called critical-vendor claims.

If you take Kmart, for instance, Kmart had $300 million in critical-vendor claims. Twenty-two hundred, out of 4,000, vendors were called critical-vendor claims. Who are critical vendors? Well, I will tell you what, it wasn't the small businesses who didn't have the political clout and couldn't hire the lawyers to get themselves on that magic list of being a critical vendor.

All that 503(b)(9) does is rationalize and equalize what had been this ad hoc, and, really, unfair process of how people were being converted into critical vendors. As Kmart illustrates, $300 million in critical vendors, in that case, is about what we see as administrative priorities in the current case.

Third, there is concerns about the expedited speed by which bankruptcy cases are supposed to proceed, such as reducing the time for exclusivity, and other checkmarks that try to make the bankruptcy case move along faster. That was to deal with a particular problem, especially in a lot of cases, which is cases that would just sit in the bankruptcy courts, and do nothing, much to the frustration of creditors, landlords, and everybody else.

The only jobs those cases were saving were the jobs of the $700-an-hour lawyers who were continuing to administer those cases, and milk those cases, for months or years on end, until those cases were finally put out of their misery.

What are those cases trying to do? They are trying to reduce the cost of dealing with those cases.

Real administrative cases and bankruptcy cases, today—talking about lawyers' fees and bankers' fees—can be tens or hundreds of millions of dollars. The process that BAPCPA tried to set up was to try to push more of that into the pre-filing period, to make the parties pay for it, rather than dumping these things in bankruptcy, and, thereby, rolling up tens or hundreds of million dollars of lawyers' fees, and to try to bring a faster reconciliation of these cases.

The question we have to ask in a case like Circuit City, then, is: Is it really worth burning through $40 million or $50 million of attorneys' fees to get to the point where we knew we were going to get with Circuit City, a company that was failed; a company that couldn't get debtor-in-possession financing; a company whose time had passed?

Thank you.

[The prepared statement of Mr. Zywicki follows:]

PREPARED STATEMENT OF TODD J. ZYWICKI

It is my pleasure to testify today on the subject of "Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?" The American economy faces a major recession and there are clear signs of major struggles ahead for the retail industry. Several major retailers have filed bankruptcy in recent months and continued sluggish spending and access to credit by consumers augurs further struggles ahead for the retail sector of the economy. Some commentators have expressed concern that a disproportionate number of retail bankruptcies have ended up in liquidation rather than successful reorganization and have argued that several Bankruptcy Code amendments enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") as creating pressures for economically inefficient liquidations.

It is possible that BAPCPA has at the margin helped to contribute to some of these liquidations. But it is far from clear that this is the case, as there are numerous other factors in the current that likely have contributed substantially to the liquidation of these firms. Moreover, to the extent that BAPCPA's amendments have arguably contributed to the problem, repealing the relevant provisions will create new problems of their own, such that the costs of their repeal might likely exceed the benefits. In fact, by bringing about a swift and decisive resolution of a failing company's prospects, thereby clearing the field for more vibrant competitors to grow, BAPCPA's impact in many cases is unquestionably productive. The amendments in BAPCPA were enacted to address particular problems under the pre-BAPCPA scheme and repealing those amendments would simply resuscitate those problems. Thus before taking this step, Congress should consider whether the benefits of their repeal exceed the costs.

Macroeconomic Conditions and Chapter 11

The overarching purpose of Chapter 11 reorganization is to distinguish between firms that are economically failed and those that are in financial distress. An economically-failed firm is one that is essentially better-off dead than alive—shut down operations and reallocate the financial, human, and physical capital of the enterprise elsewhere in the economy. A firm in financial distress is one that simply needs to reallocate its capital structure in order to be a prosperous enterprise. Chapter 11 exists to reorganize firms in financial distress but not those that are economically-failed. There is reason to believe that some of the retailers that have liquidated in recent months are economically-failed firms, rather than merely financially-distressed. Hence, efforts to reorganize and save those companies would likely be economically inefficient.

The economy in general and the retail sector specifically are currently going through some very difficult times. Unemployment is rising and consumer spending and borrowing is falling. The result has been widespread difficulties for the retail sector.

But these difficulties are not uniform. There are areas of the retail economy that are doing fine or even prospering—most notably discount stores such as Wal-Mart, BJ's Wholesale, Ross's, TJ Maxx, and Big Lots, which have reported rising sales and profits, sometimes reversing struggles during the recent economic boom years. High-end stores such as Saks and Nordstrom, by contrast, have suffered badly in the economic downturn. Going forward we can also expect the Circuit City's of the world to be faced with increasingly strong competition from on-line sellers such as Amazon or eBay, which can sell the same products more cheaply and conveniently than traditional bricks-and-mortar sellers, and especially as financially-strapped consumers shop more aggressively for lower prices.[1]

As part of the economic slowdown, therefore, we can expect to see the process of "creative destruction" at work in the economy—certain sectors of the retail industry will suffer while others prosper. Sellers of expensive discretionary items—such as big-screen televisions, high-end electronics, consumer durables, and automobiles—will likely feel the pinch especially strongly in a slowing economy. Thus, it is to be expected that there will be some business casualties as consumers tighten their belts—and those casualties probably will be stores such as Circuit City, Sharper Image, and other purveyors of higher-end discretionary consumer and electronic goods. Other retailers, such as Linens 'n Things' were consistently losing money for many years before entering bankruptcy, a decline frequently exacerbated by subpar ownership or management.

Circuit City was not immune to these trends. Reports indicate that its year-to-year foot traffic plummeted by double-digit amounts and its downward spiral was exacerbated by poor management, as exemplified by the short-sighted decision to fire several thousand of its most experienced and highly-paid hourly workers and replace them with inexperienced substitutes. Vendors also lost confidence in Circuit City's reliability and became reluctant to provide inventory. Consumers have scaled back spending and found credit card credit drying up, a particularly damaging hit to Circuit City which makes most of its sales on credit cards. None of these problems can be attributed to BAPCPA.

Bankruptcy cannot and should not be used to save economically failed enterprises plagued by a bad business plan, poor ownership, or a fundamental inability to compete in a changing marketplace. Chapter 11 can help financially-troubled but fundamentally-valuable firms live to fight another day. Chapter 11 cannot reverse the creative destruction of the competitive marketplace or force consumers to buy goods and services that they don't want. In such situations, the purpose of the bankruptcy system is to clear-out failed enterprises to allow new firms to expand to fill the void. Not every firm is worth saving and saving weak firms ties up physical, financial, and human capital that could be better deployed elsewhere in the economy. The manufacture of typewriters and typewriter accessories was once a huge industry in the United States but their disappearance isn't the fault of Chapter 11.

Moreover, some experts have suggested that the bankruptcies and liquidations we are seeing now may be consistent with a long-overdue shake-out in the retail industry. Like many other areas of the economy, many retailers may have been kept alive artificially by access to cheap credit that delayed their inevitable day of reckoning. These companies may not have been economically viable for some time but only collapsed when their access to cheap credit dried up. Consumer spending was also artificially inflated by easy access to credit.

In short, some of the liquidations that we see today may be a necessary macroeconomic adjustment to a leaner economic time where certain retailers will shrink or even disappear while others expand to take their place. It is not obvious, for instance, that Circuit City would have successfully reorganized in a market with fierce competition and sagging consumer demand. Thus, liquidation of some retailers may be a necessary medicine as the economy returns to a less-overheated state.

[1] As a personal illustration, during the past two years or so I have purchased a laptop, headphones, and record album converter from on-line sellers, a high-definition television from Costco, and portable dvd player from Target. In none of those situations did I go to a traditional seller of electronics goods such as Circuit City or Best Buy.

NON-BAPCPA BANKRUPTCY-RELATED FACTORS EXPLAINING LIQUIDATIONS

There are also other factors in the economy today that may explain a trend toward liquidation independent of BAPCPA's changes in the law.

First, many scholars have documented that over the past several years, the practice of Chapter 11 has changed dramatically away from the traditional focus on court-supervised reorganization in Chapter 11 to a secured-creditor driven system that results much more often in liquidation.

As Professor Barry Adler noted in his testimony before this Committee in September 2008, during the past decade there has been a sea change in the nature of Chapter 11 practice "as debtor control of bankruptcy has given way to creditor dominance."[2] When a firm enters bankruptcy today more or all of its assets are already pledged to one or a number of secured creditors. As a result, when bankruptcy is filed the debtor quickly loses control over the case. Shareholders are routinely wiped out and incumbent managers usually lose their jobs. These two constituencies (along with workers) typically are the strongest advocates for reorganization *even if reorganization would be inefficient*—the fact that they are typically sidelined in the bankruptcy process today both weakens internal political forces advocating reorganization as well as reflecting the reality of modern Chapter 11 practice.[3] Secured creditors, by contrast, will often prefer a swift liquidation of the debtor (or sale as a going-concern) to the uncertainty and delay of an extended Chapter 11 process. In fact, the gradual move toward greater control of the Chapter 11 process by secured creditors has better-aligned the incentives of secured creditors with the needs of the bankruptcy case as secured creditors now have proper incentives to push for efficient resolution of financial distress instead of inefficient liquidation or reorganization.[4] In the modern era of swift and competitive global capital flows investors will not tolerate bankruptcy laws and practice that impose undue delay, risk, and uncertainty.[5]

As a result of these new realities of the bankruptcy landscape there has been a growing trend toward liquidation in large Chapter 11 cases wholly independent of (and predating) BAPCPA's enactment. Professor Adler quotes the findings of Professor Lynn LoPucki, who finds that "41 firms that filed bankruptcy as public companies each with assets exceeding approximately $218 million liquidated in 2002, although no more than 8 such firms did so in any year prior to 1999."[6] Thus, it is likely that many of the retailers that have liquidated in recent months would have liquidated regardless of BAPCPA, especially those firms encumbered by high levels of secured debt.

Second, more specifically to the current environment, the continued problems in credit markets has reportedly made debtor-in-possession financing much less available than in the past. Major DIP lenders have scaled back their operations and lending volume. DIP lending is less-available and has a greater number of strings and restrictions attached to it. For instance, it appears that one major reason—if not the major reason—for Circuit City's liquidation was its difficulty in acquiring DIP financing. Although it is possible that some of the problems in DIP financing markets are caused in parts by BAPCPA's amendments, this is by no means obvious. Major providers of DIP financing have either disappeared completely or scaled back operations. It seems much more plausible that the paucity of DIP financing reflects the same stresses exhibited in all other credit markets today rather than some unintended consequence of BAPCPA.

THE POSSIBLE IMPACT OF BAPCPA

Macroeconomic conditions and non-BAPCPA related bankruptcy forces thus may provide much of the explanation for the recent tendency toward liquidation in retail bankruptcy filings. Concern nevertheless has been expressed that various provisions of BAPCPA have resulted in a growing tendency toward liquidation rather than re-

[2] Testimony of Professor Barry E. Adler, *Hearing on Lehman Brothers, Sharper Image, Bennigan's, and Beyond: Is Chapter 11 Bankruptcy Working?,* House of Representatives Committee on the Judiciary, Subcommittee on Commercial and Administrative Law (Sept. 25, 2008).

[3] Circuit City's Chief Executive Officer Philip Schoonover was paid $8.52 million in fiscal 2006, more than double that earned by Best Buy's CEO, even as Circuit City was sliding toward bankruptcy. *See* Mark Clothier, *Circuit City to Fire 3,400, Hire Less Costly Workers, http://www.bloomberg.com/apps/news?pid=20601087&sid=aw.zhHEzMpZU&refer=home (March 28, 2007).*

[4] Barry E. Adler, *Bankruptcy Primitives,* 12 ABI L. REV. 219, 226–33 (2004).

[5] Todd J. Zywicki, *The Past, Present, and Future of Bankruptcy Law in America,* 101 MICH. L. REV. 2016 (2003).

[6] Lynn LoPucki, *The Nature of the Bankrupt Firms: A Response to Baird and Rasmussen's* The End of Bankruptcy, 56 STANFORD L. REV. 645 (2003).

organization. Although this argument is possible in theory, it seems doubtful that this factor is especially important when compared to the two factors previously discussed. Moreover, several of those amendments were enacted to address particular chronic problems in the bankruptcy system; thus, even if their repeal or substantial amendment might marginally improve the prospects for reorganization, the costs associated with this course of action might exceed the benefits from marginally increasing the prospects for reorganization.

There are several provisions in BAPCPA that might potentially create a stronger dynamic toward liquidation in cases involving retailers, most notably provisions related to the decision whether to assume or reject a lease of real property and increased protection for vendors that ship goods to the debtor in the period immediately preceding bankruptcy and employees of the debtor. Both of these provisions may arguably increase the likelihood of liquidation in any given case, but may be justified by other offsetting policy concerns.

Expedited Period for Assumption or Rejection of Leases

BAPCPA amended section 365(d) of the Code to limit the time during which a debtor-lessee must decide whether to assume or reject an unexpired lease of nonresidential real property. Prior to BAPCPA, the deadline for this decision was nominally fixed, but a Bankruptcy Judge could and routinely did grant an open-ended extension of time to the debtor up to the time of plan confirmation, a process that could take months or even years to resolve. This extended deliberation period certainly provided the debtor with substantial leisure and leeway to decide whether to liquidate or reorganize.

But this luxurious time for the debtor to make up its mind came at a substantial cost to commercial landlords and other shopping-mall tenants who were forced to bear much of the cost and uncertainty during that period with minimal offsetting benefit. To ameliorate the potential harm to these parties BAPCPA provided for much tighter time-limits for a debtor to decide whether to assume or reject these leases: an initial period of 120 days from the order for relief (the date of the bankruptcy petition in a voluntary case) that the court can extend for cause for an additional 90 days. Any extension beyond this 210 day period requires the consent of the lessor.

The problem with the pre-BAPCPA regime can be illustrated by an example that draws on my own experience. I live in Falls Church, Virginia, near an area known as Seven Corners that is populated by several large strip malls. The anchor tenant in one such mall was a Montgomery Ward store.[7] In 1997 Montgomery Ward filed for bankruptcy after having been routed by competition from department stores such as Target and Wal-Mart, big box specialty stores such as Home Depot, and a host of other rivals from on-line sellers to specialized boutiques. In fact, Montgomery Ward was just one of several old-line mid-sized department stores that expired during this time, including venerable chains such as Ames (2002), Bradlees (2001), Caldor (1999), Jamesway (1995), Woolco (1994), and numerous other national, regional, and local department stores that could no longer compete. Many other failing department stores were gobbled up by stronger rivals through mergers. Although many at the time predicted Montgomery Ward's eventual demise, they nonetheless launched an extended Chapter 11 reorganization, finally emerging in 1999 having closed many but not all of its outlets. The extended bankruptcy period did nothing to fundamentally rectify Ward's weak competitive position or draw consumers back into the store, and eventually Ward liquidated.

This extended, drawn-out reorganization process certainly gave Ward ample time to decide whether to reorganize—a decision that almost immediately was revealed to be incorrect in the end. More importantly for current purposes, however, the delay and uncertainty of the process itself proved very harmful to consumers, the landlord, other tenants of the strip mall, and perhaps even the local government. During this period the store grew shabby and Ward's reorganization efforts failed to reverse its decline in popularity among consumers. Ward failed to draw the foot-traffic to the mall that is expected of an anchor tenant by the landlord and other smaller businesses and restaurants in the mall, not to mention the sales and property taxes for the local government. In fact, the Petsmart next door to the Ward store eventually suspended operations for a several-month period because of a lack of customers. Eventually Ward finally succumbed to economic reality and was replaced by a Target outlet. The Target has thrived and has buoyed its co-tenants in the mall. I can vouch from personal experience that consumers have been overjoyed by the conversion.

[7] Anchor tenants are often even given below-market rental rates in acknowledgement of the external benefits that they provide for other stores.

Under the BAPCPA regime, it is plausible that rather than being given two years to try to reorganize, Montgomery Ward may have been liquidated earlier and the store near my house shuttered. It is worth noting that in hindsight it would have been better for everyone if Ward had been shuttered earlier, allowing Target to move in. But more importantly, the extended delay and uncertainty itself about Ward's future delayed the entrance of a highly-successful Target store, causing harm to consumers, the landlord, vendors, and the small businesses and restaurants in the mall suffered mightily from the uncertainty and delay over Ward's future. The demise of Ward and renaissance of Target brought with it many better jobs in a growing enterprise, not to mention the jobs created for the vendors supplying the prosperous Target rather than the weakling Montgomery Wards and the job-creation brought to the other stores in the strip mall.

As this anecdote illustrates, there may be costs to a bankruptcy regime that brings about a swifter resolution of bankruptcy cases, including the possibility that this may lead to the liquidation of some firms that might otherwise have reorganized successfully. But this delay and uncertainty often has a cost to consumers, landlords, other tenants, vendors, and even local governments. There is harm from being too accommodating of delay as well as being insufficiently patient. One cannot say with certainty that 210 days is the exact right time period for these decisions, but it is evident that a much longer period of time will have substantial costs as well. Professor Adler stated the point well, this provision (and others in BAPCPA that expedited the resolution of bankruptcy cases), "reflect the belief that if a debtor cannot be reorganized quickly, there may be no viable business to save."

Finally, it should be noted that the BAPCPA amendments permit an extension of the 210 day period with the consent of the landlord. Thus, where a landlord and co-tenants would be benefitted from an effort at reorganization, there are procedures in place to make this possible, so there should be minimal concern about inefficient liquidation where external costs to the landlord and co-tenants are absent. If the retailer is obviously viable and will make more-valuable use of the premises than other possible tenants, the landlord would be expected accommodate a reasonable extension of time if necessary. A landlord confronted with the choice between a weak Montgomery Ward store or a prosperous Target store will find the decision an easy one—a decision that will benefit workers, vendors, and the economy as well. A landlord in the current environment, by contrast, will be unlikely to evict a bankrupt tenant if there is no substitute tenant available.

Moreover, many cases of financial distress are gradual, not immediate. As a result, debtors can and do plan their bankruptcy filings in advance of filing, and many cases are even "pre-packaged." Thus, 210 days is only the period of time for the debtor to make a decision *after* filing but is not the limit of planning when financial distress is gradual. Many big cases will have extensive pre-bankruptcy planning and there is no reason why the debtor could not open negotiations with a landlord for a consensual extension of time before the debtor even files for bankruptcy.

Increased Administrative Priority for Certain Pre-Petition Claimants

Critics of BAPCPA have pointed to a second factor that has been argued to undermine efforts to reorganize in Chapter 11, provisions that increased protection for certain categories of pre-petition claimants by providing them with administrative priority or enlarging existing administrative priority provisions. By increasing the amount of claims against the debtor that are subject to an administrative priority claim, these priority claims leave fewer assets available to pay other creditors and post-petition operating expenses. Moreover, the fact that a greater percentage of post-petition resources are being diverted to pay unproductive prepetition claims may make potential DIP lenders more reluctant to lend to finance the Chapter 11 effort.

Two basic amendments in BAPCPA have been singled out as unwisely increasing administrative priority for pre-petition against the debtor, thereby diverting assets to payment of pre-petition claims that otherwise could be used to fund reorganization efforts.[8] It should be noted at the outset that the theoretical logic of this argument is open to question—it is not clear why the relative priority of claims against a financially-troubled debtor should matter to its ability to reorganize. Nonetheless, there is a perception that increasing the size of administrative claims ties the hands of debtors, limiting their flexibility to reorganize.

The first is the addition of section 503(b)(9) to the Code, which creates a new administrative claim for goods actually received by the debtor within the 20 days prior

[8] *See* Testimony of Lawrence C. Gottlieb, *The Disappearance of Retail Reorganization in the Post-BAPCPA Era,* House of Representatives Committee on the Judiciary, Subcommittee on Commercial and Administrative Law (Sept. 25, 2008).

to the Chapter 11 filing. For a retailer with rapid inventory turnover, this may create a substantial administrative priority claim, arguably making reorganization more difficult. Moreover, this administrative priority claim status may have the unintended consequence of encouraging liquidation in another way: vendors are a constituency in bankruptcy that tends to favor reorganization because this maintains a market for their products. By reducing the value of their unsecured claims in bankruptcy, however, this may reduce their voice and clout in the reorganization process. Thus, while this increased priority helps them in the short run it ironically might create offsetting harm in the long-run by increasing the probability of liquidation.

But the impact of this change in the law may be overstated. Under pre-BAPCPA law these claims were nominally treated as general unsecured claims. But, in practice, in many retailer cases bankruptcy courts would grant administrative priority for pre-petition goods to many vendors as so-called "critical vendors" that were thought especially necessary for the debtor's successful reorganization. It was commonly argued, and accepted by most bankruptcy judges, that the likelihood of administrative priority for goods shipped in the pre-bankruptcy period was necessary to provide assurance to induce vendors who might otherwise be unwilling to ship to a struggling debtor because of fear of non-payment. Or the vendors might be willing do so only if the debtor paid C.O.D., which would likely exacerbate the problems of a cash-starved firm already on the verge of bankruptcy. If the vendors would not ship goods, the debtor would be unable to stock its shelves, thereby disappointing customers and bringing on a death-spiral into bankruptcy. Thus, it was thought necessary to assure vendors that it was safe to ship goods on credit to the struggling debtor in the period preceding bankruptcy.

In the Kmart bankruptcy case, for instance, 2330 of 4000 vendors were classified as "critical vendors" who were to be paid in full under the plan, thereby consuming $300 million of Kmart's $2 billion DIP financing. Although Kmart's particular proposal was eventually struck down by the Seventh Circuit, it illustrates the scope and ubiquity of these critical vendor payment proposals. Entitlement to this preferred status, however, was wholly discretionary by the court, allowing some well-connected and influential vendors to achieve critical vendor status while others were left out in the cold. Moreover, there were no set guidelines on how far back these unpaid bills could reach or the amount that could be treated as critical vendors.

One evident purpose of section 503(b)(9) was to rationalize this previously ad hoc "critical vendor" analysis by replacing it with a statutory scheme that would serve the same function but without the apparent arbitrariness and unfairness of the discretionary "critical vendor" regime and to limit the scope of these claims. Thus, section 503(b)(9) may not have created a major increase in overall administrative claims against the estate when compared to the actual pre-BAPCPA practice. It also makes the rules more reliable and predictable for vendors. Section 503(b)(9) recognizes the need for the functions previously played by critical vendor orders; eliminating it would either lead to the resuscitation of the ad hoc critical vendor analysis or bring about the very results that doctrine was intended to avoid.

The second set of potentially-problematic amendments in BAPCPA is changes to sections 507(a)(4) and (a)(5), which increased the aggregate monetary limits on employee wage and pension benefit priority claims. Formerly, the aggregate amount that an employee could assert as a priority wage or pension benefit claims was limited to $4,925 in wages and pension benefits earned within 90 days prior to filing. BAPCPA increases the aggregate cap to $10,950 for wages and pension benefits earned within 180 days prior to filing. Unlike the argued explanation of the increased priority for venders, however, there is no obvious economic justification for this increased priority for employee wages, unless it is thought that many employees would quit their jobs because of a fear of bankruptcy if refused this heightened priority extended for six months prior to the filing rather than just three months. This seems doubtful and, in fact, this priority is usually justified on grounds of "fairness," rather than economics. By tying-up more assets to pay pre-petition claims, however, it tends to reduce the prospects for a successful reorganization and thus may not only bring about liquidation but in so doing create job losses for precisely those who it is intended to benefit.

Summary on BAPCPA's Impact

Thus, even if certain provisions of BAPCPA are criticized as potentially encouraging liquidation instead of reorganization, at least some of these criticisms are mitigated or even outweighed by offsetting concerns. With respect to the stricter deadlines for deciding whether to assume or reject leases of non-residential real property, the purpose of BAPCPA's amendments were to protect landlords and cotenants from the delay and uncertainty caused when a firm files for bankruptcy, especially a bankruptcy involving an anchor tenant. Although there are economic costs from forcing an unduly-swift decision on the debtor there are costs to many other parties from extended delay of the process. Moreover, BAPCPA does include a safety valve by making it possible to extend the 210-day deadline with the consent of the landlord.

With respect to increased administrative priority for vendors for pre-petition shipments of goods, the primary effect of section 503(b)(9) was to rationalize the ad hoc system of "critical vendor" orders that had grown up in recent years in acknowledgement of the need to provide assurances to vendors to continue to supply goods on credit to struggling retailers.

In contrast to these provisions for which there are offsetting policy goals that may justify them, sections 507(a)(4) and (a)(5) increase the administrative priority for pre-petition wages and pension benefits. There is no obvious bankruptcy policy purpose furthered by these priorities and thus they contribute to the potential for liquidation with no offsetting economic benefit.

CONCLUSION

As the economy dips deeper into recession it is evident that the near-future will present difficult challenges for the retail industry. In recent times several major retailers have filed bankruptcy and it is foreseeable that more will before the recession is done. Many of these cases will result in liquidation, perhaps more commonly than a decade or two ago. It is tempting to blame BAPCPA's amendments for this trend.

In reality, however, it is not so easy to point to BAPCPA as a scapegoat. General macroeconomic conditions, higher credit costs, and reduced consumer spending would likely have driven many of these retailers out of business regardless. Moreover, prior to BAPCPA there was a distinct trend toward liquidation in large Chapter 11 cases. These trends have been exacerbated in the recent downturn by a restricted access to DIP financing.

To the extent that BAPCPA has also accelerated this trend, its influence is likely small. Moreover, where BAPCPA potentially has had an impact that impact is mitigated if not offset by other benefits that arise from its reforms. Perhaps the only BAPCPA amendment that has increased the trend toward liquidation with no obvious offsetting benefits is the enhanced administrative expense claim for wages and benefits added by BAPCPA.

Mr. COHEN. Thank you, Professor.

And, now, I am going to presume it is Pachulski, the younger, right?

You are recognized, sir, to testify.

TESTIMONY OF ISAAC M. PACHULSKI, STRUTMAN, TREISTER & GLATT, PC, ON BEHALF OF NATIONAL BANKRUPTCY CONFERENCE

Mr. ISAAC PACHULSKI. Thank you.

On behalf of the National Bankruptcy Conference, I would like to thank the Subcommittee for the opportunity to testify about the adverse impact of the 2005 amendments on the reorganization of debtors under Chapter 11.

Basically, the 2005 amendments worked some very major, substantive changes in provisions of the bankruptcy code that affect the ability of debtors, in particular, retailers, to reorganize. Those provisions provided special and preferential and enhanced treatment for vendors of goods—not vendors of services, just vendors of goods—for landlords, but not any other party to an executory contract with a debtor, and to utilities.

The impact of these amendments, and their adverse impact, is most pronounced in the case of retailers. And that is something that should give us cause for pause, when we realize that, in the last 12 months, we have seen Chapter 11 filings by retailers who, in the aggregate, operated at over 6,000 locations, and had over 200,000 employees—something that is unprecedented in my experience, and that of everyone else here.

Now, we have to start with the basic premise that companies file for Chapter 11 relief because they have liquidity problems. They don't have enough cash.

The 2005 amendments, in the case of retailers, poured oil on this fire, by creating a new, unprecedented priority for vendor claims. Previously, unsecured, pre-petition vendor claims could be modified like every other claim—like tort claims, like contract claims, like vendors of services.

The 2005 amendments created an administrative priority claim for these pre-petition claims, which means they have to be paid in full, and in cash, in order for the company to emerge from Chapter 11. In the case of a large retailer, this increases the exit fee to get out of Chapter 11 by hundreds of millions of dollars.

And in the economy where we are repeatedly told that there is no financing, what this means is that, unless you can cannibalize operations, defer deferred maintenance some more, and take money away from operating changes, you can't comply and you can't come out of Chapter 11.

And this problem is exacerbated by the new reclamation provisions, which were previously—the right of reclamation was limited to goods delivered 10 days before the Chapter 11 filing. They are now expanded to goods delivered within 45 days, which increases both the amount of these claims and the cost of resolving these reclamation claims.

To a lesser extent, the amendments to Section 366, which basically give a utility the right to demand a cash deposit or a deposit of cash equivalents, also impose additional liquidity constraints at the outset of a Chapter 11 case, at the very time that the debtor is having trouble getting debtor-in-possession financing.

Imagine a debtor with hundreds of locations, each one with multiple utilities. The utilities now have a right to demand cash deposits. The only thing you can argue about is the amount. And, by the way, when you are arguing about the amount, the court is not allowed to consider whether the debtor had a good payment record, and is not allowed to consider whether the utility ever obtained a security deposit before. This is simply too narrow a standard.

The 2005 amendments also changed the rules governing one type of the executory contract, commercial real estate leases, in a way that had a material adverse impact on Chapter 11. But to put this in context, there are two things that I would request the Subcommittee to keep in mind, because they are important.

First, the basic rule in Chapter 11 that applies to every executory contract, except a commercial real property lease, is that the debtor has until confirmation of a Chapter 11 plan to decide whether to assume or reject the contract. But the court can terminate it for cause. It is not in the sole and unbridled discretion of the debtor. The party can tell the court, "This contract has to be addressed sooner."

In the case of landlords, a different rule was adopted—basically, a landlord-veto rule, which is that, unless the landlord agrees, once 210 days expires from the filing of the Chapter 11 case, if the debtor doesn't assume the lease, it is deemed rejected, and the debtor has to vacate the premises immediately.

This is unrealistic, especially for a seasonal business, like a retailer. And we will get into that in a moment. But the other point to remember is that the landlords have already gotten a different protection through earlier amendments, which is that from the beginning of a Chapter 11 case until the lease is assumed or rejected, the debtor has to perform all obligations arising after the Chapter 11 filing. The landlord has to be paid on a current basis.

Now, the effect of the amendment is this: Consider the fact that we all know that the retailers' best and most profitable quarter is the last quarter of the year. If a debtor files a Chapter 11 case, and it is a retailer, and it files before the end of May, it will have to decide whether to assume or reject its leases before it even knows the results of the holiday season, before it has any kind of a realistic opportunity to determine whether particular locations work or don't work. And, remember, this decision is supposed to be made on an informed basis, for every location, location by location.

Yet, we now require the debtor to make all of those decisions within 7 months, unless the landlord agrees otherwise, which gives the landlord something that no other party in a Chapter 11 case who is a party to an executory contract, has—a veto.

In addition, this creates an impetus for secured lenders to push for liquidation. Because if you are a lender with a lien on inventory, you know that if the inventory is not liquidated in place, if you have to move it and sell it at a warehouse, you will get substantially less. So what you have in the back of your mind is: You have got a 210-day limit. And if the liquidation is going to occur, it better occur before then.

You can't work with a debtor any more for a year or a year and a half, as long as you keep paying rent on the lease, and know that, if you have to liquidate, you can do it orderly and in place.

You have to press the debtor for an early liquidation and for early decisions, which is a perverse and, I think, unintended result of the 2005 amendment.

So, again, we would like to thank the Subcommittee for considering this. We realize you are being asked to revisit issues that may have been considered in 2005, but I don't think that anybody expected that we would see this many retailers with this many employees crashing or going into Chapter 11 in so short a period of time. Thank you.

[The prepared statement of Mr. Isaac Pachulski follows:]

PREPARED STATEMENT OF ISAAC M. PACHULSKI

Testimony of

Isaac M. Pachulski[1]

on behalf of the

National Bankruptcy Conference

before the

Subcommittee on Commercial and Administrative Law

of the

House Judiciary Committee

111th Congress, 1st Session

for Hearings on

"Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?"

March 11, 2009

The National Bankruptcy Conference (the "Conference") appreciates the opportunity to participate in these oversight hearings on problems created by provisions of the 2005 Amendments to the Bankruptcy Code that adversely affect the reorganization of debtors under chapter 11 of the Bankruptcy Code. The Conference is a voluntary, non-

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profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws. Attached to this statement is a Fact Sheet about the Conference, including a list of its Conferees.

With a sharp downturn in the economy that seems to have no parallel since the Great Depression, many businesses and jobs are at risk. In this environment, the ability of chapter 11 to serve as a viable tool for the reorganization of business enterprises—both large and small—and for the preservation of jobs has assumed increased importance. The Conference believes that certain provisions of the 2005 Amendments unnecessarily impede the reorganization of debtors under chapter 11 and adversely affect the ability of chapter 11 to serve its rehabilitative purposes, preserve jobs, and preserve value for all constituencies in chapter 11 cases. Further, these same provisions create unwarranted "carve-outs" from the operation of generally applicable principles of bankruptcy law and grant unwarranted special treatment, for the benefit of certain economic constituencies, at the expense of chapter 11's rehabilitative function. We therefore commend the Subcommittee for focusing on these issues.

Three of the changes made by the 2005 Amendments, while generally applicable to all businesses in chapter 11, have particularly adverse implications for the ability of retailers and other businesses with multiple locations that sell products to the public (such as restaurants) to reorganize under chapter 11. These three changes:

- provide vendors whose pre-chapter 11 claims against the debtor would otherwise be treated as general, unsecured claims, subject to modification under a plan, with: (x) first priority administrative claims that must be fully paid in cash in order for the debtor to emerge from chapter 11, for goods delivered within twenty (20) days before the chapter 11 filing, and (y) a substantially expanded right to reclaim goods delivered to the debtor before the chapter 11 filing (§§ 503(b)(9), 546(c));

- limit a debtor or trustee to a period of no more than 210 days from the date of the filing of a chapter 11 case to decide whether to assume (keep) or reject (abandon) a lease for an operating business location, unless the landlord agrees to a longer period (§ 365(d)(4)). This deadline substantially increases the risk of (i) improvident decisions to assume or reject leases based on insufficient operating data, and (ii) the premature closure of store locations (and elimination of related jobs);

- require a debtor to provide each utility from which it receives services with a deposit of cash or cash equivalents, no matter how good the debtor's pre-petition payment record, or how low the risk of non-payment, thereby placing further strains on the liquidity of already cash-constrained chapter 11 debtors (§ 366)).

