Kara Bruce
University of Toledo College of Law
Retail Reorganization In A Post-BAPCPA Regime

## I. The Sharp Rise in Retail Liquidations.

Since 2005, family-name retailers such as KB Toys, Circuit City, Linens & Things, Friedman's Jewelry, and Sharper Image have disappeared from our retail landscape. Their bankruptcy cases highlight a troubling trend in favor of retail liquidations. Retailers are not just filing for bankruptcy relief at higher rates; they are entering bankruptcy and are not coming out again.

Chapter 11 of the bankruptcy code is designed to help struggling – but economically sound – companies restructure their debt and streamline their business, allowing them to emerge from bankruptcy more efficient going concern entities. For retailers seeking bankruptcy relief, however, chapter 11 may be broken. Recent amendments to the bankruptcy code have created a financing firestorm, increasing the debtor's liquidity obligations to benefit certain special-interest constituents, and further incentivizing creditors toward liquidation. These amendments have weakened bankrupt retailers and impeded their efforts to reorganize, resulting in job loss and further delays to U.S. economic recovery.

In this paper, I will use the rise in retail liquidations as a foundation to explore broader trends of increased creditor dominance in the chapter 11 process. I will argue that new provisions granting certain creditor groups special protections, as well as provisions reducing judicial discretion, evidence this rising creditor control. Ultimately, I will explore how these amendments have altered the decision-making and governance structures in retailers' chapter 11 cases, and, evaluating the recent trend in favor of retail liquidations, assess the wisdom of these changes.

The following pages provide a short overview of where I expect to take this writing. Part II evaluates a number of factors that have contributed to the rise in retail liquidations. Part III provides a more detailed analysis of the particular BAPCPA provisions that have reduced retailers' viability in the reorganization process. Part IV provides a rough sketch of my analysis.

## II. It's a Tough Market; But There is More to the Story.

The economic pressures of recent years certainly have affected the financial stability of retailers. After decades of loose lending, credit markets have significantly tightened. Financing has become less widely available, and it is offered on more restrictive terms. Retailers' suppliers, facing their own economic constraints, have reduced the availability of trade credit. Consumer spending plummeted in 2008 and 2009, and has only seen a modest recovery in 2010 and 2011.

Technological developments in the retail industry have further weakened the financial position of brick-and-mortar retailers. The growing online marketplace has affected large retailers and small specialty stores alike. Online shopping decreases foot traffic and calls into question the continued viability of the traditional retail model.

Added to these economic pressures are factors that further reduce the likelihood that a retailer in chapter 11 bankruptcy will successfully complete a reorganization plan. For example, declines in the real estate market have decreased the value of retailers' leasehold interests, which traditionally have provided a significant source of income in a retailer's bankruptcy case. Moreover, the structure of retail financing has fundamentally changed in recent years. Retailers entering bankruptcy these days are much more highly leveraged than they were in earlier times, and consequently much more reliant on debtor-in-possession (DIP) financing to make it through a reorganization. Today's retailers, like most corporate debtors, are more likely to enter bankruptcy after a failed out-of-court restructuring, meaning that they enter bankruptcy in greater distress than a company entering bankruptcy 15 to 20 years ago likely would be.[1]

These factors are magnified by several significant changes imposed by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). As I will discuss in Section III, below, several of BAPCPA's amendments have greatly impacted retailers' ability to exit chapter 11. In broad terms, these amendments grant benefits such as priority status or adequate assurance to vocal creditor constituencies. The amendments demonstrate distrust of debtors-in-possession and bankruptcy judges alike. Many amendments have stripped bankruptcy judges of discretion in favor of hard-and-fast rules and codified deadlines. In recent years, the combined effect of these amendments has made bankruptcy reorganization simply unattainable for many large retailers.

According to the National Retail Federation, 1 in 5 U.S. workers is employed in some capacity in the retail industry. The liquidation of Circuit City alone cost over 34,000 jobs nationwide. When retail reorganizations for economically sound companies fail, the country suffers. In the current economic climate, "the ability of chapter 11 to serve as a

[1] The bankruptcies of Macy's, Federated Department stores and K-mart in the early 1990's provide helpful points of comparison.

viable tool for the reorganization of business enterprises . . . and for the preservation of jobs has assumed increased importance."[2]

## III. A Closer Look at BAPCPA.

### A. Background on BAPCPA.

BAPCPA, which President Bush signed into law on April 20, 2005, was enacted to "improve the bankruptcy system by deterring abuse, setting enhanced standards for bankruptcy professionals, and streamlining case administration."[3] Although BAPCPA was primarily geared toward consumer bankruptcies, several amendments have impacted corporate bankruptcies and redistributed power between creditors and business debtors. BAPCPA is the most substantial revision of US bankruptcy laws since the Bankruptcy Reform Act of 1978, and it is arguably the most controversial.

