

BUSINESS BANKRUPTCY PANEL: HOT TOPICS IN RETAIL BANKRUPTCY

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MR. BERLIN: Our topic for this portion of the symposium is retail debtor chapter 11 cases. The retail sector has been hit especially hard in this extended recession, and consumer confidence and consumer spending have been at dramatic lows for the past ten months, or maybe longer, and especially during the recent holiday shopping season.

Many retailers reported holiday sales results that were disappointing at best, and as most of you probably know, many retailers rely very heavily on holiday sales. In fact, for some retailers, an entire year's profit or loss can turn on whether holiday sales are robust enough to overcome slower sales or operating losses during other times of the year. There has been plenty of attention on the retail phenomenon in the media lately. Hardly a few days go by without articles appearing that discuss the impact of the recession on consumer spending and consumer retailing.

As we meet this morning, many retailers are reporting their same-store sales figures for the month of February. Yesterday morning, an article in *Reuters* reported that most analysts expect to see yet another month of declining figures, this time in the range of around 1.2%, and the figure might be closer to 4.8% if you subtract the effect of increased revenues from Wal-Mart stores.¹ In fact, discount retailers like Wal-Mart and warehouse clubs are

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¹ Nicole Maestri, *Profit Down at Costco, BJ's Beats View with Food Sales*, REUTERS, Mar. 4, 2009, <http://www.reuters.com/article/hotStocksNews/idUSN0452561420090304>.

some of the few retailers that are seeing increased revenues in these tough economic times, which is not surprising.

Since last spring, the list of retail debtors has grown significantly, and few retail segments have been spared. We have seen retail debtors come from large national chains as well as small regional chains and from across a wide spectrum of consumer product lines. Some widely known examples include Linens 'n Things, Whitehall Jewelers, Mervyns, Boscoff's, Shoe Pavilion, Ritz Camera, Circuit City Stores, Sharper Image, Goody's, which commenced a chapter 22 case only a few months after emerging from chapter 11 last year, Steve & Barry's, and KB Toys. The list goes on and on.

Our panel this morning is going to talk about some of the key issues that arise in retailer cases. We are going to discuss some of the dynamics of DIP financing in these cases, the treatment of the debtor's commercial real property leases, the store closing process, and some of the vendor issues that are common in these cases.

So before we go any further, let me introduce my fellow panelists. To my immediate left is Bob LeHane. Mr. LeHane is special counsel at the law firm of Kelley Drye & Warren, LLP, in New York City. Mr. LeHane has a varied practice, but he specializes in representing shopping center landlords and property management companies with multiple leases in retail bankruptcy cases all over the country. In fact, during the past six years, Mr. LeHane has been involved in well over 100 retail bankruptcy cases, including many, if not most, of the recent cases I just mentioned. Mr. LeHane has published and lectured on commercial landlord rights in chapter 11. To the extent that the opinions or views expressed during the panel discussion this morning are supposed to represent those of any particular constituency during a chapter 11 case, Mr. LeHane would be wearing the hat of the landlord on the panel this morning.

To Mr. LeHane's left is Todd Meyers. Mr. Meyers is the chair of the bankruptcy and financial restructuring team at Kilpatrick Stockton, LLP. He has a depth of experience in representing creditors' committees, individual creditors, debtors, and trustees. In retail cases, Mr. Meyers had represented retail debtors, including Vista Eyecare and Nationwide Furniture, and he has represented senior lenders, both in the West Lumber case and in the first Friedman's Jewelers case. Mr. Meyers then went on to represent Friedman's Jewelers as the debtor in its second chapter 11 case.

Mr. Meyers also is an Emory Law School alum, and an alum of the *Emory Bankruptcy Developments Journal*, for which he served as an Executive Articles Editor. Mr. Meyers is a published author on bankruptcy topics and UCC Article 9 topics. He will speak from the debtor's perspective on the panel this morning.

To Mr. Meyers's left is Richard NeJame, a managing director in the Recapitalization and Restructuring Group at Broadpoint Capital, Inc. Before joining Broadpoint last year, Mr. NeJame did tours of duty with Alex Brown & Sons, Lazard Freres, Imperial Capital, and Kidder, Peabody & Co. Mr. NeJame's experience with financing and investment banking spans the spectrum that includes restructurings, M&A financing, and corporate finance for institutional and private equity investors. Mr. NeJame will represent the view of the lender on the panel this morning.