To place the impact of erecting additional hurdles to the reorganization of retailers on the economy and on jobs in context, one need only review the accelerated pace of chapter 11 filings by substantial retailers over the last twelve months. Some of those chapter 11 filings are listed in Chart 1 on the next page.

CHART 1

Selected Retail Bankruptcy Filings for the period 1-1-2008 through 2-13-2009

No.	Name of Debtor	Date of Filing and Location	Annual Sales	Liabilities	No. of Locations	No. of Employees
1.	Circuit City Stores, Inc. (electronics)	11/10/2008 USBC – Eastern District of Virginia	$11.74 billion	$2.3 billion	721	39,600
2.	Mervyn's Holdings, LLC	07/29/2008 USBC – Delaware	$2.5 billion	$359 million	177	18,000
3.	Linens Holding Co. (home furnishing)	05/02/2008 USBC – Delaware	$2.8 billion	$1.4 billion	589	17,500
4.	KB Toys, Inc. (toys, games)	12/11/2008 USBC – Delaware	Figures unavailable	$192.5 million	461	10,850
5.	Goody's Family Clothing Inc. (clothing, shoes, accessories)	06/09/2008 USBC – Delaware 01/13/2009 USBC - Delaware	$1.1 billion	$443 million	355	9,868
6.	Steve & Barry's Manhattan LLC (clothing)	07/08/2008 USBC – Delaware	$656.6 million	$638 million	276	9,695
7.	Boscov's, Inc.	08/24/2008	$1.25 billion	$479 million	49	9,500

No.	Name of Debtor	Date of Filing and Location	Annual Sales	Liabilities	No. of Locations	No. of Employees
	(clothing, home-furnishings)	USBC – Delaware				
8.	Hoop Holdings, LLC (Disney stores)	03/26/2008 USBC – Delaware	Figures unavailable	$55 million	306	8,233
9.	Gottschalks, Inc. (clothing, make-up, shoes accessories)	01/14/2009 USBC - Delaware	$557 million	$112 million	62	5,282
10.	Value City Department Stores (clothing, accessories, electronics, home furnishing)	10/26/2008 USBC – Southern District of New York	$288,542,992.00	$101 million	64	4,500
11.	Friedman's, Inc. (jewelry)	01/22/2008 USBC – Delaware	Figures unavailable	$165 million	473	3,490
12.	Whitehall Jewelers Holdings, Inc. (jewelry)	06/23/2008 USBC – Delaware	$242.9 million	$112 million	373	2,852
13.	Sharper Image Corporation (personal electronic products)	02/19/2008 USBC Delaware	$211 million	$199 million	184	2,246
14.	Fortunoff Holdings, LLC (jewelry, gifts, home furnishing & housewares)	02/05/2009 USBC – Southern District of New York (purchased	$260 million	$139 million	20	1,780

No.	Name of Debtor	Date of Filing and Location	Annual Sales	Liabilities	No. of Locations	No. of Employees
		out of Case No. 08-10353 on 3/07/2008)				
15.	Wickes Holdings LLC (furniture)	02/03/2008 USBC – Delaware	$396 million	$208 million	48	1,459
16.	Shoe Pavilion, Inc.	0715/2008 USBC – Central District of California	$154 million	$11.2 million	117	1,400
17.	Uni-Marts, LLC (convenience stores/gas stations)	05/29/2008 USBC-Delaware	$550 million	$41.9 million	283	1,250
18.	Tweeter Opco, LLC (electronics)	11/05/2008 USBC – Delaware	Figures unavailable	$50.3 million	90	1,100
19.	S & K Famous Brands, Inc. (men's apparel)	02/09/2009 USBC – Eastern District of Virginia	$22 million net loss for 2008 $2.78 million income in 2007	$20 million	136	1,095
20.	Against All Odds USA, Inc. (clothing)	01/05/2009 USBC - New Jersey	$114,000,000	$35 million	64	1,038

No.	Name of Debtor	Date of Filing and Location	Annual Sales	Liabilities	No. of Locations	No. of Employees
21.	B. Moss Clothing Company, Ltd. (clothing)	12/02/2008 USBC – New Jersey	$50,678,000.00	$10.8 million	70	703
22.	Harold's Stores, Inc. (men's apparel)	11/07/2008 USBC – Western Dist of Oklahoma	$7,714,000 net loss prior to petition date	$39.4 million	43	559
23.	Shane Co. (jewelry)	01/12/2009 USBC – Colorado	$207 million	$79 million	23	542
24.	Mattress Discounters Corp. (mattresses and bed frames)	09/10/2008 USBC – Maryland	$125 million	$18.5 million	140	477
25.	Blue Tulip Corporation (gifts and personalized items)	01/05/2009 USBC – Delaware	Figures unavailable	$7.3 million	24	390
26.	Marty's Shoes Holdings, Inc. (shoes)	09/12/2008 USBC – Delaware	Figures unavailable	$23.2 million	47	250
	Totals provided for locations and employees				5,195	153,659

The information provided herein came from the Debtors' bankruptcy filings and other publicly available information. (which is identified in the Appendix hereto; copies of the underlying source material can be provided upon request)

Moreover, for reasons similar to those applicable to retailers, the provisions of the 2005 Amendments summarized above also adversely affect the ability of financially troubled restaurant chains--who employ thousands of workers—to reorganize. The listing of chapter 11 filings by substantial restaurant chains over the last twelve months in Chart 2 below helps place this impact in economic context.

CHART 2

Selected Restaurant Chapter 11 Filings for the period 1-1-2008 through 2-13-2009

No.	Name of Debtor	Date of Filing and Location	Annual Sales	Liabilities	No. of Locations	No. of Employees
1.	Buffets Holdings, Inc. (steak-buffet restaurants)	1/22/2008 USBC – Delaware	Figures unavailable	$898 million	642	36,000
2.	Steakhouse Partners Inc. (steakhouse restaurant chain)	05/15/2008 USBC – Southern District of California	$45 million	$26 million	21	1,325
3.	VI Acquisition Corp. VICORP Restaurants (Baker's Square and Village Inn)	04/03/2008 USBC – Delaware	$106 million	$42.7 million	306	12,750
	Totals provided for locations and employees				969	50,075

The information provided herein came from the Debtors' bankruptcy filings and other publicly available information. (which is identified in the Appendix hereto; copies of the underlying source material can be provided upon request)

In the aggregate, the retailers and restaurants listed in Charts 1 and 2 employed more than 200,000 individuals when they filed their chapter 11 cases. Thus, provisions of the 2005 Amendments that impede the ability of such businesses to reorganize are cause for concern.

We understand that the Subcommittee is also interested in our views on the effect of the 2005 Amendments in general, and not just those that affect retail debtors. In this regard, the Conference also believes that certain provisions included in the 2005 Amendments that are specific to chapter 11 cases for small businesses and individuals place unwarranted impediments on the ability of chapter 11 to accomplish its rehabilitative purposes for such businesses and individuals, and should be eliminated. Finally, the Conference believes that certain provisions of the Bankruptcy Code relating to the special treatment of financial contracts, while not enacted by the 2005 Amendments, merit focused revision.

A. Provisions of the 2005 Amendments that Adversely Affect the Reorganization of Retailers and Other Chapter 11 Debtors

1. The New Vendor Administrative Priority and Expanded Reclamation Rights.

Generally speaking, absent a specific statutory grant of priority, unsecured claims that arise against a debtor before it files its chapter 11 case ("pre-petition claims") are entitled to equal treatment. A chapter 11 plan can modify such claims in a variety of ways to accommodate the debtor's liquidity constraints and to comport with its enterprise value, so long as certain requirements for plan confirmation that are designated to protect creditors are satisfied. Thus, a chapter 11 plan can modify general unsecured claims by changing debt maturities, amortization, and interest rates; converting debt to equity; satisfying claims at a discount; and eliminating junior classes of claims where there is insufficient enterprise value to leave any residual value for such claims.

The ability to effect such modifications is not, however, unbridled; the plan must comply with statutory plan confirmation requirements that protect general unsecured creditors, including the following:

- A creditor who rejects a plan must receive at least as much value as it would receive in a liquidation under chapter 7 of the Bankruptcy Code (the "straight bankruptcy" provisions). 11 U.S.C.§ 1129(a)(7).
- Where a class of claims does not accept a plan by a majority in number and two-thirds in amount of the claims actually voted on the plan, the plan must be "fair and equitable" to the dissenting creditor class, and may "not discriminate unfairly" against that class. *Id.* § 1129(b).
- The plan must provide the "same treatment" for each claim in a creditor class, unless a particular creditor agrees to less favorable treatment. *Id.* § 1123(a)(4).
- The plan must be "feasible" (*id.* § 1129(a)(11)), i.e., the court must conclude that the plan has a reasonable chance of success, considering such factors as the earning power of the business, the adequacy of its capital structure, economic conditions and the competency of management.

Taken together, these provisions help ensure that general unsecured creditors are treated fairly and equally in the context of the available liquidity and enterprise value. Importantly, however, the debtor is not required to pay all pre-petition claims in full immediately after a confirmed plan of reorganization becomes effective – ordinarily, an impossible task, given the economic difficulties that propelled the debtor into chapter 11 in the first place.

In contrast, claims which are granted priority as costs of administration ("administrative claims") must be paid *in full, in cash*, no later than on the effective date of a plan of reorganization, unless a particular creditor agrees to different treatment. There is no mechanism for the non-consensual treatment or modification of an administrative claim under a chapter 11 plan. Thus, as a practical matter, a substantial increase in the administrative claims against the debtor will produce a corresponding increase in the demands on the debtor's already-constrained cash and cash flow. The debtor will have substantially less cash available to fund operations, address deferred maintenance (a not uncommon problem of financially distressed debtors) and make improvements; will have to borrow substantial additional funds at high interest rates and emerge from chapter 11 with more debt and leverage to cover the additional administrative claims (assuming that financing is even available); or will have to resort to some combination of both. The 2005 Amendments provided for just such a substantial increase in administrative claims, with just such consequences.

Prior to the 2005 Amendments, pre-petition claims of vendors for goods sold to a debtor ordinarily constituted general, unsecured claims which, as indicated, do not have to be paid in full in cash in a chapter 11 reorganization, and can be modified under a plan. The 2005 Amendments, however, elevated, to the status of an administration claim, any claim of a vendor for goods delivered to the debtor in the ordinary course of business during the twenty days before bankruptcy. The effect of this change, in the case of a large retailer, is that tens or hundreds of millions of dollars in pre-petition unsecured claims that could otherwise have been modified under a plan, without being paid in full, must instead be paid in full and in cash—this, by a debtor whose very liquidity problems led to the chapter 11 filing in the first place. If the debtor cannot pay those claims in full or obtain the new financing necessary to do so, it will have to shut its doors and liquidate.

To illustrate the problem, if a chapter 11 debtor has $250 million of pre-petition vendor claims for goods sold that are treated as general unsecured claims, the chapter 11 plan can modify those claims without the debtor having to come up with $250 million in immediate cash payments to reorganize and emerge from chapter 11. In contrast, if these same pre-petition vendor claims are treated as administrative claims because of the 2005 Amendments, the debtor will have to pay $250 million to those creditors to emerge from chapter 11. If the debtor cannot do so, it will have to liquidate. Even if the debtor can do so, it will have to divert funds from operations, maintenance and improvements and/or borrow additional funds, incur additional financing costs and add to its leverage. Moreover, to the extent that such post-2005 Amendment administrative vendor claims for pre-petition deliveries are paid earlier in the case—for example, because the bankruptcy court may require such payment of such administrative vendor claims on a parity with the administrative claims of vendors for the post-petition delivery of goods which are typically paid in the ordinary course of business--such additional claims can place additional cash constraints on the debtor's operations early in the case.

The 2005 Amendments further increased the cost of resolving pre-petition vendor claims by greatly expending the reclamation rights of vendors of goods.[2] Prior to the 2005 Amendments, a vendor who sold goods to the debtor in the ordinary course of business while the debtor was insolvent could, if the a vendor had a legal right of reclamation under non-bankruptcy law, exercise that right with respect to goods delivered to the debtor up to *ten* days before the bankruptcy filing. The 2005 Amendments more than quadrupled the reclamation "reach-back" period to *forty-five days* before the bankruptcy filing, and arguably created a new "federal" right of reclamation which may exist even if the seller would not have been entitled to reclaim its goods under state law. These new, post-2005 Amendment reclamation rights can create still further demands on the cash flow of a struggling retail debtor, while imposing on the debtor the administrative burden and cost of responding to such claims.

In sum, the special, preferential treatment accorded to the claims of vendors of goods by the 2005 Amendments can substantially impede the successful reorganization of retailers, restaurants, and other businesses that purchase and sell goods. The Conference believes that these changes should be repealed.

2. Limitation on the Time Within Which a Debtor or Trustee May Assume or Reject a Lease of Non-Residential Real Property to 210 Days From the Petition Date

One of the important powers granted to a chapter 11 debtor or trustee is the right to assume or reject an executory contract or unexpired lease. Generally speaking, the "assumption" of a contract enables the debtor or trustee to retain the benefits of the contract and bind the other party to continued performance, but requires that the debtor or trustee cure defaults and provide adequate assurance of future performance. Upon assumption, the contract becomes an administrative (i.e., first priority) liability of the chapter 11 estate and, following confirmation of a plan, will remain an ongoing liability of the reorganized debtor. In contrast, if the debtor rejects an executory contract, the debtor will no longer be entitled to the other party's performance, or be obliged to perform, under the contract, and the other contract party will (except to the extent of any security deposit) have a pre-petition, general unsecured claim for damages for breach of contract that may be modified under a plan of reorganization in the same manner as the other general unsecured claims.

Recognizing the importance of allowing a chapter 11 debtor—particularly, a large enterprise that may have thousands of contracts—to make an informed decision on the assumption or rejection of each executory contract or unexpired lease, the Bankruptcy Code generally allows a debtor until the confirmation of a plan of reorganization to assume or reject an executory contract or unexpired lease, subject to the power of the

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3 In essence, a reclamation right is a right of a vendor to "reclaim" the goods, rather than simply having a general, unsecured claim for the price of the goods.

bankruptcy court to shorten the time for assumption or rejection of a particular contract or lease for "cause."

Prior to the 2005 Amendments, the rule governing the period to assume or reject an unexpired lease of non-residential real property under which the debtor is the tenant was somewhat different, but still gave the court considerable flexibility. Specifically, Bankruptcy Code § 365(d)(4) required the trustee or debtor to assume or reject such a real property lease within sixty days after the bankruptcy filing; but this period could be extended "for cause," and typically was extended, particularly in large chapter 11 cases.

The 2005 Amendments amended Bankruptcy Code § 365(d)(4) to (i) extend the initial period to assume or reject nonresidential real property leases from 60 to 120 days after the chapter 11 filing, but (ii) limit any extension of the 120-day period to 90 additional days, thus giving the trustee or debtor in possession a maximum of 210 days after the chapter 11 filing to assume or reject every one of its nonresidential real property leases, except where the landlord agrees to a longer extension.

It is critical to note that even before the 2005 Amendments, the Bankruptcy Code already protected (and still protects) the landlord during the period prior to assumption or rejection of a lease by requiring, in Section 365(d)(3), that the trustee or debtor in possession must timely perform all of the obligations of the debtor under a real estate lease arising from the time the bankruptcy petition is filed, until that lease is assumed or rejected (except for "ipso facto" bankruptcy termination clauses and covenants relating to the debtor's insolvency or financial condition). Thus, the debtor is already required to pay all post-petition rent and perform all other post-petition obligations under the lease until the lease is assumed or rejected. It is because of this statutory protection accorded to landlords that courts were flexible in extending the assume/reject period for real estate leases prior to the 2005 Amendments. Despite this protection, the 2005 Amendments took away the court's flexibility to extend the assume/reject period beyond the new 210-day limit.

The adverse impact of this 210-day limitation is best understood in the context of the cost to a debtor of the premature assumption or rejection of a lease. If the debtor assumes a lease, then any claim for a subsequent breach or abandonment of the lease constitutes a first priority administrative claim, which must be paid in full in cash on the effective date of a plan unless the landlord agrees otherwise; or, if the claim arises after the confirmation of a plan, constitutes a post-confirmation liability of the reorganized debtor that is not discharged. Although the Bankruptcy Code generally limits the administrative claim for breach of an assumed real property lease to two years' worth of monetary obligations under the assumed lease, *see* 11 U.S.C. § 503(b)(7), such an administrative claim can still require a substantial cash outlay. Moreover, once the debtor confirms a plan and emerges from chapter 11, the two-year "cap" will not apply to any subsequent claim by the landlord for breach or abandonment of the assumed lease. Faced with the potential cost of a premature and improvident lease assumption, the debtor may be forced to err on the side of rejecting leases for locations that might have proved profitable (and firing all the employees who work at such locations), once the 210-day deadline is impending.

The 210-day time limit to assume or reject leases can be particularly problematic in the case of retailers with highly seasonal businesses, because such retailers and their creditors may be forced to commit to a business plan involving the closure of certain locations before they have had a fair opportunity to evaluate whether operational turnaround efforts to improve underperforming locations have succeeded. For example, if a retailer files a chapter 11 case right after the Christmas holiday season (which is not uncommon), the 210-day time limit will force it to decide which locations to retain and which to close *before* the next holiday season. This is a significant obstacle to informed decision-making, because the last quarter of the year (with the holiday season) is typically the most profitable quarter for a retailer (indeed, the first nine months may be break even at best). Thus, the debtor will have to make its "close - do not close" decision without the benefit of any information regarding the impact of its business and operating changes on operating results during the most important quarter of the year.

Moreover, the 210-day limitation on the time to assume or reject contracts also creates incentives and precipitates lender demands (via post-petition debtor in possession financing arrangements) for the liquidation of retailers if they are not refinanced or a buyer of the debtor's business obtained within the first 30 or 60 days of a chapter 11 case. Generally, the lender has a lien on the inventory and recognizes that the inventory has to be liquidated in place or it will lose substantial value. As a result, the lender imposes onerous conditions as part of its debtor in possession financing that force liquidations, because the lender wants the inventory liquidated before the leases have to be rejected, the premises vacated and the inventory moved elsewhere. This is an absolute condition weighed by every secured lender to a retail organization, and it is a major precipitating factor in the chapter 11 liquidation of retailer debtors.

For all of these reasons, the Conference believes that the inflexibility of the 210-day time limit is unwarranted and that this fixed time limit for the assumption or rejection of non-residential real property leases should be eliminated.

3. The Imposition of Stringent Cash Deposit Requirements In Favor of Utilities.

Bankruptcy Code § 366 requires that a chapter 11 debtor afford providers of utility services with "adequate assurance of payment." The 2005 Amendments modified Section 366 so that it virtually compels a debtor or trustee to provide each utility with a deposit of cash or cash equivalents satisfactory to the utility. In the case of a retailer or other debtor with many locations, this requirement can impose substantial additional cash requirements on an already cash-strapped debtor, and divert cash from operations and/or impose additional financing costs on the debtor, early in the case.

Prior to the 2005 Amendments, a utility was entitled to "adequate assurance of payment;" but, the term was not defined; and a court could find that a first priority administrative claim for post-petition utility services constituted "adequate assurance of payment," without requiring a cash deposit, and could be more flexible in the case of a debtor that had a good record of paying its utility bills. Moreover, there was no presumption in favor of the form of "adequate assurance" demanded by the utility.

The 2005 Amendments changed these rules. An administrative expense priority can no longer constitute "adequate assurance of payment"—the utility can demand cash or a cash equivalent. Section 366 now provides explicitly that "an administrative expense priority shall not constitute an assurance of payment" and now defines "assurance of payment" to mean a cash deposit; letter of credit; certificate of deposit; surety bond; prepayment; or "other form of security that is mutually agreed on between the utility and the debtor or the trustee." Moreover, a utility is given the right to discontinue service if "the utility does not receive from the debtor or the trustee adequate assurance of payment for utility service that is satisfactory to the utility" within thirty days of the chapter 11 filing. Although the court is given the power to modify the amount of the assurance of payment demanded by the utility, the court may not, in so doing, consider the debtor's timely payment for utility service before the chapter 11 filing; the fact that no security was required before the chapter 11 filing; or the availability of an administrative expense priority.

There are certainly cases where an administrative claim alone may not be sufficient to provide a utility with "adequate assurance of payment" because of the risk of an administratively insolvent estate. In its current form, however, Section 366 does not permit the court to consider any option other than a security deposit of cash or cash equivalents. For example, in its current form, the statute would not permit a court to consider a combination of an administrative claim plus utility-friendly provisions in the secured debtor in possession financing facility (such as a "carve-out" of some sort), to function as "adequate assurance of payment" in lieu of a security deposit. This is simply too inflexible a construct.

Taken together, these provisions now enable utilities to impose substantial cash demands on a debtor at the outset of a chapter 11 case, thereby limiting the cash available for operations in the critical early months of a chapter 11 case. The Conference believes that these changes should be repealed.

B. 45-Day Confirmation Time Limit in Small Business Chapter 11 Cases

In a chapter 11 "small business case" (defined in § 101(51C)), Section 1129(e) requires that plan confirmation be "not later than 45 days after the plan is filed unless the time for confirmation is extended in accordance with Section 1121(e)(3)." The 45-day limit has proven to be difficult and, in some situations impossible, to satisfy. *See Caring Heart Home Health Corp., Inc.*, 380 B.R. 908 (Bankr. S.D. Fla. 2008) (case dismissed because court set disclosure statement hearing beyond the 45-day limit). An extension of the 45-day time limit is possible under Section 1121(e)(3), but requires a cumbersome, time consuming and expensive hearing at which the debtor must demonstrate by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time. An easy solution to the problem is to extend the time limit to a more realistic 90 days.

After a chapter 11 plan is filed, a lot must occur before a plan can be confirmed. The court must approve a disclosure statement; notice of the confirmation hearing must be sent to all creditors; ballots accepting or rejecting the plan must be filed; a confirmation hearing must be held; and the court must enter a confirmation order. Under the best of circumstances it is difficult to accomplish all of this within 45 days.

Rule 2002(b)(2) of the Federal Rules of Bankruptcy Procedure requires that parties in interest, including all creditors, be given not less that 25 days notice of the time fixed for filing objections and the hearing to consider confirmation. Several things must happen before the 25-day notice can be given, including the approval by the court of a disclosure statement. Rule 2002(b)(1) requires a 25-day notice to parties in interest of the time fixed for filing objections and the hearing to consider approval of the disclosure statement. Taken together, the 25-day notice regarding the disclosure statement hearing and the 25-day notice regarding the confirmation hearing exceed the 45-day confirmation limit. Bankruptcy judges have the discretion in small business cases to (1) conditionally approve the disclosure statement (§ 1125(f)(3)(A)) and combine the disclosure statement hearing with the confirmation hearing (§ 1125(f)(3)(D)), (2) determine that the plan itself contains adequate information and that a separate disclosure statement is not necessary (§ 1125(f)(1)), and (3) approve a disclosure statement on a court approved form or an Official Form, but unless the court adopts one of these options, meeting the 45-day confirmation deadline is impossible.

Bankruptcy judges often conditionally approve disclosure statements in small business cases, but still, meeting the 45-day confirmation limit requires resourcefulness by the clerk's office and some scheduling good fortune. Typically, the 25-day notice of the confirmation hearing is not given for several days after the plan is filed, which reduces the time in which a confirmation hearing can be held and a decision made to a period of 10 to 15 days. If amendments to the disclosure statement are required or if extensive modifications to the plan are needed, confirmation within the 45-day limit cannot be achieved.

As previously mentioned, the 45-day time limit may be extended, but only after it has been shown by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time. Most small business debtors have limited resources that could be better used to pay creditors than to fund an expensive hearing to prove that an unduly restrictive time limit should be extended.

The Conference recommends that the confirmation time limit in small business cases be expanded from 45 days to 90 days.

C. Discharges for Individuals Who Are Chapter 11 Debtors

The 2005 Amendments made significant changes with respect to individuals who are chapter 11 debtors, one of which repeatedly proves to be an impediment to their reorganization. Section 1141(d)(5)(A), in most cases, postpones an individual debtor's discharge until all plan payments have been completed, thus treating individual chapter 11 debtors very differently from business chapter 11 debtors and increasing the costs to these individual debtors. To address this problem, the Conference recommends that chapter 11 debtors who are individuals receive a discharge upon confirmation of their plans pursuant to Section 1141(d)(1)(A), as do chapter 11 debtors who are not individuals.

There are three types of discharges that are possible for an individual who is a debtor in a chapter 11 case. First, there is the discharge that is granted by the court "on completion of all payments under the plan" pursuant to Section 1141(d)(5)(A). The second type is the post-confirmation "early discharge" pursuant to Section 1141(d)(5)(B), which is similar to the chapter 13 "hardship discharge" under Section 1328(b), but requires no hardship. Finally, there is the discharge that is granted pursuant to Section 1141(d)(5)(A) at a time other than when all payments are completed: The discharge is instead granted when "after notice and a hearing the court orders otherwise for cause."

Early post-confirmation discharges under Section 1141(d)(5)(B) are rare, and although courts occasionally allow a discharge to occur "for cause" prior to completion of plan payments, *see In re Sheridan*, 391 B.R. 287 (Bankr. E.D.N.C. 2008) (court allowed discharge upon confirmation where debtors gave conspicuous notice of the request for discharge, established the likelihood that all plan payments would be made, and provided assurance in the form of collateral that creditors would receive the amount promised even if all plan payments weren't made), most debtors who are individuals receive their chapter 11 discharge only after all payments have been made.

Granting a discharge upon completion of a plan works well in chapter 13 cases where, pursuant to Section 1322(d), a confirmed plan can not last longer than five years. In contrast, in chapter 11, plans may be for much longer durations. In addition to the administrative burden imposed on courts to attend to the case and determine when it may be closed, the larger difficulty is that as long as a case remains open, a chapter 11 debtor must continue to pay the quarterly fee required by 28 U.S.C. § 1930. The obligation to pay these fees is significant.

The amount of the quarterly fees is based on all disbursements made by the reorganized debtor, "including ordinary operating expenses." *Walton v. Jamko, Inc. (In re Jamko, Inc.)*, 240 F.3d 1312, 1313 (11th Cir. 2001); *In re Danny's Markets, Inc.*, 266

F.3d 523 (6th Cir. 2001). Even if a debtor has a very low net income, the fee will be calculated on the chapter 11 debtor's day to day operating expenses, and will range from a minimum of $325 per quarter for any debtor to as much as $30,000 per quarter in a very high disbursement case. The operating expenses for individuals who run businesses can be quite high, and payment of the quarterly fee over many years imposes an onerous and unfair burden on chapter 11 debtors who are individuals.

The Conference recommends that individual debtors in chapter 11 cases be granted a discharge pursuant to Section 1141(d)(1)(A) like other reorganized debtors in chapter 11. Alternatively, the discharge could be granted prior to the payment of all plan payments but after the payment of all plan payments required for a specified period of time, such as one year. This alternative serves the purpose of ensuring that the individual chapter 11 debtor establishes the likelihood of continued payment and protects creditors, without imposing excessively costly burdens on the individual debtors. Even this alternative, though, would result in quarterly fee payments totaling at least $1,400 by a chapter 11 debtor who is an individual. In the view of the Conference, the better plan is to grant discharges to individual debtors in chapter 11 cases under Section 1141(d)(1)(A).

D. Provisions Relating to the Treatment of Financial Market Contracts

1. Background

Commencement of a case under the Bankruptcy Code results in the imposition of an automatic stay of the exercise of most creditor remedies and collection efforts with respect to prepetition claims and contracts. In particular, the automatic stay generally blocks a non-debtor counterparty to prepetition contracts with the debtor from

(a) terminating the prepetition contracts notwithstanding the debtor's default, (b) exercising its rights as a secured creditor to realize on any property of the debtor pledged to secure the obligations owing to it by the debtor under such contracts, and (c) exercising any rights of setoff that it may have to recover amounts owing to it by the debtor by netting them against amounts that it owes to the debtor. Additionally, the Bankruptcy Code contains powerful avoidance provisions that generally permit a debtor to recover preferential transfers – prepetition amounts paid by an insolvent debtor on its debts that allowed some creditors to receive a higher recovery than other similarly situated creditors – and fraudulent transfers – prepetition transfers made with actual intent to hinder, delay or defraud creditors or by an insolvent debtor without receiving reasonably equivalent value in exchange.

Congress has determined on several occasions that the application of the foregoing provisions presents systemic risk to certain key financial markets, and therefore has added provisions to the Bankruptcy Code affording special protections to several types of financial market contracts: securities contracts; commodities contract; forward contracts; repurchase agreements; swap agreements; and master netting agreements. Each of these terms is separately defined in the Bankruptcy Code. Among other things, the special protections permit most non-debtor counterparties to protected contracts to:

(a) Exercise contractual rights triggered by the debtor's bankruptcy to terminate, liquidate and accelerate protected contracts, free from the automatic stay and most other stays.

(b) Exercise contractual rights to realize against collateral and set off obligations to recover amounts owing to them under protected contracts.

(c) Retain most amounts transferred to them under or in connection with protected contracts free from the Bankruptcy Code's avoidance provisions, except in cases of actual fraud related to such transfer.

These protections can be enormously valuable to a non-debtor counterparty to such a protected contract but are not available with respect to other prepetition contracts, such as loan agreements and normal commercial agreements. Over time, Congress has expanded these protections and the types of protected contracts covered by them. Important business practices have developed to take advantage of the special protections in ways that were taken into consideration by Congress when crafting the legislation. For example, "mortgage warehouse financing" – secured lending arrangements collateralized by mortgage loans – have largely been replaced by mortgage repo arrangements – repurchase agreements for the financing of mortgage loans. However, the potential exists for straightforward lending or commercial arrangements to be "disguised" or reconfigured in ways not contemplated by Congress to fit within the parameters of the Bankruptcy Code's definitions of repurchase agreements, swap agreements or other types of protected contracts. Indeed, in view of the current broad definitions of such terms, it takes very little imagination to reconfigure any loan and many types of commercial arrangements into what is facially a protected contract, even though such contract is unrelated to the markets sought to be protected by Congress. The potential for abuse is compounded by the fact that, in order to afford certainty to the markets, the courts are afforded little or no discretion by the language of the Bankruptcy Code to weed out such abusive transactions.

2. Limitation of Types of Collateral Subject to Special Protections

The current special protections contain no limitation on the types of collateral against which a non-debtor counterparty may exercise contractual rights. Therefore, a non-debtor counterparty to a protected contract, such as a swap agreement, may exercise its secured party rights against the collateral posted for such agreement free from any bankruptcy stay, regardless of whether such collateral is cash or securities (as would be common for a swap agreement) or the debtor's principal plants, equipment and other operating assets (which would be quite uncommon for a legitimate swap agreement). Indeed, the use of uncommon collateral in what is otherwise facially a protected contract may be a strong indicator that the transaction is, in fact, a secured loan or commercial arrangement that has been documented to appear to be a protected contract.

The unfettered exercise of secured party rights against operating assets could end the debtor's prospects for reorganization, and thus likely lead to the termination of its employees and the loss of going concern values to other creditors and stakeholders. Where collateral is cash, securities or other fungible financial assets not used in the operation of the debtor's business, affording a non-debtor counterparty the right to realize on such collateral free from a stay, should not deprive the debtor of its reorganization prospects. In contrast, where the collateral is operating assets – which can often be unique or practically irreplaceable – not only does the type of collateral raise serious issues as to the bona fides of the transaction as a protected contract, but the loss of the stay can be fatal to the debtor's reorganization prospects. Therefore, the Conference has been focusing on limiting the special protections related to the exercise of contractual rights against collateral to financial assets of types that are usual for legitimate protected contracts and whose loss does not present as high a level of risk to reorganization prospects. In particular, the Conference has been considering:

(a) limiting the stay exemption protections contained in Bankruptcy Code §§ 362(b), (6), (7), (17) and (27) for the exercise of secured party contractual rights under protected contracts to "financial collateral";

(b) defining "financial collateral" as:

(i) cash, cash equivalents, securities, instruments, certificates of deposit, mortgage loans, interest in a protected contract or property sold or to be sold in the performance of a protected contract, excluding any security or instrument issued or executed by the debtor or a person under common control with the debtor;

(ii) any other property not used in the operation of any business owned or conducted by the debtor or a person under common control with the debtor; and

(iii) any letter of credit, guarantee, reimbursement agreement or other credit enhancement issued or provided by a person other than the debtor for the obligations under such contracts;

(c) expressly excluding from "financial collateral" any receivable arising in the ordinary course of the business of the debtor or a person under common control with the debtor, any property that was not of a kind constituting financial collateral at the time of the filing of the petition, and the proceeds of such property.

The Conference has not completed its work with respect to the foregoing proposal as to financial collateral, but the work has sufficiently progressed that it was deemed appropriate to present at this time.