The following amendments, in particular, have undermined retailers' ability to successfully reorganize:

### B. 11 U.S.C. § 366: Utilities Providers Now Receive Adequate Assurance in Cash or Cash Equivalents.

Utility providers may not cut services to a debtor "solely on the basis of the commencement of a [bankruptcy] case," but utilities have long had the ability to request "adequate assurance of future payment" from the debtor. Before BAPCPA, courts had discretion to determine what amounted to "adequate assurance." If the debtor had a strong history of timely payments and solid post-petition cash flow, a court would often find a grant of administrative priority for the amounts owing to constitute adequate assurance.

---

[2] *Written Statement of Isaac Pachulski*, submitted on behalf of the National Bankruptcy Commission, House of Representatives, Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, "Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?" March 11, 2009.
[3] H.R. Rpt. 109-31 (I) at 47 (Apr. 8, 2005) (reprinted in 2005 U.S.C.C.A.N. 88, 118).

But after BAPCPA, section 366 provides that chapter 11 debtors provide utilities adequate assurance only by providing a "cash deposit, letter of credit, certificate of deposit, surety bond, prepayment or similar security satisfactory to the utility."[4]

In light of this amendment, chapter 11 debtors must find sufficient cash to satisfy adequate protection payments at the outset of their cases. This new obligation is magnified for large retail debtors, who can have hundreds of locations, each with multiple utilities that can demand such a deposit. Indeed, for Linens & Things, a 600-store national chain, the aggregate adequate assurance demand was estimated to be $2,138,662.52. Although not a massive sum in relation to Linens and Things' total debt load, it was a significant new liability for the company to address during the first weeks of its bankruptcy case, when a debtor's position is particularly vulnerable.

Revised section 366 is a prime example of BAPCPA's overall discretion-reducing effect; it both dictates what form adequate assurance must take, and lists those factors that bankruptcy judges may not consider in making their determinations.[5] The bankruptcy judge retains discretion only over the amount of assurance that will be adequate, and it appears even that determination is subject to some measure of creditor approval.

### C. 11 U.S.C. § 365(d)(4): Debtors Must Now Assume or Reject Executory Contracts or Unexpired Leases within 210 Days.

Section 365 of the Bankruptcy Code affords debtors the opportunity to either assume or reject executory contracts or unexpired leases. If the debtor wishes to assume a contract, it must cure defaults and provide adequate assurance of future performance. The

[4] 11 U.S.C. § 366.
[5] In determining whether assurance is adequate, a judge may not consider the absence of any deposit or security before the debtor filed for bankruptcy relief; timely pre-petition payments; or the availability of administrative expense priority.

contract is then treated as an administrative liability, which will survive the debtor's bankruptcy. The debtor may instead reject a contract, which creates a breach, giving the non-debtor party a pre-petition unsecured claim for damages. That claim, like all general unsecured claims, may be modified pursuant to a plan of reorganization to receive pennies on the dollar.

The power to assume or reject executory contracts is a valuable tool for retailers in bankruptcy. Large retailers have historically used section 365 to monetize the leases of underperforming locations, which allows them to both cut operating costs and bring value to the estate.

Before BAPCPA, debtors had sixty days to assume or reject a non-residential real property lease, but could request extensions of time by showing "cause." Bankruptcy courts were generally willing to grant the debtor extensions, and it became the norm that debtors would have as long as they needed, even up to the plan confirmation date, to make lease decisions. As amended, section 365(d)(4) provides that the debtor has an initial 120 days after the petition date to assume or reject non-residential real property leases. This timeframe is subject to only one 90-day extension, resulting in a maximum 210-day window to make a lease determination. Any extension beyond this 210-day time-period can occur only if the debtor obtains the landlord's written consent.[6] If the debtor fails to

[6] The extent to which landlords have and will consent to extensions beyond 210 days is a hot-button issue. The international council of shopping centers (a consortium of commercial landlords) highlights examples of landlord cooperation in retail bankruptcies and argues that the interests of retail debtors and landlords are aligned. Critics of section 365(d)(4) highlight the risk of landlord non-cooperation, the rise in "consent fees," and related issues to underscore the leverage landlords have obtained under this provision. I have not come down on this issue one way or another, except insofar as I acknowledge that communicating with landlords and getting the necessary "prior written consent" before the deadline arrives has proved to be a massive communications challenge.

elect assumption or rejection within this period, and cannot secure the written consent of the landlord for a further extension, then the lease is deemed rejected.

