Testimony of

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of the

House Judiciary Committee

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for Hearings on

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

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

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

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

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

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

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

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

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

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

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

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

The Erosion Of The Chapter 11 Paradigm

The world of restructuring and reorganization has dramatically changed from that which existed in 1978. This change has been precipitated by globalization, the expansion and predominance of secured creditors, claims trading, technological advances in all areas, particularly communications and access to information, a shift from a manufacturing to a service economy, and major business consolidations. The change was accentuated by the very robust economy that the United States enjoyed during the period from 2003 to mid-2007. Unprecedented low interest rates and overwhelming liquidity radically diminished the fear of loss and enhanced greed for higher and higher returns. The result was reckless spending and highly risky lending and investing. The availability of easy credit provided by financial institutions and the entry of hedge funds into the lending market enabled weak companies to

increase their leverage without taking necessary actions to correct deficiencies in their operations and potential financial problems.

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

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

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

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

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

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

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

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

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

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

foundation, other creditor groups pressed Congress for legislative containment of the bankruptcy court and the powers of the debtor/debtor in possession. Congress responded generously to the "needs" of these special interest groups.

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

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

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

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

***The contraction of unsecured credit*.**

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

***The emergence of secured inventory financing*.**

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

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

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

Consequently, the only source of financing is the pre-chapter 11 lender. In the case of Circuit City, the lenders' syndicate led by the Bank of America. From the perspective of the Bank of America syndicate, as stated, its objective was to get paid, with interest, costs and fees. The primary source for its quick recovery was the proceeds from the merchandise

inventory. Therefore, the bank had to consider how that merchandise inventory could be converted into dollars. The inventory-secured lender does not want the merchandise inventory. It wants dollars. To obtain dollars, the inventory has to be liquidated in place, i.e., in the store locations. Pursuant to section 365(d)(4)(B) of the Bankruptcy Code, Circuit City had a maximum of 210 days from the filing date of its chapter 11 case to assume or reject the unexpired leases of non-residential real property, i.e., the approximately 700-800 retail store locations. The liquidation of the merchandise inventory takes a substantial amount of time. As a result, the Bank of America and other similarly situated secured lenders want to be sure that there is adequate time to use the store locations to liquidate the merchandise inventory and obtain the full recovery of their loans.

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

Debtor In Possession (DIP) Financing.

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

characterized as "defensive DIP financing." The term is a misnomer. Financings by pre-chapter 11 secured creditors have become offensive.

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

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

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

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

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

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

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

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

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

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

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

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

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

Finally, the costs of DIP financing are prohibitive. In the case of Circuit City, it appears that the DIP financing, which included a roll-up of the pre-chapter 11 outstanding loan balance, only provided Circuit City with a very limited amount of new money, probably in the area of $200 million, despite a face amount of the DIP financing of approximately $1.2 billion. The approximately $800 million of pre-chapter 11 indebtedness was simply rolled into the DIP

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

Claims Trading.

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

Distressed debt traders and hedge funds have different objectives than those of vendor/suppliers. They are motivated by quick and sizeable returns on their investment. Because their entry price usually is much lower than the face amount of the acquired debt, they are more apt to favor the sale and dismemberment of a debtor, if it will yield faster and greater recoveries based upon the costs of purchasing claims. Unless they are extending loans to own

the debtor, a process that gained some favor in the mid-2000s, there is little or no interest in the rehabilitation of the debtor. In the case of Circuit City, it well may be that claims of the Bank of America syndicate were traded and, perhaps, acquirors took aggressive actions to have the Bank of America compel or influence the early termination of operations and the abandonment or the reorganization effort.

Conclusions

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

- Amend section 365(d)(4)(B) to remove the limit on the period within which a debtor in possession may assume or reject unexpired leases of non-residential real property. The Bankruptcy Code requires the lessee during the period to comply with the terms and provisions of the lease and to pay the rents required under the lease. Removal of the 210-day limitation will not prejudice lessors. Bankruptcy courts have been considerate and receptive to lessors who require early decisions as to assumption or rejection when necessary.

- Explore the enactment of enabling legislation during this economic crisis to provide debtor in possession financing for distressed businesses on reasonable terms and provisions while limiting the exercise of remedial rights by existing secured creditors.

- Explore means to limit the negative effects of excessive claims trading that hinder the ability to reorganize distressed businesses.

- Revisit the provisions of BAPCPA that tend to drain operating capital out of retail debtors in possession, such as section 366 (utility deposits), sections 503(b)(9) and 546(c) of the Bankruptcy Code.

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

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