3. Distributions on Securities

Bankruptcy Code § 546(e) was designed to protect prepetition transfers under securities contracts from avoidance as preferential transfers or fraudulent transfers. For example, a mark-to-market margin payment under a securities purchase agreement, securities loan, margin loan, clearing advance or other securities contract might be subject to avoidance as a preferential transfer absent Section 546(e) protection. Similarly, Section 546(e) protects intermediaries in the national securities clearance process from avoidance exposure with respect to the transfers for which they act as intermediaries.

There has been disagreement among the courts as to the scope of the Section 546(e) protection with respect to payments to shareholders in connection with leveraged buyouts and similar transactions. Absent Section 546(e), shareholders who received payouts for their stock in connection with a leveraged buyout that rendered the target company insolvent may be vulnerable to recovery of their payouts as constructive fraudulent transfers by the target company's bankruptcy estate. The recovered amounts would be available to repay the target company's unpaid creditors. Some (but not all) courts have interpreted Section 546(e) sufficiently broadly as to immunize shareholders from such recoveries if they received their payouts through the national securities clearance or payment system, even though no securities contract was implicated and they are not themselves securities intermediaries. The Conference believes that this result is unfair and unnecessary to protect the securities markets.

To address this issue, the Conference suggests that:

(a) Section 546(e) be amended to exclude from its protection redemption payments, principal payments, dividend payments, interest payments or other distributions on or in respect of a security, made for the benefit of the beneficial holder of the security, by or on behalf of the issuer of the security or another entity obligated with respect to the security; and

(b) a new section be added to Bankruptcy Code § 550, which deals with the persons from whom an avoidable transfer may be recovered, to provide that payments so excluded from Section 546(e) can be recovered solely from the beneficial holder of the relevant security.

In this way, securities intermediaries would be protected from liability for any such payments that may pass through them, while preserving the ability for the bankruptcy estate to recover preferential or fraudulent transfers from the beneficial holders who receive them.

Appendix

Electronic resources

4. http://bankruptcy.morrisjames.com/2008/12/articles/delaware-chapter -11-filings-1(2/12/2009)

5. http://bankruptcy.morrisjames.com/tags/retail-bankruptcy/ (2/12/2009)

6. http://www.bloomberg.com/apps/news (2/12/2009)

7. http://www.bizjournals.com/losangles/stories (12/22/2008)

8. http://www.bizjournals.com/louisville/stories (10/27/2008)

9. http://www.bizjournals.com/philadephia/stories (08/04/2008)

10. http://www.bizjournals.com/sanantoni/stories (11/10/2008)

11. Brad Dorfman, Retailers Gottschalks, Goody's File Chapter 11, http://www.forbes.com/feeds/reuters (1/14/2009)

12. http://www.chapter11blog.com (2/13/2009)

13. http://www.chapter11blog.com/chapter11/new_chapter_11_filing/ (2/13/2009)

14. http://www.chapter11blog.com/chapter11/consumer_products_bankruptcy/ (2/13/2009)

15. http:///www.chapter11blog.com/chapter11/food_and_beverage_chapter_11/ (2/13/2009)

16. http://www.chapter11blog.com/chapter11/funriture_company_chapter_11/ (2/13/2009)

17. http:///chapter11blog.com/chapter11/retail_chapter_11/ (2/13/2009)

18. http://www.chapter11library.com/CaseDetail.aspx?CaseID=181383 (2/13/2009)

19. http://www.chapter11library.com/CaseDetail.aspx?CaseID=180031 (2/13/2009)

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21. http://cpg-retail-litigation.kotchen.com (12/15/2008)

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23. Gillian Gaynair, Retail Brokers Rear Up To Pitch DC Area At International Council Of Shopping Centers Convention, http//www.bizjournals.com/washington/stories (5/19/2008)

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25. Liz McKenzie, Ch. 11 Filings Soar In August Amid Credit Crisis, http://www.lplegal.com/jpf (09/10/2008)

26. Matthew Boyle, Retail Bankruptcy: Only The Strong Will Survive, http://www.businessweek.com/magazine/content (11/19/2008)

27. Peter Van Allen, Bankruptcies, Store Closings Put Retail Space On Market, http://www.bizjournals.com/philadelphia/stories (8/04/2008)

28. Richard Bilbao, Bankruptcy Filings up 122% (2009); http://www.bizjournals.com/orlando/stories/2009/01/05/story2

29. http://www.snopes.com/politics/business/bankruptcies.asp (2/12/2009)

30. http://www.thedeal.com/newweekly/2009/02/retailers_and_bankrutpcy/print (2/12/2009)

Bankruptcy Cases

1. In re Against All Odds, USA, Inc., Ch. 11 Case No. 09-10117 –DHS No. 1 and No. 13 (Bankr. D.N.J.)

2. In re B. Moss Clothing Company, Ltd. Ch. 11 Case No. 09-33980-NLW No. 1 and No. 17 (Bankr. D.N.J.)

3. In re Blue Tulip Corporation, Ch. 11 Case No. 09-10015-KG No. 1 and No. 3 (Bankr. Del.)

4. In re BSCV, Inc. et al., Ch. 11 Case No. 08-11637-KG No. 1 and No. 2 (Bankr. Del.)

5. In re Circuit City Stores, Inc. et al., Case No. 08-35653-KRH No. 1 and No. 22 (Bankr. E.D. Va.)

6. In re Fortunoff Holdings, LLC, Case No. 09-10497-RDD No. 1 and No. 14 (Bankr. S.D.N.Y.)

7. In re Friedman's, Inc., Case No. 08-10161-CSS No. 32 (Bankr. Del.)

8. In re Goody's Family Clothing, Inc. Case No. 08-11133-CSS No. 1 and No. 2. (Bankr. Del)

9. In re Gottschalks Inc., Case No. 09-10157-KJC, No. 1 and No. 14 (Bankr. Del)

10. In re Harold's Stores, Inc., Case No. 08-15027-TMW, No. 1 and No. 4 (Bankr. W.D. Ok.)

11. In re Hoop Holdings, LLC, Case No. 08-10544-BLS, No 1 and No. 3 (Bankr. Del.)

12. In re KB Toys, Inc., Case No. 08-13269-KJC, No. 1 and No. 5 (Bankr. Del.)

13. In re Linens Holding Co. et al., Case No. 08-10832-CSS, No. 1 and No. (Bankr. Del)

14. In re Marty Shoes Holdings, Inc., Case No. 08-12129-KJC, No. 1 and No. 4 (Bankr. Del.)

15. In re Mattress Discounters Corp., Case No. 08-21642 No. 1 and No. 20 (Bankr. D. Md.)

16. In re Mervyn's Holdings, LLC, Case No. 08-11586-KG No. 1 and No. 2 (Bankr C.D. Cal.)

17. In re Shane Co., Case No. 09-10367-HRT, No. 1 and No. 22 (Bankr. Co.)

18. In re TSIC, Inc. Case No. 08-10322-KG, No. 1 and No. 3 (Bankr. Del.)

19. In re Shoe Pavilion, Inc. Case No. 08-14939-MT, No. 1 and No. 7 (Bankr C.D. Cal.)

20. In re S & K Famous Brands, Inc., Case No. 09-30805-KRH, No. 1 and No. 16 (Bankr. E.D. Va.)

21. In re Stone Barn Manhattan, LLC, Case No. 08-12579-alg, No. 1 and No. 14 (Bankr. S.D.N.Y.)

22. In re Tweeter Opco, LLC, Case No. 08-12646-MFW, No. 1 and No. 20 (Bankr. Del.)

23. In re Uni-Marts, LLC, et al., Case No. 08-11037-MFW, No. 1 and No. 5 (Bankr. Del)

24. In re Value City Holdings, Inc., et al., Case N0. 08-14197-jmp, No. 1 and No. 2 (Bankr. S.D.N.Y.)

25. In re Wickes Holdings, LLC, et al., Case No. 08-10212-KJC, No. 1 and No. 3 (Bankr. Del)

26. In re Whitehall Jewelers Holdings, Inc., et al., Case No. 08-11261-KG, No. 1 and No. 5 (Bankr. Del.)

27. In Buffets Holdings, Inc., et al. Case No. 08-10141-MFW, No. 1 and No.

28. In re Steakhouse Partners, Inc., Case No. 08-04147-JM11, No. 1 and No. 12 (Bankr. S.D. Cal.)

29. In re VI Acquisition Corp., Case No. 08-10623-KG, No. 1 and No. 22 (Bankr. Del.)

Mr. COHEN. Thank you, sir. We appreciate your testimony.

And, now, Professor Williams, if you would, conclude our testimony.

TESTIMONY OF JACK F. WILLIAMS, AMERICAN BANKRUPTCY INSTITUTE RESIDENT SCHOLAR, GEORGIA STATE UNIVERSITY COLLEGE OF LAW

Mr. WILLIAMS. Thank you very much.

Mr. Chairman and Members of the Subcommittee, I want to thank you for the opportunity to visit with you today over a number of the issues that are percolating in retail bankruptcy.

I want to begin with this simple observation: 2008 was a very bad year for bankruptcy. During that time period, we witnesses 1.1 million bankruptcy filings. And it is not going to get any better for 2009. At the American Bankruptcy Institute, we are estimating that at least 1.4 million bankruptcy filings will be made in 2009. We also anticipate an increase in business bankruptcy filings of approximately 40 percent.

Retail bankruptcies are not faring any better, as well. Eight major retailers have already filed bankruptcy petitions for this year, following the 27 major retailer bankruptcy filings in 2008. The 2008 total was the most since the 32 retailers that filed in calendar year 2001.

Of these 27 retailers that filed in 2008, 37 percent of those filed in the fourth quarter of that year, during the Christmas season, which is highly unusual. As Mr. Pachulski has pointed out, the Christmas season, or the fourth quarter of the calendar year, in many retail sub-sectors, will generate 50 percent or more of that year's revenue.

The present market and lending environment is also important to consider to provide what I think is the contextual space of which to look at three tension points that we are focusing on today.

For retailers, the top-line numbers, revenues, are way down; the profit margins are way down. Businesses are reducing their prices to draw customers into the facility. Consumer spending and credit are down, with consumer savings increasing, and increasing at an increasing rate. Now, that is good for consumers with debt, but not so good for a weak economy that is driven by consumer demand.

Vendors are aggressive managing their credits. They are reducing credit turns. They are pulling back in volume shipments. Vendors are no longer serving as short-term banks for the retailers.

Banks are simply not making loans. They are not lending beyond what it may take for a quick sale, or to liquidate the business, unless the business has very good cash flows and a good brand.

And, in short, in retail, what we have seen is we have hit a liquidity wall. There are no financial buyers to speak of because of the scarcity of available capital.

The present bankruptcy strategy is to find a strategic buyer quickly, because your creditors are giving you very little time, or, simply, to liquidate the business and shut it down.

Now, the 2005 amendments to the bankruptcy code created a Chapter 11 for good times, not a Chapter 11 that is most effective for financially bad times. This Subcommittee should consider addressing some of the structural flaws in the bankruptcy code that were infused through the 2005 amendment.

A major thrust of the drafters of Chapter 11 of the Bankruptcy Reform Act of 1978 was to develop a flexible, adaptive and transparent system that was business-plan agnostic.

Our original Chapter-11 design permitted a debtor a broad range of discretion, consistent with the exercise of sound business judgment, and the best interest of the bankruptcy estate, to develop a business plan with the greatest chances of success.

If anything, recent amendments to Chapter 11 of the bankruptcy code have failed to serve the law's original purposes and policy goals. The points for consideration have been discussed by my panelists.

And I will just add a few observations to that: The consideration for removing the administrative priority for goods sold to the debtor within 20 days, and returning that pre-petition claim back to the prior practice of either establishing a reclamation claim, or living with a general unsecured claim is precisely the type of thing we need when we are looking at the serious crunch on liquidity for a business.

The 503(b)(9) claim is, in itself, an anomaly. It is a distortion of the priority-and-distributions theme that is in the bankruptcy code.

Consideration of relaxing the deadline by which commercial real property leases must be either assumed or rejected—again, the prior practice was not unbridled discretion on the part of the debtor-in-possession; yet, a third-party neutral, the bankruptcy court—and any determination had to be not only consistent with the sound business judgment of the debtor, but also with the best interest of the estate.

And, finally, consideration of relaxing the deadline for the period of exclusivity—that time period in which the debtor has the sole authority and power to propose a plan of reorganization. I believe that also would be consistent with infusing sufficient judicial discretion so that each case can be adapted. The system, itself, can be flexible, and we provide the greatest chance of success within—well, what is consistent with the best interest of the estate.

I want to thank you very much for the opportunity to share some thoughts on the issues raised by retail bankruptcies. I appreciate it.

[The prepared statement of Mr. Williams follows:]

PREPARED STATEMENT OF JACK F. WILLIAMS

Statement of Professor Jack F. Williams
Resident Scholar, American Bankruptcy Institute

Before the House Judiciary Subcommittee on Commercial and Administrative Law

CIRCUIT CITY UNPLUGGED: WHY DID CHAPTER 11 FAIL TO SAVE 34,000 JOBS?

March 11, 2009

I. INTRODUCTION

Mr. Chairman and members of the Subcommittee, my name is Jack Williams. I am a Professor of Law at Georgia State University College of Law in Atlanta, Georgia, and currently the Robert M. Zinman Resident Scholar at the American Bankruptcy Institute (ABI). I am also a Managing Director in the Business Restructuring Group of BDO Consulting, a division of BDO Seidman, LLP. In that capacity, I provide financial advisory services to both debtors and official creditors committees in a broad range of retail bankruptcy cases. I am pleased to appear today to speak about bankruptcy law and the retail sector.

Founded on Capitol Hill in 1982, the ABI is a non-partisan, non-profit association of over 12,000 professionals involved in bankruptcy and insolvency, representing both debtors and creditors in consumer and business cases. The ABI is not an advocacy group and does not take lobbying positions on legislation before Congress or advocate any particular result in matters pending before the courts. Rather, the ABI is a neutral source for information about the bankruptcy system (such as how courts are interpreting provisions of the Bankruptcy Code) and a resource for members of Congress and their staff considering changes to the Code. As an academic, and as the ABI resident scholar, I am permitted to give my personal views on legislation, but those views should not be taken as the views of the ABI.

At Georgia State, I teach and write primarily in the areas of bankruptcy law (including business and consumer bankruptcies), commercial law, and taxation. My biography is attached to this written statement, but let me briefly say that after graduating from George Washington University Law School, clerking for Judge William J. Holloway, Jr., of the U.S Court of Appeals for the Tenth Circuit, and working for four years in the Dallas, Texas office of Hughes and Luce, I joined the faculty of Georgia State University College of Law, where I have taught for the past eighteen years. For the time period January 2008 to present, I am serving as the Resident Scholar at the ABI offices in Alexandria, Virginia.

Today's subject is not new to me; for over twenty years I have devoted time as an academic to the study of retail sector bankruptcies and have served as legal counsel or financial advisor to retail debtors, creditors committees, and secured creditors in retail bankruptcy cases. Most recently, as the ABI Resident Scholar, I am undertaking research and writing on retail bankruptcies.

The title of today's hearing is intriguing: *Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?* Of course, Chapter 11 failed no one. If anything, recent amendments to chapter 11 of the Bankruptcy Code have failed to serve the law's original purposes and policy goals.

A major thrust of the drafters of chapter 11 of the Bankruptcy Reform Act of 1978 was to develop a flexible, adaptive, and transparent system that was business-plan agnostic. Our original chapter 11 design permitted a debtor a broad range of discretion, consistent with the exercise of sound business judgment and the best interests of the estate, to develop a business plan with the greatest chance of success. This system rested on a number of provisions in the Bankruptcy Code, including the stay of any creditor action against the debtor or property of the estate, relief from the payment of prepetition claims, a high priority in payment for those entities that deal with the debtor postpetition, the ability of the debtor to remain in possession of property of the estate, the ability of the debtor to continue to operate the business in the ordinary course without court approval, the ability of the debtor to incur debt postpetition, the exclusive right of the debtor to propose and confirm a plan of reorganization, and the discretion to either reject or assume (and assign) unexpired leases and executory contracts. The drafters infused discretion throughout the process with both the debtor, in the first instance, and the bankruptcy court. They recognized that famously, bankruptcy is a flexible process. Thus, the actual structure of the business plan was driven by the financial facts and circumstances on the ground and the sensibilities of the stakeholders, rather than any particular provision or combination of provisions found in the Bankruptcy Code. This is no longer the case.

II. BAPCPA CHANGES TO BANKRUPTCY CODE RELEVANT TO RETAIL CASES

On April 20, 2005, former President George W. Bush signed into law Senate bill number 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). BAPCPA is the most substantial revision of bankruptcy law since enactment of the Bankruptcy Reform Act of 1978. More specifically, BAPCPA dramatically changed several aspects of business bankruptcy law relevant to retail debtors. BAPCPA generally became effective as to cases filed on or after October 17, 2005. My remarks will address several business bankruptcy points. These points include the following:

- Consideration of relaxing the deadline by which commercial real property leases must be either assumed or rejected. The 2005 Amendments place a cap of 210 days. By that time, a lease is deemed rejected if not assumed. In my opinion, Congress should consider removing this cap and restoring the discretion of the bankruptcy court to determine on a case-by-case basis whether cause has been shown to extend the deadline.

- Consideration of relaxing the deadline for the period of exclusivity from 18 months to a time period determined by the bankruptcy court. In my opinion, infusing more and not less judicial discretion is the appropriate way by which to provide a reasonable opportunity for debtor rehabilitation. The period of exclusivity is the period by which only a debtor may propose and obtain confirmation of a plan of reorganization. During this period, no other party may file a competing plan until that time period lapses.

- Consideration of removing the administrative priority for goods sold to the debtor within 20 days and returning that prepetition claim back to the prior practice of establishing a reclamation claim or living with a general unsecured claim.

A. Deadline to Reject or Assume Unexpired Leases

Prior to BAPCPA, chapter 11 debtors had a reasonable time period to make critical decisions involving commercial real property leases. For example, in the case of *In re Hechinger Investment Company of Delaware, et. al.*[1] on the June 11, 1999 petition date, the debtors had in excess of 260 leases and subleases of nonresidential real property. Through a series of motions, the time to assume or reject these leases was extended, over objection from landlords, until June 1, 2000, approximately 1 year later.[2] Similarly, in the case of *In re Montgomery Ward, LLC, et. al.*[3] when the case was filed on December 28, 2000, the debtor had approximately 300 non-residential real property assets. On January 24, 2002, in a motion for a further extension of time to assume and reject until August 31, 2002, the debtor reported that 137 leases had been rejected, 30 had been terminated, and 51 had been assumed and assigned.[4] Of course, as in the *Hechinger* case, this had taken over a year and they still needed more time. While the confirmation of a plan made the motion for additional time moot in *Montgomery Ward*, these cases are indicative of the length of time it takes to fully analyze leases in a large retail bankruptcy. Because of the 2005 Act's amendment to Section 365(d)(4),[5] debtors no longer have the time to make a meaningful decision either to assume or reject an unexpired lease. Where there used to be years, now, without the consent of the landlord, the maximum time is 210 days from the order for relief – the initial 120 days provided by Section 365(d)(4)(A) and the possible additional 90 days provided by Section 365(d)(4)(B). Any extension of time past the 210 days will require the consent of the landlord; which, in turn, will most like require the payment of a "consent fee." Of

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[1] United States Bankruptcy Court for the District of Delaware Case Number 99-02261. I thank Susan Seabury, Director, BDO Consulting, a division of BDO Seidman, LLP, for her research in support of this witness statement.

[2] Revised Disclosure Statement for Revised First Amended Consolidated Plan of Liquidation, *In re Hechinger Investment Company of Delaware, et. al,* Case Number 99-02261, United States Bankruptcy Court for the District of Delaware, page 22.

[3] United States Bankruptcy Court for the District of Delaware Case Number 00-4667.

[4] *In re Montgomery Ward, LLC et. al.*, Motion for Order Under 11 U.S.C. §§ 105, 365(d)(4) and Fed. R. Bankr. P. 9006 (I) Authorizing Extension of time Within which Debtors May Assume or Reject Unexpired Leases of Nonresidential Real Property and (II) approving Extension of Kimsward, LLC's Designation Rights, Docket Number 2577, p. 5.

[5] §365(d)

(4)(A) ~~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~~ 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 ~~such~~ 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 120 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 120- 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.

course, in fact, the 210-day period is often shorter because of the need to consider and potentially conduct a going out of business (GOB) sale as an alternative to a rehabilitation of the debtor.

Professor Ken Klee suggests one other possible outcome – retail debtors with a significant number of leases will simply refuse to file voluntary petitions during slower periods and will instead wait to be forced into involuntary cases. The "gap period" created by the involuntary case will create additional time to analyze the leases during periods of greater sales activity but may also impose greater uncertainty and business risk.[6]

As discussed above, the 2005 Act imposes serious limitations on the time debtors-in-possession have to analyze leases and determine which ones should be assumed and which ones rejected. Inevitably, less time has lead to one of three outcomes: (1) some leases that should be assumed and/or assumed and assigned have been rejected; (2) some leases that should be rejected have been assumed; and (3) some leases that are assumed and assigned have been assigned for less than they would bring if more time were available for marketing after the lease analysis had been completed.

1. The "Consent Fee" and Other Concessions

There is, however, a fourth option – obtain the consent of the landlord so that the time can be extended past the 210 days specified in Section 365(d)(4). However, landlords are unlikely to consent without cost to the estate. To gain the landlord's consent to extend the assumption/ rejection period, the debtor will be forced to pay the landlord some sort of "consent fee" or make some other form of concession. To the extent that these other concessions limit the ability of the debtor to assign the lease to the highest bidder (*i.e.*, to gain consent, the landlord requires the debtor to assign the contract, if at all, to an entity that will operate a specific type or types of establishment therein.), obtaining this consent will be detrimental to the debtor's estate and the other unsecured creditors.

2. Premature Assumption Leads to Bigger Administrative Expenses

What happens if the landlord is unwilling to give consent for a reasonable price? In these cases, the debtor will be forced to make a premature decision. If that decision is to assume a lease which must later be rejected, there is a significant price to pay. While acknowledging authority to the contrary, *Nostas Assoc. v. Costich (In re Klein Sleep Products, Inc.)*[7] held that any damages arising from the rejection of a previously assumed nonresidential real property lease were entitled to administrative expense priority.[8] Further, in *Klein Sleep*, the Second Circuit also determined that the limitations on damages specified by Section 502(b)(6) are inapplicable to such damages[9] Thus, if a debtor prematurely assumed a nonresidential real property lease, the administrative expense related thereto could conceivably consume the entire estate.[10]

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[6] Klee, Kenneth N., *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 Business BankruptcyAmendments*,www.ktbslaw.com/publications/Business%20Bankruptcy%20Amendments202005.PDF.
[7] 78 F.3d 18 (2nd Cir. 1996).
[8] *Id.* at 28. (See also *In re Baldwin Rental Centers, Inc.*, 228 B.R. 504, 511-512 (Bankr. S.D. Ga. 1998) for a collection of cases so holding.)
[9] *Id.* at 30.
[10] Note, the provisions relating to the priority of rejection damages related to all executory contracts, not just nonresidential real property leases, however, in most cases, the costs of later rejection of an assumed contract or personal property lease are not usually as devastating.

The 2005 Act's amendment of Section 503(b) followed *Klein Sleep* to the extent that it provided some administrative expense for the damages arising from leases that are assumed and later rejected, but overruled that portion which excepted these damages from all caps.[11] Under Section 503(b)(7), as amended by the 2005 Act, the landlord will be entitled to rents for two years at non-penalty rates from the date of rejection or turnover, which ever is later, less and rents actually received from another entity during that period. All other damages fall under Section 502(b)(6), and are thus subject to the limitations contained therein.

Perhaps an example would be helpful. Suppose debtor, Retail Nightmares, files for Chapter 11 and assumes a nonresidential real property lease for one of its stores. Further suppose that the debtor is in year three of a ten year lease which requires it to pay $10,000 per month. At the time of the filing it was in arrears for one month, but cured that deficiency when it assumed the lease on day 90 of its case. However, things have not gone as anticipated for Retail Nightmares and now they are going to liquidate under Chapter 11 rather than try to reorganize. Retail Nightmares vacates the property and then, on the lease anniversary date, rejects the lease with exactly six years remaining. Finally, assume that after 18 months, the landlord is able to release the property at the rate of $9,000 per month. What are Landlord's damages?

Administrative Expense Under Section 503(b)(7) of the Bankruptcy Code:

2 years worth of lease payments: (10,000*2*12):	$ 240,000.00
Less Six months worth of mitigation rent (10,000*6):	$ (60,000.00)
	$ 180,000.00

Unsecured Claim Under Section 502(b)(6) of the Bankruptcy Code:[12]

The Greater of one years rents: (10,000*12):	**$ 120,000.00**	
and the lesser of:		
(i) 15% of the remaining lease rents (10,0000*12*6*.15):	**$ 108,000.00**	
and (ii) Three years rents (10,000*12*3):	$ 360,000.00	
		$ 120,000.00

Strictly following the guidelines set by *Klein Sleep*, Landlords damages, without the cap provisions specified in Section 503(b)(7) as amended by the 2005 Act, would have been treated

[11] 11 U.S.C.A. § 503(b)(7) provides:

> with respect to a nonresidential real property lease previously assumed under Section 365, and subsequently rejected, a sum equal to all monetary obligations due, excluding those arising from or relating to a failure to operate or a penalty provision, for the period of 2 years following the later of the rejection date or the date of actual turnover of the premises, without reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor, and the claim for remaining sums due for the balance of the term of the lease shall be a claim under Section 502(b)(6);

[12] Note, *In re PPI Enterprises, Inc.*, 324 F.3d 197, 208 (3rd Cir. 2003) in footnote 17, the Third Circuit states:

> The landlord retains a duty to mitigate the tenant's breach, but any mitigation of damages secured by reletting the premises will offset only the landlord's overall potential recovery, and does not affect the § 502(b)(6) cap. The "overwhelming majority of courts" have held that the § 502(b)(6) statutory cap is not reduced by any amount a landlord has received by reletting the leased premises and mitigating its damages. *5th Ave. Jewelers,* 203 B.R. at 381; *see also In re Atl. Container Corp.*, 133 B.R. 980, 990 (Bankr.N.D.Ill.1991).

as a $720,000 administrative expense. While the limitation on the administrative expense could be seen as a loss, the clear recognition of the fact that this situation, which is likely to occur more often after the 2005 Act, entitles the landlord to an administrative expense not capped by Section 502(b)(6), makes these provisions a draw at worst for the landlord.

B. Period of Exclusivity

Along with the period to analyze leases, the period in which the debtor has the exclusive right to propose a plan has also been tightened, which may cause the debtor to contemplate an exit strategy earlier in the case. The legislative history prior to the 2005 Act shows that "[e]xclusivity is intended to promote an environment in which the debtor's business may be rehabilitated and a consensual plan may be negotiated."[13] This seems to be an acknowledgement that it takes time for the debtor to determine how a case will shake out and negotiate with differing constituencies the terms of a plan. It also seems to be an acknowledgement of the fact that competing plans cause dissention and cause the cost of the process to spiral upward exponentially.

The questions is, then, how big an impact does limiting the period in which only the debtor can propose a plan (the "Exclusivity Period") to a maximum of 18 months have? Again, looking at *Montgomery Ward,* the docket and certain documents reveal that plans were filed by two competing groups – the creditors' committee on one hand and the debtors and their secured creditor on the other. The condensed timeline looks as follows:

Date	Docket Number	Description
12/28/2000		Petition Date;
04/11/2001	1060	Motion filed by the debtors to extend 120 "exclusivity" period provided by Section 1121(b) pursuant to the provisions of Section 1121(d);
04/27/2001	1217	Initial period 120 day period specified by Section 1121(b) set to expire – extended by order of the court until October 29, 2001;
10/05/2001	2126	Motion filed by the debtors to extend the "exclusivity" period - seeking an extension until February 28, 2002; (while the docket does not appear to show objections to this motion, the "bridge order" states that the secured lender and the creditor's committee each sought additional time to consider the motion.)
10/25/2001	2219	Order entered – the "bridge order" extending the "exclusivity" period until a hearing on November 8, 2001;
11/08/2001		Exclusivity period appears not to have been extended;
01/16/2001	2549	Joint plan filed by debtors and secured lender
01/24/2001	2582	Competing plan filed by creditor's committee
02/15/2002	2750	Amended plan filed by creditor's committee
03/04/2002	2885	Amended joint plan filed by debtors and secured lender

[13] H.R.Rep. No. 103-835, at 36 (1994), reprinted in 1994 U.S.C.C.A.N. 3340, 3344.

04/24/2002	3203	Supplement to plan filed by secured lender
04/30/2002	3227	Second amended plan filed by creditor's committee
05/01/2002	3244	Order approving disclosure statement for plan amended – 3203
05/06/2002	3257	Third amended plan filed by creditor's committee
05/06/02	3277	Order approving disclosure statement for plan as supplemented 3257
05/08/2002	3304	Amended Order approving disclosure statement for plan 3257
7/11/2002	3498	Supplement to third amended plan (3257) filed by creditor's committee
8/6/2002	3593	Order confirming third amended plan (3257)

At the end of the day, the debtors' exclusive period was approximately 315 days long, but no plan was proposed within that period. The debtor, along with its secured creditor did propose a plan, which was amended or supplemented twice. The creditors' committee proposed the competing plan, which was eventually confirmed, but not before being amended three times and supplemented on top of that. In this case, the cap on the Exclusivity Period imposed by the 2005 Act would have been of no impact – the plan that was eventually confirmed was proposed within 16 months and confirmed within 19. Therefore, it is possible, even in a contentious case, to propose a plan within the 18 month, and have it confirmed within the 20 month, period mandated by Section 1121(d) as amended by the 2005 Act.

But will it become more difficult to meet the 18-month deadline? Many constituencies in retail bankruptcy cases have concluded that it is more difficult to move to a consensual plan and may provide a disincentive to certain parties in interest in seeking a consensual plan so that such parties may propose their own plan. Moreover, additional time in a bankruptcy case would allow a greater opportunity to obtain exit financing, a difficult task at the present time when the financial systems are dysfunctional.

C. <u>Goods Sold in the Days Before the Petition Date</u>

1. Reclamation Rights

The Bankruptcy Code incorporates the state law and Uniform Commercial Code right of a seller of goods to reclaim those goods through the inclusion of section 546(c) which provides:

> (1) Except as provided in subsection (d) of this section and in section 507 (c), and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee under sections 544 (a), 545, 547, and 549 are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the date of the commencement of a case under this title, but such seller may not reclaim such goods unless such seller demands in writing reclamation of such goods—

(A) not later than 45 days after the date of receipt of such goods by the debtor; or

(B) not later than 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.

(2) If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503 (b)(9).[14]

Timing is a key issue when making a reclamation demand. However, reclamation under section 546(c) of the Bankruptcy Code is rarely an issue, as most debtors have asset based financing which provides a prior perfected lien on most goods such that the right of reclamation is rendered moot.[15] Thus, while many creditors still go through the motions of reclamation, it rarely produces results.

2. 503(b)(9) Administrative Expenses

On the other hand, the inclusion of a new section 503(b)(9), gives vendors supplying goods in the 20 days before the petition is filed significantly more power. This section states:

(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502 (f) of this title, including— …

(9) the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.[16]

The series of decisions in *In re Plastech Engineered Products, Inc.*, provides a wealth of information on how at least one court views this provision. The first decision, "*Plastech I*",[17] begins by summarizing the previous decisions on this provision stating that both *In re Global Home Products, LLC*,[18] and *In re Bookbinder's Restaurant, Inc.*,[19] the courts determined that the allowance of a claim under 503(b)(9) does not give an unqualified right to immediate payment. Further, other than as of the effective date of the chapter 11 plan, payment of administrative expenses is left to the discretion of the court. In determining when the payment should be made, the court in *Global Home* determined that it should consider three factors:

1. The prejudice to the debtor of making the payment;

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[14] 11 U.S.C. § 546(c).
[15] There was some thought that the changes to this provision made by BAPCPA somehow created a federal right of reclamation different from the UCC and state law, but at least one court has found otherwise. See, *In re Dana Corp.*, 367 BR 409 (Bankr. S.D.N.Y. 2007).
[16] 11 U.S.C. § 503(b)(9).
[17] 394 B.R. 147 (Bankr. E.D. Mich. 2006) decided on September 16, 2008.
[18] 2006 WL 3791955 (Bankr. D. Del. Dec. 21., 2006)
[19] 2006 WL 3858020 (Bankr. E.D. Pa. Dec. 28, 2006)

2. The hardship on the administrative expense holder of not making the payment; and

3. The potential detriment to other parties in the case (i.e. how would the cash drain impact the ongoing operations of the debtor).[20]

There, the court denied the motion seeking immediate payment. It would seem that filing a motion seeking such a payment may be a way to cause the court to: (a) direct the payment; (b) direct the debtor to determine if the case is administratively solvent; and/or (c) convert the case to chapter 7.