From the perspective of DIP lenders, section 365(d)(4)'s new time limitation changes the game in a number of key ways:

- First, whereas a lender could previously wait and see how various stores fared after the bankruptcy filing (or through the next holiday season), after BAPCPA the 210-day window is foremost in any prudent lender's mind. The lender likely has a lien on the inventory contained in the stores. If a given store ultimately may close, the lender wants it to close substantially before the 210 days has expired, so that there is sufficient time (usually 9 to 12 weeks) to conduct a going out of business sale on site.

- Second, with less time to evaluate individual locations' performance before making a lease decision, debtors may be more likely to make mistakes in choosing which leases to reject and which to keep. Mistakes in this context can be expensive,[7] which makes financing the debtor's bankruptcy a higher-risk investment.

- Third, a lender's willingness to lend has relied, at least in part, on the value of the debtor's commercial leases. The leases can be a valuable asset in the event of a failed reorganization. Because the time period for marketing leases is so truncated, their value is greatly reduced. Indeed, the once-vibrant market for designation rights has all but disappeared following BAPCPA.[8]

As a result, bankruptcy financing transactions following BAPCPA reflect lenders' unwillingness to provide the funding to carry a retailer through a chapter 11 case. If a

---

[7] Mistaken assumptions of leases carry with them stiff consequences. If the debtor rejects a lease prematurely, it risks losing a profitable location, injuring both itself and the landlord. If a debtor assumes a lease prematurely and later decides that it must reject the lease, the landlord may have a large administrative claim against the debtor (more or less equal to the monetary obligations due for a period of two years under the lease). Amended 503(b)(7) acknowledges that mistakes will likely be more prevalent and places limits on the recoverable damages for an assumed-then-rejected lease. Notwithstanding this adjustment, this damage award has the potential to be a significant obligation for an already cash-deficient debtor.

[8] Designation rights are the rights to assign leases to another party. Designation-rights sales have been especially helpful to large retail bankruptcies because they allow the debtor to quickly monetize the value of the leases while shifting the administrative burden of assigning individual leases to a willing buyer.

retailer files for bankruptcy relief, the case is either filed as a liquidation case from the outset, or the post-petition financing is limited to the base amount necessary to float the debtor for a few months, followed by either an accelerated sale or liquidation.

### D. 11 U.S.C. § 503(b)(9): A New Class of Administrative Claimants.

Prior to BAPCPA, unsecured, pre-petition claims held by vendors were treated as general unsecured claims. Unsecured claims may be modified pursuant to a plan of reorganization and often receive pennies on the dollar, so long as a plan complies with certain statutory requirements.

After BAPCPA, however, substantial portions of these claims receive administrative priority, a status reserved for the "actual, necessary costs and expenses of preserving the estate."[9] Section 503(b)(9) of the Bankruptcy Code now grants administrative priority to claims for goods delivered to the debtor in the ordinary course of business during the twenty-day period preceding bankruptcy. In contrast to unsecured claims, administrative claims must be paid in full, and in cash, as a prerequisite to the creditor's emergence from chapter 11.

As a result, chapter 11 debtors now have a new class of creditors whose claims must be satisfied by the effective date of a reorganization plan. As retailers continuously receive delivery of goods, this amendment can provide a significant new liability. For example, application of section 503(b)(9) increased Circuit City's exit fee by some $350 million. In a climate where financing is extremely difficult to obtain, this will force more debtors to liquidate if they cannot secure the exit financing to meet these obligations.

This problem may be exacerbated by the expanded reach-back period for reclamation

[9] 11 U.S.C. 503(b)(1)(A).

claims, which increases the value of these claims and the costs of resolving them. While the pre-BAPCPA code allowed sellers to reclaim goods that were delivered to the debtor in the ordinary course of business within the ten days prior to the petition date, the amendments have increased the period to forty-five days.[10] As a result, vendors may demand that the debtor either return any goods falling within this provision or pay for them in cash.[11]

These amendments elevate the unsecured claims of vendors over the claims of service providers and other unsecured creditors, and provide little-to-no rationale for drawing the distinction.[12] Moreover, section 503(b)(9) imposes a blanket administrative expense priority on vendors' *pre-petition* claims, allowing for no consideration of whether the vendor has provided, or will provide, any benefit to the estate.[13]

### E. The Problem with BAPCPA.

Working together, these amendments create an inhospitable bankruptcy forum for debtors of all kinds, but for large retailers in particular. The cash demands on a retail debtor have substantially increased at the outset of a case in order to meet utilities' adequate assurance payments. The debtor's exit fee, to address new administrative priority claims, has increased as well. Lenders' support is vital to enable a company to make it through a bankruptcy case and meet these payments. BAPCPA, however, tips the

---

[10] 11 U.S.C. § 546(c).

