Testimony of

Richard M. Pachulski

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

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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.

<u>Bankruptcy Code § 503(b)(9)</u>

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.

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[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 20th 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.