

## **Supplemental Materials**

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**Panel on Legislative Impediments-New Administrative Expenses,  
Shortened Time Periods and Other BAPCPA Changes:  
Should BAPCPA Be Rolled Back?**

# **BAPCPA Rollback As A Cure For Unsuccessful Reorganizations? Not So Fast!**

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Abstract: Grounds for opposing a roll back of certain BAPCPA amendments; reasons for the implementation of BAPCPA; how certain BAPCPA changes have worked in practice; the real explanation for the failure of so many retailers (and other) post-BAPCPA chapter 11 debtors, and the circumstances under which debtors presently can and have emerged from post-BAPCPA chapter 11 cases.

## **I. Introduction**

On April 2, 2009, Representative Jerrold Nadler (D-NY) proposed a bill, HR 1942, “The Business Reorganization and Job Preservation Act of 2009,” that would roll back certain of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) amendments. This BAPCPA rollback would:

- eliminate trade creditors’ rights to an administrative priority claim pursuant to § 503(b)(9) of the Bankruptcy Code for the value of goods sold in the ordinary course and received by a debtor within the 20 days preceding the bankruptcy filing;<sup>1</sup>
- limit the forms of adequate assurance of future payment under § 366 of the Bankruptcy Code that utilities can demand, and instead grant bankruptcy courts greater discretion to determine if a utility is adequately assured of payment; and

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<sup>1</sup> HR 1492 also seeks to roll back the changes made under BAPCPA to § 546(c)(1) of the Bankruptcy Code related to reclamation of goods. *See infra*, footnote 3. It does not appear that § 546(c)(1), as amended by BAPCPA, has improved reclaiming claimants’ rights. *See infra*, footnotes 3 and 4.

- allow bankruptcy courts to grant debtors additional time to assume or reject unexpired leases of nonresidential real property “for cause” under § 365 of the Bankruptcy Code, without mandating an outside date, unlike the present deadline of 210 days after the bankruptcy filing under BAPCPA.

Advocates of a BAPCPA rollback have also sought to replace the 18 month outside date under § 1121 of the Bankruptcy Code, during which a debtor has the exclusive right to file a plan, and the 20 month outside date to solicit acceptances to the plan, and replace them with the pre-BAPCPA rule that allowed courts to extend, for “cause” shown, the 120 day deadline to file a plan and 180 day period to seek acceptances, without mandating an outside date.

This paper addresses (1) the reasons for the implementation of the BAPCPA amendments that are being considered for elimination, (2) how these amendments have worked in practice (how debtors have adapted to them), (3) the true causes of the failures of many retailer and other post-BAPCPA chapter 11 debtors, and (4) the circumstances under which retailers and other debtors can and have emerged from post-BAPCPA chapter 11 cases, notwithstanding the present economic climate.<sup>2</sup>

Although it is tempting to roll back BAPCPA and restore the perceived balance of power to debtors, such efforts would not increase the likelihood of rehabilitating debtors in chapter 11. In many cases it would be a futile attempt to assist companies incapable of reorganization and harm creditors and other financially healthy companies. It is well recognized that chapter 11 can be a valuable tool to distressed companies as a forum to reorganize. However, it is equally true that it is not the purpose of chapter 11 to attempt to rehabilitate failed companies incapable of reorganization.<sup>3</sup> Critics of BAPCPA are looking for an easy fix to systemic problems in the current economic environment. The economic climate prior to the

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<sup>2</sup> The authors of this paper were asked by ABI to advocate the position of defending the BAPCPA changes for the Panel on Legislative Impediments. The views expressed herein are not necessarily those of the authors or Lowenstein Sandler PC.

<sup>3</sup> See *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 47-53 (2009) (statement of Todd J. Zywicki, Professor, George Mason School of Law).

credit industry collapse encouraged excess leverage and encumbrance of debtors' assets, as well as an irrational trust in poor management personnel. One cannot point to the failure of entities with any realistic hope of reorganization as the supposed victims of the 2005 amendments.

## II. Reasons for BAPCPA Amendments

In the most basic sense, the corporate restructuring revisions to BAPCPA were triggered in large part by a concern that the caselaw interpreting certain key provisions of chapter 11 had become increasingly disproportionately pro-debtor, to the detriment of creditors' rights. Set forth below is a discussion of how BAPCPA sought to, and successfully accomplished, restoring a proper balance between the rights of debtors and creditors.

### A. Section 503(b)(9) of the Bankruptcy Code

Prior to BAPCPA, trade creditors' reclamation rights were governed by Uniform Commercial Code ("UCC") § 2-702 and Bankruptcy Code § 546(c)(2). Under UCC § 2-702, a creditor seeking to exercise its reclamation rights must send its reclamation demand within 10 days after the buyer receives the goods.<sup>4</sup> For bankruptcy cases filed prior to BAPCPA, Bankruptcy Code § 546(c)(2) required a trade creditor seeking to reclaim goods to send a written reclamation demand to the debtor within 10 days of the buyer's receipt of goods, and if the 10-day period had not expired on the date of the bankruptcy filing, the creditor had to send its reclamation demand to the debtor within twenty days after the buyer received the goods.<sup>5</sup>

Prior to the 1990s, trade creditors' reclamation rights had value. When a trade creditor satisfied the requirements of UCC § 2-702 and § 546(c)(2), the creditor often received an allowed administrative claim in the bankruptcy case for the value of the goods subject to reclamation. The courts recognized that the reclamation rights were important on the theory that

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<sup>4</sup> A trade creditor seeking reclamation of its goods under state law must also prove the debtor's insolvency and is also subject to loss of its reclamation rights where the goods are sold to a good faith or bona fide purchaser prior to the reclamation demand.