The court in *Plastech I* then addressed the question at hand, which was the interplay of section 501 which governs the filing of claims; section 502 which governs the allowance of claims; and section 503 administrative expenses. Specifically, the question was whether section 502(d) of the Bankruptcy Code which provides for the disallowance of a claim filed under section 501 of the Bankruptcy Code due to the failure to repay an allegedly preferential transfer under section 547 of the Bankruptcy Code apply to section 503(b)(9) administrative expenses. Noting that no other court had ruled on the matter, the court reviewed decisions on the question of whether section 502(d) applies to section 503(b) in general and noted a split in the circuits. The court found that section 502(d) did not apply to section 503(b)(9) for a variety of reasons, most importantly:

1. The court agreed with the line of cases finding that section 502(d) was not applicable to section 503, rather 502(d) only applied to claims filed under section 501 and allowed under section 502;

2. Requests for administrative expenses, including 503(b)(9) are not filed under section 501 but rather under section 503(a); and

3. Determining that 502(d) did apply to section 503(b)(9) violates statutory rules of construction.[21]

The second decision in the *In re Plastech Engineered Products, Inc., et al.* ("*Plastech II*") case involving section 503(b)(9) is an unpublished decision dated October 7, 2008.[22] This decision determined the question of whether the goods in question had to be received by the debtor, or simply the value of the goods. The court stated: "In the Court's view, the word *received* modifies the word *goods* and not the *value* that must be received by the debtor to trigger § 503(b)(9)."[23] Thus, the goods in question must actually be received by the debtors to give rise to the claim under section 503(b)(9). This line of reasoning is cited heavily in *In re Goodys' Family Clothing, Inc.*[24]

[20] *Global Home*, 2006 WL 3791955 at *4.
[21] *Plastech I*, 394 B.R. at 161-64.
[22] 2008 WL 5223014.
[23] *Id.* at *2.
[24] 2009 WL 294384 (Bankr. D. Del. 2009)

The third decision in this case is dated December 10, 2008 ("*Plastech III*")[25] This decision provided several important points. First, the UCC definition of goods applies to section 503(b)(9) such that there is no claim for services provided.[26] The court cited favorably to *In re Samaritan Alliance,*[27] which provided that electricity is more in the form of a service and does not give rise to a 503(b)(9) expense and *In re Deer*[28] which also consulted the UCC to determine the definition of goods when determining if advertising was a good or a service.[29]

Second, *Plastech III* states that the predominate purpose test used in some instances to determine if a contract was for goods or services is not applicable to section 503(b)(9). Where an entity provides both goods and services, it is entitled to section 503(b)(9) treatment for the goods provided, but not the services in a bifurcated manner, unlike the "winner take all" result of the predominate purpose test.[30]

Finally, *Plastech III* states that the goods need not be reclaimable (i.e. identifiable, still in the hands of the debtor, in their original state, and not subject to a superior lien) to give rise to section 503(b)(9) treatment. The court states: "...there is nothing in § 503(b)(9) that requires a claimant to be also be entitled to a reclamation right under § 546. Section 546 does not limit or control in any way the rights that a claimant has under § 503(b)(9)"[31]

The decision of *In re Brown & Cole Stores, LLC*[32] filed on August 17, 2007 addressed a different set of questions. Specifically, whether the creditor needed to be unsecured to be entitled to section 503(b)(9) treatment and whether the 503(b)(9) expense's prepetition nature possessed the requisite mutuality for setoff purposes with regard to alleged prepetition breach of contract claim against the holder of the section 503(b)(9) expense. There, the court determined that the provision of goods on a wholly secured basis can give rise to a section 503(b)(9) expense. In answer to the debtors contention that this was unfair to other creditors, the court stated: "...if AGI's twenty-day sales claim is fully secured, then payment of it by B&C will free the value of the security for that claim for the benefit of other creditors. If AGI's claim proves to be undersecured or unsecured, then to deny administrative priority would be to ignore the statute, something we cannot do." [33] The court then noted that there was mutuality under the test set forth in *Biggs v. Stovin (In re Luz Int'l, Ltd.)*[34] which states:

1. The debtor owes the creditor a prepetition debt;
2. the creditor owes the debtor a prepetition debt;

[25] 397 B.R. 828 (Bankr. E.D. Mich. 2008)
[26] *Id.* at 835-6.
[27] 2008 WL 2520107 (Bankr. E.D. Ky. June 20, 2008)
[28] No. 06-02460, slip op. at 2 (Bankr. S.D. Miss. June 14, 2007)
[29] See Also *In re Goodys' Family Clothing, Inc.*, 2009 WL 294384 (Bankr. D. Del. Feb. 6, 2009)
[30] *Plastech III*, 397 B.R. at 837.
[31] 397 B.R. at 838.
[32] 375 B.R. 873 (9th Cir. BAP 2007).
[33] 375 B.R. at 878.
[34] 219 B.R. 837 (9th Cir. BAP 1998).

3. the debts are mutual.[35]

Since both the potential breach of contract claim and the sale giving rise to the 503(b)(9) expense were prepetition, setoff was available.[36] The court went on to note, however, that the issue was premature because the debtor simply alleged a breach of contract claim and had not filed a contested matter or an adversary proceeding to determine those rights. Until the right to payment from the creditor was established, there was nothing to setoff against.[37]

The creation of a new *per se* administrative expense priority for what has in the past been presumptively an unsecured claim has taken a toll in retail bankruptcy cases. Debtors must account for and pay over in cash these claims at some point in the bankruptcy process. This favored treatment drags down cash flow at a point in the life of a business when liquidity is king.

III. Conclusion

As shown by cases both before and after enactment of BAPCPA, the 2005 law has made it more difficult for businesses to reorganize in chapter 11. Thank you again for the opportunity to appear today. Please do not hesitate to call upon me or the ABI if we can be of further assistance on this or any other bankruptcy policy issue.

[35] 219 B.R. at 843-44.
[36] 375 B.R. at 879-80.
[37] 375 B.R. at 880-881.A

Mr. COHEN. Thank you, Mr. Williams. I appreciate your testimony.

We have got—those buzzers didn't mean somebody else went into bankruptcy. It probably happened, but it meant we need to vote. We have got 11 minutes.

Well, I think we have got time—if I could do my questioning, if the panel doesn't mind, then we can leave 6 minutes, and we will have time to go. So if we can start with the questioning. And I will start and recognize myself.

Mr. Miller, are you still with us? Mr. Miller?

Mr. MILLER. Yes, sir.

Mr. COHEN. Thank you. I didn't know if you had taken a siesta or not.

If Circuit City had filed before the 2005 amendments went into effect, would it have been able to successfully reorganize?

Mr. MILLER. That, sir, is a difficult question. Let me make this comment——

Mr. COHEN. That is why I asked you.

Mr. MILLER. Here, you have a situation in the environment, where, in 1978, when the code was adopted, it contained many provisions which were intended to induce debtors to go into Chapter 11 before it became too late, when there was nothing left to reorganize.

In Chapter Three of the bankruptcy code, you have these administrative provisions like the automatic stay, the ability to sell lease property, use collateral security, and, 364, to allow DIP financing.

The issue which arose even before 2005, and from 2003 to 2008, was that bankruptcy had become an unattractive thing for a company to reorganize in. It became the last possible resort. And the 2005 amendments made it even worse.

So companies stayed out of Chapter 11, and they tried to survive outside of Chapter 11. With all their secured debt, going into Chapter 11, very often, meant they were going to end up in liquidation anyway. So the issue would have been: When would Circuit City have made the decision to go into bankruptcy, when it had the resources to survive in a bankruptcy?

The bankruptcy code was intended to give a debtor a reasonable opportunity for the courts to determine, for the creditors to determine, whether there was a possibility of reorganization. And that depends on when you go in.

Unfortunately, because of all the clawbacks, i.e. special interest amendments, starting with the amendments in 1984, and many of them in favor of the real estate lobby, bankruptcy reorganization became less and less attractive.

In the case of Circuit City, because of the liens on the inventory, the seasonal nature of retailing, the decision would have been a decision that would have had to be made by that corporation, at a point in time when it had more resources and more ability to survive a Chapter 11. In large fashion, that would have been dependent upon the ability to get the DIP financing, which is critical.

Now, Professor Zywicki referred to the Montgomery Ward store. That is one store out of—I think Montgomery Ward had at least 200 or 300 department stores. It employed thousands and thousands of people. It was being financed by the General Electric Company.

The effort that was being made in Montgomery Ward saved jobs for a long time. It was not a futile effort. The company actually did come out of one Chapter 11.

So the decision to file or not to file is a very critical one, based upon the ability—could you survive? As the environment of Chapter 11 has become more hostile, and the balance which Professor Zywicki referred to—the balance between the debtors' protections and the creditors' rights, which was affected in 1978, long after 1984, became skewed in favor of creditors. So that affects the decision-making.

I think if Circuit City had filed much earlier, it would have had a much better chance of survival. I don't think, with very rare exceptions, there has been a successful retail reorganization, since the beginning of 2008.

Essentially, every retail chain that has gone in, starting, I think, with Sharper Image, in February of 2008, has ended up in a liquidation, with the possible exception of Boscov's, where the family bought the company out.

Mr. COHEN. So, Mister——

Mr. MILLER. So that decision has to be dependent upon: "What resources do we have? What kind of financing do we have?"

You have to recognize companies don't go into Chapter 11 because they are financially vibrant. They need time to get back to financial vibrance, if we are going to have a reorganization policy in our law.

Mr. COHEN. We are about to run out of time here, and have to go vote.

Let me ask you this quickly, if you can: This economy we are in, particularly in regard to Chapter 11—are the 2005 amendments effectively hurting our country's ability to keep people employed, in jobs, and get out of this recession?

Mr. MILLER. In my opinion, Mr. Chairman, absolutely. It has just skewed the balance so much in favor of the secured creditors, that no company—I will tell you very frankly: CEOs will say to me, "I don't want to be seen with you, and I am not going into bankruptcy. I can't survive in the environment of bankruptcy."

So these companies wait too long. There is not enough asset left—free assets—with which to reorganize. This is exactly what Congress was looking at in 1975, 1976 and 1977—"How do we get companies to file before it is too late?" And we have taken away those protections.

Mr. COHEN. Thank you, sir. My time has expired, and we have 5 minutes and 30 seconds to get to the floor.

If you and the other witnesses would remain available for questions when we return from voting, which should be approximately, maybe, 25 minutes—and, in the intermittent 25 minutes, if the five panelists would come up with a model bill, we would appreciate it.

We are in recess.

[Recess.]

Mr. COHEN. We don't have any Republican Members here yet, and they are next in line for questioning. I think we should wait until at least one of them returns.

Mr. Franks was making a statement, a 1-minute, and he didn't know when he was going to get a chance to make that 1-minute. And he said it might affect an election in South America. I would be very interested in hearing his 1-minute.

And, then, Mr. Issa was going to be back shortly. So we will wait for Mr. Issa and let him have questions first.

Meanwhile, have you got your bill together?

Done? Good. Good.

Mr. Miller, are you there?

Mr. MILLER. Yes, sir.

Mr. COHEN. Thank you, sir. We will get going in a few minutes. Thank you.

We are back and convened for questions.

And I now would like to recognize the honorable gentleman from Southern California, Mr. Issa, for his 5 minutes of questions.

Mr. ISSA. Thank you, Mr. Chairman.

I must first say that I am not without some conflict as to Circuit City. They were a customer of mine from the mid 1980's. And my former company enjoyed hundreds of millions of dollars in business with them, and—right up until the very end.

Having said that, it also allows me to see that the very end had been inevitable for a very long time. And to that end, I have a couple of questions, because this is more about bankruptcy than about anything else.

But I want to, first, say one more thing, which is: I don't think there was any saving of Circuit City. I don't think any shrewd investor would have saved a substantial portion of it, given their holdings, the indivisibility and the historic level of traffic.

So having said that, I would like to go to a round of questioning that is more real estate appropriate.

Mr. Hurwitz, now, you are the largest owner, I understand, or one of the largest owners of the real estate from Circuit City. Is that correct?

Mr. HURWITZ. That is correct, sir.

Mr. ISSA. In order to understand the bankruptcy and the conversations that have been made here, I want to phrase a couple of questions. First of all, would you have been helped or hurt from a more protracted Chapter 11 period for Circuit City, in your opinion?

Mr. HURWITZ. We would have been significantly hurt by a more protracted bankruptcy proceeding for Circuit City, primarily because everyone knew, as you just mentioned, sir, that Circuit City was not going to survive. And it would have been death by a thousand cuts for us to sit through a process whereby people were pursuing, really, a folly for trying to prop up a company that had failed.

And in so doing, it would have significantly hurt the value of our shopping centers, and significantly impacted negatively the business viability of the tenants that are in our shopping centers that didn't have any direction on what was going to ultimately happen to that box.

So it makes leasing vacant space very, very difficult. And it doesn't drive any business to the shopping center when you are a failed retailer, like Circuit City was, or is. And so a protracted process would have been very damaging to our company.

Mr. ISSA. Well and to that extent, my understanding is when Circuit City made the decision quite a few years ago to give up white goods—washers, dryers, refrigerators and the like—that drove a lot of traffic through the stores—that impacted the traffic not just to Circuit City, but to the entire centers that you owned that they were in. Isn't that correct?

Mr. HURWITZ. That is correct, sir.

And if you look at the difference, for example, in our shopping centers, between a Best Buy that has white goods, and a Circuit City that didn't, the difference in volume per square foot in Best Buy was double that of Circuit City. And a lot of that had to do with the mix of the merchandise.

Mr. ISSA. Now, because we are talking bankruptcy, and I want to understand this, you have had many years in real estate as a head of a REIT and so on. My understanding—you have seen it before the 2005 changes, and after.

Tell us what you think is the single biggest difference for you, as the holder of an asset which they get to keep if they want, they get to get rid of, if they want, in Chapter 11, and you have no choice but to wait for their ultimate end of lease. How was it different before and after 2005, for you?

Mr. HURWITZ. Well, the biggest difference between before and after 2005 is the fact that we have, as landlords, a seat at the table, and we are engaged in conversation with retailers far in advance of a bankruptcy filing.

For really the first time, with the 2005 amendments, we are able to engage our retailers, listen to what they have to say. They have to listen to what we have to say. And more importantly, the retailer is being forced to plan much more in advance.

One of the things that people, I think, have to remember is that bankruptcy is a process. It is not an event. You don't wake up one morning and decide to file bankruptcy. We were having conversations with Circuit City 18 months before they decided to file. And we had conversations with Circuit City right on through the process.

Had we not had a seat at the table, which was afforded to us by the 2005 amendments, we would not have been in that position, and really would not have been able and willing to help Circuit City, even though they were beyond hope at that point.

Mr. ISSA. Well, Mr. Zywicki, how do you feel? Because this is an area that some would like to reverse—that this, before and after 2005, would impact other similar landlords and creditors.

Mr. ZYWICKI. I think that Mr. Hurwitz hits the nail on the head, which is that 210 days is just the outer limits. Most bankruptcies are gradual. You engage in a lot of planning before that.

And as I mentioned earlier, one of the whole purposes of the 2005 amendments was to increase the amount of planning that goes into bankruptcy. I mean, we have to keep in mind that bankruptcy is not a cheap process. They are going to come up with—lawyers are going to charge over $1 billion in the Lehman Brothers' bankruptcy—$1 billion for lawyers and bankers, right?

When these cases go into bankruptcy, we are talking about tens or hundreds of millions of dollars of lawyers and accountants and bankers. And what the 2005 amendments were trying to do, as Mr. Hurwitz said, was not just have these things go into bankruptcy, and let everything go all over the place, and let the chips fall where they may, but to negotiate things ahead of time.

As you said, there is plenty of time in most of these situations, when a debtor knows they are going to have to file bankruptcy. They can negotiate things out ahead of time and, thereby, reduce the amount of disruption and uncertainty when they actually do file bankruptcy.

So I think that once you take that into account, it makes for a much smoother and more predictable process in the same way that increasing the administrative claims for vendors gets rid of the uncertainty and—of the critical-vendor process, which was just, you know, catch as catch can—whether of not you could get on the critical-vendor list—not saving any money. All you were doing was just making it a completely chaotic and unpredictable process. For now, at least you know what the rules are.

I can understand why they had a critical-vendor list, which was to try to get vendors to deal with a retailer that was in trouble. That is why they invented the doctorate. All 503(b)(9) did was make it better and make it more predictable, I think. And I think, if we get rid of 503(b)(9), then we are going to go right back into that world of whether or not you can engage in critical-vendor transactions, and whether Kmart was correctly decided, and all those different sorts of questions.

Mr. ISSA. Thank you.

And thank you for your indulgence, Mr. Chairman.

Mr. COHEN. Thank you, sir. I appreciate it.

Now, I would like to recognize the Ranking Member, and, possibly, the savior of South America, Mr. Franks.

Mr. FRANKS. Well, thank you, Mr. Chairman. I hope I can be as effective here, and we can save Western civilization, here, if we work at it.

Mr. Chairman, I know that, oftentimes, you know, our economy is—the conservatives make the argument that the free markets are critical to its survival. And I think there is some consensus in that regard.

But I think that we forget that there is an even more important element than competition in our economy, to hone it and to make it efficient and effective, and that is the word "trust." That, when people make agreements with other entities within the society, that it is important to keep their promises. Otherwise the investor or those who are willing to go out and put themselves at risk to try to make a productive element of our economy—are less willing to do so.

So I think that is an important premise to be laid. And I hope that that is a central consideration in the discussion today.

With that, I thought the Chairman asked a very pertinent and intelligent question to Mr. Miller, which, essentially asked, you know, "What would have happened, had the 2005 amendments to the bankruptcy—Chapter 11 code—what would have happened to Circuit City, had those things not been in place?"

Mr. Zywicki, with your permission, could you give me some perspective of what you think? Would Circuit City have done better if we hadn't changed the code in 2005?

Mr. ZYWICKI. The end result would have been the same. I think it is almost certainly—it would have been the same. It would have just been a much more expensive, painful process that would have injured a lot of other people.

I think Mr. Hurwitz said it perfectly. The uncertainty that it would create while we sat around and watched the downward spiral of Circuit City, and the damage it would do to vendors, to other tenants, to landlords, to employees—would have really been, I think, a real shame.

And I think the writing was on the wall. I think it was inevitable. In this economy, it is just not a great economy to be in the business of selling big-screen TVs on credit. I think we have lived through the experience of people buying big-screen TVs they couldn't afford. And I don't think that is what the near future looks like.

The economy is bad. What we know is a lot of businesses were propped up by cheap access to credit, who probably should have disappeared a few years ago. Consumers were living beyond their means, buying discretionary, high-end electronic goods they couldn't afford. They had incompetent management—by all indications, just terrible business decisions. Bankruptcy can't fix incompetent management.

There were changes in the market, as we talked about. Foot traffic was going down precipitously. And there is no reason to think that was going to be reversed, when you look at the rise of online selling. And consumers are going to become much more price-conscious. If they are going to buy electronic goods, more and more, it is going to be online.

A lack of vendor confidence, and the final bottom line that we talk about was just a lack of available DIP credit. The reason why the terms were so onerous was because the lenders are in trouble. Circuit City was in trouble.

And, yes, they are—by all indications, there is a reduction in DIP lending out there. The reduction in DIP lending, though, is just because of the problems in the credit markets.

So I think it was inevitable. It was just a matter of whether or not we were going to allow—keep this company on life support for a year or two, and allow it to pull down everybody else with it—or whether or not we were going to do what we did.

And, Mr. Hurwitz, I am sure, would vouch that if Circuit City was a company worth saving, they would be more than happy to negotiate an extension of the deadline, if they think that that is the best tenants for their particular location, in any given mall. That is an option. It is not 210 days. It is 210-day, unless they agree to an extension.

So I think this was probably the right thing at the right time.

Mr. FRANKS. Well, thank you, Mr. Chairman.

Not to belabor the point, but when business entities make an agreement with each other, you know, the end result, hopefully, is productivity. And it is so easy for us to forget—and especially in the challenging times that we face—that the monetary system is merely to facilitate that productivity; and, that, in the absence of creating a system that ultimately results in the best productivity possible, we are getting less than the best that we can out of the economy.

So, with that in mind, I just think that the person who has kept their part of the bargain in any agreement—that there should be, you know, a tendency to favor them in the bankruptcy proceedings. And there is a balance, and I don't know where it is sometimes, but the bottom line is, if we miss that, then we undermine our entire system.

So with that, I am going to ask a last question to Mr. Zywicki.

You note the downturn in the Chapter 11 organizations began before the 2005 Bankruptcy Act. Do you think that if we repeal those today, that that downturn would be reversed? And, perhaps, I would pass that along to Mr. Hurwitz, if he is inclined, as well.

Mr. ZYWICKI. I can't see that it could possibly make any difference, because there are—what it does is it expedites the process. What it does is it helps resolve companies that are likely to fail. But I can't see that it could have any impact on companies that are likely to reorganize. What we save in the process is a couple tens or hundreds of millions of dollars of lawyers' fees, but—and maybe those are the jobs that we are trying to preserve, here.

But I think that, in the end—I just don't think that the amendments can be said to have had any real impact in this case or the other case.

Mr. HURWITZ. I agree. I think that the amendments are helpful in the sense and, in fact, I know that this won't be a popular comment, but I think that the 210 days, in a tougher economy, should be shorter, not longer, because I think you need to bring people to the table.

You don't have the luxury of time. You are sitting with your vendors, and their clock is ticking. You are sitting with the landlords, your clock is ticking. Certainly, the employees have a right to know what their future is going to be. And we know there is no real capital out there to keep this business afloat.

Now, there are a lot of ways that we can address that issue, if we believe in the business plan. See, at the end of the day, this is a retail business. And the consumer votes every day with its dollar. And the American people are smart. And they voted this company out of business a long, long time ago—long before they even entered into bankruptcy, quite frankly.

So I think that the 2005 amendments would not have been—if they were not there, would not have been able to save any of the tenants, quite frankly, that we are currently looking at now, that are liquidating.

Mr. FRANKS. Well, thank you, Mr. Chairman.

Thank you, gentlemen.

Thank you for allowing me to save South America. I appreciate it.

Mr. COHEN. You are welcome. Thank you. Thank you, Mr. Franks.

We will have a second round.

Mr. Hurwitz, there have been companies that have gone into Chapter 11 in the past, prior to 2005, in particular, that have come out of it strong, right? So would you have said that the voters—the consumers were the voters, and they voted them out of business then, and somehow they came back to life? They were resurrected?

Because, you know, if—under the current law, a lot of those businesses that were brought back to health through Chapter 11, under this present 2005 amendments, they probably would have just been voted off the island. I think you represented Mr. Trump—or somebody did, here—and they would have been voted out of the—you know, not made the ground—or whatever that game show is.

Mr. HURWITZ. I think, Mr. Chairman, the difference between those companies that survive and those companies that fail is if they have a reason to be.

For example, prior to 2005, if you look at the Macy's bankruptcy, clearly Macy's had too much debt. They had over-leveraged the company. But they were outstanding merchants. They were outstanding merchants, and they ran a very, very good business, and were an important part of the American retail fabric.

So when they went into bankruptcy, there was no question that the industry rallied to bring Macy's out of bankruptcy, because they had a purpose.

With due respect to Mr. Miller's comments about Montgomery Ward, they came out and failed because they were lousy merchants.

Mr. COHEN. Let me ask you this: How many leases did you have of Circuit City?

Mr. HURWITZ. Fifty.

Mr. COHEN. And how many of those did you lease to a new tenant within the next 6 months?

Mr. HURWITZ. Well, we don't have them back yet, sir, because they are still doing their liquidation.

Mr. COHEN. Are they?

Mr. HURWITZ. So the answer is zero.

Mr. COHEN. Do you have any leases for when they finish their liquidations?

Mr. HURWITZ. We have letters of intent that we are working on, but we have no executed leases right now in the——

Mr. COHEN. How many letters of intent do you have?

Mr. HURWITZ. About six or seven of the 50.

Mr. COHEN. So, at some point, you might have six or seven of—occupancies?

Mr. HURWITZ. That is correct.

Mr. COHEN. Might it had been better if Circuit City could have survived, or something similar to Circuit City, through Chapter 11? And, at least, while they might have been reorganizing and on life support—that you had at least had 50 tenants?

Mr. HURWITZ. No, sir, because——

Mr. COHEN. You don't think so?

Mr. HURWITZ [continuing]. I think it would have—speaking to Professor Zywicki's point, which—it just delays the inevitable. It was a poorly-run organization that had no reason to be.

Mr. COHEN. And that may not be the best example.

Mr. Pachulski, the younger——

Mr. RICHARD PACHULSKI. Thank you.

Mr. COHEN. You are welcome, sir.

Do you believe there are businesses that went through a reorganization prior to 2005 in Chapter 11 that could not have—would not have survived under the laws—with the amendments of 2005?

Mr. RICHARD PACHULSKI. Absolutely. Absolutely, Mr. Chairman.

Mr. COHEN. What are the different provisions in the 2005 law that, looking at the economy in 2009, do you believe should be changed to keep American jobs?

Mr. RICHARD PACHULSKI. Well, Mr. Chairman, just to give an example—and I do want to address something that Professor Zywicki said in response to your question.

I actually did a survey within our firm of how many companies would likely have reorganized if 503(b)(9) did not exist after 2005, versus how many of them would have survived pre-2005. And just within our firm, there are seven companies that could not reorganize because their 503(b)(9) administrative claims were dramatically too high. It was impossible.

And even if there was enough money to pay the 503(b)(9) claims, you couldn't prove feasibility under a plan, because there was no money to pay for capital expenditures, labor upgrades or other necessary expenses. And my experience is probably no different than others.

In fact, Mr. Chairman, what I find is troubling about Professor Zywicki's testimony is I don't believe the legislative history of Section 503(b)(9) actually addresses critical-vendor status. And the reason it doesn't is it didn't change it.

So let me give you, Mr. Chairman, a piece of information that was absolutely public in the Circuit City case, because I actually know a lot about it, both publicly and not publicly. And I will provide the public information.

But most of the vendors in that case—and I certainly understood it—not only wanted their Section 503(b)(9) claims, they wanted critical-vendor status. So not only did you have a $215 million problem or $350 million problem, you still had critical-vendor status.

BAPCPA did not get rid of critical-vendor status. Cases today still have critical-vendor status. So this concept that somehow the 2005 amendments had anything to do with that is, frankly, preposterous. And the concept—which, I must say, I take some offense—that somehow this was done to keep Circuit City alive to promote professional fees, your honor—I apologize—Mr. Chairman, nine out of 10 of our firm's largest-fee cases in its 26-year history—nine out of 10 were liquidations.

Professionals make more on liquidations. Our firm will make more on the Circuit City liquidation than it would have made on a reorganization. Those are facts. It will happen in Lehman Brothers. It happened in Enron. It will happen in other cases.

But this concept that somehow 503(b)(9) settled the critical-vendor status isn't the case whatsoever. And what you effectively did is took one group of unsecured creditors and preferred them over other groups.

If someone provides services within 20 days, they are not given that status. If I give unsecured credit during the 20 days, a bank loan, they don't get that same priority. One group of parties has received the priority which helps certain vendors in certain cases, and hurts them in other cases.

But the fact of the matter is, Mr. Chairman, there is no doubt that Section 503(b)(9) has had a detrimental effect on reorganizations, and will continue. I know there is a lot of histrionics about the 210-day period. And, frankly, in Circuit City, it was not an issue. It probably will be issues in other retailers. It was not in Circuit City because we never got far enough for that to be an issue, because the banks put the squeeze, because they knew a reorganization was impossible.

And answering Mr. Miller—what Mr. Miller was asked—having lived it, while I don't think Circuit City could have been reorganized as a whole, I think if there had been additionally time, potentially, there would have been pieces of it that actually would have survived. And I think the landlords and the vendors would have appreciated a going concern business, in all fairness.

So the simple answer is yes, Mr. Chairman. In direct response to your question, the fact that—what may have made sense in 2005, in a better economy absolutely does not make sense in today's economy, particularly with Section 503(b)(9). It is death to retailers on Day One, just because certain vendors will get priority over other unsecured creditors.

And the critical-vendor status is with us, will be with us forever. It is not gone, not withstanding what Professor Zywicki said.

Mr. COHEN. With Mr. Franks' indulgence, I want to follow up. One of the witnesses had some statistics—and I don't recall which—in their testimony, as far as how many retail bankruptcies there have been—retailers.

Who was that? Was that—Professor?

Mr. WILLIAMS. Yes, I did have a number.

Mr. COHEN. Yes. How many professional retail bankruptcies were there?

Mr. WILLIAMS. Well, all I counted, at this point, were major retailers——

Mr. COHEN. All right.

Mr. WILLIAMS [continuing]. That had filed.

There are a lot of very small outfits with one, two, three, four stores that wouldn't be in these numbers. For calendar year 2009, which is just a couple of months now, we have had eight major retailers that have filed for bankruptcy.

And calendar year 2008, major retail filings were at 27. And that is the largest number since 2001, where we had 32 major retail bankruptcy filings.

As I pointed out, of the 27 major retailers that filed in 2008, 30 percent of the—37 percent of those filings took place in the fourth quarter of 2008, which is—that is the Christmas season, which is typically the quarter in which as much as 50 percent or more of revenues will be generated. That was an unusual number and an unusual time, that a retailer would file.

Mr. COHEN. Do you expect more bankruptcies in the retail sector in this coming year?

Mr. WILLIAMS. Absolutely. Our research at the ABI would support that we don't see any turnaround in 2009, involving retail. Bankruptcy filings, themselves, are a lagging economic indicator.

Typically, the economy will begin to turn before the bankruptcy numbers start to flatten out. For retail bankruptcy, we estimate close to a 50 percent or more increase in bankruptcy filings.

Mr. COHEN. And do you have any recommendations for this Subcommittee, on what this Subcommittee could suggest or propose in the way of changes to the bankruptcy law, to help the economy, based on the number of retail bankruptcies we foresee?

Mr. WILLIAMS. Yes, I do.

Again, I think a number of the panelists have pointed this out. The 2005 amendments made sense in a system or an economy that was good. But a bankruptcy system has to pass the test, both in good times and in bad times. We are in bad times.

This is a weak economy, and consumer demand is down. The consumer interface is most directly with the retail sector, and we don't expect an increase in revenue—an increase in margins or anything of that nature, in the short term.

And what we are looking for—what I would suggest is taking a look at the 2005 amendments and, first, addressing the liquidity hit that the 503(b)(9) claims take, because cash is the lifeblood of any successful reorganization.

So a revisiting of that, and simply taking us back to the pre-2005 era, I think, would be a major step in preparing a system that, when the economy begins to turn, can provide the type of flexibility and adaptability that will allow a greater success as far as retailers are concerned—that keeps customers—that is, the retailer itself—in business. It keeps their vendors in business. It preserves an employer. It preserves a state and local tax base, as well as a tax base for Federal taxes as well.

It can certainly be, with the changes that have been suggested here, an excellent system for addressing the needs that we are going to see, both in short and long term.

And I think one other thing you have to keep in mind is that the 2005 amendments created a bankruptcy code—a system, if you will—that is unpalatable for business, because of, among other things, a direct hit on cash, the concern about the limitation on lease extensions, the utilities issue that Mr. Pachulski pointed out, as well as the period of exclusivity and its limitations.

Consequently, as Mr. Miller pointed out, businesses aren't seeking bankruptcy relief at a time when we can make a better go of it. Bankruptcy is not only the—it is a last resort for a carcass, for a zombie business. And making bankruptcy unpalatable helps no one in that situation.

Mr. COHEN. Thank you, sir.

Mr. Hurwitz or Professor Zywicki, do either of you differ—not so much on the 210-day rule, but—and Mr. Zywicki is going to the buzzer quickly—he knows the answer—to what Professor Williams or Mr. Pachulski has said, other than the fact that lawyers shouldn't go first?

Not for Goody's Family Clothing, Inc.

Mr. ZYWICKI [continuing]. And on the business side.

But at the same time, what we see are companies, like Wal-Mart, who have been struggling the past few years—really, they have been struggling—companies like Wal-Mart and that sort of thing are going to be growing, just like Target grew to replace Montgomery Ward's.

So I think we need to be careful about thinking that the way we have things now is the only way to have it, when it has been sustained on cheap credit by both consumers and businesses.

Mr. COHEN. And let me ask you this—and this is for the—Mr. Pachulski, Isaac Pachulski, did have some statements of some retailers in his testimony.

I don't know these retailers. But let me guess, Professor Zywicki, that K.B. Toys, Inc., Goody's Family Clothing, Inc., Against All Odds USA, Inc., S&K Famous Brands, Inc., are not exactly Bergdorf's.

Mr. ZYWICKI. I have not studied—I don't know whether they had management problems in those companies. I know a lot of them did.

All I am saying is that, yes, we are going to have retailer casualties in the next few years. If we want to focus on a problem, let us focus on problems in the credit market. And, maybe, there are possibilities that DIP financing is not as available as it should be.

But, I think, to sort of go off on this wild-goose chase that somehow the 2005 amendments are the problem here—I think is going to—is not going to make any difference at all in sorting out these——

Mr. COHEN. Thank you, sir.

If the Ranking Member doesn't mind, if somebody wants to make a comment, I would appreciate it.

Mr. MILLER. Hi, Mr. Chairman. It is Harvey Miller.

Mr. COHEN. Yes, sir.

Mr. MILLER. May I say something?

Mr. COHEN. Please.

Mr. MILLER. References were made to the Macy's case, and that Macy's had great merchandising when it went into Chapter 11. Having represented Macy's in that case, at the beginning of that case, that was not true at all.

But the point I want to make is that neither Macy's nor Federated department Stores were the two biggest retail department stores at that time—could have survived in a Chapter 11 with the 2005 amendments.

First, there was enormous opposition from landlords in those cases. The cases went well beyond 210 days. The amendments that were made in 2005 would have severely restricted the ability of either one of those chains to survive and come out of Chapter 11, employing thousands of people, and still be in business today, as a consolidated unit.