I. DIP FINANCING FOR DISTRESSED RETAILERS

I'm going to direct the first question to Mr. NeJame, and get us talking about DIP financing and its availability in retail cases and the issues in retail cases that influence a lender's approach to, and terms for, financing in these cases. I expect that we will quickly segue from that topic into the topic of the debtor's deadline under § 365(d)(4) of the Bankruptcy Code for assuming, rejecting, or assigning unexpired, nonresidential real property leases.

As you might recall, under BAPCPA in 2005, Congress placed a cap on the debtor's timeline for making these decisions at 120 days after the petition date with the availability to the debtor of one extension from the bankruptcy court, if requested, of up to 90 days, for a total of 210 days.² Any opportunity to extend the decision beyond that point is contingent upon consent from the landlord. We will talk about how this change to the statute has affected retail cases, generally, and DIP financing in those cases.

So, Mr. NeJame, what are you seeing as the latest outlook for DIP financing availability for distressed retailers?

MR. NEJAME: Well, the previous presentation is a good backdrop for addressing the question because there is kind of a triple whammy. The first big issue is the underlying financial system. The financing markets have

² 11 U.S.C. § 365(d)(4) (2006).

completely converged in terms of the cost of one particular type of fixed-income, financing is now closely tied to the cost of another.

There is full arbitrage across the market. Whereas you previously had a situation where the asset-based lending market, and in particular, the DIP lending market, was somewhat insulated from the whims of the capital markets because of a number of well-financed, strong financial institutions who knew how to lend into those markets. That has gone away for a couple of reasons. Number one, the underlying financial crisis, which has limited the ability of these formerly strong financial institutions to extend capital on a predictable basis. Thus, the likes of General Electric, CIT, and Wells Fargo Foothill, some of the supposedly strongest financial institutions, are no longer aggressively lending into those markets. They have been supplemented by the hedge fund community, which obviously invests across all markets. Because of the lack of liquidity for a number of fixed-income markets, whether high yield, leverage loan, or investment grade, everything is more expensive. Therefore, the required return for a DIP facility also needs to recognize that same return.

People are looking at the loan market and saying, "I can use this capital just as easily to buy any Blue Chip name. I can buy IBM paper that yields me 11%." IBM, 11%: usually you do not think of it in the same sentence unless it is earnings growth, and certainly not with respect to fixed-income obligations. So, that is one factor just on a macroeconomic basis.

Another factor that I think is really curtailing the opportunity to finance is years of over-capacity in terms of building out retail capacity. Because cheap financing was available for so long, developers and landlords had the ability to access financing inexpensively across the board, which made it efficient for retailers with gross strategies to grow and expand their footprint. So, there is a certain part of this that is just a secular boom in capacity that probably needs to rationalize in some way, shape, or form.

I think the third aspect is kind of on the back-end of what is happening. When credit goes away, there is a pervasive impact it has on the consumer itself. If you are a retailer, you are marketing directly to the consumer. I do not think that impact has fully worked its way through the system but it may already be anticipated in some respects by the lending community. Which is why you are seeing deals like Gottschalks, where we (Broadpoint Capital) are representing a potential acquirer of that company, and the company is in bankruptcy. For a company like that, you are probably going to be struggling

to get advance rates of about forty percent, believe it or not, on certain lines of products.

It is hard to say whether the full effect of the negative impact on the consumer is realized or not because people are anticipating it, and it is hard to judge how bad things are going to get.

MR. BERLIN: You know, under those circumstances, what some commentators are asking the media is whether at this point in time it is even a realistic possibility for a retail debtor to expect to be able to reorganize and actually emerge from chapter 11. We've seen in some of the largest cases recently, like Circuit City and Linens 'n Things, just as a couple of examples, retailers who begin their cases with all earnest hope of emerging from a reorganization with a reduced footprint, or whatever other modifications to their business plan they want to make, but ending up in liquidation mode.

Mr. Meyers, from the debtor's perspective, is it even realistic to expect a retail debtor right now to be able to reorganize in chapter 11?

MR. MEYERS: Well, these are definitely unique times, and as everybody knows, the answers to these questions would have been very different six months ago or a year ago.

It is going to be very difficult for retailers to get financing and emerge. One thing that is clear right now is that there is just such volatility in the economy. I am working with several clients right now, and they have done a business plan for the lender in December, only to revise it in January and to revise it again in February. Exit financing requires some type of faith in the numbers, and right now, the debtors do not even have faith in their own numbers. Could anyone have predicted six months ago that we would be where we are today, or two years ago that we would be where we were six months ago?