<sup>5</sup> Under the pre-BAPCPA version of § 546(c), a creditor seeking reclamation had to prove the debtor's insolvency and identify the goods on hand at the time of the demand. Pre-BAPCPA § 546(c)(2) also provided that a creditor that satisfied the requirements for reclamation was entitled to either return of the goods, a replacement lien, or an administrative priority claim for the value of the goods.

they were protecting a “defrauded seller”—the vendor who had discovered that it recently unknowingly sold and delivered goods on credit to an insolvent buyer that was incapable of paying for the goods.<sup>6</sup>

However, starting in the 1990s and continuing into this decade, courts have drastically curtailed, if not eliminated, trade creditors’ reclamation rights. This trend has been encouraged by the practice of secured lenders obtaining a blanket lien in all of the debtor’s inventory. More and more courts held that reclamation rights were rendered valueless where the debtor granted a secured lender or creditor a blanket lien in all the debtor’s present and after-acquired inventory, and either the secured lender did not release its lien on the goods subject to reclamation or its claim exceeded the value of the goods subject to reclamation.<sup>7</sup>

BAPCPA amended § 546(c) to extend the reclamation reachback period to 45 days, and if the 45-day period had not expired when the bankruptcy petition is filed, the creditor has an additional 20 days from the commencement of the bankruptcy case to send its written reclamation demand.<sup>8</sup> While on its face this change sounded favorable to trade creditors, it has turned out to be illusory. Section 546(c) also states that reclamation rights are expressly subject to the prior rights of a creditor with a security interest in the goods, largely reaffirming prior case law. As a result, creditors seeking to enforce their “expanded” reclamation rights under § 546(c) must continue to deal with prior adverse court decisions that have effectively rendered

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<sup>6</sup> *Phar-Mor, Inc. v. McKesson Corporation*, 534 F.3d 502, 506 (6th Cir. 2008).

<sup>7</sup> See *In re Pester Refining Co.*, 964 F.2d 842, 847 (8th Cir. 1992); *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128, 136 (Bankr. S.D.N.Y. 2003); *In re Arlco, Inc.*, 239 B.R. 261, 267 (Bankr. S.D.N.Y. 1999); *In re Video King of Illinois, Inc.*, 100 B.R. 1008, 1017 (Bankr. N.D. Ill. 1989); *In re FCX, Inc.*, 62 B.R. 315, 322-23 (Bankr. E.D.N.C. 1986); *In re Leeds Building Products, Inc.*, 141 B.R. 265, 270 (Bankr. N.D. Ga. 1992).

<sup>8</sup> In addition, under § 546(c)(1), BAPCPA eliminated the alternative remedies of an allowed administrative priority claim or replacement lien in lieu of return of the goods that existed in the pre-BAPCPA version of § 546(c). Current § 546(c)(1) provides that reclamation of the goods is the sole remedy for a creditor that has satisfied the requirements for reclamation. This change has raised troubling questions about whether a creditor loses its reclamation rights when the debtor sells the subject goods, and whether a creditor may be required to commence a reclamation action and immediately seek injunctive relief at the beginning of the bankruptcy case in order to block the debtor from disposing of the reclamation goods and defeating reclamation rights, a costly proposition. This issue is rendered moot in cases involving court approved procedures for asserting, reconciling and adjudicating reclamation claims.

reclamation rights valueless where the debtor has an outstanding prepetition inventory secured claim. The case law since BAPCPA has largely reaffirmed this trend.<sup>9</sup>

Perhaps more important to the revisions to the Bankruptcy Code's reclamation provisions, BAPCPA added a new § 503(b)(9) designed to grant trade creditors selling goods (but not providing services) an administrative priority claim for the value of all goods sold in the ordinary course of the debtor's business that the debtor had received within 20 days of bankruptcy, whether or not the seller satisfies the requirements for reclamation. This safety net elevates an unpaid goods supplier's claim from a low priority general unsecured claim to a higher priority administrative expense claim with respect to all goods received during the 20-day period. A creditor asserting this priority claim is no longer subject to all the requirements and limitations that made pursuing reclamation claims costly and ineffective both prior to and since BAPCPA's enactment.

BAPCPA's addition of § 503(b)(9) has made significant progress in rectifying the imbalance between debtors and trade creditors that was amplified by the increasingly irrelevant reclamation remedy. With the implementation of § 503(b)(9), goods suppliers that had lost a right they once had (to receive, among other things, an administrative claim for goods subject to a valid reclamation claim shipped shortly before a bankruptcy filing), could now reassert this priority for a larger amount of their claim. This additional remedy is undoubtedly a consideration by credit professionals in their decisions to continue extending credit terms to financially distressed companies.

#### B. Section 365(d)(4) of the Bankruptcy Code

Prior to the implementation of BAPCPA, § 365(d)(4) of the Bankruptcy Code provided that bankruptcy courts had the authority to grant debtors additional time, beyond an

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<sup>9</sup> See *In re Dana Corp. et al.*, 367 B.R. 409, 419 (Bankr. S.D.N.Y. 2007); *In re Advanced Marketing Services, Inc.*, 360 B.R. 421, 427 (Bankr. D. Del. 2007); but see *Phar-Mor, Inc.*, 534 F.3d at 507-508 (applying pre-BAPCPA law and finding that reclamation claims were not rendered valueless when goods subject to the claim were sold in satisfaction of secured creditor's lien).

initial 60 day period, to assume or reject unexpired leases of nonresidential real property. Section 365(d)(4) stated that such extensions would only be granted by the court for “cause” shown. However, the meaning of “cause” was progressively watered down as courts routinely extended debtors’ time to assume or reject such nonresidential real property leases until plan confirmation, which is the same deadline by which the debtors needed to make a determination to assume or reject all executory contracts. The justification of “cause” proffered by debtors in many cases was that the chapter 11 case was relatively complex and the debtors required additional time to review leases. The willingness of many courts to extend these periods to plan confirmation, upon a minimal evidentiary showing by debtors, left landlords in the dark concerning the debtors’ intentions with respect to a significant number of leased properties. This had the effect of preventing landlords from making any long-term decisions with respect to the occupancy of their premises and potential capital improvements.