In addition, the 503(b)(9) 20-day rule for goods—as other speakers have pointed out, has not solved the critical-vendor situation. A key to the critical-vendor situation is the debtor-in-possession saying to the vendor, "Yes, you are critical to me, but I am not going to make you a critical vendor unless you give me the best credit terms that I had before Chapter 11." You don't get that out of 503(b)(9). All 503(b)(9) does is give you an obstacle to confirmation.

The same is true with Section 366, with the utility department. Here we are, a company which is cash-starved, that has to turn around—and a retail chain normally has many utility companies it deals with, and has to place deposits all over the country, if it is a big retail chain, which takes away operating capital, in a situation where, for all kinds of reasons, we have a difficulty in getting debtor-in-possession financing. So it makes the ability to reorganize and rehabilitate a company very, very difficult.

Unfortunately, I think we have a bad example with Circuit City, because, as a number of speakers have pointed out, because of its narrow product—merchandise-inventory line, and the changes that it made—it may have been preordained.

But if you looked at Circuit City—and we are talking about landlords—long before it ever filed for Chapter 11, it had probably more than 200 non-productive, or closed stores. And, for years, it was paying rent on closed stores—many millions of dollars.

Every effort that the company made at that time to get concessions from landlords fell on deaf ears. So this process before a filing, to smooth the way in, sometimes doesn't work.

If Circuit City had filed 3 years ago, with those 200-odd stores that were unproductive or closed, they could have rejected those leases. They could have organized around a core universe of stores. And, as Mr. Pachulski pointed out, there might have been a core company that came out, that had a basis for rehabilitation.

Once we got into 2005, that became almost impossible, and we not only had to think in terms of the debtor, but the lender, who has the lien on the inventory, and what it is thinking about, and its desire to convert that inventory into proceeds of cash that will satisfy it.

The other aspect of it is the prohibitive expense of debtor-in-possession financing—notwithstanding what Professor Zywicki says—sometimes it exceeds the legal fees. Also there has to be some examination, some review, as to how, in a society which is based upon credit—how are we to deal with failure—we have to have an escape valve when there is a downturn in the economy, where there are companies that need assistance and help, to rehabilitate.

Either we have a goal of rehabilitation, or, as I think Professor Zywicki would like, a very speedy process, where all these companies get liquidated. That is the issue we have. Are we going to have a process that assists and supports rehabilitation, saves jobs, particularly in this kind of an economy, or are we going to have this process where, within 60 days, most of these cases—if it has any kind of liquid collateral—ends up with the secured creditor pushing the company into liquidation, sometimes, in coordination with the landlords.

But I thank you, Mr. Chairman.

Mr. COHEN. Thank you—appreciate your remarks.

Now, I would like to yield to the Ranking Member, Mr. Franks.

Mr. FRANKS. Well, thank you, Mr. Chairman.

Professor Zywicki, with all due respect to your fellow panel members, your name has been taken in vain here, pretty profusely. And I wanted to give you a chance to respond in any direction you would like to, here to begin with.

Mr. ZYWICKI. Well, thank you. Thanks for that opportunity.

First, I just want to say I am not in favor of speedy liquidations in every case. What I am in favor of is a process that winnows companies that are in financial distress, and can be fixed and live to fight another day, from those that cannot. And with those that cannot, I think that those are ones that we should have a speedy liquidation so that we don't have to bear the cost and delay and uncertainty associated with that.

I believe that the code had been tilted too far in one direction prior to the 2005 amendments. Father Robert Drinan, for instance, when he was in Congress, voting on the 1978 act, referred to it at the time as, "the full-employment bill for lawyers." And it was a litigation process that was very heavily tilted toward the debtor.

And all the things we have talked about—the greater secured-creditor control—all those sorts of things were ad hoc attempts to try to rebalance it. The 2005 amendments, I think, were an effort to try to rebalance the statute to do it.

Second, with respect to critical vendors and 503(b)(9), I acknowledge that there are still judges out there, and vendors, who want even more. And it would be good if the judges would tell them, "No." 503(b)(9), as I understand it, was an effort to try to get rid of all that critical-vendor rigmarole, and the unfair treatment that arose under it.

And so maybe it didn't. But the answer, I think, is to get out of the critical-vendor game at this point, because I think that what it was trying to do is, by and large, satisfied in a more fair and efficient way by 503(b)(9).

Mr. FRANKS. Well, thank you, sir.

Mr. Hurwitz, other than, you know, the bankruptcy-law changes, do you think there are other things that government could do to implement—they could implement that would lead to more reorganizations, rather than liquidations?

Mr. HURWITZ. I do.

I think, particularly, in this environment—and I know this is something that you keep hearing from everybody that sits before you—but the availability of capital is key.

I happen to agree, for example, with what Mr. Miller said, about Macy's coming out of liquidation today, because they could never have gotten the capital to come out—I mean coming out of bankruptcy—they never would have gotten the capital to come out of bankruptcy today.

In 2006, they would have. They would have come out of bankruptcy. They would have been just fine. In 2008, 2009, it is very doubtful, because of the lack of liquidity in the market.

I think, as a practical matter, there does need to be a look—and I do agree—at some of the fees that are charged at these bankruptcy proceedings, because, at the end of the day, the employees and the operating company, and the debtor, is severely limited in what it could do, because of the enormous amount of fees that are paid to professionals throughout the entire process.

But where we are today, and where we sit today, I think it is very tough to say who would or wouldn't come out of bankruptcy, when there is no liquidity in the market. And there is no liquidity for the operator, and there is no liquidity for the vendor, either, because the vendor has lenders that are also putting the tight squeeze on the vendor.

So there really is no place to go, and we put ourselves, due to a lack of liquidity, in this box.

Mr. FRANKS. Well, I think you make a lot of sense.

If a lack of DIP financing was a main issue in the Circuit City case, are there things that government could do to free up that financing? And I will just throw this out to you, first, Mr. Hurwitz, and, then, Mr. Zywicki and anybody else who wants to take a shot at it.

Should we make TARP funds available for something like that?

Mr. HURWITZ. I don't think we should. I don't think we should, because, at the end of the day, when you look at who should or shouldn't survive, it is an analysis of a business plan.

It really could, and has been, in the past—and Montgomery Ward is a great example—throwing very, very good money after bad. And that business plan really should be made by the professionals who are closest to the industry; and that is, certainly, the vendors; the lenders who study retail on a day-to-day basis; the landlords who do business and see what the traffic counts are, and see what the sales volumes are, and see what the trends are in that retailer.

And as a practical matter, I think it would force the government to be in a position where it has to make the judgment as to who is and who is not a good merchant. And I don't think that is the business the government wants to be in.

Mr. FRANKS. Well, some of us have been making that point for a long time.

Mr. Zywicki?

Mr. ZYWICKI. I would disagree a little bit, which is it seems to me that a reasonable case—I will let you decide whether you should do it—but a reasonable case could be made for something like making TARP funds available for DIP lending.

And the logic is—we are on about the 14th iteration of explanations for what the TARP is supposed to do—but from what I recall, the initial explanation was to deal with liquidity problems in the banking sector, which is not, you know, propping up the zombie, dead banks, but, basically, to deal with the situation of liquidity problems, and allowing healthy banks to lend.

And that is what is going on in the DIP market in the—or potentially could be going on in some of these cases. It is not what is going on in Circuit City.

But take an example—in December, I wrote a column in the Wall Street Journal where I criticized the bailout of General Motors and called for—that Chapter 11 was the right way to resolve the General Motors bankruptcy.

And their response was, "Well, there is no DIP funds out there." And that could be true, but I think that illustrates the point, which is that if General Motors liquidated, it would be because they couldn't get DIP financing. And the only reason they couldn't get DIP financing would be because of a liquidity problem.

Obviously, there is a healthy business there to be reorganized. So if you think of that stylized example, this is a situation where, clearly, a business that has core value could potentially fail because of lack of DIP lending. That is clearly—to my mind, at least, that is a liquidity problem that would be appropriate for something like

TARP funds, in some sort of way, to be used to help get us over that hump, if that makes sense.

Mr. FRANKS. Thank you, Mr. Chairman.

Mr. COHEN. Thank you.

Mr. Zywicki, do you see any problems with the 2005 law at all?

Mr. ZYWICKI. When it comes to this question, to the Chapter 11 questions? Not that I can think of, from the standpoint that it was—again, it was an attempt to balance certain aspects of the system.

So the issues we are talking about today, I am very satisfied with the balance that was struck on the issues that we have talked about today.

I will confess: I haven't thought that much about utility payments, for instance. So I would have to get back to you on the question——

Mr. COHEN. Has the system changed, though? I mean, hasn't the system changed drastically in the last 4 years, with the number of creditors and debtors, and the amount of bankruptcies, and the threat to our economy?

So, shouldn't the balance, the fulcrum, have to move some to make it a balance?

Mr. ZYWICKI. No. The law was rebalanced. And I believe that it moved the law in a productive direction. And so the economic circumstances have changed, but I think that the law is set up to deal with this particular situation.

What we are dealing with are macroeconomic problems in an economy that has been afloat on cheap credit for too long. And trying to keep that rising tide of cheap credit alive, I don't think makes any sense.

And so I think, to the extent that the law helps us—that the law, in general, helps the situation that were—or it certainly doesn't hurt the situation that we are in.

So I would say no, with respect to the issues we have discussed. I think that the balance now is pretty much right.

Mr. COHEN. Does anybody disagree with that thinking—that the change of circumstances moves the balance point?

Mr. MILLER. Yes, sir—Harvey Miller, again.

I would disagree with that contention.

Professor Altman has recently—from the NYU Business School—recently issued a report on default rates. And he noted that, for 2009, the consensus default rate for high-yield debt is going to be an average rate of 13.63 percent. That is a very high default rate, considering that in 2008, it was 4.6 percent. And in 2007, it was 0.51 percent.

We are going to see a lot of defaults in retailing, and in other industries, at the rate we are going.

The lack of capital and the prohibitive cost of a DIP financing—just think of what other speakers have said about how much it cost Circuit City to get $100 million—or less than $100 million—of new money.

There is a system today, in DIP financing, where the pre-Chapter 11 secured creditor rolls up the old debt into a new DIP financing. And, then, all of the charges in connection with that DIP financing are taking on the whole debt.

So in the case of Circuit City—I may be off by some dollars—there was almost $900 million outstanding, pre-petition. Facially, there was $1.1 billion DIP financing. All the fees were based on $1,100,000,000, when there was only $100 million or less in new financing.

So when you hear the fees that were—that had to be paid by Circuit City—the amount of new real money that it got was minimal. There was no chance for Circuit City to survive.

If you have a credit-intensive society, as I said before, you have to have some means to deal with default. And the needle has to move when you are in an economy that is as bad as this economy.

The 2005 amendments passed after a period of a robust economy, when the volume of Chapter 11 cases was declining every year. It may have been the fault of too much credit, which was, I think, sponsored, to a large extent, by financial institutions. But, now, we have moved into a different economy. We have to see what the Nation needs.

Is there a virtue to rehabilitation and reorganization? If there is, the use of TARP funds to create a facility, where you could borrow money at reasonable rates and reasonable fees is necessary. The criteria for such financing would not be, "Is this going to be a successful Chapter 11?" but, "Is it a sound loan?" Will it give a debtor a reasonable opportunity to determine whether there is a core business there that can be reorganized, that can benefit the economy?

We are going into a deep tailspin. I hope it is not going to be a period with a capital "D" in front of it, but there has to be some recognition that there are going to be a lot of businesses that are going to be in difficulty. They may be good businesses.

Should they have a reasonable opportunity to try and reorganize? Should the Federal law help them in that respect? And I think, if we can find some way where a DIP facility can be arranged or—supported—I think the example that Professor Zywicki gave, in connection with General Motors, is a very good one.

It would be not a question of underwriting the success of a reorganization, but giving the opportunity to all of the parties to determine, "Is there something here that should be reorganized?" You cannot make that determination in 60 days. That is one of the real difficulties we confront.

I don't know what we can do about the fees that are now being charged. I mean, banks and hedge funds and insurance companies who do DIP financing—they are charging, basically, 1,000 basis points above LIBOR, with a floor on LIBOR of 3 percent.

So you are talking about 13 percent. When you factor in all of the charges and fees, in many of these cases, the interest rate is, effectively, 18 percent or 20 percent.

Well, you can't run a business on that basis. It is impossible. Meanwhile, those organizations, if they are banks—what are they paying for the cost of their money? Probably less than a half a point. The argument that they use in court is, "Well, that is market for a company that is risky."

Well, if you are in Chapter 11, you are automatically deemed to be a risk. But that situation substantially decreases the possibility of reorganization. And when you put on top of that the utility deposits, the 503(b)(9), the 210-day limitation, you are—you are making it a situation in which the possibility of reorganization is slim and none.

That is what we have to face up to. We have to face up to whether we want to have a Federal statute which is going to assist and enhance the ability to reorganize companies in a very bad economy. Thank you.

Mr. COHEN. You are welcome. I appreciate it.

And I would now like to yield to the Ranking Member.

Mr. FRANKS. Well, Mr. Chairman, thank you.

And I guess I would start out by saying the minority would stipulate that if a company's in bankruptcy, that they, perhaps, could be considered a credit risk.

But having said that, you know, landowners can go bankrupt, too. And if we institute greater flexibility for judges to decide when retail debtors must accept or reject their stores' leases, won't that, potentially, take us back to a time when we had, you know, the "ghost" term—or "ghost tenants" that we have talked about?

And what standards would we use to guide a judge's discretion? And what would we insist upon to make sure landlords weren't, again, treated unfairly by the code? I mean, how do we balance that?

I mean, I would suggest that, you know, what we are trying to do, here, is to create both a desire and a fear on both sides to do anything but to analyze this situation very carefully, and to do as Mr. Zywicki said, and that is to ascertain which companies are viable and which are not.

And those that are—to do everything possible to bring them back to sound operations; and those that are not viable, to do everything possible to minimize their damage, both to the creditors and to the economy at large.

So, with that said, how would we guide the judges' discretion if we gave them the flexibility to decide when the stores, and the landowners have to accept one another's terms.

Mr. Hurwitz, I will give you a shot at that.

Mr. HURWITZ. Well, I am probably the least qualified person to answer that question, because, you know, we, as an industry, felt very victimized by judicial discretion in the past. And the 210-day amendment was done to try to give us some more room to be part of the process.

But, again, I will defer to the more scholarly members of the panel. But I would add that I think anything that requires all the vested and interested parties to meet and discuss it, and sit down and talk about it, is the most important component you can have in a bankruptcy today.

And anything that does not require that to happen, or excludes one of the major participants who have a vested interest in the outcome of the event, would be a mistake, and would be imprudent.

Mr. FRANKS. Well, listen, Mr. Chairman—is there anyone else that wanted to take a shot at it? All right.

Well, listen, I just wanted to thank the Chairman for his indulgence here. I would just, perhaps, just close on the thought that, ultimately, you know, bankruptcy is something that kind of has a connotation of a bad word to any one of us in business. And it is a heartbreak for anybody to have to face that.

And so there are no judgments on my part that would diminish anyone in the circumstance. But we do have to recognize that the Congress is not able to repeal the laws of mathematics here, though we try on a regular basis, and that reality always has to be remembered, and will have the last word.

And so I think that it is important that we try to inject as much predictability into the system as possible. I believe that the amendments of 2005 helped the predictability element of it, and that we do everything that we can to create an environment where, as Mr. Hurwitz said—that everyone gets a chance to sit at the table, and to make their position known, and to make sure that we create, if at all possible, a win-win situation for everyone, and where everyone has some significant investment in the process of losing, as well.

And with that, I thank the Chairman.

I thank all of you.

And I hope we can come up with the right answers, and not go backwards, instead of forward. Thank you.

Mr. COHEN. I would like to thank all the witnesses for their testimony today. And I would like for them to know that since they started testifying, the Dow went up 60 points. Accordingly, if you will come back for the next 99 days—without objection, Members will have 5 legislative days to submit any additional written questions, which we will forward to the witnesses and ask they answer as promptly as they can, and be made part of the record.

Also, without objection, the record will remain open for 5 legislative days for the submission of any other additional materials.

I thank everyone for their time and patience.

The witnesses, and, Mr. Miller, as witness, by telephone—I thank each one for their time and patience.

This hearing of the Subcommittee on Commercial and Administrative Law is adjourned.

[Whereupon, at 4:43 p.m., the Subcommittee was adjourned.]

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

PREPARED STATEMENT OF THE HONORABLE JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN, CHAIRMAN, COMMITTEE ON THE JUDICIARY, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

Last Sunday, Circuit City, one of the Nation's largest retailers, finally shuttered its remaining stores and laid off approximately 34,000 employees. It did this notwithstanding the fact that the company had only recently filed for bankruptcy protection under Chapter 11, a form of bankruptcy relief originally enacted to help businesses reorganize their debts and retain jobs.

Unfortunately, Circuit City's demise in Chapter 11 is not unique. As we heard at a hearing held last September before this Subcommittee, recent experience suggests that Chapter 11 of the Bankruptcy Code may not working for our Nation's companies.

As many of you know, Chapter 11 was amended in several significant respects in 2005. I'd like to mention three aspects of Chapter 11 that we may want to revisit given the current economic climate.

First, we should consider whether Chapter 11 needs a major overhaul to address developments that may have weakened its ability to promote successful reorganizations in the 21st Century. These developments include the growing trend for businesses to be highly leveraged and the increasing use of state law to make assets "bankruptcy-remote," both of which deprive debtors of essential funding sources.

It is critical to our Nation's economy and our workforce that we ensure that Chapter 11 works to save businesses and to save jobs, as it was originally intended to do.

Second, we should consider whether the 2005 amendment imposing a hard and fast deadline by which retailers must decide to retain their leases is forcing businesses to liquidate rather than reorganize.

The purpose of Chapter 11 is to give a debtor a financial breathing spell so that the company can assess its ability to reorganize and propose a plan for economic rehabilitation.

Since the enactment of this amendment, however, very few retailers have successfully emerged from Chapter 11.

One contributing cause appears to be that the deadline for retaining or rejecting a lease may not provide enough flexibility for companies to reorganize in light of their unique business cycles. And, this has, in turn, caused lenders to restrict credit access to Chapter 11 debtors.

I must say that I am not surprised by the problems this provision has engendered. My colleagues on this side of the aisle and I repeatedly expressed serious concerns about this deadline over the seven years it was under consideration.

As a representative from the AFL-CIO presciently testified in 2001 before this Subcommittee, this provision is "designed to encourage liquidation which will necessarily lead to job loss."

Third, we must also scrutinize whether the 2005 amendments impose too many cash demands on a business in financial distress. As a result of these amendments, a Chapter 11 debtor must be prepared to make various cash outlays.

For example, the debtor must pay vendors in cash for inventory received *prior* to the filing of the bankruptcy case during a stated time period.

In addition, the debtor must provide utility service providers with "adequate assurance of payment"—in essence—a cash deposit. This requirement pertains even if the debtor never missed a single payment to the utility before filing for bankruptcy.

For a debtor in financial distress, these additional cash demands may be the proverbial straw that breaks the camel's back.

LETTER DATED MARCH 11, 2009, FROM MALLORY B. DUNCAN, SENIOR VICE PRESIDENT, GENERAL COUNSEL, THE NATIONAL RETAIL FEDERATION

National Retail Federation®
The Voice of Retail Worldwide

March 11, 2009

The Honorable Stephen Cohen
Chairman
Subcommittee on Commercial and Administrative Law
U.S. House of Representatives
1005 Longworth House Office Building
Washington, DC 20515

Dear Chairman Cohen:

On behalf of the retail industry and the millions of workers our members employ, the National Retail Federation urges the subcommittee to reconsider recent changes to the executory contract provisions of bankruptcy law. As now written, the law limits the bankruptcy court's discretion to the point that it has become more difficult for retailers to successfully emerge from Chapter 11. For businesses and workers, the consequences of this change are devastating.

From the sales floor to the executive suite, one in every five U.S. workers is employed in the retail industry. At anytime, but particularly during times of economic stress, preserving those businesses and jobs is important.

Prior to the 2005 bankruptcy amendments, retailers selected which leases to cancel or extend, and the time period within which to do so, subject to the court's discretion. However, in 2005 landlords overreached. They sought to increase their financial leverage by obtaining an amendment that effectively gave them the power to dictate the terms of retail reorganizations, rather than the judge. Their amendment put a 210 day cap on bankruptcy judges' ability to determine whether leases could be extended or rejected. From that date forward, no reorganization could proceed except under conditions dictated by the landlords. As we saw recently in the case of Circuit City, landlords' demands trumped flexibility, financing and jobs.

Ordinarily, bankruptcy provides the breathing room to revitalize stressed companies. When a retailer with multiple locations seeks to reorganize, it must thoroughly examine its operations, develop a new plan in conjunction with its creditors, determine which stores are most likely to be profitable, and close those that are not. The plan must then be tested. Although the precise period varies from company to company, most merchants make the largest portion of their earnings in a relatively few months of the year, often around the holidays. For a reorganization plan to be realistically vetted, it must be tested during that critical period. If at the end of the test

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period the plan proves successful, underperforming leases are canceled, performing leases are extended and the retailer emerges from Chapter 11 with its business and often tens of thousands of jobs intact. Landlords, of course, continued to be paid throughout this process.

But by greatly shortening the time period, and removing the court's discretion, the new law inadvertently dooms reorganizations to failure. Congress can solve this problem by amending the code back to its pre-2005 standard, or at a minimum, by extending the 210 day period beyond 365 days, so that there is time for both the planning and the testing of retail plans that Chapter 11 so clearly envisioned.

Thank you for considering our views, we look forward to working closely with the subcommittee to address this serious flaw in the new law.

Sincerely,

Mallory B. Duncan
Senior Vice President, General Counsel

RESPONSE TO POST-HEARING QUESTIONS FROM HARVEY R. MILLER, WEIL, GOTSHAL & MANGES, LLP

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on "Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?"
Wednesday, March 11, 2009

<u>**Harvey R. Miller, Esq., Weil, Gotshal & Manges LLP**</u>

Questions from the Honorable Steve Cohen, Chairman

1. **If Circuit City filed before the 2005 Amendments went into effect, would it have been able to successfully reorganize?**

   Assuming that the financial condition of Circuit City was the same in October, 2005 as it was in November, 2008, it would have been difficult for Circuit City to successfully reorganize because of the extent of secured debt outstanding. As I have previously noted, the dynamics of chapter 11 reorganization cases have changed since the November, 1979 effective date of the Bankruptcy Code. The major players in the reorganization scenario have shifted from unsecured creditors to secured creditors.

   Accordingly, unless Circuit City was able to refinance its outstanding secured debt or persuade the Bank of America to extend reasonable debtor-in-possession financing, or obtain the right to use cash collateral, the ability to operate the business would have been severely impaired. Nonetheless, Circuit City would have had a better chance of pursuing reorganization if it did not have to confront the 210 day limitation on the power to assume or reject unexpired leases of nonresidential real property. That limitation acts as a catalyst for secured creditors deciding to press liquidation so that the encumbered inventories can be sold in the retail store locations before they have to be vacated. Without that catalyst, the secured creditors may be more amenable to giving a retail business a more fulsome opportunity to attempt to reorganize. The proximity of the retailer's best season, Christmas, would have enabled a business such as Circuit City the ability to demonstrate that its business plan has within it the seeds of a reorganization.

   Unfortunately, Circuit City in 2008 was far down the road to liquidation. It had failed to adequately confront its real estate problems and had continued to maintain unproductive and closed stores. In addition, it was basically a single-product retailer, i.e., electronics, confronted by very severe competitors such as Best Buy and Wal-Mart. In that perspective, Circuit City may have deferred the need to seek formal restructuring and reorganization at an earlier date because of the 2005 amendments. Those amendments moved the needle in favor of creditors and has made chapter 11 an undesirable environment for distressed businesses.

2. As someone who has practiced bankruptcy law for 50 years, it is a very dramatic claim for you to say that Chapter 11 "is not a process in which a debtor and creditors work together to rehabilitate a debtor."

Isn't that the very purpose of Chapter 11?

As enacted in 1978, chapter 11 contemplated a dynamic pursuant to which the debtor and a creditors' committee would meet and act in a rational manner based upon the economics of the case to affect a rehabilitation and reorganization of a debtor. It was premised upon the fact that in most cases prior to 1978, the largest creditor constituency often was trade creditors who had a desire for the distressed entity to be rehabilitated and continue as a customer. It was also the age of relationship banking. In today's environment with the emergence and predominance of secured creditors, distressed debt traders, and in large cases, the holders of Credit Default Swaps, often creditors no longer have the view that rehabilitation and reorganization is desirable. Such creditors are much more concerned about immediate or more expeditious recoveries and not a continuation of an ongoing business. The opaque Credit Default Swaps conceal who holds such instruments and what benefits the holders of such instruments attain by forcing defaults and the resulting liquidations.

The unsecured creditors' committee may not be the focal point of the reorganization case, as the value of the assets may not exceed the claims of the secured creditors. Further, the debtor's leverage, as well as that of the debtor-in-possession, has been stripped by Bankruptcy Code amendments or court decisions that restrict the assumption of certain forms of executory contracts, as well as the limitations in respect of shopping center leases, etc.

A review of the retail cases commenced since the early part of 2008, starting with The Sharper Image Corporation, illustrates the short life that a retailer has under the current form of chapter 11. Generally, operations are forced to terminate within the first 60 days of the chapter 11 case. The creditors' committees really do not have a voice in that decision, which is compelled by the secured creditors.

In addition to the change in the chapter 11 dynamics, in the current economic circumstances a debtor-in-possession is unable to obtain sufficient financing to meet its operational needs. Even if financing is obtained, the cost and conditions are prohibitive. The general interest rate for debtor-in-possession financing currently approximates 20%, and may get more expensive even though debtor-in-possession financing is relatively safe and afforded the highest administrative expense priority, and is fully collaterally secured. If this problem in reorganization is not cured by the creation of a government-sponsored facility such as a Reconstruction Finance Corporation that will provide financing to chapter 11 distressed companies at reasonable rates and conditions, few chapter 11 cases will be successful. Those will only be the cases in which the existing secured creditors cannot easily convert their collateral security into cash.

3. Do you think the 2005 Amendments to Chapter 11 are playing any role in our Nation's current economic situation?

Yes. The effect of the 2005 amendments and the changing dynamics of chapter 11 have caused distressed companies to defer any decision to seek relief under the Bankruptcy Code. This is a situation that prevailed under the former Bankruptcy Act. Distressed companies waited too long to seek reorganization and by the time they sought such relief, there was nothing left to reorganize.

As a result, the 1978 Bankruptcy Code attempted to balance the playing field by providing protections for debtors, as well as rights of creditors. The administrative powers enacted as part of Subchapter IV of Chapter 3 (Case Administration) under Chapter 3 of the Bankruptcy Code provided for: the automatic stay; use, sale or lease of property; the ability to incur credit and borrow monies; to assume or reject executory contracts and unexpired leases; and to deal with utilities (§§362-366) and are representative of the types of provisions that Congress enacted to induce distressed companies to seek formal reorganization knowing that the onset of bankruptcy would not result in immediate liquidation. As the legislative history of the Bankruptcy Reform Act of 1978 shows, a specific purpose of that legislation was to make the reorganization process more rational and predicated on the principle that a debtor should have a reasonable opportunity within which to pursue rehabilitation and reorganization.

4. Why has the debtor in possession become marginalized and why has creditor control of the reorganization process iucreased so exponentially?

As stated in the answer to question 1, the chapter 11 dynamics have changed because of the way in which business is now conducted. Debtor/creditor relationships have been largely diminished. We function in a global market. Many businesses purchase raw materials or finished goods from foreign suppliers and vendors. Most often those transactions are financed by letters of credit. They often result in another layer of secured creditors and, most often, the letter of credit issuer requires the debtor to post collateral security before a letter of credit will be issued. Consolidations and mergers have contracted the supplier chain. The consequence is the debtor has no alternative or leverage to oppose overly oppressive terms.

The ability of the debtor-in-possession to assume certain types of executory contracts and unexpired leases of nonresidential real property have been contracted and limited, e.g. shopping center leases, the enlargement of the class of non-assignable contracts which has been interpreted by various courts to mean that the contracts cannot be assumed.

In addition, secured creditors often require a debtor to engage a Chief Restructuring Officer. In effect, that person is almost a *de facto* trustee and its loyalties may be divided and more inclined to the creditor constituency responsible for its appointment.

Finally, bankruptcy courts have tended to become more receptive to the positions taken by creditors as opposed to actions which the debtor/debtor-in-possession might wish to pursue for the purpose of rehabilitation. The argument is always made that the creditors own the debtor's business and continued operations to effect a rehabilitation will diminish creditor recoveries. Combined with the changing dynamic, the debtor-in-possession is often standing alone with no support in a more creditor-oriented bankruptcy court.

5. Why do you think Congress as "responded generously to the 'needs'" of special interest groups in granting more protections to creditors in Chapter 11 cases?

This is a difficult question. My answer is that debtors are a distinct minority and do not have an organized association that may promote or influence the making of legislation. The political system is such that Congress responds to its constituents. Generally, debtors neither represent a constituency nor are able to deliver a block of votes.

A history of bankruptcy law reveals that remedial bankruptcy legislation is most often enacted during or immediately after a financial panic. It is a reaction by Congress to the need to protect the national interests rather than just catering to any particular special interest group. In that context, it is more objective and predicated on the nation's best interests.

As a result, during periods of prosperity and of a robust economy, history reflects that bankruptcy laws are either repealed or amended to meet the desires of well-financed and effective special interest groups.

6. Macy's, the ubiquitous department store, is celebrating its 100 year anniversary this year. In 1992, at the end of a significant economic downturn, albeit less severe than the current crisis, Macy's filed for chapter 11. Macy's continued to exist under bankruptcy protection for over 2 years before Federated Department Stores purchased the retailer. At the time of filing, Macy's employed over 69,000 Americans.

If Macy's filed for Chapter 11 bankruptcy relief today, what is the likelihood that it would be forced to liquidate like Circuit City?

Assuming that Macy's is in the same financial condition that it was in 1992, it is most likely that a Macy's case under the current version of chapter 11 would be unsuccessful. At the time of the 1992 chapter 11 case, Macy's was suffering from severe illiquidity, an inability to adequately stock its stores, and a multitude of oppressive real property leases. Macy's needed time to restructure its organization, eliminate unproductive stores, revamp its financial systems and establish its viability. The time limitations in connection with §§365 and 1121 of the Bankruptcy Code, respectively, as to assumption and rejection of unexpired leases of nonresidential real property, and exclusivity, would have seriously impaired the ability of Macy's to successfully rehabilitate itself. The process took more than 18 months and the decisions as to store locations more than 210 days.

Macy's was successful in rehabilitating itself and becoming an attractive merger partner for Federated Department Stores, Inc. because it had the protection of the Bankruptcy Code and a bankruptcy court that exercised its discretion to extend exclusivity over the objections of various creditor constituencies.

It is doubtful that that same level of protection could be attained for Macy's under the 2005 amendments and the erosion in debtor protections that has occurred over the various amendments that have been made to the 1978 Bankruptcy Code since its enactment.

7. **In your prepared statement you note how globalization has led to a retail industry standard where lending syndicates, often administered by large financial institutions require liens on merchandise inventory, a practice that has emerged over the past 20 or so years.**

   Assuming that is true, is the push by these lien holders for the liquidation of the secured merchandise more closely related to the current credit crunch and the seeming under-capitalization of these syndicates (for example, Bank of America) and not the result of the 2005 Amendments? In other words, in a better economy, would Bank of America have been so quick to seek liquidity?

   No. I do not believe that the Bank of America syndicate was concerned about their own undercapitalization, if any. I believe that the syndicate viewed the merchandise inventory as easily convertible into cash and enough cash to satisfy the syndicate's claims in full, with interest and costs.

   In the case of Circuit City, in all likelihood, because of Circuit City's record for the two years prior to November, 2008, the Bank of America syndicate probably lost all confidence in the ability of Circuit City's management to turnaround the steep decline that had occurred in its business. The delay on the part of Circuit City in seeking rehabilitation and reorganization severely impaired any ability to successfully achieve those objectives.

8. **In your prepared statement you mention that strict restrictions in DIP agreements are partially to blame for the lack of success in reorganizations generally.**

   How have these restrictions evolved over the past 20 or so years?

   Regarding the $44 million in fees and expenses that Bank of America was charging under their proposed DIP agreement with Circuit City, what would a "better" facility have looked like?

   The restrictions in debtor-in-possession financings are the result of the (a) superior bargaining power of the lenders; (b) the reluctance on the part of bankruptcy courts to disapprove overly restrictive debtor-in-possession financing agreements and (c) the credit crunch and contraction in the number of potential financing sources resulting from the mergers and consolidation of financial organizations. The use of restrictive provisions accelerated and expanded over the last 5-10 years. A debtor that is in desperate need for financing has no real leverage to reject demands of a lender syndicate. Lenders tend to push the envelope and if they are successful, i.e., court approval is obtained for the debtor-in-possession financing, they will continue to push the envelope and seek more lender-friendly provisions.

In the early 1980s, some bankruptcy courts refused to approve overly restrictive debtor-in-possession finance agreements. Interestingly, those decisions did not stop debtor-in-possession financing. The lenders in that period became more rational and reasonable.