The volatility of the market is freezing up everything. GE Capital, which has been one of the largest DIP financing companies and exit financing companies, froze all financing for a good period of time. The market will ultimately respond. There are distressed hedge funds closing now and raising \$500 million in capital to lend to companies. They are not quite doing it yet, but I think they are ramping up, and they are getting ready to do it. I think the market will react. It will be very expensive financing, but it will come out. However, the market is so volatile right now that I do not think it is likely today.

One thing I would sort of note is that while most retailers have bank financing as well as vendor financing, there are retailers large enough to have public debt, like Blockbuster. The companies that are billion-dollar-over type companies, like Circuit City, who I don't think had public debt, notwithstanding; I think they have a legitimate chance of getting more financing. But for those that do have public debt, the public bondholders are very amenable to converting their holdings. If not, it will be forced upon them to convert debt to equity. In contrast, banks and secured lenders do not typically want to go that route.

So, if a company that has bank financing that's not in that much trouble and an enormous amount of public debt that they can convert, if they can show some kind of operating profitability, I think that they, retailers like Blockbuster, may have a chance.

II. THE § 365(D)(4) DEADLINE FOR ASSUMING, REJECTING, OR ASSIGNING UNEXPIRED, NONRESIDENTIAL REAL PROPERTY LEASES

MR. BERLIN: It is interesting that whatever the reasons, the reasons that you mentioned and the reasons that might even apply to smaller companies, we do still see these retailers commencing their cases. Some of the cases are only a few days old at this point. We had Ritz Camera filed, I think, only within the past ten day, as well as smaller retailers, including Everything But Water. So we see a lot of retailers commencing these cases, and they are still taking a shot at it, and they are managing to get DIP financing in some form or another.

Obviously the § 365(d)(4)³ issue that I mentioned earlier plays a big impact on the decision of the debtor to commence its case, because that section is going to place a great amount of pressure on the debtor to make decisions about its leases. So let us talk about that a little bit. I will direct that question to Mr. LeHane. How has this amendment played out so far and what have been its effects?

MR. LEHANE: Thanks, Mr. Berlin. To put it in context, prior to the change to the Code, the ability of debtors to get successive extensions of their time to assume or reject had two significant impacts on a retail bankruptcy case. One of the things it did was turn the leases the debtors had into assets. That was a

³ *Id.* (capping the amount of time a DIP or trustee has to assume, reject, or assign an unexpired nonresidential real property lease without the lessor's prior written consent at 120 days with the possibility of a 90 day extension, for a total of 210 days).

contract. If those contracts are under market value, they can be marketed and sold to third parties. That was an asset the debtor could lend against and something that they often sold in what are called “designation rights packages.”

The other significant impact of the preamendment Code was that lenders had faith that debtors would get these extensions for cause, which bankruptcy judges often granted as wide open extensions, sometimes even up to confirmation. So, lenders and DIP lenders understood that when they lent into a bankruptcy case, that time for the debtor to make its decision to assume or reject its leases would be continually extended, probably until they could confirm a plan, they could find a going-concern buyer, or determined that they had to liquidate the company.

The intent of the 2005 amendment to the Code was to give landlords certainty. The landlord complaint was that the 1984 statute resulted in bankruptcy cases that were going on and on. It was passed with a group of other amendments to the Code, called the “Shopping Center Amendments,” which also required debtors to pay the rent on a go-forward basis under § 365(d)(3) to give those landlords some certainty that debtors would be forced to make a quick decision to assume or reject their leases.⁴

What Orrin Hatch said was that only in the most complicated cases could a debtor possibly need an extension of time to assume or reject.⁵ Bankruptcy judges differed. The cause to get an extension was usually because you asked for it.

So, before the Code changed, these extensions were routine, and banks had confidence that the leases would be there. The leases being there is important because that is where the debtor is going to sell and do its business going forward, and that is where the bank is going to liquidate its collateral if it has to. With the amendment to the Code, the maximum time that the debtor has to assume or reject is 210 days, which is seven months. It seems like a reasonable amount of time, but as Mr. Berlin mentioned, the retail business is seasonal. Most retailers are not in the black until after Thanksgiving. It usually takes a full twelve-month cycle for a retailer to know what is going on.

⁴ *Id.* § 365(d)(3).