Section 365(d)(4) under BAPCPA allows a debtor to decide whether to assume or reject its nonresidential real property leases for up to 120 days from the date of the bankruptcy filing, and to seek an additional 90 day extension for “cause” shown (for a total of 210 days). Any further extensions require the prior written consent of the respective landlords. The current version of § 365(d)(4) affords landlords the ability to meaningfully participate in any discussions concerning further extensions of the debtor’s time to assume or reject leases and puts an end to the practice of bankruptcy courts routinely granting significant extensions of time without adequate consideration of the prejudice such extensions may cause to landlords.

At a hearing on March 11, 2009, before the House Judiciary Committee Subcommittee on Commercial and Administrative Law (the “Subcommittee”) that addressed the reasons for the liquidation of Circuit City Stores, Inc.<sup>10</sup>, whether certain business provisions of BAPCPA were responsible for Circuit City’s failure, and whether these changes needed to be rolled back, there was testimony that § 365(d)(4) of the Bankruptcy Code under BAPCPA struck

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<sup>10</sup> *In re Circuit City Stores, Inc.*, Case No. 08-35653 (Bankr. E.D. Va.).

a better balance concerning relations between retail vendors and their landlords. Prior to BAPCPA, landlords were left in limbo as debtors often died a slow and inevitable death.<sup>11</sup> While debtors were deciding to assume or reject store leases, often little money was spent to maintain and improve stores (especially stores that were likely to be closed).<sup>12</sup> Under BAPCPA, debtors must now make a more prompt decision to assume or reject their nonresidential real property leases, unless landlords agree to an extension of the deadline. Even if that means debtors vacating stores, landlords can re-lease the stores to new and stronger tenants for the benefit of the economy and neighboring stores (instead of a to debtor that is unlikely to survive, which will negatively impact nearby businesses).<sup>13</sup>

Testimony before the Subcommittee further confirmed that large retail chapter 11 cases could be detrimental to shopping centers, as well as other retailers.<sup>14</sup> In a focused effort to address the significant negative consequences facing these shopping centers and other retailers, the 2005 amendments “created 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.”<sup>15</sup> To return to a standard that gave tenants an

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<sup>11</sup> See *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 46 (2009) (statement of Todd J. Zywicki, Professor, George Mason School of Law); *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 44, 107 (2009) (statement of Daniel B. Hurwitz, President and COO, Developers Diversified Realty Corporation, on behalf of International Council of Shopping Centers).

<sup>12</sup> See *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 46 (2009) (statement of Todd J. Zywicki, Professor, George Mason School of Law); *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 44, 107 (2009) (statement of Daniel B. Hurwitz, President and COO, Developers Diversified Realty Corporation, on behalf of International Council of Shopping Centers); *Lehman Brothers, Sharper Image, Bennigan’s and Beyond: Is Chapter 11 Bankruptcy Working?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 110th Cong. 22 (2008) (statement of Barry E. Adler, Esq., Professor, New York University School of Law).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 44 (2009) (statement of Daniel B. Hurwitz, President and COO, Developers Diversified Realty Corporation, on behalf of International Council of Shopping Centers).

unlimited amount of time to decide to assume or reject a lease would do nothing to stop the number of unsuccessful reorganizations, and could potentially make the situation worse by putting neighboring retailers in shopping centers at even greater risk.<sup>16</sup>

C. Section 366 of the Bankruptcy Code

Prior to BAPCPA's enactment, pursuant to Bankruptcy Code § 366, utility providers were permitted to discontinue service if such providers were not granted "assurance of payment" going forward within 20 days of a bankruptcy filing. Through a long line of progressively more "debtor friendly" cases, the courts had effectively stripped the phrase "assurance of payment" of any meaningful protections for utilities. In determining the meaning of the phrase, several jurisdictions considered a debtor's payment history prior to the commencement of the bankruptcy case, as well as any security deposits held by the utility providers. Often courts had held that debtors had provided "adequate assurance of payment to utilities for their postpetition services by virtue of an existing cash deposit, in addition to the administrative expense claim to which a utility was entitled.

Some courts have taken an even more pro-debtor interpretation of "assurance of payment" by holding that even without a deposit, a debtor's prepetition payment history, and the debtor's postpetition liquidity (*e.g.*, DIP financing received by the debtor) provided "adequate assurance of payment" for a utility's continued service when the following procedures were in place: (1) granting an "administrative expense priority"; (2) an expedited procedure for relief in the event of a payment default by the debtor; and (3) an order requiring the debtor to convey its monthly operating statements directly to the utilities.<sup>17</sup>

Section 366, as amended under BAPCPA, essentially overruled this line of jurisprudence, which had deviated substantially from the plain language of § 366(b). BAPCPA

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<sup>16</sup> *Id.*

<sup>17</sup> See *Virginia Elec. & Power Co. v. Caldor, Inc.*, 117 F.3d 646, 651-52 (2d Cir. 1997).

restores greater protection to utilities by providing that a utility may alter, refuse, or discontinue service, if during the 30-day period beginning on the date of the filing of the bankruptcy petition, the utility does not receive from the debtor adequate assurance of payment for utility service that is satisfactory to the utility. More importantly, the amended § 366 moots the numerous judicial pro-debtor interpretations and instead spells out what constitutes “assurance of payment”:

- cash deposit;
- letter of credit;
- certificate of deposit;
- surety bond;
- prepayment of utility consumption; and
- another form that is mutually agreed upon between the debtor and the utility.