In today's environment, there are bankruptcy judges who will question the provisions of a proposed debtor-in-possession agreement. The usual answer from the lender's attorneys is that the provision is "market." The problem is the lenders make the market.

There is no easy answer to this problem unless there are alternative sources of financing. As banks have consolidated, the alternative sources of financing have disappeared. As a consequence, the debtor-in-possession financing market is controlled by a few lenders who rely upon syndicates for large debtor-in-possession financings. Syndicate members very often are hedge funds. Hedge funds have a huge appetite for big returns. It is an ironic situation, because in most circumstances, debtor-in-possession financings are less risky than ordinary commercial lending, yet the debtor-in-possession pays higher fees and higher interest rates. In addition, the lenders cost of funds currently is minimal. Nevertheless, the effective interest rate charged by debtor-in-possession lenders may exceed 20%. Accordingly, if it is in the nation's interest to enable the rehabilitation and reorganization of distressed businesses so that they may provide employment, then it may be appropriate to create a federal lending agency for the purposes of bankruptcy reorganization.

In respect of the $44 million in fees and expenses charged by the Bank of America to Circuit City, it is hard to state what would have been a "better" facility. Fees and expenses of debtor-in-possession lenders, as well as fees and expenses in commercial lending today, have increased exponentially as lenders seek better returns and there is, essentially, no check or limit on the amount of fees and expenses that may be charged by the syndicate's professionals.

I believe that the percentage ratio of the fees to the available free cash under a debtor-in-possession financing should be substantially less than it was in the Circuit City case. Taking into account the free cash availability to Circuit City in comparison to the fees and expenses charged, one could almost say that the financing was illusory. An analysis of the evolution of the increase in fees and expenses would demonstrate, from my view, that lending syndicates have taken advantage of their bargaining power and imposed extraordinary fees and expenses upon debtors possessing little or no leverage.

9. In a better retail economy, does the marketability of bankruptcy claims encourage debtor emergence from chapter 11?

I do not believe that claims trading as practiced over the last few years facilitates rehabilitation and reorganization. The amendment of the claims trading rule was to enable debtholders the right to liquefy their claims, a worthy objective. However, the law of unintended consequences has occurred. Claims trading has led to major speculation and the acquisition of claims by entities whose interests may be antithetical to reorganization.

The inability to ascertain who is trading and who has acquired claims often derails the reorganization effort. Purchasing claims at substantial discounts creates different motivations for purchasers that is sometimes counterproductive to the objectives of chapter 11.

10. Would you recommend some form of legislative restriction on claims trading in Chapter 11 cases?

The proposal of a legislative restriction on claims trading obviously is a delicate matter. It requires a balancing of the desirability of enabling debt-holders to liquefy their claims and yet not create successor debtholders whose interests would be opposed to enabling a debtor to effectively reorganize. However, either by legislation or rule, there should be more transparency in connection with the trading of claims. Tranferees should be required to file statements of trading activity, whether before or after the filing of any proof of claims, with the bankruptcy court identifying the claims purchased or sold and, particularly, the purchase price. This would bring more clarity to the interests involved in the reorganization cases.

11. You list various types of onerous provisious in debtor-in-possession lending agreements that appear "[d]espite some resistance by bankruptcy courts."

If the courts were more resistant to these provisions, would that give debtors more leverage in their negotiations with their lenders?

It is my opinion, as indicated above, that if bankruptcy courts were more resistant to the onerous and restrictive provisions imposed by debtor-in-possession lenders, the negotiations with such lenders would be more balanced. That was the experience of the 1980s.

Of course, lenders are quick to say that they will never lend if some onerous provision is disapproved. It has been my personal experience that notwithstanding such statements, in the very same case, the lenders will come back with a more moderate proposal. Reorganization is a delicate process. To be effective, there must be a level playing field. The debtor/debtor-in-possession is often without major allies and little in the way of economic leverage. Creditor constituencies have many interests and objectives and such change as claims are traded. Hence, there is a need for an objective court which may exercise its discretion to keep the playing field level. As more and more discretion is taken from the bankruptcy court, it has less and less authority to maintain some balancing of the equities and interests so that a debtor has a fair and reasonable opportunity to reorganize. The bankruptcy process should not be used <u>solely</u> as a means to expeditiously fulfill the objectives of secured lenders. The needs of all of the stakeholders, including employees and the public interest, must be considered.

RESPONSE TO POST-HEARING QUESTIONS FROM RICHARD M. PACHULSKI, PACHULSKI STANG ZIEHL & JONES, LLP

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May 14, 2009

VIA E-MAIL

The Honorable Steve Cohen
Chairman, Subcommittee on
Commercial and Administrative Law
U.S. House of Representatives
Committee on the Judiciary
Washington, D.C. 20515-6216

Re: Responses to Question for the Record from the Subcommittee on Commercial and Administrative Law/Hearing on "Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?" ("Hearing")/Hearing Conducted on Wednesday, March 11, 2009

Dear Chairman Cohen:

As requested, please find below my responses to the questions presented in your letter of March 23, 2009.

Question No. 1

If Circuit City filed before the 2005 Amendments went into effect, would it have been able to successfully reorganize?

Response to Question No. 1

While it is unlikely that even prior to the 2005 Amendments that Circuit City would have been able to successfully reorganize in its pre-chapter 11 form, I believe that a scaled down entity could have been reorganized but for Circuit City's § 503(b)(9) claims.

Question No. 2

What were the principal reasons, in your opinion, why Circuit City failed to reorganize in chapter 11.

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Response to Question No. 2

As provided in my testimony, I believe that because of the downturn in the retail market, the lack of reasonable debtor-in-possession financing and the large amount of § 503(b)(9) claims Circuit City was unable to reorganize.

Question No. 3

You refer in your prepared testimony to the "stranglehold" that Circuit City lenders negotiated through the debtor-in-possession financing. Was this financing agreement unique to Circuit City or has become the norm for the industry? If this has become the norm for the industry, is there anything you would recommend legislative to address this problem?

Response to Question No. 3

There is little question that the financing agreement entered into between Circuit City and its lenders has become the norm not only in the retail industry but in virtually all industries. Lenders have provided financially distressed companies with little room to effectively reorganize and, and have required extraordinary fees in lenders' attempts to force a liquidation of their distressed customers. Frankly, there is really no legislative solution to the problem other than Congress providing a fund for debtor-in-possession financing for financially distressed companies.

Question No. 4

Was there a separate committee representing the debtor's workers? If not, did you as counsel for the creditors' committee in the Circuit City Case represent their interests?

Response to Question No. 4

There was no separate committee representing the Debtor's workers. The Creditors' Committee is statutorily required to represent the interests of all unsecured creditors with respect to their unsecured claims. On the other hand, the Creditors' Committee does not represent the interests of creditors other than with respect to their unsecured claims, whether those are trade creditors pursuing

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§ 503(b)(9) administrative claims or employees pursuing their rights and remedies under, among other things, any collective bargaining agreement.

Question No. 5

Shouldn't vendors have some type of protection – such as an administrative expense priority – when the buyer filed bankruptcy?

Response to Question No. 5

No. As provided in my testimony it is fundamentally unfair to provide special administrative claim treatment for pre-petition vendors when no such treatment is accorded, for instance, to unsecured bank debt, unsecured bond debt and service providers. So, for instance, if a company provides temporary employee services for a company such as Circuit City 20 days prior to the filing of a chapter 11 case it would not have an administrative priority presently under § 503(b)(9), but a company that provided goods during that same period would receive such a priority. Such a result is patently unfair.

Question No. 6

You cite various problems with the debtor-in-possession financing agreement. Among them, you note that it included $30 million in loan fees, a forced timeline for sale of the company, cramdown immunization, and the ability to call a default at any time after the holiday season ended.

As counsel for the creditors' committee, did you have an opportunity to appear to be heard on this agreement?

Did the United States Trustee take a position on this agreement?

Did anyone appeal the court's approval of this agreement?

Response to Question No. 6

As counsel to the Creditors' Committee we did have an opportunity to appear and be heard on the DIP financing agreement.

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The problem was that such a fight over the agreement would have such a negative practical effect on the business that such a public fight would have resulted in a likely more strained liquidation of the company. Ultimately, the Creditors' Committee had to negotiate the best deal that it could under the circumstances. With respect to the United States Trustee's Office, I have no recollection of whether or not the United States Trustee took a position on the debtor-in-possession financing. Last, no one appealed the Court's approval of the debtor-in-possession financing agreement.

Question No. 7

With respect to Bankruptcy Code § 503(b)(9), you identify various litigation issues it presents.

If these issues were clarified, would you then accept the value of this provision at least for the vendors that it is intended to protect?

Response to Question No. 7

While clarifying certain litigation issues associated with § 503(b)(9) would at least subject such claims to less litigation, the provision would still be unfair as it favors one group of unsecured creditors to the detriment of other groups and, more significantly, results in a greater unlikelihood of reorganizing financially troubled companies because of the need to satisfy § 503(b)(9) claims on the effective date of any plan of reorganization.

Question No. 8

In light of the fact that Circuit City had more than 700 leases at the time it filed for Chapter 11, would the 210-day assumption/rejection time frame been difficult to meet?

Response to Question No. 8

As a result of Circuit City having more than 700 leases, one can only presume that the 210-day assumption/rejection timeframe would have been difficult, if not impossible, to meet in a thoughtful manner. While the landlords on the Circuit City Creditors' Committee were extremely helpful in working with the company to

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get agreement with the various Circuit City landlords, 210 days was not likely sufficient time to get resolution with respect to the vast majority of the 700 leases.

Question No. 9

Considering the fact that at least some of the leases signed by Circuit City were signed when real estate values were peaking and that real estate values have plummeted since, what incentive would the debtor have to continue to operate under these inflated and currently impractical leases?

Response to Question No. 9

In many cases Circuit City would have needed the time to negotiate modifications of many of the 700 leases because the rental rates under the leases was significantly greater than the present market rate of those leases. Such a process would have taken many months to achieve and, likely, would have been difficult to achieve within 210 days.

Question No. 10

Would another 120 days have helped Circuit City negotiate with landlords who are suffering horribly as result of the economy?

Response to Question No. 10

There is no question that an additional 120 days would have dramatically increased the likelihood that successful negotiations could have been achieved with the many Circuit City landlords.

Question No. 11

Wouldn't another 120 days have merely delayed the inevitable initiation of a Going Out of Business sale in this case?

Response to Question No. 11

An additional 120 days would have not simply delayed the inevitable initiation of a going-out-of-business sale in the case. The more time given to negotiate with landlords, the more likely that the

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banks would have provided adequate funding to sell or reorganize a substantial portion of Circuit City's business. Because of the 210-day limitation the bank group concluded that a going-out-of-business sale had to be achieved in a very short timeframe or they would be been left with the inability to conduct such sales at the various Circuit City locations as the leases would have terminated at the conclusion of the 210 day assumption/rejection period.

Question No. 12

Many leases signed by major big box retailers such as Circuit City involve a percentage of sales. These agreements benefit both the landlord and the lessee. However, in today's economy doesn't it make more sense for such leases to be renegotiated from scratch? If so, doesn't the time limit for assumption or rejection become irrelevant?

Response to Question No. 12

The real question is how much time is necessary in today's, or any, environment to appropriately deal with 700 leases. Some of the leases would simply be assumed, some would be rejected, with probably the vast majority being renegotiated. 210 days is simply insufficient. 330 days may be better and may still be insufficient. My opinion is that the period should be somewhere between 12 and 18 months for the Court to allow a debtor to assume or reject non-residential leases in order to provide all parties a fair amount of time to assume, reject or re-negotiate the applicable leases.

Question No. 13

It has been suggested that retailers tend to have extensively evaluated their financial situations long before the decision to file for bankruptcy protection. In fact, Circuit City hired professionals to analyze their situation in the summer of 2008. Moreover, Circuit City filed before the Christmas shopping season; a point often referred as the litmus test for a successful retail reorganization.

Assuming that this was 2004, how would the pre-2005 limits in Bankruptcy Code § 364(d)(4) have helped Circuit City to emerge and save at least some of the 34,000 jobs lost?

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Didn't the company have all of the benefits that are being argued today: Christmas shopping season? Months for analysis? The ability to pre-package a plan of reorganization?

Response to Question No. 13

As reflected above, the more time that a company such as Circuit City would have to assume or reject leases under § 365(d)(4) the more likely that many of the leases could be re-negotiated. Additionally, the bank group would have had more comfort that if a reorganization could not take place that sufficient time would be available to conduct going-out-of-business sales. With more time to negotiate with landlords and more flexibility from the bank group there is little question that some of Circuit City could have been maintained and not liquidated and some portion of Circuit City's 34,000 jobs would have been saved.

Further, in fairness, Circuit City did not have lots of time to plan an organized chapter 11 case because vendor credit was cut off. No retailer wants to file a chapter 11 case prior to the Christmas season. Unfortunately, vendors limited product deliveries to Circuit City stores, causing inadequate product inventories in company stores ultimately resulting in a reduced likelihood of reorganization.

Question No. 14

Professor Zywicki says that concerns about § 503(b)(9) are "overstated" as many court authorize Chapter 11 debtors to pay these creditors as critical vendors?

What is your response?

Response to Question No. 14

Professor Zywicki's statement is fundamentally incorrect. Circuit City is a good example of the flaws in Professor Zywicki's statement. As stated during my testimony, Circuit City had approximately $350 million of § 503(b)(9) claims filed in the case of which Circuit City estimated approximately $215 million would be deemed allowed § 503(b)(9) claims. As in the case of so many chapter 11 eases, though certain creditors might have received critical vendor status, the amount that would have been paid to those

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vendors would have been dramatically less than $215 million, leaving precious resources available to Circuit City to reorganize its business affairs.

I do hope the above adequately responds to each of the questions set forth in your list of questions and, again, I thank you for the opportunity to present to the House Judiciary Subcommittee on Commercial and Administrative Law.

Very truly yours,

Richard M. Pachulski

RMP

RESPONSE TO POST-HEARING QUESTIONS FROM DANIEL B. HURWITZ, PRESIDENT AND COO, DEVELOPERS DIVERSIFIED REALTY CORPORATION

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on "Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?"
Wednesday, March 11, 2009

Daniel B. Hurwitz, Developers Diversified Realty Corporation for ICSC

Questions from the Honorable Steve Cohen, Chairman

1. **Although it is reassuring that your company, DDR, agreed to extend the deadline to assume or reject leases, Circuit City operated more than 500 stores domestically, and DDR had more at stake than any other lessor.**

   Doesn't this expose the heart of the issue: in order to get DIP financing, the lender is going to want to have some assurance that lessors won't deny extensions?

As I testified, the "heart of the issue" for recent retail bankruptcies is actually a combination of the current lack of liquidity and restrictive vendor terms. Giving landlords a "seat at the table," as the 2005 amendments do, ensures an inclusive forum for discussion among the major parties in interest—lenders, vendors, landlords and debtors—in which the very issue you have posed can be addressed at the outset. For Circuit City, we offered to extend the deadline at the beginning of the case, and we also offered to advocate for an extension to the other landlords (we had done so successfully, for example, in the recent Hancock Fabrics case).

2. **As you might imagine, lenders want assurance of payment, particularly in the current economic environment. Why would a lender extend credit to a retailer with numerous leases without assurance that the retailer, if necessary, will have sufficient time to deal with these leases?**

Consistent with my response to the previous question and as I testified, the 2005 amendments permit the major stakeholders to address these issues at the outset of the case, and often - and more importantly - before the retailer files for bankruptcy. The converse to your question makes that point: a landlord would be reluctant to agree to an extension without some assurance that its tenant will be able to secure the financing to meet its rental obligations. The 2005 amendments provide a structure for these concerns to be addressed much earlier in the process.

3. **You acknowledge in your prepared testimony that Bankruptcy Code section 365(d)(4) "has changed the dynamic of retail bankruptcy cases."**

   Please expand on what these changes are.

At a minimum, the amendments have taken the real estate out of bankruptcy "purgatory," where leases could remain in limbo for years, crippling an owner's ability to appropriately value and lease its own real estate and inadvertently stigmatizing adjacent retailers who through no fault or choice of their own were forced to live and operate in the shadow cast by what one of the panelists called a "ghost". The 2005 amendments provide certainty for planning at the beginning or even before the case, and finally gave the landlord a voice in the reorganization process where before it was forced to sit silent and helpless while others controlled the destiny of its assets.

4. **Lawrence Gottlieb, counsel for creditors' committees in numerous high profile Chapter 11 cases, testified before our Subcommittee last September about the impact of sectiou 365(d)(4) on the ability of Chapter 11 debtors to reorgauize. He stated that "the fixing of an immutable deadline for the assumption or rejection of commercial real estate leases has dealt a knockout blow to prospective retail reorganizations." He went on to explain that "retail cases filed in the last three years have invariably taken one of two forms: either the case is filed as a liquidation or the debtor is given a window of no more than three to four months to complete a reorganization process that history dictates takes at least three times that amount of time to accomplish"**

   What is your response?

We know Mr. Gottlieb well, having participated on several committees represented by his firm. We respectfully disagree with his opinion. In fact, Mr. Gottlieb's firm represented a committee for a retail bankruptcy in which my company took an active role in convincing other landlords to extend the deadline to assume or reject, which ultimately permitted the retailer (Hancock Fabrics) to reorganize and pay unsecured 100% on their claims. Other post-amendment bankruptcies have seen landlords agree to extensions in both reorganizations (Movie Gallery) and liquidations (Linens 'N Things) The "knockout blow," as Mr. Gottlieb describes it, is more likely a one-two combination delivered by the lenders (no reasonable financing terms available) and vendors (no reasonable credit terms available).

5. **When this issue first came before the Judiciary Committee more than 10 years ago, the argumeut ISCS essentially argued that it was unfair for commercial lessors to be "stuck in limbo" because they are special.**

   Please explain why commercial lessors, who are paid current during this "limbo" period, should receive special rights not available to other unsecured creditors and parties to executory contracts.

Bankruptcy actually confers special rights on commercial tenants which can disadvantage landlords and co-tenants. Shopping center owners occupy a unique status among creditors because a tenant filing for bankruptcy can transform lessors into involuntary landlords. Unlike most other creditors, who merely seek payment for a claim, shopping center owners face substantial uncertainty as Section 365 gives the tenant the right to continue in an ongoing business relationship with the lessor at the tenant's discretion. Fundamental fairness dictates that the landlord have some certainty as to when or if a tenant will honor or reject its lease.

6. **You argue exactly what was argued over by the ISCS when the economy was peaking: There is a synergy between neighboring stores, the lessor, and the customers, and a bankrupt tenant negatively affects each party.**

   Assuming that this true, and that in the current economy, it is unlikely that over 500 stores encompassing hundreds of thousands of square feet can be leased, isn't a bankrupt store being forced to stay current at 60 day intervals better than no store at all?

This question underscores why no amendments to Section 365 are necessary. In the current economy, market dynamics ensure that shopping center owners have every incentive to work with bankrupt tenants.

RESPONSE TO POST-HEARING QUESTIONS FROM TODD J. ZYWICKI, PROFESSOR, GEORGE MASON UNIVERSITY SCHOOL OF LAW

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on "Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?"
Wednesday, March 11, 2009

Professor Todd J. Zywicki, George Mason University School of Law

Questions from the Honorable Steve Cohen, Chairman

1. **You acknowledge in your prepared statement that the 2005 Amendments to Chapter 11 have "at the margin" helped to contribute to a greater level of liquidations in Chapter 11.**

   With all due respect, this question simply misreads my statement as I made no such acknowledgement. What I said is, "It is possible that BAPCPA has at the margin helped to contribute to some of these liquidations. But it is far from clear that this is the case, as there are numerous other factors in the current that likely have contributed substantially to the liquidation of these firms."

   Please explain how the 2005 Amendments have so contributed to increased liquidations in Chapter 11.

   Again, I did not say that the 2005 Amendments "have" contributed to increased liquidations in Chapter 11. Those who criticize the 2005 reforms have yet to provide a concrete, demonstrable case where BAPCPA has caused the liquidation of a firm that otherwise would have reorganized as opposed to bringing about a more timely and inexpensive resolution of the affairs of a firm that was efficient to liquidate.

2. **You argue that Chapter 11 serves to distinguish between firms that are economically failed and those that are in financial distress.**

   Was Circuit City an economically failed business with more than 700 store locations and 34,000 employees when it filed for Chapter 11 last November?

   Yes. The economic failure of Circuit City was overdetermined. Poor management, a poor economy especially for high-end discretionary electronics goods purchases, poor credit conditions, poor retailing strategies, all contributed to Circuit City's demise.

   The number of stores and employees Circuit City had at the time of bankruptcy is irrelevant to whether it was an economically failed enterprise. At the time Montgomery Wards finally shuttered in December 2000 it had 37,000 employees and 250 stores. When Enron filed bankruptcy, for example, it had some 22,000 employees and $101 billion in annual revenues. What matters is whether the company was worth more alive *as a going-concern or liquidated with its human, physical, and financial capital redeployed elsewhere in the economy.*

3. **You acknowledge that debtor-in-possession financing is much less available in the current economic environment.**

   Would you support legislation easing this difficulty for Chapter 11 debtors?

Of course, before saying I would "support" legislation I'd want to see the details. But I would say that it is plausible in the current environment that because of problems in the credit markets there may be some situations where firms that might be able to obtain DIP financing in a well-working market may be unable to do so now because of liquidity problems by lenders. If so, and if this was the result of liquidity problems in the market, this seems like the sort of intervention that the TARP program was designed to address.

Moreover, even if one might support such a program in theory, whether the government could competently create and administer such a program in a coherent and workable fashion is a separate question. Recent actions by Congress related to the implementation of TARP raise doubts about whether the government could be trusted to administer this sort of program could be administered in an efficient manner free from political meddling. If this were the case with respect to the way in which a hypothetical DIP lending facility was implemented then it could make matters worse overall rather than better

4. **In the case of Circuit City, or for that matter, any other retailer, how is it possible to argue that the current statute decreases the number of administrative claims especially considering the fact that inventory is usually done on a monthly basis?**

I'm not sure I understand this question. I don't think I said that the statute "decreases the number of administrative claims." With respect to the increase in administrative claims provided to employees' unpaid wages and benefits, for instance, BAPCPA obviously increased the administrative claims for those claimants. So I don't think I said that the statute decreases the amount of administrative claims nor would I make this argument.

5. **Before 2005, was it the practice of Chapter 11 debtors to obtain critical vendor admiuistrative expense priority to all of their vendors?**

No. It was the practice to provide administrative expense priority to those vendors who had political clout with the debtor, often large well-connected vendors, and to not provide administrative expense priority to small businesses that were less-connected and less-savvy about bankruptcy. Moreover, those who were lucky enough to wangle their way onto the administrative expense priority list would routinely gain administrative expense priority for well over the 20 days of administrative expense priority provided in BAPCPA. As I noted in my testimony, in the Kmart case, "2330 of 4000 vendors were classified as "critical vendors" who were to be paid in full under the plan, thereby consuming $300 million of Kmart's $2 billion DIP financing."

RESPONSE TO POST-HEARING QUESTIONS FROM ISAAC M. PACHULSKI, STRUTMAN, TREISTER & GLATT, PC

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on "Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?"
Wednesday, March 11, 2009

Isaac M. Pachulski, Esq., Stutman, Treister & Glatt Professional Corporation

Questions from the Honorable Steve Cohen, Chairman

1. **If Circuit City filed before the 2005 Amendments went into effect, would it have been able to successfully reorganize?**

RESPONSE:

I cannot predict whether Circuit City would have been able to reorganize successfully had it filed its chapter 11 case before the 2005 Amendments went into effect; but, clearly, it would have had a *better chance* to reorganize successfully – even if only through a going concern sale of some of its stores – than it ever had after the 2005 Amendments. Circuit City's ability to reorganize would not have been hobbled by the requirement that it pay hundreds of millions of dollars in administrative vendor claims which would not have been entitled to priority treatment prior to the 2005 Amendments. That priority retards, and does not advance, the reorganization process.

2. **In your opinion, do you think the 2005 Amendments – at least with respect to their impact on Chapter 11 – are playing any role in our Nation's current economic situation?**

RESPONSE:

The 2005 Amendments are aggravating the current economic problems by making it harder for debtors to reorganize under chapter 11, and adversely affecting the financial health and viability of those debtors that are able to reorganize. Chapter 11 is designed to facilitate the rehabilitation and reorganization of business enterprises which, when successful, preserves jobs and going concern value. Chapter 11 is not intended to guarantee that every debtor reorganizes, but it is designed to give debtors an opportunity to reorganize as going concerns by, for example, allowing debtors to restructure past debt which exceeds the debtor's ability to repay it, and to retain beneficial contracts and leases while rejecting unfavorable or burdensome ones.

By making it more difficult for debtors who might otherwise be able to do so to reorganize under this construct, and by weakening the financial condition of companies that are able to reorganize, the 2005 Amendments aggravate the current economic situation: They undermine the ability of chapter 11 to perform its rehabilitative function and, thereby, to help ameliorate the impact of a recession. The importance of enabling chapter 11 to serve as a viable tool for business reorganization is magnified in a recession; almost by definition, a bad reorganization law is more harmful in a recession than in a robust economy.

3. **What is your response to Professor Zywicki's view of Chapter 11, that is, it's working fine by weeding out the debtors that should fail?**

RESPONSE:

Professor Zywicki's view that chapter 11 "works fine by weeding out the debtors that should fail" misses the point of chapter 11: The purpose of chapter 11 is not to "weed out" debtors who should fail, but to facilitate the reorganization of debtors who should not fail and who can reorganize by restructuring their pre-chapter 11 debt, rejecting unfavorable executory contracts and leases while preserving favorable ones, and operating profitably on a going forward basis. His theory also misses the point that statutory obstacles to successful reorganization can "weed out" debtors who should *not* fail and weaken those who are able to emerge from chapter 11.

The vendor priority created by Section 503(b)(9), which can burden a debtor with additional cash requirements to pay tens or even hundreds of millions of dollars on account of unsecured pre-petition vendor debt, is a perfect example. The fact that a debtor cannot pay in full and in cash all of the vendor claims incurred on account of shipments of goods during the 20 days prior to the chapter 11 filing does not mean that the debtor "should fail." This is a wholly artificial impediment to reorganization that unnecessarily weakens the financial condition of debtors by creating large, unwarranted administrative claims.

Similarly, while the 210-day limitation on the ability of a debtor to assume its commercial leases may "weed out" debtors who should fail, it can also hobble or even prevent the reorganization of debtors that should not fail. In trying to justify the 210-day limit, Professor Zywicki cited Montgomery Ward as an example of a poorly-run retailer that should have been liquidated long before it finally was liquidated. Such anecdotal evidence does not, however, justify a mandatory 210-day limitation for *all* retailers that leaves no room for judicial discretion. This "one size fits all" approach ignores the diversity of the retailers who end up in chapter 11, in terms of the number of locations they have to deal with, the quality of their operations, whether or not they serve as an "anchor tenant" and other differences. This diversity is highlighted by reviewing the list of larger retailers that have filed chapter 11 cases in the last twelve months contained at pages 5-8 of my testimony. That list includes 26 retailers engaged in the sale of a wide variety of products, who operated anywhere from 23 locations to over 700 locations when they filed; some of those retailers were anchor tenants, and some were not. While a "one size fits all" approach may help "weed out" retailers, such as Montgomery Ward, that should fail, it also threatens retailers that should not fail.

Finally, the "weeding out" rationale ignores the fact that the alternatives in chapter 11 are not simply (i) a failure or (ii) a reorganization. Companies that reorganize under chapter 11 can emerge from chapter 11 in different conditions of financial health.

Even if impediments to reorganization created by the vendor administrative priority under Section 503(b)(9) and the 210-day limitation under Section 365(d)(4) do not cause the failure of a particular chapter 11 debtor, they can result in reorganized companies that are less healthy and less able to weather any setbacks, by saddling such debtors with the additional cash burden of the vendor administrative expense priority and with the consequences of the premature and improvident assumption or rejection of commercial real estate leases.

4. **In your prepared testimony, you state that the 210-day deadline "substantially increases the risk of improvident decisions to assume or reject leases based on insufficient operating data and the premature closure of store locations," that result in the loss of jobs.**

   If you are correct, why is the International Council of Shopping Centers opposed to removing that deadline?

RESPONSE:

As its name implies, the concern of the International Council of Shopping Centers is what is best for shopping center owners, and not the broader concern of what will maximize the ability of chapter 11 to serve its rehabilitative purposes in a way that will fairly maximize value for *all constituencies* in a chapter 11 case. From the standpoint of shopping center owners, it is certainly desirable to have a "one way" 210-day limitation (extendable by the shopping center owner, but not by the debtor-tenant or the bankruptcy court) that essentially puts the shopping center owner in the driver's seat: If the shopping center owner wants to cooperate with the debtor, it can do so by voluntarily extending the 210-day deadline but, if it does not, it can force the debtor to assume or reject the lease within that deadline.

While it is understandable why a "council of shopping centers" would advocate such an asymmetrical, shopping center owner-friendly construct, that advocacy is unrelated to the broader question of whether such a construct represents sound bankruptcy policy. Shopping center owners are already sufficiently protected by the fact that, as a result of prior, shopping center owner-friendly amendments to the Bankruptcy Code: (i) a chapter 11 debtor is required to pay, on a current basis, all rent that comes due under a commercial lease after the chapter 11 filing, and until the lease is rejected (§ 365(d)(3)), and (ii) a chapter 11 debtor who seeks to assume a lease of property in a shopping center must satisfy a special, heightened standard of "adequate assurance of future performance" that is unique to shopping center leases (§ 365(b)(3)). To add the one-way 210-day limitation of Section 365(d)(4) on top of these protections benefits no one but shopping center owners, and does so at the expense of the chapter 11 process and the ability of debtors to reorganize.

5. **Professor Zywicki states that the vendor administrative expense priority under Bankruptcy Code section 503(b)(9) is very similar to the critical vendor payment scheme that many courts have used over the years.**

What is your response to his statement?

<u>RESPONSE</u>:

This statement is grossly inaccurate: It ignores the fundamental differences between (i) limited, permissive critical vendor payments that must be justified by a benefit to the debtor's post-chapter 11 operations and can be tailored to meet the needs of the estate, and (ii) the mandatory vendor administrative expense priority created by Section 503(b)(9), that is not limited by anything but the "20 day" requirement and is not tied to any such benefit to the debtor's post-chapter 11 operations. Characterizing the two types of payments as "very similar" because they both involve vendors and a form of priority is like saying that a surgeon's scalpel and a butcher's knife are "very similar" because they are both used to cut things.

I would note at the onset that the practice of critical vendor payments i.e., paying the pre-petition claims of certain vendors on a preferential basis, has come in for considerable criticism. *See, e.g., In re K-Mart Corp.*, 359 F.3d 866, 871-74 (7th Cir. 2004) (affirming district court order that reversed the bankruptcy court's order authorizing critical vendor payments) (copy attached as Appendix "A"); *see also, In re Berry Good, LLC.*, No. 08-bk-16500, 2008 WL 5114311, at *4 (Bankr. D. Ariz. Dec. 4. 2008) (explaining that not all Circuits have adopted the 'doctrine of necessity' or the 'critical vendor' theory, specifically finding that the Ninth, Seventh, Fourth, and Fifth Circuits "have held that the bankruptcy court does not have general equitable power under § 105(a) to overrule the Code's priority scheme by favoring one class of unsecured creditors over another."); Shirley S. Cho, *The Intersection of Critical Vendor Orders and Bankruptcy Code § 503(b)(9)*, 29 Cal. Bankr. J. 7, 7(2007) (hereinafter "Cho Article") ("Historically, the concept of critical or essential vendor programs has been controversial in chapter 11 cases"). Indeed, it did not sound to me like Professor Zywicki was an advocate of such preferential payments.

The response that follows is not, and should not be read as, an endorsement of preferential "critical vendor" programs as they have developed over time. In fact, a few years ago, the National Bankruptcy Conference (the "Conference") voted to recommend an amendment to the Bankruptcy Code that would have limited critical vendor payments by statute to a narrow class of circumstances. A copy of the proposal (a new section 1117 of the Code) is attached as Appendix "B".

In any event, the theoretical basis for permitting "critical vendor" payments is that the debtor's operations will receive some post-chapter 11 operating benefit from the favored vendors in return. Any "critical vendor" payment must be justified by some such benefit, like assurance of the continued delivery of goods or services from a difficult-to-replace vendor, or the post-petition delivery of goods or services on favorable terms. Indeed, a "critical vendor" who receives payment on its pre-chapter 11 debt under a critical vendor order but then fails to provide the debtor with the consideration required by that order may be required to disgorge the critical vendor payment. *See In re Meridian Automotive Systems-Composites Operations, Inc.*, 372 B.R. 710 (Bankr. D. Del. 2007) (ordering return of critical vendor payment made to vendor who failed to comply with agreement to deliver goods contemplated by critical vendor order).

In contrast, the indiscriminate administrative expense priority accorded to vendors of goods under Section 503(b)(9) is not premised on the receipt of any post-petition benefit from the favored vendors. They are not required or expected to provide any post-chapter 11 benefit in return. Thus, even after the 2005 Amendments, critical vendor programs continue to be implemented when deemed appropriate to obtain benefits for the debtor's operations. *See, e.g., In re Global Home Products,* No. 06-10340, 2006 WL 3791995 (Bankr. D. Del. Dec. 21, 2006); *see also,* Appendices "D" – "E" (critical vendor orders entered in cases filed after 2005 Amendments); Cho Article, *supra*, at 11 n. 27 (listing a number of cases post-BAPCPA which have used section 503(b)(9) as justification for granting critical vendor motion).