⁵ *See, e.g.*, 151 CONG. REC. S2461 (daily ed. Mar. 10, 2005) (statement of Sen. Hatch) (“Mr. President, the bankruptcy legislation cures some abuses in the Bankruptcy Code regarding executory contracts and unexpired leases. One provision, Section 404(a) of the bill, amends Section 365(d)(4) of the Bankruptcy Code.”).

With a seven-month deadline, banks lending into a retail debtor with seven months automatically back out somewhere between six to twelve weeks before the deadline to conduct their liquidations of their collateral if they need to. So, it is not seven months; it is maybe five months—maybe even less. We cannot underestimate the impact of the change to the Code on DIP lending and what DIP lenders are willing to do.

In most of the retail cases filed since the passage of BAPCPA, the DIP facility order requires the debtor to immediately try to get the extension of time from 120 to 210 days, but also often times will say, “You have to have a plan of reorganization filed or a going-concern buyer lined up within ninety days of the filing of this bankruptcy case.” That was the case in Mervyns, Goody’s, Circuit City, and S&K. I think S&K, which just filed in Richmond, needed to sell within sixty days. The DIP financing for Everything But Water, which just filed, is actually coming from a proposed purchaser, and they have a thirty-day trigger on that. They have already teed up their sale process, two days after they filed for bankruptcy.

So, the statute, has it served its purpose? Well it has given landlords certainty. We know that the debtor has to make its decision within 210 days, unless we, as landlords, provide written consent. So, we know how long most bankruptcy cases are going to go, unless we grant more time. However, the fact is, we have been willing to work with debtors and DIP lenders.

In Hancock Fabrics, one of the first significant retail cases that filed after BAPCPA, I believe eighty-or-so percent of the landlords were willing to extend the time to assume or reject, and Hancock was in a position to assume those that were not willing to grant that extension.⁶ In Linens ‘n Things, ninety percent of the landlords provided that extension of time to assume or reject.⁷

So the landlords are willing to work with the debtors, but what the statute has done is given lenders incredible, incredible leverage, and put really drastic requirements in their DIP lending.

To go to one of Mr. NeJame’s points about the cost of the DIP lending. Debtors are getting very little liquidity for what people perceive to be exorbitant fees. In Circuit City, it was a phenomenal figure, something like a

⁶ *In re Hancock Fabrics, Inc.*, No. 07-10353 (Bankr. D. Del. Aug. 24, 2007).

⁷ *In re Linens Holding Co.*, No. 08-10832 (Bankr. D. Del. May 2, 2008).

\$900 million DIP facility. But it really only gave the debtor an excess of \$50 million in liquidity, and the fee was \$30 million. The debtor's counsel more or less said to the judge on the first day, "That's right, Your Honor, you heard me. We are really only getting \$50 million in liquidity, and the fee is \$30 million. I am not hiding that fact. We know it's a lot of money, but we need this to try and make it through at least the next three months of the case."

MR. NEJAME: One point I would add as far as what has changed besides the law is that for the longest period of time, you had a steadily increasing real estate market and property market, and along with that, steadily increasing rent. So on average, and you alluded to this, Mr. LeHane, lenders could always look, potentially, to bad stores actually having intrinsic value through the value of a very old lease that might be below market.

Now, that is not the case, and it could be very much the opposite for quite some period of time, which I think is one of the most fundamental reasons why retailers are going to have trouble reorganizing under any extended period. You can go to a group of bondholders and you can say, "Lower my interest rate. Lower your principal amount." If you get enough people on your side, you can force everyone along with you, through your traditional two-thirds approval.

That type of ability to herd cats and get a class of creditors to act in unison doesn't exist among a hodgepodge of landlords across your store base, and they probably are going to be the largest institutional creditor of any retailer going forward.

MR. LEHANE: Mr. NeJame, that is an excellent point. What I take from that is that one of the things that debtors need to do is really key into that early pre-filing. You have got to be reaching out to your landlords, and frankly, all across the country landlords are getting these requests from their tenants, saying, "Guys, we can't afford the rent. Something really bad is going to happen unless you give us a rent reduction or a rent abatement." Next week, I will be back here in Atlanta speaking to one of my client's leadership conferences discussing with them how to deal with the pile of rent relief requests that all of the leasing agents and property managers are getting from all of their tenants.

Working with the landlord community in advance of the filing and getting that extension, in addition to letting them know "We're going to need rent concessions, we're going to need to extend the time to assume or reject," takes away from the banks, and to a certain extent, vendors, the ability to say, "You

have to have all your decisions done in five months, because if you don't, we're going to need to liquidate the collateral before the 210-day deadline expires."