Moreover, § 366 under BAPCPA specifically provides that when determining whether assurance of payment is adequate, the court may **not** consider: (i) the absence of security before the date of the filing of the petition; (ii) the payment by the debtor of charges for utility service in a timely manner before the date of the filing of the petition; or (iii) the availability of an administrative expense priority. From a practical standpoint, § 366 under BAPCPA now compels a debtor to provide some form of cash deposit to secure post-bankruptcy payment to utility providers in return for the utilities continuing to provide services on a postpetition basis.

#### D. Section 1121 of the Bankruptcy Code

Prior to BAPCPA’s enactment, there was, in practice, no statutory limit to the amount of time that a debtor had the exclusive right to file a plan of reorganization and solicit acceptances thereto. Similar to the issue of nonresidential leases, under § 1121(b)-(d) courts were entitled to extend for “cause” shown the initial 120 day deadline to file a plan and 180 day period to seek acceptances to the plan, without mandating an outside date. Depending on the

court and the case, the exclusivity period could potentially be extended out for years based upon a debtor's often minimal showing that a case was "complex."

With the hope of bringing debtors and creditors to the negotiating table sooner and reducing time and expense debtors spent in chapter 11 proceedings, BAPCPA imposed a strict time limit that cannot be altered by the courts. BAPCPA § 1121(d) sets the outside date at 18 months from the order for relief for a debtor to have the exclusive right to file a plan and 20 months to solicit acceptances. Following the expiration of its initial 18 month period, the debtor still has the right to file a plan; however, the debtor must be cognizant that creditors and other parties in interest may also propose their own plans. Presumably, for cases that are truly too complex to formulate a plan within the 18 month period, the deadlines imposed by BAPCPA should not have any material affect because no party would be in a position to propose a confirmable plan. Shortening the exclusivity deadlines, coupled with the truncated deadline to assume or reject nonresidential real property leases, appears to have resulted in more pre-bankruptcy planning, negotiations with creditors, and ultimately prepackaged or prenegotiated chapter 11 filings (which can be much less burdensome for the debtor and the other parties in interest).

### III. How BAPCPA Amendments Have Worked in Practice

#### A. Section 503(b)(9)

Section 503(b)(9) has provided additional protections to certain trade creditors and has helped to restore the balance between debtors and creditors, which was lost when trade creditors began being denied an effective remedy for their reclamation rights. However, § 503(b)(9) is by no means a windfall to trade creditors. First, in most cases, § 503(b)(9) claims have not been paid immediately upon the request of moving trade creditors. Instead, payment of these claims has frequently been deferred until the effective date of a confirmed chapter 11 plan. There has also been significant litigation over many of the requirements of § 503(b)(9), including what constitutes goods; determining the value of goods; when goods have been received; and

whether these claims should be disallowed when a preference or other avoidance claim is asserted against the creditor of these claims.<sup>18</sup> All of these issues have made it expensive and time-consuming for trade creditors to pursue these claims. Moreover, for many debtors that rely upon trade creditors providing services, rather than goods, § 503(b)(9) under BAPCPA has had virtually no impact on attempted chapter 11 reorganizations.

Many in the bankruptcy bar have wrongfully blamed the failure of many chapter 11 debtors, including a large number of retail chapter 11 debtors, on BAPCPA's changes, including the addition of § 503(b)(9). While § 503(b)(9) may create a new pool of administrative priority claims that must be paid in full pursuant to a chapter 11 plan, this fact has not been the cause of the failure of many chapter 11 cases since the enactment of BAPCPA. Prior to the 1990's, trade creditors received payment of their allowed reclamation claims, based on the allowed administrative claims they were granted under § 546(c)(2). Prior to BACPA, trade creditors also received payment of their prepetition claims pursuant to court-approved critical vendor orders. Through these orders, debtors paid the prepetition claims of general unsecured claims deemed "critical" to the debtor's reorganization or business, in return for the vendors' agreement to continue to extend credit and other terms to the debtor during the chapter 11 case. This consideration is notably absent from most arguments calling for the repeal of § 503(b)(9). As a result, it is quite possible that in many cases, trade creditors may be receiving *less* of a recovery today from § 503(b)(9) claims than they previously did on account of reclamation claims and from payments received under critical vendor orders. Moreover, trade creditors may also be relying on the § 503(b)(9) priority in their credit decisions. The loss of this priority could result in fewer trade creditors extending credit terms to a financially distressed customer.

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<sup>18</sup> A synopsis of decisions involving § 503(b)(9) is included in Case Law Developments On Critical BAPCPA Provisions submitted in conjunction with this paper.

B. Section 365(d)(4) of the Bankruptcy Code

Critics of the 210 day deadline to assume or reject commercial real property leases often fail to appreciate that landlords have the discretion to consent to further extensions, and have done so in many cases.<sup>19</sup> BAPCPA afforded landlords exactly what they were previously denied, a seat at the table, the opportunity to be heard, and the opportunity to consider whether further extensions are appropriate.<sup>20</sup> In addition, BAPCPA encourages debtors to better plan in advance of bankruptcy, instead of filing without a clear strategy in place and unnecessarily extending the bankruptcy process.

Assuming a landlord believes that a space can be occupied by a more viable tenant, the debtor will have to make a decision to assume or reject a nonresidential real property lease within not more than 210 days. For example, in the chapter 11 cases of Hancock Fabrics<sup>21</sup>, Movie Gallery<sup>22</sup>, Linens N' Things<sup>23</sup>, and Bally Total Fitness<sup>24</sup>, the landlords agreed to extend the 210 day deadline and/or agreed to rent and other concessions (such as reducing debtors' obligations to cure prepetition defaults or waiving immediate payment of "stub rent"<sup>25</sup>) to maintain the debtors in the leased locations.<sup>26</sup> Many landlords, including a Circuit City landlord with 50 store locations, would agree (or would have agreed) to such extension/concessions rather than be left with empty stores.<sup>27</sup>

A decision must be made by the landlord, presumably after communicating with the debtor, whether the debtor has a viable business. If the landlord concludes that the debtor's

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<sup>19</sup> See *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 43 (2009) (statement of Daniel B. Hurwitz, President and COO, Developers Diversified Realty Corporation, on behalf of International Council of Shopping Centers).