Importantly, critical vendor programs are flexible and can be tailored to the needs of the estate – a feature that is conspicuously absent from section 503(b)(9). For example, critical vendor payments are typically subject to a "cap" on the aggregate amount of such payments. *See, e.g., Zenith Industrial Corp. v. Longwood Elastomers, Inc. (In re Zenith Industrial Corp.)*, 319 B.R. 810, 817 (Bankr. D. Del. 2005) ($1 million cap). In contrast, there is no "cap" on section 503(b)(9) claims, beyond the 20-day limitation.

Further, by their terms, critical vendor orders are "permissive, not mandatory." *See HLI Creditor Trust v. Export Corp. (In re Hayes Lemmerz International, Inc.,)*, 313 B.R. 189, 193 (Bankr. D. Del. 2004). The debtor may pay less than the authorized amount and can limit the aggregate critical vendor payments to prevent them from imposing an unmanageable cash flow burden. The debtor cannot so limit the amount of the Section 503(b)(9) priority claims. Moreover, parties such as the U.S. Trustee or a creditors' committee can object to critical vendor programs and negotiate limitations on critical vendor payments by threatening to object to the motion for their approval: "The Court obviously welcomes the U.S. Trustee's position on critical vendor motions and debtors often modify their request in order to avoid a courtroom dispute on a U.S. Trustee's objection to such a motion." *In re Zenith Industrial Corp.*, 319 B.R. at 818. I know of at least one bankruptcy judge who will not approve such payments until after a creditors' committee is formed. In contrast, Section 503(b)(9) is mandatory and admits of no such flexibility, objection or discretion by the court.

Finally, critical vendor payments apply to vendors of goods *and services*. In contrast, Section 503(b)(9) provides a preference only for vendors of goods, and does not address vendors of services, who are left with only the "critical vendor" construct.

The following chart summarizes the salient differences between critical vendor payments and the section 503(b)(9) administrative priority:

Characteristic	**Critical Vendor Payments**	**Section 503(b)(9) (Administrative Priority) Claims**
Cash payment is discretionary with the debtor and subject to court approval and objection by the U.S. trustee and other parties in interest	Yes	No (administrative priority is mandatory)
Debtor can require a post-petition *quid pro quo* (such as continued delivery of goods on favorable post-petition terms) in exchange for the cash payment	Yes	No
Debtor has the ability to limit the amount based on debtor's cash flow situation	Yes	No
Applies to vendors of both goods and services	Yes	No (only goods)
Court can decline cash payment or priority if determined not to be in the best interests of the estate	Yes	No

These differences are illustrated by the terms of the attached "critical vendor" order (Appendix "C") entered in a chapter 11 case in which my law firm represented the debtors: On the Petition Date, the debtors operated over 400 skilled nursing and assisted living facilities with approximately 49,000 licensed beds. Although not a retailer, the facilities received a variety of goods and services from vendors, such as food, general supplies, pharmaceutical and medical supplies and a variety of related services. The Order limited the critical vendor payments to no more than "$20 million in the aggregate." Order ¶ 2. Of course, no such limitation could be imposed under Section 503(b)(9) and, had Section 503(b)(9) applied, the vendor priority claims under that section for a business operation of this magnitude would have been well in excess of $20 million.

Moreover, the debtors were authorized to condition any payment of a "critical vendor" on an agreement by the critical vendor to provide post-chapter 11 credit on terms and conditions acceptable to the debtors. Order ¶ 6. In contrast, a chapter 11 debtor cannot impose any similar conditions on a beneficiary of the Section 503(b)(9) priority.

To the extent that there is any concern that critical vendor programs may have been abused, the solution lies in legislation imposing appropriate conditions and limitations on critical vendor payments (such as those contained in the recommended legislation attached as Appendix "B") – not in a mutation that creates a blanket administrative priority for all goods delivered to the debtor within 20 days of the chapter 11 filing.

6. **In your prepared testimony you note that the 2005 Amendments to subsections 503(b)(9) and 546(c): (1) create an administrative claim that must be paid in full prior to the commencement of the plan for all pre-petition vendor claims for goods sold to the debtor within 20 days before filing for bankruptcy and (2) create, what you describe as a "federal right of reclamation" for the claimant beyond what might have existed outside of bankruptcy.**

   It seems that the language of 546(c) limits any right of reclamation that a vendor might have to those rights available outside of bankruptcy. Can you please, very briefly, describe your argument as to why this amendment creates a "federal right" of reclamation?

   RESPONSE:

   The argument that the 2005 Amendment to Section 546(c) may be read to create a federal right of reclamation that is not rooted in applicable non-bankruptcy law results from the fact that: (i) prior to the 2005 Amendments, Section 546(c)(1) spoke in terms of subjecting the trustee's powers "to ***any statutory or common law*** right of a seller of goods that sold goods to the debtors, in the ordinary course of such seller's business, to reclaim such goods . . ." (emphasis added); and (ii) the 2005 Amendments deleted the highlighted phrase "any statutory or common law" before "right of a seller," implying that the reclamation right need not be rooted in applicable non-bankruptcy law, i.e., "statutory or common law." I do not understand why this phrase was deleted. Although there is some case law holding that the amendment to Section 546(c) did not create a new federal right of reclamation, *see In re Dana Corp.*, 367 B.R. 409 (Bankr. S.D.N.Y. 2007); *accord, In re Magwood,* No. 07-11288, 2008 WL 509635 at *2 (Bankr. M.D. Ala. Feb. 22, 2008), the retention of the deleted language would have avoided any ambiguity on the point.

7. **With regard to DIP financing, how does the amount of 503(b)(9) claims truly determine whether a DIP agreement will be reached?**

   RESPONSE:

   I am not aware of any situation in which the amount of the Section 503(b)(9) claims was the determining factor in whether a DIP agreement would be reached. Nonetheless, the magnitude of the Section 503(b)(9) claims can adversely affect the ability to reach a DIP agreement and/or the amount available to the debtor under such an agreement.

   DIP facilities generally require full repayment on the effective date of a plan of reorganization, and DIP lenders typically look to be "cashed out" at that time. The ability to cash out the DIP lenders, in turn, generally depends on the debtor's ability to obtain sufficient "exit financing" to do so. If the debtor also has hundreds of millions of dollars of Section 503(b)(9) claims that must be paid on the effective date of a plan *on top of* the DIP facility, then the amount of exit financing necessary for the debtor to emerge from chapter 11 will be correspondingly higher. Thus, a DIP lender trying to gauge the debtor's ability to obtain sufficient exit financing to pay off the DIP loan must consider the fact that the exit financing will also have to cover the Section 503(b)(9) claims. The resulting concern about the availability of adequate exit financing may either discourage a prospective DIP lender from participating at all, or result in a DIP lender insisting on a lower DIP facility.

I would add that the entire subject of debtor in possession financing is one of concern to the Conference on which we are focusing our attention. We are concerned about excesses that have developed in the debtor in possession financing process over time that appear to give debtor in possession financiers an inordinate level of control of the chapter 11 process – to the point where one article has referred to this phenomenon as "The Secured Creditor In Possession." This level of control can result in early – and sometimes premature – sales of the whole business or liquidation. The Conference hopes to be able to recommend a solution to this problem.

8. It has been suggested by members of this panel and by others who have testified before this Committee that exemptions from the automatic stay of various commercial instruments has led to an incentive for parties to disguise otherwise non-exempt contracts such as repurchase agreements and swap agreements.

To what extent, if any, does this issue apply to a retail bankruptcy of a company such as Circuit City?

The risk that secured lenders may try to disguise otherwise non-"safe harbored" commercial loans as repurchase or swap agreements to try to take advantage of the exception to the automatic stay for such financial contracts (and for the collateral that secures them) is as applicable to a retailer as it is to any other business that obtains commercial loans. While I am not aware of a situation in which lenders have resorted to this subterfuge in the context of a loan to a retailer, that risk remains. The Conference has been concerned about, and focused on, this potential abuse and has sought to ameliorate this risk by recommending legislation to limit the type of collateral for protected financial contracts that is excepted from the automatic stay. This recommendation is set forth at pages 29-30 of my testimony.

To summarize, the Conference recommends limiting the type of collateral against which the non-debtor counterparty to such financial contracts may exercise contractual rights without being subject to the automatic stay. Specifically, such excepted collateral would *exclude* operating assets, even if they purport to secure a protected financial contract. The collateral for financial contracts typically consists of cash, securities or other financial assets or, in the case of a commodities contract, may consist of the underlying commodity. It would be highly unusual for a swap or repurchase agreement to be collateralized by operating assets, and the inclusion of such collateral raises serious issues as to the bona fides of the transaction as a protected contract and suggests that the transaction is a garden variety commercial loan masquerading as a swap or repurchase agreement. To avoid such abuse, the special protections accorded to the exercise of contractual rights against collateral for financial contracts should be limited to financial assets of the types that are usual for legitimate protected contracts. In the case of a retailer, the result of this limitation would be that a lien on inventory, fixtures or equipment of a retailer to secure a financial contract like a swap or repurchase agreement would *not* be excepted from the automatic stay. The Conference would be pleased to provide you with a specific legislative proposal in this regard.

Would allowing either more or less judicial discretion remedy this disguising or issue, or is the only alternative legislation?

A legislative change of the type described above would provide a more appropriate solution to the problem than creating additional judicial discretion that might, for example, permit a court to recharacterize a swap or repurchase agreement as some other transaction or to otherwise delay the exercise of rights under a protected financial contract. The whole purpose of the exception to the automatic stay for the exercise of contractual rights under protected financial contracts is to enable the non-debtor counterparty to such a contract to "unwind" the transaction, make appropriate alternative arrangements, and obtain access to its collateral promptly and with certainty. A construct that allowed the debtor to mire the non-debtor counterparty in litigation over whether the transaction was or was not a "true" swap or repurchase agreement or whether the exercise of the non-debtor counterparty's rights should otherwise be delayed would undermine this basic purpose. In effect, the debtor could obtain the benefit of the automatic stay with respect to a protected financial contract and related collateral which are supposed to be excepted from the automatic stay, while it litigated the "true nature" of the transaction. If you accept the basic premise underlying the special protections given to certain financial contracts – avoiding systemic risk to certain key financial markets – that basic premise requires that the non-debtor counterparty be able to act with certainty immediately upon the debtor's chapter 11 filing.

That said, the Conference is considering the issue of whether the scope of the financial contracts which are accorded this "special protection," and the class of cases in which such protections are afforded, should be narrowed. Any such narrowing, however, should be based on an objective "bright line" test, with clear standards, rather than on one that allows the result to vary on the basis of judicial discretion or recharacterization of the transaction.

APPENDIX "A"

1 of 2 DOCUMENTS

In the matter of: KMART CORPORATION, Debtor-Appellant, Additional intervening appellants: KNIGHT-RIDDER, INC.; HANDLEMAN COMPANY; IRVING PULP & PAPER, LIMITED.

Nos. 03-1956, 03-1999, 03-2000, 03-2001, 03-2035, 03-2262, 03-2346, 03-2347 &, 03-2348

UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

359 F.3d 866; 2004 U.S. App. LEXIS 3397; Bankr. L. Rep. (CCH) P80,054; 51 Collier Bankr. Cas. 2d (MB) 1076; 42 Bankr. Ct. Dec. 166

January 22, 2004, Argued.
February 24, 2004, Decided. *

* This opinion is being released in typescript. A printed copy will follow.

SUBSEQUENT HISTORY: Rehearing denied by *In re Kmart Corp., 2004 U.S. App. LEXIS 9050 (7th Cir. Ill., May 6, 2004)*
US Supreme Court certiorari denied by, Motion granted by *Irving Pulp & Paper, Ltd. v. Capital Factors, Inc., 2004 U.S. LEXIS 7649 (U.S., Nov. 15, 2004)*
US Supreme Court certiorari denied by *Handleman Co. v. Capital Factors, Inc., 2004 U.S. LEXIS 7528 (U.S., Nov. 15, 2004)*
US Supreme Court certiorari denied by *Knight-Ridder, Inc. v. Capital Factors, Inc., 2004 U.S. LEXIS 7527 (U.S., Nov. 15, 2004)*

PRIOR HISTORY: [**1] Appeals from the United States District Court for the Northern District of Illinois, Eastern Division. No. 02 C 1264 et al. John F. Grady, Judge.
Capital Factors, Inc. v. Kmart Corp., 2003 U.S. Dist. LEXIS 17437 (N.D. Ill., Sept. 29, 2003)

DISPOSITION: Affirmed.

COUNSEL: For CAPITAL FACTORS, INCORPORATED, Appellee (03-1956, 03-1999, 03-2000, 03-2001, 03-2262, 03-2346, 03-2347, 03-2348): Steven B. Towbin, SHAW, GUSSIS, FISHMAN, GLANTZ, WOLFSON & TOWBIN, Chicago, IL.

For HANDLEMAN COMPANY, Intervenor - Appellant (03-1956, 03-1999, 03-2000, 03-2001, 02-2035): Richard C. Godfrey, KIRKLAND & ELLIS, Chicago, IL USA.

For K-MART CORPORATION, Debtor - Appellant (03-1956, 03-1999, 03-2000, 03-2001, 03-2262, 03-2346, 03-2347, 03-2348): Andrew N. Goldman, WILMER, CUTLER & PICKERING, New York, NY USA.

For MERIDIAN RETAIL INCORPORATED, Amicus Curiae (03-1956, 03-1999, 03-2000, 03-2001, 03-2035, 03-2262, 03-2346, 03-2347, 03-2348): Kevin D. Finger, GREENBERG TRAURIG, Chicago, IL USA.

For KNIGHT-RIDDER, INCORPORATED, Appellant (03-2035): Joseph D. Frank, NEAL, GERBER & EISENBERG, Chicago, IL USA.

For CAPITAL FACTORS, INCORPORATED, Appellee (03-2035): Peter J. Roberts, SHAW, GUSSIS, FISHMAN, GLANTZ, WOLFSON & TOWBIN, Chicago, IL.

For K-MART CORPORATION, Debtor (03-2035): William J. Barrett, BARACK, FERRAZZANO, KIRSCHBAUM, PERLMAN & NAGELBERG, Chicago, IL USA.

For IRVING PULP & PATER, LIMITED, doing business as IRVING PAPER, Appellant (03-2262, 03-2346, 03-2347, 03-2348): George Eric Brunstad, Jr., BINGHAM MCCUTCHEN, Hartford, CT USA.

JUDGES: Before EASTERBROOK, MANION, and ROVNER, Circuit Judges.

OPINION BY: EASTERBROOK

OPINION

[*868] EASTERBROOK, *Circuit Judge*. On the first day of its bankruptcy, Kmart sought permission to pay immediately, and in full, the prepetition claims of all "critical vendors." (Technically there are 38 debtors: Kmart Corporation plus 37 of its affiliates and subsidiaries. We call them all Kmart.) The theory behind the request is that some suppliers may be unwilling to do business with a customer that is behind in payment, and, if it cannot obtain the merchandise that its own customers have come to expect, a firm such as Kmart may be unable to carry on, injuring all of its creditors. Full payment to critical-vendors thus could in principle make even the disfavored creditors better off: they may not be paid in full, but they will receive a greater portion of their claims than they would if the critical-vendors cut off supplies and the business shut down. Putting the proposition in this way implies, however, that the debtor must *prove*, and not just [**2] allege, two things: that, but for immediate full payment, vendors *would* cease dealing; and that the business will gain enough from continued transactions with the favored vendors to provide some residual benefit to the remaining, disfavored creditors, or at least leave them no worse off.

Bankruptcy Judge Sonderby entered a critical-vendors order just as Kmart proposed it, without notifying any disfavored creditors, without receiving any pertinent evidence (the record contains only some sketchy representations by counsel plus unhelpful testimony by Kmart's CEO, who could not speak for the vendors), and without making any finding of fact that the disfavored creditors would gain or come out even. The bankruptcy court's order declared that the relief Kmart requested -- open-ended permission to pay any debt to any vendor it deemed "critical" in the exercise of unilateral discretion, provided [*869] that the vendor agreed to furnish goods on "customary trade terms" for the next two years -- was "in the best interests of the Debtors, their estates and their creditors". The order did not explain why, nor did it contain any legal analysis, though it did cite *11 U.S.C. § 105(a)*. [**3] (The bankruptcy court issued two companion orders covering international vendors and liquor vendors. Analysis of all three orders is the same, so we do not mention these two further.)

Kmart used its authority to pay in full the prepetition debts to 2,330 suppliers, which collectively received about $ 300 million. This came from the $ 2 billion in new credit (debtor-in-possession or DIP financing) that the bankruptcy judge authorized, granting the lenders super-priority in post-petition assets and revenues. See *In re Qualitech Steel Corp., 276 F.3d 245 (7th Cir. 2001)*. Another 2,000 or so vendors were not deemed "critical" and were not paid. They and 43,000 additional unsecured creditors eventually received about 10 [cent] on the dollar, mostly in stock of the reorganized Kmart. Capital Factors, Inc., appealed the critical-vendors order immediately after its entry on January 25, 2002. A little more than 14 months later, after all of the critical-vendors had been paid and as Kmart's plan of reorganization was on the verge of approval, District Judge Grady reversed the order authorizing payment. *291 B.R. 818 (N.D. Ill. 2003)*. He concluded that neither [**4] *§ 105(a)* nor a "doctrine of necessity" supports the orders.

Appellants insist that, by the time Judge Grady acted, it was too late. Money had changed hands and, we are told, cannot be refunded. But why not? Reversing preferential transfers is an ordinary feature of bankruptcy practice, often continuing under a confirmed plan of reorganization. See *Mellon Bank, N.A. v. Dick Corp., 351 F.3d 290 (7th Cir. 2003)*. If the orders in question are invalid, then the critical-vendors have received preferences that Kmart is entitled to recoup for the benefit of all creditors. Confirmation of a plan does not stop the administration of the estate, except to the extent that the plan itself so provides. Compare *In re Hovis, 356 F.3d 820, 2004 U.S. App. LEXIS 1481, No. 02-2450 (7th Cir. Feb. 2, 2004)*, with *In re UNR Industries, Inc., 20 F.3d 766 (7th Cir. 1994)*. Several provisions of the Code do forbid revision of transactions completed under judicial auspices. For example, the DIP financing order, issued contemporaneously with the critical-vendors order, is sheltered by *11 U.S.C. § 364(e)*: "The reversal or modification on appeal of an authorization under this section to obtain [**5] credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal." Nothing comparable anywhere in the Code covers payments made to pre-existing, unsecured creditors, whether or not the debtor calls them "critical." Judges do not invent missing language.

Now it is true that we have recognized the existence of a long-standing doctrine, reflected in *UNR Industries*, that detrimental reliance comparable to the extension of new credit against a promise of security, or the purchase of assets in a foreclosure sale, may make it appropriate for judges to exercise such equitable discretion as they possess in order to protect those reliance interests. See also *In re Envirodyne Industries, Inc., 29 F.3d 301, 304 (7th Cir. 1994)*. Thus once action has been taken to distribute assets under a confirmed plan of reorganization, it would [**6] take some extraordinary event to turn back the clock. These appeals, however, [*870] do not question any distribution under Kmart's plan; to the contrary, the plan (which was confirmed after the district court's decision) provides that adversary proceedings will be filed to recover the preferences that the critical vendors have received. No one filed an appeal, which means that it is appellants in this court that now wage a collateral attack on the plan of reorganization.

Appellants say that we should recognize their reliance interests: after the order, they continued selling goods and services to Kmart (doing this was a condition of payment for pre-petition debts). Continued business relations may or may not be a form of reliance (that depends on whether the vendors otherwise would have stopped selling), but they are not *detrimental* reliance. The vendors have been paid in full for post-petition goods and services. If Kmart had become administratively insolvent, and unable to compensate the vendors for post-petition transactions, then it might make sense to permit vendors to retain payments under the critical vendors order, at least to the extent of the post-petition deficiency. Because [**7] Kmart emerged as an operating business, however, no such question arises. The vendors have not established that any reliance interest -- let alone any language in the Code -- blocks future attempts to recover preferential transfers on account of prepetition debts.

Handleman Company, which received $ 49 million as a critical vendor, makes a different procedural objection: that the district court's order does not affect it because Capital Factors' notice of appeal did not name Handleman as an appellee. Handleman was not a "party" in the district court and, consistent with the due process clause of the *fifth amendment*, cannot be bound by the district judge's decision -- or so it says. We permitted Handleman to intervene in this court. Thus it is a party today and will be bound by *our* decision, so it is hard to see why it matters whether the district judge's resolution would have had independent effect.

Notices of appeal in bankruptcy must name "all parties to the judgment, order, or decree appealed from". *Fed. R. Bankr. P. 8001(a)(2).* Handleman was not a "party" to the critical-vendors order; Kmart was the sole party at the time. Kmart filed an [**8] *ex parte* application that did not specify any particular creditor. It had notified only 65 creditors of its impending request, and none of these was among the 2,000 vendors to be left high and dry. The bankruptcy judge's order likewise did not identify any creditor that acquired rights, for *no* creditor acquired rights. All the order did was authorize Kmart to pay any vendor that Kmart in its discretion deemed "critical." The party that Capital Factors had to name thus was Kmart itself, and this it did. If the lack of personal notice about the proceedings before the district judge deprived Handleman of due process, then Kmart's application to the bankruptcy judge deprived about 47,000 unsecured creditors of due process! That would render the critical-vendors order void, and Handleman would be worse off -- for then it would have to repay the money even if the order's entry otherwise would have been lawful. But there is no constitutional obligation to make every creditor a party to every contested matter in the bankruptcy. As a rule, a trustee or debtor in possession represents the interests of many stakeholders. Kmart vigorously represented the interests of Handleman and the [**9] other vendors Kmart deemed "critical".

Other creditors must look out for their own interests and intervene if need be -- as Handleman could have done had it devoted to these proceedings the care that a $ 49 million stake warrants. Handleman will [*871] be a party, and receive all the notice that the Constitution requires, if Kmart initiates a preference-recovery action against it. As a party in this court, Handleman will not be allowed to contest matters resolved here; even the 2,327 critical vendors that are not parties in this court must accept the precedential effect of our decision. No rule of law requires personal notice to all entities that might be affected by the precedential (as opposed to the preclusive) force of an appellate decision. Today's opinion affects thousands of "critical vendors" and other unsecured creditors; decisions by the Supreme Court may affect millions of persons. Only those persons who will be formally bound by a decision are entitled to individual notice, and then only when practical (the lesson of many a class action, see *Mirfasihi v. Fleet Mortgage Corp., 356 F.3d 781, 2004 U.S. App. LEXIS 1326, *14-15, No. 03-1069 (7th Cir. Jan. 29, 2004)*. So there was no flaw in the notice of appeal [**10] or the district judge's view that Kmart and Capital Factors were the only parties to the proceedings.

Thus we arrive at the merits. *Section 105(a)* allows a bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the Code. This does not create discretion to set aside the Code's rules about priority and distribution; the power conferred by *§ 105(a)* is one to implement rather than override. See *Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206, 99 L. Ed. 2d 169, 108 S. Ct. 963 (1988)*; *In re Fesco Plastics Corp., 996 F.2d 152, 154 (7th Cir. 1993)*. Cf. *United States v. Noland, 517 U.S. 535, 542, 134 L. Ed. 2d 748, 116 S. Ct. 1524 (1996)*. Every circuit that has considered the question has held that this statute does not allow a bankruptcy judge to authorize full payment of any unsecured debt, unless all unsecured creditors in the class are paid in full. See *In re Oxford Management Inc., 4 F.3d 1329 (5th Cir. 1993)*; *Official Committee of Equity Security Holders v. Mabey,* *832 F.2d 299 (4th Cir. 1987)*; *In re B&W Enterprises, Inc., 713 F.2d 534 (9th Cir. 1983)*. [**11] We agree with this view of *§ 105*. "The fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be." *In re Chicago, Milwaukee, St. Paul & Pacific R.R., 791 F.2d 524, 528 (7th Cir. 1986)*.

A "doctrine of necessity" is just a fancy name for a power to depart from the Code. Although courts in the days before bankruptcy law was codified wielded power to reorder priorities and pay particular creditors in the name of "necessity" -- see *Miltenberger v. Logansport Ry., 106 U.S. 286, 27 L. Ed. 117, 1 S. Ct. 140 (1882)*; *Fosdick v. Schall, 99 U.S. 235, 25 L. Ed. 339 (1878)* -- today it is the Code rather than the norms of nineteenth century railroad reorganizations that must prevail. *Miltenberger* and *Fosdick* predate the first general effort at codification, the Bankruptcy Act of 1898. Today the *Bankruptcy Code of 1978* supplies the rules. Congress did not in terms scuttle old common-law doctrines, because it did not need to; the Act curtailed, and then the Code replaced, the entire apparatus. [**12] Answers to contemporary issues must be found within the Code (or legislative halls). Older doctrines may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding entitlements to trump the text. See, e.g., *Lamie v. United States Trustee, 157 L. Ed. 2d 1024, 124 S. Ct. 1023, 1031 (U.S. 2004)*; *United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 242-46, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989)*; *Bethea v. Robert J. Adams & Associates, 352 F.3d 1125, 1128-29 (7th Cir. 2003)*. See also *Noland* (courts lack authority to subordinate creditors that judges, as opposed to legislators, believe should be lower in the hierarchy).

[*872] So does the Code contain any grant of authority for debtors to prefer some vendors over others? Many sections require equal treatment or specify the details of priority when assets are insufficient to satisfy all claims. E.g., *11 U.S.C. §§ 507, 1122(a), 1123(a)(4)*. Appellants rely on *11 U.S.C. §§ 363(b), 364(b), and 503* as sources of authority for unequal treatment. *Section 364(b)* reads: "The court, after notice and a hearing, may authorize the trustee to obtain unsecured [**13] credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense." This authorizes the debtor to obtain credit (as Kmart did) but has nothing to say about how the money will be disbursed or about priorities among creditors. To the extent that *In re Payless Cashways, Inc., 268 B.R. 543 (Bankr. W.D. Mo. 2001)*, and similar decisions, hold otherwise, they are unpersuasive. *Section 503*, which deals with administrative expenses, likewise is irrelevant. Pre-filing debts are not administrative expenses; they are the antithesis of administrative expenses. Filing a petition for bankruptcy effectively creates two firms: the debts of the pre-filing entity may be written down so that the post-filing entity may reorganize and continue in business if it has a positive cash flow. See *Boston & Maine Corp. v. Chicago Pacific Corp., 785 F.2d 562 (7th Cir. 1986)*. Treating pre-filing debts as "administrative" claims against the post-filing entity would impair the ability of bankruptcy law to prevent old debts from sinking a viable firm.

That leaves *§ 363(b)(1)*: "The trustee [**14] [or debtor in possession], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." This is more promising, for satisfaction of a pre-petition debt in order to keep "critical" supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy. Capital Factors insists that *§ 363(b)(1)* should be limited to the commencement of capital projects, such as building a new plant, rather than payment of old debts -- as paying vendors would be "in the ordinary course" but for the intervening bankruptcy petition. To read *§ 363(b)(1)* broadly, Capital Factors observes, would be to allow a judge to rearrange priorities among creditors (which is what a critical-vendors order effectively does), even though the Supreme Court has cautioned against such a step. See *United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213, 135 L. Ed. 2d 506, 116 S. Ct. 2106 (1996)*; *Noland, supra*. Yet what these decisions principally say is that priorities do not change unless a statute supports that step; and if *§ 363(b)(1)* is such a statute, then there is no insuperable problem. [**15] If the language is too open-ended, that is a problem for the legislature. Nonetheless, it is prudent to read, and use, *§ 363(b)(1)* to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code. We need not decide whether *§ 363(b)(1)* could support payment of some prepetition debts, because *this* order was unsound no matter how one reads *§ 363(b)(1)*.

The foundation of a critical-vendors order is the belief that vendors not paid for prior deliveries will refuse to make new ones. Without merchandise to sell, a retailer such as Kmart will fold. If paying the critical vendors would enable a successful reorganization and make even the disfavored creditors better off, then all creditors favor payment whether or not they are designated as "critical." This suggests a use of *§ 363(b)(1)* similar to the theory underlying a plan crammed down the throats of an impaired class of creditors: if the impaired class does at least as [*873] well as it would have under a Chapter 7 liquidation, then it has no legitimate objection and cannot block the reorganization. See generally *Bank of America* *v. 203 N. LaSalle St. Partners, 526 U.S. 434, 143 L. Ed. 2d 607, 119 S. Ct. 1411 (1999).* [**16] For the premise to hold true, however, it is necessary to show not only that the disfavored creditors *will* be as well off with reorganization as with liquidation -- a demonstration never attempted in this proceeding -- but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued. If vendors will deliver against a promise of current payment, then a reorganization can be achieved, and all unsecured creditors will obtain its benefit, without preferring any of the unsecured creditors.

Some supposedly critical vendors will continue to do business with the debtor because they must. They may, for example, have long term contracts, and the automatic stay prevents these vendors from walking away as long as the debtor pays for new deliveries. See *11 U.S.C. § 362.* Fleming Companies, which received the largest critical-vendors payment because it sold Kmart between $ 70 million and $ 100 million of groceries and related goods weekly, was one of these. No matter how much Fleming would have liked to dump Kmart, it had no right to do so. It was unnecessary to compensate Fleming for continuing to [**17] make deliveries that it was legally required to make. Nor was Fleming likely to walk away even if it had a legal right to do so. Each new delivery produced a profit; as long as Kmart continued to pay for new product, why would any vendor drop the account? That would be a self-inflicted wound. To abjure new profits because of old debts would be to commit the sunk-cost fallacy; well-managed businesses are unlikely to do this. Firms that disdain current profits because of old losses are unlikely to stay in business. They might as well burn money or drop it into the ocean. Again Fleming illustrates the point. When Kmart stopped buying its products after the contract expired, Fleming collapsed (Kmart had accounted for more than 50% of its business) and filed its own bankruptcy petition. Fleming was hardly likely to have quit selling of its own volition, only to expire the sooner.

Doubtless many suppliers fear the prospect of throwing good money after bad. It therefore may be vital to assure them that a debtor will pay for new deliveries on a current basis. Providing that assurance need not, however, entail payment for pre-petition transactions. Kmart could have paid cash or its equivalent. [**18] (Kmart's CEO told the bankruptcy judge that COD arrangements were not part of Kmart's business plan, as if a litigant's druthers could override the rights of third parties.) Cash on the barrelhead was not the most convenient way, however. Kmart secured a $ 2 billion line of credit when it entered bankruptcy. Some of that credit could have been used to assure vendors that payment would be forthcoming for all post-petition transactions. The easiest way to do that would have been to put some of the $ 2 billion behind a standby letter of credit on which the bankruptcy judge could authorize unpaid vendors to draw. That would not have changed the terms on which Kmart and any of its vendors did business; it just would have demonstrated the certainty of payment. If lenders are unwilling to issue such a letter of credit (or if they insist on a letter's short duration), that would be a compelling market signal that reorganization is a poor prospect and that the debtor should be liquidated post haste.

Yet the bankruptcy court did not explore the possibility of using a letter of credit to assure vendors of payment. The [*874] court did not find that any firm would have ceased doing business with Kmart [**19] if not paid for pre-petition deliveries, and the scant record would not have supported such a finding had one been made. The court did not find that discrimination among unsecured creditors was the only way to facilitate a reorganization. It did not find that the disfavored creditors were at least as well off as they would have been had the critical-vendors order not been entered. For all the millions at stake, this proceeding looks much like the Chapter 13 reorganization that produced *In re Crawford, 324 F.3d 539 (7th Cir. 2003).* Crawford had wanted to classify his creditors in a way that would enable him to pay off those debts that would not be discharged, while stiffing the creditors whose debts were dischargeable. We replied that even though classification (and thus unequal treatment) is possible for Chapter 13 proceedings, see *11 U.S.C. § 1322(b),* the step would be proper only when the record shows that the classification would produce some benefit for the disfavored creditors. Just so here. Even if *§ 362(b)(1)* allows critical-vendors orders in principle, preferential payments to a class of creditors are proper only if the record shows [**20] the prospect of benefit to the other creditors. This record does not, so the critical-vendors order cannot stand.

AFFIRMED

APPENDIX "B"

National Bankruptcy Conference Proposal
April 2005

Section 1117. Payment of Prepetition Claims

(a) After the order for relief, except as provided in section 365, 503, 546, 1110, 1113, 1114, or 1168, subsection (b) or (c) of this section, a plan confirmed in the case, or the order confirming the plan, the trustee may not pay an unsecured claim that arose before the commencement of the case under this title.

(b) The court, on request of the trustee and after notice and a hearing, may authorize the trustee to pay, or otherwise perform an obligation in connection with, an unsecured claim that arose before the commencement of the case, whether or not proof of the claim has been filed or deemed filed or the claim has been allowed, if such payment is in the best interest of the estate and --

(1) the claim is owed to an employee of the debtor and is of the kind and for the amount and time periods specified in section 507(a)(4) or 507(a)(5); or

(2) the claim arose from the purchase, before the commencement of the case, of goods or services, or the right to use technology or information, from the debtor in the ordinary course of business of the debtor, including a claim based on a warranty, right to a price discount, or right to receive delivery of goods or services.

