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

Four ABI Members Testify before House Subcommittee on Commercial and Administrative Law

On March 11, 2009, the House Judiciary Committee's Subcommittee on Commercial and Administrative Law held a hearing on "Circuit City Unplugged: Why Did Chapter 11 Fail To Save 34,000 Jobs?" The witnesses were: ***Richard M. Pachulski****, Pachulski Stang Ziehl & Jones LLP in Los Angeles; Harvey R. Miller, Weil, Gotshal & Manges LLP in New York; Daniel B. Hurwitz, president and COO of Developers Diversified Realty Corporation in Beachwood, Ohio;* ***Todd J. Zywicki****, professor of law at George Mason University School of Law in Arlington, Va.;* ***Isaac M. Pachulski****, Stutman, Treister & Glatt Professional Corporation in Los Angeles; and* ***Jack Williams****, ABI's current Robert M. Zinman Resident Scholar and professor of law at Georgia State University College of Law in Atlanta. This Legislative Update column features excerpts from the written testimony of Richard M. Pachulski, Todd J. Zywicki, Isaac M. Pachulski and Jack Williams, all of whom are ABI members. For their full testimony and for the testimony of the non-ABI member witnesses, please go to http://judiciary.house.gov/hearings/hear_090311_1.html. ABI is a nonpartisan organization dedicated to research and education on matters related to insolvency. The statements of these ABI members reflect their views and/or positions, not those of ABI.*

Testimony of Richard M. Pachulski
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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 [Pachulski Stang Ziehl & Jones LLP] 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.

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Legislative Update

The Bank Group's DIP Financing


Richard M. Pachulski

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.

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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.

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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.

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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 Dec. 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.

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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 postpetition 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.

Testimony of Prof. Todd Zywicki
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Prof. Todd Zywicki

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.

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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.

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.

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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. Prof. [Barry] Adler quotes the findings of Prof. 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."[1] 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.

1 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).

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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 reorganization. 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.

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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 nonresidential real property, the purpose of BAPCPA's amendments were to protect landlords and co-tenants 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 prepetition shipments of goods, the primary effect of §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, §507(a)(4) and (a)(5) increase the administrative priority for prepetition 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.

Testimony of Isaac M. Pachulski

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Isaac M. Pachulski

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... [T]he 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 20 days before the chapter 11 filing, and (y) a substantially expanded right lo 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 or 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); [and]
- 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 prepetition 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)).

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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 §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.

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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 forn, however, §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 forn, 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.

[T]he 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.

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.

Testimony of Jack F. Williams

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Prof. Jack F. Williams

Today's subject is not new to me; for over 20 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.

BAPCPA Changes to Bankruptcy Code Relevant to Retail Cases

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

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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.

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. … Because of the 2005 Act's amendment to §365(d)(4),[1] debtors no longer have the time to make a meaningful decision either to assume or reject an unexpired lease.

[T]he 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.

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 §365(d)(4)(A) and the possible additional 90 days provided by §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 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.

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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] Section 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.