<sup>20</sup> *Id.*

<sup>21</sup> *In re Hancock Fabrics, Inc., et al.*, Case No. 07-10353 (Bankr. D. Del.).

<sup>22</sup> *In re Movie Gallery, Inc., et al.*, Case No. 07-33849 (Bankr. E.D. Va.).

<sup>23</sup> *In re Linens Holding Co., et al.*, Case No. 08-10832 (Bankr. D. Del.).

<sup>24</sup> *In re Bally Total Fitness, Inc. et al.*, Case No. 08-14818 (Bankr. S.D.N.Y.).

<sup>25</sup> Stub rent under a lease is rent attributable to the period of time for which a debtor uses and occupies a space from the petition date until the next rent payment comes due (for example, if rent payments come due on the first of the month and the bankruptcy is filed on the 15th of the month, the stub rent period is for the 15th until the end of the month). Although prevailing case law affords such rent administrative priority, debtors will often claim that a landlord is not entitled to such priority, or is not entitled to immediate payment with payment deferred until confirmation of a plan of reorganization.

<sup>26</sup> See *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 43 (2009) (statement of Daniel B. Hurwitz, President and COO, Developers Diversified Realty Corporation, on behalf of International Council of Shopping Centers).

<sup>27</sup> See *id.* at 41 (2009).

business may fail, there is no basis for allowing the debtor more than 210 days to assume or reject its nonresidential real property lease. That was the case in Circuit City, which collapsed well before the 210 day deadline, independent of any pressure by landlords.

Debtors do not land in chapter 11 overnight and day one of a bankruptcy case is not the first time debtors are analyzing lease assumption and rejection issues. Considering chapter 11 is often a debtor's last resort, analysis, planning and negotiation regarding leases often have taken place well in advance of a filing. Debtors have likely experienced a drawn out period of economic distress prior to filing chapter 11, during which time they attempted and failed to work out their problems. It is especially true that in larger chapter 11 cases, debtors will likely have conducted extensive pre-bankruptcy planning and it would be prudent for debtors to open negotiations with landlords for a consensual extension of the 210 deadline (if such an extension is needed) before the debtor even files for bankruptcy.<sup>28</sup>

#### C. Section 366 of the Bankruptcy Code

Utilities are not cutting off debtors from service and bankruptcies are not failing because of BAPCPA's changes to § 366 of the Bankruptcy Code. Instead, debtors are adapting. First, even assuming debtors are required to fund utility deposits from the limited DIP financing they are provided, the amount of deposits should be *de minimis* compared to debtors' expenses as a whole. Furthermore, pre-BAPCPA, it was not a foregone conclusion that a debtor would not have to make a deposit as adequate assurance. It depended on the case and the respective debtor's payment history. In certain cases therefore, debtors are no worse off than they would have been pre-BAPCPA. In addition, debtors, prior to commencing chapter 11 cases, must consider and plan for, among other things, utility deposits. For example, because payment history is no longer a factor in considering adequate assurance of payment, yet a cash deposit is a factor, it is quite possible that a debtor may decide not to pay the last utility bill prior to the

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<sup>28</sup> See *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 51 (2009) (statement of Todd J. Zywicki, Professor, George Mason School of Law).

bankruptcy filing and instead set aside that cash as a proposed post-petition deposit for the utility.

In practice, the process for determining and negotiating the appropriate “adequate assurance” of payment to a utility has not been significantly different from the pre-BAPCPA process. Debtors continue to file a first-day motion seeking court orders directing utilities to continue service, proposing adequate assurance of payment terms, and establishing an objection procedure. Assuming expedited relief is not granted, a hearing on the motion will still be scheduled at some point during the first 30 days of the case and before the shutoff of any utility service. Depending on timing, utilities that are not satisfied with the adequate assurance terms being offered, as in pre-BAPCPA cases, tend to object to the motions or the proposed adequate assurance. Frequently, consensual resolutions are reached, just as they had been pre-BAPCPA.

There is no evidence to suggest overly aggressive utilities have been making demands for excessive deposits that are jeopardizing the success of chapter 11 cases. To the contrary, it appears that adequate assurance of payment issues have been consensually worked out between debtors and utilities. However, frequently, the appropriate adequate assurance will be dictated by the amount of funds set aside by the DIP lenders. Litigation is likely if the proposed allocated funds are not adequate and the utility and debtor cannot settle on an appropriate deposit amount. Regardless, § 366 of the Bankruptcy Code, as amended by BAPCPA, is not making or breaking debtors’ chapter 11 cases.

#### D. Section 1121 of the Bankruptcy Code

The exclusivity deadline of 18 months after an order for relief for debtors to file a plan and 20 months after the order for relief for debtors to solicit acceptances of a plan is more than adequate, and prevents debtors from lingering in chapter 11. When debtors enter chapter 11, they should already have some direction on their exit strategy. Because of the time limitations, it is beneficial for debtors to plan ahead and negotiate with their constituencies prior

to filing, where possible, in an attempt to limit potential objection points going forward.<sup>29</sup> This may be contributing to the increased frequency of chapter 11 cases with prepackaged and prenegotiated plans that have emerged more quickly from chapter 11 than debtors in traditional reorganization cases. If a debtor still has no direction after 18 months, it begs the question whether this type of debtor is capable of reorganizing and even equipped to continue as a going concern. Regardless, after exclusivity terminates, debtors are not barred from proposing plans and other parties should be given the opportunity to propose that which the debtor was unable to do.