(c) The court, on request of the trustee and after notice and a hearing, may authorize the trustee to pay, or otherwise perform an obligation in connection with, an unsecured claim that arose before the commencement of the case, other than a claim of the kind specified in subsection (b), whether or not proof of the claim has been filed or deemed filed or the claim has been allowed, if –

(1) there is a compelling public interest in the continuation of the debtor's business and a material risk that the debtor's business will not continue without such payment or performance;

(2) such payment or performance is necessary to permit the reorganization of the debtor and the benefit to the estate of such payment or performance substantially outweighs the cost to the estate; or

(3) there is a compelling public interest in such payment or performance and the benefit to the estate of such payment or performance outweighs the cost to the estate.

APPENDIX "C"

(11)

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF DELAWARE

In re	) Chapter 11
MARINER POST-ACUTE NETWORK, INC., a Delaware corporation,	) Case No. 00-00113 (MFW)
and affiliates,	) (Jointly Administered Case Nos. 00-00113 (MFW) through 00-00214 (MFW), inclusive)
Debtors.	)

ORDER AUTHORIZING PAYMENT OF CLAIMS OF CRITICAL TRADE VENDORS

Upon review and consideration of the motion (the "Motion"), filed by Mariner Post-Acute Network, Inc. ("MPAN"), and its affiliated entities which are the debtors and debtors in possession herein (collectively, the "Debtors" or the "MPAN Debtors"), for an order authorizing the Debtors to satisfy prepetition claims (the "Critical Vendor Claims") of certain of their critical vendors and suppliers, including, but not limited to, the Debtors' national critical vendors listed on Exhibit "1" attached to the Motion and the local critical vendors (collectively, the "Critical Vendors"), all as more fully set forth in the Motion; and upon consideration of the "Affidavit of Boyd P. Gentry in Support of Chapter 11 Petitions and First-Day Motions and Applications"; and the Court having jurisdiction to consider the Motion and the relief requested therein in accordance with 28 U.S.C. §§ 157 and 1334; and notice of the Motion having been given to the United States Trustee for the

District of Delaware, counsel to the Agent for the MPAN Debtors' senior secured prepetition lenders, and counsel to the Agent for the MPAN Debtors' proposed postpetition debtor in possession lenders, and it appearing that such notice is adequate and that no other or further notice need be provided; and the Court having determined that the relief sought in the Motion is in the best interests of the Debtors, their creditors, and all parties in interest; and upon the Motion and all of the proceedings had before the Court; and sufficient cause appearing therefor

NOW, THEREFORE, IT IS HEREBY ORDERED THAT:

1. The Motion is GRANTED;

2. The Debtors are authorized, but not obligated, to pay or settle the Critical Vendor Claims in an amount not to exceed $20 million in the aggregate;

3. The Debtors are authorized, but not obligated, to issue postpetition checks, or to effect postpetition fund transfer requests, in replacement of any checks or fund transfer requests in respect of prepetition obligations owed to Critical Vendors which are dishonored or rejected as of or after the commencement of these chapter 11 cases;

4. The Debtors are authorized (subject to paragraph 2), but not obligated, to pay invoices received postpetition for goods and services received prepetition from the Critical Vendors;

5. Any Critical Vendor who accepts payment from the Debtors pursuant to this order shall be deemed to have waived any and all prepetition claims, of any type, kind, or priority,

against the Debtors, their assets and properties, and any funds or amounts held in trust by the Debtors to the extent that the foregoing claims, funds, or amounts relate to the paid Critical Vendor Claims;

6. The Debtors are authorized, but not obligated, (i) to condition any payment of a Critical Vendor on an agreement by such Critical Vendor to provide postpetition credit on terms and conditions acceptable to the Debtors and to return or apply any prepetition deposits as requested by the Debtors and (ii) to require written confirmation of such postpetition credit terms and limits to be provided by the critical Vendors prior to paying such vendors' Critical Vendor Claims;

7. Until Critical Vendors agree to the Payment Conditions (as defined in the Motion) and are subsequently paid, the Critical Vendors may not exercise any claimed rights of setoff against any prepetition deposit without relief from the automatic stay, as specified in Section 362(a)(7) of the Bankruptcy Code;

8. The Debtors are hereby authorized and empowered to take such actions as may be necessary and appropriate to implement the terms of this order; and

9. Any authorization granted by this order is subject in all cases to any limitations imposed under any postpetition debtor-in-possession financing agreement.

Dated: January 18, 2000

Mary F. Walrath
JUDGE

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cc: Collins & UST 1/20/00

Movant to send copies to all parties and file certificate of service with the court.

APPENDIX "D"

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF DELAWARE

In re:	)	Chapter 11
	)	
J.L. FRENCH AUTOMOTIVE CASTINGS, INC.,[1]	)	Case No. 06-10119 (MFW) (Jointly Administered)
	)	
Debtors.	)	**Related to Docket No. 25**

FINAL ORDER GRANTING THE DEBTORS AUTHORITY FOR PROVISIONAL PAYMENT OF PREPETITION CLAIMS OF CRITICAL TRADE CREDITORS

Upon the motion (the "Motion")[2] of the Debtors for entry of an order authorizing, but not directing, the Debtors to pay prepetition claims of certain Critical Trade Creditors in the ordinary course of business pursuant to the terms and conditions set forth in the Motion, and it appearing that the relief requested is in the best interests of the Debtors' estates, their creditors, and other parties-in-interest; and it appearing that this Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334; and it appearing that this proceeding is a core proceeding pursuant to 28 U.S.C. § 157(b)(2); and it appearing that venue of these proceedings and the Motion in this district is proper pursuant to 28 U.S.C. §§ 1408 and 1409; and it appearing that notice of the Motion and the opportunity for a hearing on the Motion was appropriate under the particular circumstances and that no other or further notice need be given; and the Court finding that based

[1] The Debtors are: J.L. French Automotive Castings, Inc., Nelson Metal Products Corporation, Allotech International Inc., Shore Line Industries, Inc., J.L. French Automotive LLC, French Holdings, Inc., J.L. French Corporation, J.L. French Automotive Castings New York, Inc., J.L. French Automotive Castings Illinois, Inc.

[2] Capitalized terms used but not defined herein shall have the same meaning as in the Motion or the Affidavit of James Amodeo, Chief Financial Officer of J.L. French Automotive Castings, Inc., in Support of First Day Motions (the "First Day Affidavit"), as the case may be.

on the testimony of James M. Amodeo the Debtors have established the necessity of making payment to certain Creditors whom they deem are critical trade creditors and who meet the criteria set forth below (each, a "Critical Trade Creditor") up to a maximum amount of $10,600,000; and after due deliberation and sufficient cause appearing therefor, it is hereby, it is hereby

ORDERED, that the Motion is granted in its entirety, except as modified herein; and it is further

ORDERED that the Debtors are authorized, but not obligated, in their sole discretion, in the reasonable exercise of their business judgment, pursuant to the "Doctrine of Necessity" and section 105 of the Bankruptcy Code, to pay the prepetition "Trade Claims" of Critical Trade Creditors in the ordinary course of business, up to a maximum amount of $10,600,000, upon such terms and in the manner provided in this Order. As used herein, a "Trade Claim" is the claim (as such term is defined in section 101(5) of title 11 of the United States Code as amended from time to time (the "Bankruptcy Code)) against the Debtors for goods or services provided to the Debtors before the petition date. As used herein, the term "Critical Trade Creditor" refers to an entity that is <u>not</u> an indirect or direct subsidiary of the Debtors, and is the holder of a Trade Claim; and it is further

ORDERED, that the Debtors shall maintain a matrix beginning on the Petition Date, and shall provide that matrix to counsel for the official committee of unsecured creditors (the "Committee") and counsel for the Second Lien Noteholders by the close of business each Friday updated on a weekly basis through the previous Friday, setting forth the:

(i) name of each Critical Trade Creditor paid on account of its Trade Claims;

(ii) amount paid to each Critical Trade Creditor on account of its Trade Claims;

(iii) the category of goods or services provided by such Critical Trade Creditor;

(iv) type of documentation supporting each such Trade Claim, whether a "spot buy" purchase order, a "blanket" purchase order covering a specific time period, a capital equipment purchase order, a contract with one or more purchase orders or otherwise (each, a "Prepetition Agreement") and the duration or time period specified in such documentation;;

(v) Applicable trade terms of each such Prepetition Agreement (including payment terms, the period in which the Prepetition Agreement is in force and similar terms, as applicable) that were in force on June 30, 2005, and prior to the Petition Date;

(vi) trade terms obtained from the Critical Trade Creditor in exchange for payment of part or all of its Trade Claims, whether documented in a Trade Agreement or otherwise;

(vii) period of time during which such trade terms are effective; and

(viii) whether any Trade Agreement has been terminated or renegotiated on the terms set forth herein;

and it is further

ORDERED, that the Debtors shall undertake all appropriate efforts to cause Critical Trade Creditors to enter into an agreement with Debtors substantially similar to Exhibit A to the Motion, including the following terms:

(i) The amount of such Critical Trade Creditor's estimated prepetition trade claims, accounting for any setoffs, other credits and discounts thereto, shall be as mutually determined in good faith by the Critical Trade Creditor and the Debtors (but such amount shall be used only for the purposes of this Order and shall not be deemed a Claim allowed by the Court and the rights of all interested persons to object to such Claim shall be fully preserved until further Order of the Court);

(ii) The Critical Trade Creditor's agreement to be bound by the normal and customary trade terms, practices and programs (including, but not limited to, credit limits, pricing, cash discounts, timing of payments, allowances, rebates, coupon reconciliation, normal product mix and availability and other applicable terms and programs), which were most favorable to the Debtors and in effect between such Critical Trade Creditor and the Debtors on a historical basis for the period within one-hundred twenty (120) days of the Petition Date or such other trade terms as agreed by the Debtors and such Critical Trade Creditor or such other trade terms, practices and programs that are at least as favorable as those that were in effect prepetition in the Debtors' sole discretion ("Customary Trade Terms");

(iii) The Critical Trade Creditor's agreement to provide goods and services to the Debtors based upon Customary Trade Terms or on such terms as the Debtors and the Critical Trade Creditor may otherwise agree, and the Debtors' agreement to pay in accordance with such terms;

(iv) The Critical Trade Creditor's agreement that it will not separately seek payment for reclamation, setoff or recoupment claims arising from prepetition trade claims outside of the terms of this Order unless the Critical Trade Creditor's participation in the trade payment program authorized by this Order is terminated; provided that such claims, if thereafter raised by the Critical Trade Creditor as permitted by this Order, shall be treated as though raised on the date of this Order;

(v) The Critical Trade Creditor's acknowledgment that it has reviewed the terms and provisions of this Order and consents to be bound hereby;

(vi) If either the trade payment program or the Critical Trade Creditor's participation therein terminates, or a Critical Trade Creditor who has received payment of a prepetition claim later refuses to continue to supply goods to the Debtors on Customary Trade Terms, subject to defenses, any payments received by the Critical Trade Creditor on account of such Critical Trade Creditor's prepetition claim will be deemed to have been in payment of then outstanding postpetition obligations owed to such Critical Trade Creditor and that such Critical Trade Creditor shall immediately repay to the Debtors any payments made to it on account of its prepetition claim to the extent that the aggregate amount of such payments exceed the postpetition obligations then outstanding, without the right of any setoffs, claims, provision for payment of reclamation or trust fund claims, or otherwise.

(vii) An agreement executed between the Debtors and a Critical Trade Creditor as set forth in this paragraph is referred to herein as a "Trade Agreement." The Order is intended to authorize, but shall not require, the Debtors to enter into Trade Agreements, it being the express intention of this Court that the Debtors shall enter into Trade Agreements only when the Debtors determine, in the exercise of their reasonable business judgment, that it is appropriate to do so; and it is further

ORDERED that the Debtors shall be authorized, in their discretion, to make prepetition payments to a Critical Trade Creditor in the absence of a Trade Agreement after the Debtors have undertaken all appropriate efforts to cause such Critical Trade Creditor to execute a Trade Agreement; and it is further

ORDERED, that the Debtors may, in the exercise of their reasonable business judgment, make the payments authorized in the preceding paragraphs on account of prepetition Critical Trade Creditor Claims either (a) after goods are delivered or services are rendered postpetition, or (b) before requested service is rendered or the postpetition goods are delivered; provided, however, that (a) the Debtors shall have issued purchase orders (or computer equivalents thereof), and (b) the Critical Trade Creditor shall have confirmed shipment will occur not later than the next business day after the aforementioned payment has been made and further agrees that postpetition goods are being shipped in accordance with Customary Trade Terms or on such terms as the Debtors and the Critical Trade Creditor may otherwise agree, and also agrees to the terms of this Order by executing an acknowledgment form substantially similar to Exhibit B, attached hereto; and it is further

ORDERED, that the Debtors may, in their discretion (and with prior notice to counsel for the Committee), declare a Trade Agreement with an individual Critical Trade Creditor to have terminated, together with the other benefits to the Critical Trade Creditor as contained in this Order, on the date the Debtors deliver notice to the Critical Trade Creditor that the Critical Trade Creditor has not complied with the terms and provisions of the Trade Agreement or has failed to continue to provide Customary Trade Terms (or on such terms as the Debtors and the Critical Trade Creditor had otherwise agreed); provided, however, that the Trade Agreement may be reinstated if:

(i) Such determination is subsequently reversed by the Court for good cause shown that the determination was materially incorrect after notice and a hearing following a motion from the Critical Trade Creditor; or

(ii) The underlying default under the Trade Agreement was fully cured by the Critical Trade Creditor not later than five business days after the date when the initial default occurred, and the Debtors agree that such cure is sufficient to remedy any harm attendant thereto and to reinstate the Trade Agreement; or

(iii) The Debtors, in their discretion (and with prior notice to counsel for the Committee), reach an agreement with the Critical Trade Creditor; and it is further

ORDERED, that all Trade Agreements shall be deemed to have terminated, together with the other benefits to Critical Trade Creditors as contained in this Order, upon entry of an order converting the Debtors' Chapter 11 Cases to cases under chapter 7 of the Bankruptcy Code; and it is further

ORDERED, that if a Trade Agreement is terminated as set forth in either of the two previous paragraphs, or a Critical Trade Creditor who has received payment of a prepetition claim later refuses to continue to supply goods to the Debtors on Customary Trade Terms during the pendency of the Chapter 11 Cases, the Debtors may, in their discretion (with prior notice to counsel for the Committee), declare that provisional payments made to the Critical Trade Creditor on account of prepetition Critical Trade Creditor Claims be deemed to have been in payment of then outstanding postpetition claims without further order of the Court or action by any person or entity. A Critical Trade Creditor shall then immediately repay to the Debtors any payments made to it on account of its prepetition Critical Trade Creditor Claims to the extent that prepetition Critical Trade Creditor Claim payments exceed the postpetition claims then outstanding without the right of any setoffs, claims, provision for payment of reclamation or trust fund claims, or otherwise, it being the express intention of this Court to return the creditors to the status quo in effect as of the date of entry of this Order with respect to all prepetition claims if a Trade Agreement is terminated; and it is further

ORDERED, that the Committee shall have the right to challenge, by motion, the Debtors' administration of its authority under this Order, on a Trade Creditor-by-Trade Creditor basis, and with respect to any such motion, the Court may fashion such relief as it deems fit; and it is further

ORDERED, notwithstanding the possible applicability of Fed R. Bankr. P. 6004(h), 7062, 9014, or otherwise, the terms and conditions of this Order shall be immediately effective and enforceable upon its entry; and it is further

ORDERED, that this Court retains jurisdiction with respect to all matters arising from or related to the implementation of this Order.

Dated: March 6, 2006

Mary F Walrath

Honorable Mary F. Walrath
Chief United States Bankruptcy Judge

K&E 10753644.

APPENDIX "E"

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	Chapter 11
Dana Corporation, *et al.*,	:	Case No. 06-10354 (BRL)
Debtors.	:	(Jointly Administered)

ORDER, PURSUANT TO SECTIONS 105(a), 363(b), 364(b) AND 503(b)(9) OF THE BANKRUPTCY CODE, AUTHORIZING THE DEBTORS TO PAY PREPETITION CLAIMS OF CERTAIN ESSENTIAL SUPPLIERS AND ADMINISTRATIVE CLAIMHOLDERS AND GRANTING CERTAIN RELATED RELIEF

This matter coming before the Court on the Motion of Debtors and Debtors in Possession, Pursuant to Sections 105(a), 363(b), 364(b) and 503(b)(9) of the Bankruptcy Code, for an Order Authorizing Them to Pay the Prepetition Claims of Certain Essential Suppliers and Administrative Claimholders and Granting Certain Related Relief (the "Motion"),[1] filed by the debtors and debtors in possession in the above-captioned cases (collectively, the "Debtors"); the Court having reviewed the Motion, the Consolidated Memorandum of Law in Support of Motions of Debtors for Orders Authorizing Them to Pay Certain Prepetition Claims (the "Memorandum of Law"), the Affidavit of Michael J. Burns filed in support of the Debtors' first day papers and the Affidavit of Paul E. Miller in support of the Motion (collectively, the "Affidavits") and having considered the statements of counsel and the evidence adduced with respect to the Motion at a hearing before the Court on the Motion (the "Hearing"); and the Court having found that (a) the Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and

1 Capitalized terms not otherwise defined herein shall have the meanings given to them in the Motion.

1334, (b) this is a core proceeding pursuant to 28 U.S.C. § 157(b), (c) notice of the Motion and the Hearing was sufficient under the circumstances; and (d) the payment of the Essential Supplier Claims on the terms and conditions set forth herein is necessary and appropriate (i) to prevent serious disruptions to the Debtors' business operations that would cause potentially immediate and irreparable damage to the Debtors' operations, value and ability to reorganize and (ii) to preserve the going concern value of the Debtors' businesses and the Debtors' estates for the benefit of all stakeholders and, thus, will facilitate the reorganization of the Debtors' businesses; and the Court having determined that the legal and factual bases set forth in the Motion, the Memorandum of Law and the Affidavits and at the Hearing establish just cause for the relief granted herein;

IT IS HEREBY ORDERED THAT:

1. The Motion is GRANTED, subject to modification by the application of any party in interest for cause after notice and a hearing.

2. The Debtors are authorized, in the Debtors' sole discretion and in the ordinary course of their businesses, to pay Essential Supplier Claims, up to the aggregate amount of $52.1 million (the "Essential Supplier Cap").

3. Each recipient of an Essential Supplier Payment shall be required, to the extent applicable, to: (a) continue to extend normalized trade credit and provide other business terms on a postpetition basis (consistent with past practices), including with respect to any applicable credit limits, the pricing of goods and services and the provision of equivalent levels of service, on terms at least as favorable as those extended prepetition or on such other terms that are acceptable to the Debtors in their business judgment, until the Debtors emerge from chapter 11; and (b) release to the Debtors as requested goods or other assets of the Debtors in the Essential Supplier's possession (collectively, the "Trade Terms").

4. If an Essential Supplier accepts a Essential Supplier Payment and fails to provide the Debtors with the requisite Trade Terms, then (a) any Essential Supplier Payment received by the Essential Supplier shall be deemed an unauthorized postpetition transfer under section 549 of the Bankruptcy Code that the Debtors may either (i) recover from the Essential Supplier in cash or goods or (ii) at the Debtors' option, apply against any outstanding administrative claim held by such Essential Supplier; and (b) upon recovery of any Essential Supplier Payment, the corresponding prepetition claim of the Essential Supplier will be reinstated in the amount recovered by the Debtors, less the Debtors' reasonable costs to recover such amounts.

5. The Debtors shall implement and provide notice of the conditions set forth in paragraphs 3 and 4 above through the following procedures:

- The Debtors may require a Essential Supplier to execute an agreement (a "Trade Agreement") prior to its receipt of a Essential Supplier Payment that (a) confirms that the Essential Supplier agrees to be bound by the terms set forth above, (b) confirms that the Essential Supplier has received and agrees to be bound by this Order and (c) contains such other terms and conditions as the Debtors believe proper, including confidentiality provisions.

- Any check pursuant to which an Essential Supplier Payment is made will be accompanied by (a) a letter from the Debtors explaining that acceptance of the check by the Essential Supplier constitutes its agreement to provide the Trade Terms and explaining the consequences of its failure to comply with such agreement and (b) a copy of this Order (collectively, the "Essential Supplier Information").

- If the Debtors make Essential Supplier Payments by wire transfer or automated clearinghouse transaction, the Essential Supplier Information shall be sent by the Debtors, and received and agreed upon by the Essential Supplier, prior to the payment.

- Each check issued on account of a Essential Supplier Payment may, in the Debtors' sole discretion, include a restrictive endorsement on the back of the check as follows:

> By accepting this check, the payee agrees (a) to provide the payor and its affiliates with normalized trade credit and provide other business terms on a postpetition basis (consistent with past practices), including with respect to any applicable credit limits, pricing and the provision of equivalent levels of service, on terms at least as favorable as those extended to the payor and its affiliates prior to the commencement of payor's chapter 11 case, or as are otherwise acceptable to the payor, for the duration of the payor's chapter 11 case, identified as Case No. _______, pending in the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"), and (c) upon request, to release to payor any property of payor in payee's possession. Payee hereby submits to the jurisdiction of the Bankruptcy Court for the enforcement of such agreement.

6. The Debtors are authorized, but not required, in the exercise of their business judgment, to pay claims of any creditors or claimants entitled to administrative priority pursuant to section 503(b)(9) of the Bankruptcy Code (the "Twenty-Day Administrative Claims") in the ordinary course of the Debtors' businesses and on such terms and conditions as the Debtors deem appropriate. Nothing in this paragraph 6 shall be construed as requiring the Debtors to make a payment to a particular creditor or claimant. Payment of any Twenty-Day Administrative Claims shall not count against the Essential Supplier Cap.

7. If a Repudiating Vendor refuses to perform its postpetition obligations pursuant to an executory contract with one or more of the Debtors in violation of the Bankruptcy Code because the Debtors have failed to pay the vendor's prepetition claim, the Debtors are authorized to pay such claim provisionally (and such payment will not count against the Essential Supplier Cap) (a "Provisional Payment"), provided that, within ten business days of payment, the Debtors file a Notice of Repudiating Vendor and seek the entry of an Order to Show Cause as set forth in paragraph 8 below.

8. If a Repudiating Vendor refuses to perform its postpetition obligations pursuant to an executory contract with one or more of the Debtors in violation of the Bankruptcy Code, the Debtors may (whether or not they made a Provisional Payment as described above): (a) file a Notice of Repudiating Vendor, substantially in the form of notice attached to the Motion as Exhibit A, setting forth the Debtors' belief that the vendor is in violation of the Bankruptcy Code through its failure to perform under a prepetition agreement, identifying the name of the vendor, the identity of the agreement in question and, if any Provisional Payments were made, the amounts and date of such Provisional Payments; and (b) seek the entry of an Order to Show Cause, substantially in the form attached to the Motion as Exhibit B, which shall require the Repudiating Vendor to appear at the next regularly scheduled omnibus hearing in the Debtors' chapter 11 cases that is at least five business days after the date that the Notice of Repudiating Vendor is filed, to show why it should not be found to have willfully violated sections 362 and 365 of the Bankruptcy Code and required to return any Provisional Payment made by the Debtors.

9. The Debtors' banks and financial institutions (collectively, the "Banks") are authorized and directed, when requested by the Debtors in the Debtors' sole discretion, to receive, process, honor and pay all checks presented for payment of, and to honor all funds transfer requests made by the Debtors related to, Essential Supplier Claims, the Twenty-Day Administrative Claims and the Provisional Payments, whether such checks were presented or funds transfer requests were submitted prior to or after the Petition Date, provided that funds are available in the Debtors' accounts to cover such checks and funds transfers. The Banks are authorized to rely on the Debtors' designation of any particular check or funds transfer as approved by this Order.

10. Nothing in the Motion or this Order, nor the Debtors' payment of claims pursuant to this Order, shall be deemed or construed as: (a) an admission as to the validity of any claim against the Debtors; (b) a waiver of the Debtors' rights to dispute any claim on any grounds; (c) a promise to pay any claim; (d) an implication or admission that any particular claim would constitute a Essential Supplier Claim; or (e) a request to assume any executory contract or unexpired lease, pursuant to section 365 of the Bankruptcy Code.

11. Pursuant to Bankruptcy Rule 6004(h), this Order shall be immediately effective and enforceable upon entry.

12. Any subsequent modification of this Order shall not impair any action taken pursuant to the authority granted in this Order.

Dated: March 3, 2006
New York, New York

/s/Burton R. Lifland
UNITED STATES BANKRUPTCY JUDGE

RESPONSE TO POST-HEARING QUESTIONS FROM JACK F. WILLIAMS, AMERICAN BANKRUPTCY INSTITUTE RESIDENT SCHOLAR, GEORGIA STATE UNIVERSITY COLLEGE OF LAW

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on "Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?"
Wednesday, March 11, 2009

Professor Jack Williams

Questions from the Honorable Steve Cohen, Chairman

1. **If Circuit City filed before the 2005 Amendments went into effect, would it have been able to successfully reorganize?**

   Probably yes. The 2005 Amendments to the Bankruptcy Code created a Chapter 11 for good times, not a chapter 11 that is most effective for financially bad times. A major thrust of the drafters of chapter 11 of the Bankruptcy Reform Act of 1978 was to develop a flexible, adaptive, and transparent system that was business-plan agnostic. Our original chapter 11 design permitted a debtor a broad range of discretion, consistent with the exercise of sound business judgment and the best interests of the estate, to develop a business plan with the greatest chance of success. It would have been with this backdrop that the bankruptcy professionals would have considered the many challenging issues that Circuit City presented. In my opinion, Circuit City was doomed for two interconnected reasons. First, Circuit City simply could not access sufficient capital or financing to continue in existence. This deficiency was a result of the economy and may have condemned Circuit City from the outset. Second, Circuit City waited too long, largely, in my opinion, because the 2005 Amendments to the Bankruptcy Code ripped the safe harbor that bankruptcy once provided to retailers away from debtors like Circuit City.

2. **In your prepared statement you argue that landlords are unlikely to consent to an extension beyond the 210 days specified in section 365(d)(4), and if they do consent, they are likely to request a Consent Fee or other Concessions.**

   In light of the fact that a store such as Circuit City served as the anchor for other smaller retailers in a shopping center, and that in the current commercial retail market it is unlikely to find a retailer of that size willing to sign a new lease as the anchor, isn't it in the best interest of a landlord to keep a store like Circuit City around for as long as possible?

   Yes, it is in the best interests of the Landlord to keep a store like Circuit City around as long as possible. However, Landlords may nonetheless demand payment for their consent. Moreover, there is a hidden purpose behind the 210 day rule. Under section 365 of the Bankruptcy Code, a debtor may assume a lease, reject a lease, or assign a lease. By imposing the hard 210 day cap, Landlords sought to prevent the assignment of leases. That time period effectively limits the ability to consider reorganization and, in the alternative, assigning leases. In my opinion, it is the backdoor prevention of lease assignment that was the primary motivation behind the 2005 Amendments to section 365(d)(4).

3. **You support removing the 210-day deadline from Bankruptcy Code section 365 and allowing the courts to determine the extension period on a "case-by-case" basis.**

   Shouldn't a landlord such as Developers Diversified know that at some point in the case the debtor must definitively assume or reject a lease?

   Yes, and the Landlord does. Under the old rule, the debtor had until plan confirmation to assume or reject a lease. In my experience as a bankruptcy attorney, financial advisor, and academic, most landlords know where they stand well before confirmation. As a practical matter, leases are quickly coded into three buckets – net assets (performing leases); net liabilities (nonperforming assets); and pushes (we do not know if this will be a net asset or liability). The net liabilities are rejected quickly if they cannot be assigned to a third party. That cuts off the obligation of the debtor to continue to pay rent and otherwise perform under the lease. The net asset leases are well know by all parties. The third category is more dicey but landlords have several tools by which to force a debtor's hand and the debtor must fully perform (preserving the benefit of the bargain) under the lease.

4. **Professor Zywicki cites the Montgomery Ward case as an example of a debtor that should have simply liquidated. You also discuss Montgomery Ward in your prepared testimony.**

   What is your response to Professor Zywicki's comments on this case?

   I disagree. All business decisions, including whether to liquidate in chapter 11 or not, are fraught with risk. I was involved in the Ward bankruptcy and have studied it carefully since. Under the Bankruptcy Code as then constructed, management and the debtor's constituencies were given a full and fair opportunity to rehabilitate the business. In attempting to do just that, the landlords were paid in full, taxing authorities were paid in full, employees were retained and paid, vendors continued to provide supplies and were paid, etc. If you envision a Bankruptcy Code with a chapter 11, then Ward is precisely the cases it would be designed for. The fact that it failed cannot be support for Professor Zywicki's comment.

   Would you characterize Montgomery Ward's Chapter 11 case as a success or a failure?

   It was a chapter 11 success and a business failure. As previously mentioned, Ward was given every reasonable opportunity to rehabilitate. Ultimately, it could not do so. It then moved to liquidation. Of course, with hindsight, we could criticize the process for not forcing liquidation at the outset. But no system is better than the people who operate within it. As long as we build a Bankruptcy Code with a chapter 11, then decision makers must be given the discretion to make decisions. With discretion will come success and failure.

5. Do you think the 2005 Amendments to Chapter 11 are playing any role in our Nation's current economic situation?

Calendar year 2008 was not a very good year as far as bankruptcies were concerned. In that year we witnessed about 1.1 million bankruptcy filings. Unfortunately, the numbers are not looking any better for CY 2009. At the ABI, we are projecting over 1.5 million bankruptcy filings with at least a 50% increase in business bankruptcy cases. In fact, as of Q1 2009, eight national retailers have sought relief under the Bankruptcy Code, thus following 27 national retailers that had filed in CY 2008. (Of those 27, 37% filed in Q4 of 2008). The CY 2008 total was the mot since 32 retailers filed in CY 2001. Retailers who filed in the 4Q 2008/1Q 2009 included:

- Value City Department Stores LLC; 10/26/2008
- House of Taylor Jewelry, Inc.; 11/5/2008
- Harold's Stores, Inc.; 11/7/2008
- Circuit City Stores, Inc.; 11/10/2008
- National Wholesale Liquidators, Inc.; 11/10/2008
- Antioch Company, The; 11/13/2008
- BH S&B Holdings LLC; 11/19/2008
- Lenox Group Inc.; 11/23/2008
- KB Toys, Inc.; 12/11/2008
- Theater Xtreme Entertainment Group, Inc.; 12/15/2008
- Recycled Paper Greetings, Inc.; 1/2/2009
- Retail Pro, Inc.; 1/10/2009
- Shane Co.; 1/12/2009
- Goody's, LLC; 1/13/2009
- Gottschalks Inc. Department & Specialty Store Chain 1/14/2009
- Fortunoff Holdings, LLC; 2/5/2009
- S & K Famous Brands, Inc.; 2/9/2009
- Ritz Camera Centers, Inc.; 2/22/2009[1]

Present market conditions and the lending environment suggest that the retail sector will continue to suffer substantial losses and witness more and more companies liquidating or seeking other forms of relief under the Bankruptcy code. For example, top line revenue numbers are down. Profit Margins are down – businesses are reducing prices to draw customers. Consumer spending and credit are down with consumer savings increasing – good for consumers with debt but not so good for a weak economy that is driven by consumer demand. Vendors are aggressively managing their credits, reducing credit terms, pulling back in volume shipments, etc. Vendors are no longer serving as short

[1] Bankruptcydata.com (all numbers).

term banks. Banks are simply not lending beyond what it may take for a quick sale or to liquidate the business unless the business has good cash flows and a good brand. We are also seeing that we are way over built in retail space that the reduced consumer demand can no longer justify. In short, in retail, we have hit a liquidity wall. There are no financial buyers to speak of because of a scarcity in available capital. The present bankruptcy strategy is to find a strategic buyer quickly – because your creditors are giving you little time – or liquidate.

As capital returns to this sector, retailers will continue to face many challenges to rehabilitation – some of which are embedded in the law itself designed to help in rehabilitations of businesses. As mentioned, the 2005 Amendments to the Bankruptcy Code created a Chapter 11 for good times, not a chapter 11 that is most effective for financially bad times. Our original chapter 11 design permitted a debtor a broad range of discretion, consistent with the exercise of sound business judgment and the best interests of the estate, to develop a business plan with the greatest chance of success. If anything, recent amendments to chapter 11 of the Bankruptcy Code have failed to serve the law's original purposes and policy goals.

In my opinion, Congress should consider at least three points in helping recalibrate bankruptcy law to provide a greater chance of success. First, Congress should consider removing the administrative priority for goods sold to the debtor within 20 days and returning that prepetition claim back to the prior practice of establishing a reclamation claim or living with a general unsecured claim. Second, Congress should consider relaxing the deadline by which commercial real property leases must be either assumed or rejected. The 2005 Amendments place a cap of 210 days. By that time, a lease is deemed rejected if not assumed. In my opinion, Congress should consider removing this cap and restoring the discretion of the bankruptcy court to determine on a case-by-case basis whether cause has been shown to extend the deadline. Finally, Congress should consider relaxing the deadline for the period of exclusivity from 18 months to a time period determined by the bankruptcy court. The period of exclusivity is the period by which only a debtor may propose and obtain confirmation of a plan of reorganization. During this period, no other party may file a competing plan until that time period lapses. In my opinion, infusing more and not less judicial discretion is the appropriate way by which to provide a reasonable opportunity for debtor rehabilitation.