[11] Reclamation under 546(c) is an important issue to consider, but because most debtor have asset-based financing which gives another party a perfected lien on goods that otherwise would be subject to reclamation, the reclamation rules are frequently moot.

[12] The legislative history on section 503(b)(9) is "virtually nonexistent." Michael G. Wilson & Henry P. Long III, *Section 503(b)(9)'s Impact: A Proposal to Make Chapter 11 Viable Again for Retail Debtors*, 30-1 ABI Journal (February 2011).

[13] *See id.* (arguing that in enacting section 503(b)(9), "Congress effectively ignored one of the principal tenets underlying the Code, namely, that claims accorded administrative-expense priority should be narrowly limited to those that provide a benefit to the bankruptcy estate to ensure that a debtor has a realistic opportunity to successfully reorganize and stay in business.").

scales in favor of liquidation by stripping the value of the debtor's key assets – store leases and inventory – through operation of the 365(d)(4) limitation.

## IV. Putting the Retail Story Into Context: Increased Creditor Control and Eroding Judicial Discretion.

### A. The Rise in Retail Liquidations Reflects a Broader Trend of Increased Creditor Dominance in Chapter 11 Cases.

Over the last twenty-five years, the classic chapter 11 model, in which a debtor emerges from bankruptcy having confirmed a stand-alone plan of reorganization, has gradually given way to a rising number of going-concern sales and liquidations.[14] This change reflects a shift in bankruptcy policy: a rising emphasis on maximizing creditor recoveries over the interest in rehabilitating the debtor.

Creditors – particularly secured creditors – play an increasingly central role in debtors' chapter 11 reorganization proceedings. The rising level of "creditor dominance" in chapter 11 cases is frequently cited as motivating the concurrent shift from reorganizations to bankruptcy sales and liquidations.[15]

Much of the scholarship addressing creditor control over chapter 11 proceedings focuses on DIP financing arrangements. DIP loans generally are structured as revolving credit arrangements, which typically include frequent reporting requirements and restrictive conditions governing the Debtor's ability to draw funds. These conditions allow the DIP lender substantial oversight and control over the chapter 11 process. As the credit market constricted in 2007 and 2008, DIP financing became more difficult to obtain, and

---

[14] *See* Francoise C. Arsenault, *Going, Going Gone – Upward Trend in Section 363 Sales*, TURNAROUNDS & WORKOUTS, Dec. 15, 2004, at 4.

[15] *See, e.g.*, Harvey R. Miller and Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. Rev. 129 (2005) (arguing that DIP lenders "may favor asset sales in Chapter 11, given that they face limited upside potential but significant downside risk from an extended Chapter 11 case.").

was offered on increasingly more onerous terms.

### B. BAPCPA Represents a Leap Forward in Creditor Dominance.

This article will focus on how BAPCPA's provisions further increase creditor dominance in the chapter 11 process. I will argue that the shifting tide in favor of creditor control is evidenced not just through the inclusion of BAPCPA's various "special interest" provisions, but also through statutory limitations on the judicial function.

The recent trends in retail bankruptcies provide an excellent forum for exploring these issues. First, several BAPCPA provisions affecting retailers demonstrate a clear preference toward certain creditor groups, as well as an intent to replace bankruptcy judges' decision-making authority with set rules and creditor-reliant terms. In particular:

- In section 365(d)(4), extensions for cause have been replaced with a hard-and-fast deadline, extendable only with the consent of the landlord.
- In section 366, the judge's discretion to determine what assurance of future payment is "adequate" has been replaced with an exhaustive definition, coupled with a requirement that this assurance be "satisfactory to the utility."
- In section 503(b)(9), the grant of administrative priority, premised solely on the delivery date of goods, sidesteps the traditional case-by-case determination whether a creditor is entitled to administrative priority.

Second, these amendments have profoundly impacted the ability of retailers to reorganize, providing a rich set of facts to consider in weighing the competing policy objectives of creditor recovery and rehabilitation of the debtor.

## V. Conclusion

The analysis section of this article is in its nascent stages (as undoubtedly is evident from the above discussion). I welcome your thoughts and comments as I work to develop this writing.