#### IV. The True Causes for the Failure of Many Retailer and Other Post-BAPCPA Chapter 11 Reorganizations

Although no one factor has caused debtors to fail and not emerge from chapter 11 post-BAPCPA, when a number of the below factors are considered as a whole, it is apparent that certain debtors have failed business models and are overleveraged with too much secured debt that, when combined with the most severe recession since the Great Depression, have rendered them incapable of rehabilitation. The factors that have caused retailers and other debtors to fail in large numbers today, are the same factors that have caused certain debtors to fail in the past. The BAPCPA changes are simply not one of these factors.

The fact that the business cycle and other external forces, other than the BAPCPA changes, contribute to the current lack of successful reorganizations is further supported by the research 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.’ 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.”<sup>30</sup>

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<sup>29</sup> *Id.*

<sup>30</sup> See *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 49 (2009) (statement of Todd J. Zywicki, Professor, George Mason School of Law); *Lehman Brothers, Sharper Image, Bannigan's and Beyond: Is Chapter 11 Bankruptcy*

A repeal of BAPCPA to cure the increased frequency of failing chapter 11 reorganizations is akin to prescribing that a patient's limb be amputated to cure a sprain – the proposed cure is unrelated to the illness. Not only would a rollback of the BAPCPA changes have no appreciable affect on business models already prone to failure for the host of reasons set forth below, such a repeal would cause a shift in bankruptcy law back to a time when the balance of power was unfairly set against creditors' rights. This was the exact problem Congress sought to correct through the 2005 amendments.

This is not the first time that there has been a shake up in the retail industry through which weaker stores perished and their competitors weathered the storm. For example, the following “old-line mid-sized department stores” failed pre-BAPCPA: Ames<sup>31</sup> (2002), Bradlees<sup>32</sup> (2001), Caldor<sup>33</sup> (1999), Montgomery Ward<sup>34</sup> (1997), Jamesway<sup>35</sup> (1995), and Woolco (1994).<sup>36</sup>

However, unique to the present retailer failures, and in no way caused by BAPCPA, are the following factors:

- “An overreaction by lenders toward risky borrowers following years of lending laxity.
- A general scarcity of capital and reduced lending capacity at banks in the aftermath of the credit crisis.
- The continuing dominance of the largest discount retailers at the expense of specialty stores.
- The penetration of online sales, which now account for at least 5 percent of U.S. retail sales nationally and more than 10 percent in several product categories.

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*Working??: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 110th Cong. 21 (2008) (statement of Barry E. Adler, Esq., Professor, New York University School of Law).

<sup>31</sup> *In re Ames Department Stores, Inc.*, Case No. 01-42217 (Bankr. S.D.N.Y.).

<sup>32</sup> *In re Bradlees Stores, Inc.*, Case No. 00-16033 (Bankr. S.D.N.Y.).

<sup>33</sup> *In re Caldor Inc.-NY, et al.*, Case No. 95-44080 (Bankr. S.D.N.Y.).

<sup>34</sup> *In re Montgomery Ward Holding Corp.*, Case No. 97-1409 (Bankr. D. Del.).

<sup>35</sup> *In re Jamesway Corp.*, Case No. 95-44821 (Bankr. S.D.N.Y.).

<sup>36</sup> *See Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 50 (2009) (statement of Todd J. Zywicki, Professor, George Mason School of Law).

- The fading popularity of enclosed shopping malls after a multidecade run in favor of nearby venues.
- The declining value of retail real estate and leases.
- The diminishing concentration of company-wide operating losses coming from a relatively small cluster of stores.”<sup>37</sup>
- The proliferation of financing by non-traditional lenders and the increase in financing secured by multiple tiers of liens in the debtor’s assets.

A. Failed business model/management beyond repair

Certain retailers, such as Linens 'N Things and Circuit City fall into this category. Following its leveraged acquisition in 2006, Linens 'N Things consistently incurred losses prior to filing bankruptcy, was not well managed, and had bank and bond secured debt that exceeded the recoverable value of its assets, leaving nothing for unsecured creditors. Similarly, Circuit City was not managed well and made poor staffing decisions.<sup>38</sup> By contrast, one of Linens 'N Things’ largest competitors, Bed Bath & Beyond, carries no significant secured debt. Moreover, Linens 'N Things and Circuit City both had to contend with Wal-Mart and Target and their successful business models. Similarly, critics of BAPCPA conveniently overlook the fact that Bombay Company and Steve & Barry’s were in a hopeless state the day they entered chapter 11, having suffered dismal financial performance for years prior to their inevitable bankruptcy filings.<sup>39</sup>

When a debtor has a failed business model, the only thing that BAPCPA may be responsible for (and, indeed, take credit for) is speeding up the inevitable. Even assuming the BAPCPA amendments were rolled back and made even more debtor friendly, and even assuming certain debtors were could obtain sufficient financing, a business that is not viable, cannot and should not be allowed to continue at the expense of creditors’ rights. In this regard, BAPCPA has served its economic purpose of making the chapter 11 process quicker and more efficient by eliminating nonviable companies.

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<sup>37</sup> Bob Duffy, *Broken Beyond Repair: Is BAPCPA Unfairly Blamed for Rash Retail Liquidations*, J. OF CORPORATE RENEWAL (Jan. 8, 2009), <http://www.turnaround.org/Publications/Articles.aspx?objectID=10305>.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

B. Worst recession since the Great Depression

Consumer spending and confidence has been at all-time lows and unemployment has reached levels not seen since the early 1980s. Consumers have scaled back spending and have had less access to credit from credit cards. Sales by retailers of discretionary items have dropped significantly. Reduced consumer spending reduced retailer sales, which in turn makes lenders reluctant to lend. Without access to credit, even otherwise well-run retail operations may not be able to survive.<sup>40</sup>

C. Most Chapter 11 Debtors are Overleveraged, Including Several Tiers of Liens

After years of borrowing cheap money, it should not be a surprise that companies, who perhaps should have collapsed long ago, are now filing and failing in chapter 11.<sup>41</sup> These companies only filed chapter 11 after over-borrowing for years, and securing payment of these claims with one or multiple layers of liens. When companies took on this cheap credit, that was their opportunity to work out their problems.<sup>42</sup> Those debtors that did not work out their problems filed chapter 11 years later with even less of an ability to reorganize.

Modern chapter 11 retail and other debtors have quite different debt structures from their past debtors. For instance, when Macy's<sup>43</sup> filed chapter 11 in 1992, its inventory was unencumbered.<sup>44</sup> The same was true of Kmart Corporation<sup>45</sup> when it filed for chapter 11 in 2002.

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<sup>40</sup> See *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 44 (2009) (statement of Daniel B. Hurwitz, President and COO, Developers Diversified Realty Corporation, on behalf of International Council of Shopping Centers); Bob Wills, *U.S. Recession Worst Since Great Depression, Revised Data Show*, Bloomberg, Aug. 1, 2009, [http://www.bloomberg.com/apps/news?pid=20601087&sid=a5\\_5Vq2hV3EQ](http://www.bloomberg.com/apps/news?pid=20601087&sid=a5_5Vq2hV3EQ) (“[t]he first 12 months of the U.S. recession saw the economy shrink more than twice as much as previously estimated, reflecting even bigger declines in consumer spending and housing”).

<sup>41</sup> Duffy, *Broken Beyond Repair: Is BAPCPA Unfairly Blamed for Rash Retail Liquidations; See Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 47-48 (2009) (statement of Todd J. Zywicki, Professor, George Mason School of Law); *Lehman Brothers, Sharper Image, Bennigan's and Beyond: Is Chapter 11 Bankruptcy Working?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 110th Cong. 22 (2008) (statement of Barry E. Adler, Esq., Professor, New York University School of Law).

<sup>42</sup> Duffy, *Broken Beyond Repair: Is BAPCPA Unfairly Blamed for Rash Retail Liquidations*.

<sup>43</sup> *In re R.H. Macy & Co., Inc.*, Case No. 92-40477 (Bankr. S.D.N.Y.).

<sup>44</sup> See *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 7 (2009) (statement of Harvey R. Miller, Weil, Gotshal & Manges, LLP).

<sup>45</sup> *In re Kmart Corporation, et al.*, Case No. 02-02474 (Bankr. N.D. Ill.).

This fact must be considered in contrast to today's debtors whose inventory and other assets are frequently fully encumbered by one or more groups of lienholders.

D. Unavailability of DIP Financing/ Change in the Landscape of Lenders

Because debtors are so overleveraged, the possibility of a third party providing DIP financing is remote. There is no dispute that the credit market dried up in 2008 and this has continued into 2009. Absent obvious equity in a chapter 11 debtor (a rare occurrence these days), new and existing lenders have not been willing to take the risk of continuing to lend to financially distressed companies for a sufficient time to allow for their rehabilitation. Of course, if the company has equity, its chance of survival is significantly greater than overleveraged companies, regardless of BAPCPA. "In many instances, the absence of any sufficient collateral value at the very outset of a case—often the result of years of underperformance, persistent operating deficits, and previous failed turnaround efforts—would have discouraged most traditional DIP lenders—with or without BAPCPA."<sup>46</sup>

There have also been changes in the financing markets that have made existing lenders less willing to risk continuing to lend to a financially distressed debtor in chapter 11.<sup>47</sup> First, there has been an increase in syndicated loans where multiple lenders are involved in a loan.<sup>48</sup> Second, the composition of these lending syndicates has changed. More and more hedge funds are either participating in these loans or acquiring the loans from the initial members of the syndicate.<sup>49</sup> There has also been an increase in secured lending with multiple liens in a debtor's assets.<sup>50</sup> In fact, the second lien market has exploded over the last several years.<sup>51</sup>

The new breed of secured lender may not be as willing as the money center and other traditional secured lenders of yesterday, to allow for a drawn out reorganization and/or sale

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<sup>46</sup> Duffy, *Broken Beyond Repair: Is BAPCPA Unfairly Blamed for Rash Retail Liquidations*.

<sup>47</sup> Douglas G. Baird & Robert K. Rasmussen, *New Age Constituencies in Chapter 11*, 42 (2009).

<sup>48</sup> *Id.*, Steven A. Dennis & Donald J. Mullineaux, *Syndicated Loans*, J. FIN. INTERMEDIATION 404, 407 (2000)

<sup>49</sup> Baird & Rasmussen, at 44; Barry Bobrow, Mercedes Tech & Linda Redding, *An Introduction to the Primary Market*, THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING 157, 168 (Allison Taylor & Alicia Sandstone, eds., 2006)./

<sup>50</sup> Baird & Rasmussen, at 44;

<sup>51</sup> *Id.*

process that may have resulted in a better return for the secured lender. Traditional lenders, who previously held loans without aggressive loan participants, were more likely to manage the loan and work with the borrower. By comparison, today's debtholders often view their loan participation as an equity investment that can be quickly sold off and liquidated. The non-traditional lenders of today often would rather cash out (via liquidation or quick sale by the debtor), perhaps even at a loss, and invest their money elsewhere, rather than risk a continuing relationship with a faltering debtor with an uncertain future.

These lenders may also pursue a loan to own strategy that is not compatible with a drawn out chapter 11 reorganization process. This problem is exacerbated by non-traditional lenders that purchase debt at a discounted price, meaning that even if a quick sale of a debtor's assets does not realize the most value for the debtor's estate, the lender may nonetheless be able to recover its investment as well as receive a considerable return on its capital.

E. Inability to Obtain Trade Credit from Vendors

Once a vendor has lost confidence in its customer (the retailer), or the retailer is unable to pay its invoices that have come due, the vendor will likely stop extending trade credit and request cash in advance or cash on delivery terms. When vendors cut a retailer off *en masse*, which happens frequently when chapter 11 appears inevitable, the only way that retailers may be able to reorganize is if a DIP lender provides funding. As discussed above, DIP lenders often are unwilling in this economy to jeopardize the present value of their collateral and sink more money into a struggling debtors. This combined loss of confidence by its vendors and existing lender and the unavailability of outside funding, is the one-two punch that has sent many retailers down for the count—not BAPCPA.

V. Notwithstanding BAPCPA Debtors, Including Retailer Debtors, are Still Reorganizing

Debtors, including retailers, can and have emerged from post-BAPCPA chapter 11 cases, despite the alleged obstacles posed by the BAPCPA changes. Debtors that are able to demonstrate real potential to emerge as a reorganized company or effectuate a successful sale

have been able to successfully work with their constituents within the BACPA framework. For instance, Bally's obtained valuable lease amendments and consensual extensions of time to assume or reject its leases from its landlords who viewed the reorganizing company as a valuable business partner. Similarly, DIP lenders evaluate the reorganization or sale prospects and impose shorter timeframes for failing companies, such as Steve & Barry's<sup>52</sup> and Circuit City, while recognizing that sufficient breathing room can lead to a successful reorganization for entities with a viable business model, as in the case of Calpine Corporation<sup>53</sup>.

Following the fashion of excess that was so prevalent earlier this decade, many companies, such as Linens N' Things, find themselves hopelessly overleveraged and subject to multiple liens that fully encumber their assets, and unable to find lenders willing to take the enormous risk of giving them free financial reign to operate in bankruptcy. By contrast, companies that kept their prepetition borrowings at bay are able to work with their lenders as in the successful retail chapter 11 cases of Hancock Fabrics. Indeed, Hancock's prepetition lender was willing to enter into a ratification agreement in connection with its prepetition secured facility to see this company through a successful reorganization.

#### VI. Increase in Prepackaged, Prenegotiated and Prearranged Chapter 11 Cases

Following the enactment of BAPCPA, the trend has been toward debtors filing prepackaged, renegotiated or prearranged chapter 11 cases. Prepackaged bankruptcies hit a eight-year high in the first quarter of 2009 and such filings appear to be continuing to increase thereafter.<sup>54</sup> In a chapter 11 case where the debtor reorganizes, the debtor files a chapter 11 petition, negotiates a chapter 11 plan with its creditor and other constituencies, obtains court approval of a disclosure statement with respect to the plan, solicits votes from its impaired classes that will be receiving a recovery and then seeks confirmation of the plan.

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<sup>52</sup> *In re Steve and Barry's Manhattan LLC, et al.*, Case No. 08-12579 (Bankr. S.D.N.Y. ).

<sup>53</sup> *In re Calpine Corporation, et al.*, Case No. 05-60200 (Bankr. S.D.N.Y.).

<sup>54</sup> Dena Aubin & Padraic Cassidy, *Prepackaged Bankruptcies Hit 8-yr High in Q1-SP*, REUTERS, <http://www.reuters.com/article/marketsNews/idUSN1346008820090513>.

In the case of a prepackaged chapter 11, the debtor negotiates and solicits acceptances of its plan prior to filing for bankruptcy. On or shortly after the date of its chapter 11 filing, the debtor files its chapter 11 plan and disclosure statement. The debtor also then moves for approval of the plan and disclosure statement at a single hearing scheduled shortly after the filing.

A prenegotiated or prearranged chapter 11 process refers to a plan that the debtor had negotiated with certain constituencies, such as its senior lienholders, prior to the bankruptcy filing. The debtor has not already solicited the votes of other classes of creditors whose claims would be impaired under the plan. Then, after its bankruptcy filing, the debtor files a plan and disclosure statement and seeks to confirm its plan on an expedited basis. This often results in a much faster completion of the chapter 11 case than would occur in the normal reorganization scenario.

So why are prepackaged and prenegotiated chapter 11 cases on the rise? One answer may lie with BAPCPA's 210-day limit on a debtor to make its decision to assume or reject its nonresidential real property leases, as well as the 18-month and 20-month limits on the debtor's exclusive right to file and solicit a chapter 11 plan and control its reorganization process. Debtors are now encouraged to complete much of their restructuring prior to the bankruptcy filing and rely on the bankruptcy process to obtain approval of their prepackaged or prenegotiated plans on an expedited basis. The benefit of this model is it eliminates the substantial expense to all parties from an extended stay in chapter 11.

### **CONCLUSION**

There is no dispute that the number of chapter 11 filings is at historical levels and that a significant number of these debtors have failed to reorganize. The question is why? Upon a superficial review of the timing of the BAPCPA changes, and the chapter 11 failures that took place only a couple of years following the amendments, it is very tempting to assume a cause and effect between the two events. However, upon further in-depth analysis, it becomes apparent

that indeed there is no link between the two, other than proximity in time. Indeed, most of the persons testifying at the March 11, 2009 hearing on Circuit City's failure, stated that Circuit City would have failed regardless of the BAPCPA changes.

As set forth above, the only impact the BAPCPA changes had were to restore some balance to a bankruptcy system that had been long-criticized for being debtor friendly at the expense of sacrificing fundamental rights of creditors. Although not nearly as appealing as the "quick fix" of simply repealing the BAPCPA changes, an honest analysis of why so many corporations are sick and dying, requires a detailed review of many macro and micro economic factors. Upon final analysis, it becomes clear that unprecedented economic turmoil, a complete collapse in financial markets, and the new players in the secured lending market are the main drivers contributing to the death of successful chapter 11 reorganizations – not the BAPCPA changes.