AUDIENCE MEMBER: I wanted to ask you because you are representing landlords. It is possible that you are representing landlords not just in these big retail bankruptcies but landlords where the tenant is just a small business, some guy that put his life savings in. It seems to me that § 365(d)(4) works very differently for that type of debtor. You do not have the sort of situation where you are going all over the country. You have some guy that tried to open up a gym or he's got a consulting business, and a lot of us here who do consumer and very small business debtor representation, that the § 364(d)(4) thing is really just a matter of if the business is eventually going to fall apart, and whether you set up a situation where the landlord's administrative claim is going to suck up all the money and leave the individual, one hundred percent shareholder, with a tax liability, very often from 941s.⁸

I don't know that § 365(d)(4) works as well for that kind of a debtor who is not out there looking for DIP financing. As the attorney, you are just trying to find out when to tell your client to pull the plug, if it comes to that.

Have you got any thoughts about that?

MR. LEHANE: My statement that § 365(d)(4) serves its purpose is with respect to the landlord intention, prior to the triple whammy that we've all been talking about, of getting certainty as to when they are going to have a debtor that's going to make its decision. Does it work for debtors? No. It really reduced the value of their asset of leases across the board. In the smaller debtor cases, where they have one significant lease they have to deal with, it significantly reduced the amount of time they have to deal with that. My sense is that in this economic environment, landlords are particularly willing to extend that time.

Keep in mind that there is a reason why the Code has so many provisions that protect landlords: prior to 1984 and under the old Act, landlords were abused in bankruptcy cases. Debtors would file for bankruptcy and just not pay rent anymore, and a landlord was an involuntary participant in that bankruptcy case. Unlike a vendor who gets to decide whether or not to

⁸ Form 941, available at <http://www.irs.gov/pub/irs-pdf/f941.pdf> (last visited Apr. 6, 2009) (calculates an employer taxpayer's quarterly federal tax return).

continue shipping goods, if you file for bankruptcy, you have got my space and I do not get it back until we have reached that deadline. Before those deadlines were in place and there was an automatic obligation of the debtor to pay the rent, debtors routinely funded their bankruptcy cases by not paying their landlords.

So, the landlord community got together. The International Council of Shopping Centers is a very, very powerful lobbying force. It is an organization of all the shopping centers, developers, and owners across the country that got together and said to Congress, "Hey, the Bankruptcy Code should be treating shopping centers as one economic unit, and we shouldn't be the involuntary interest for unsecured creditors in all bankruptcy cases."

The amendments to the code really have favored landlords. When I appear in bankruptcy courts across the country, the views of the bankruptcy judges vary widely in some of them. I think we, as landlord attorneys, get the sense that if we wanted anything else, we just should have asked Congress for it. Bankruptcy judges are not going to do us any favors, and there have been some interesting decisions. I frankly do not hold that against any of the bankruptcy judges. We will talk about Circuit City later, but judges are doing what they can to save these struggling retailers and their employees.

Circuit City, alone, was 38,000 people that were lost. I think we've probably lost, Mr. Berlin may have a handle on this, but, two hundred or three hundred thousand retail jobs in the last three or four months, and that's a difficult process.

But, no, this deadline has not worked well for debtors, to answer the question.

MR. MEYERS: You know, I was just going to add, Mr. Berlin, that there is a concept in § 365(d)(4) that may make sense, which is that we all saw years and years of extensions just for the asking, just like with exclusivity. But the fix, which was to put this fixed deadline of 120 plus 90, does not take into account seasonality.

MR. BERLIN: It gives no discretion to the judge.

MR. MEYERS: It is very difficult. Congress knows when to change cause standards to irreparable harm standards. We saw that in one of the 6000

Rules,⁹ which now deals with first-day motions and puts an irreparable harm standard on certain other things you need to do.¹⁰ By just changing cause to irreparable harm, you would have had a real hearing on § 365 extensions. The amendment to § 365(d)(4) gave, probably, way too much power to the landlords.

I think right now, the leverage is probably diffused, if not eliminated, because landlords are currently happy to take a rent check. There are not a lot of tenants, and there are a lot of empty spaces out there.

There are discussions about keeping this concept of having a definite timeframe with which to accept or reject leases, but lengthening it. Assuming the economy returns to some kind of normalcy you might get to something that makes sense. But I think they kind of went overboard the other way. As debtor's counsel, it is a very difficult provision to work with.

MR. BERLIN: I think that Congress has observed some of the results in the retail cases, at least the ones in the past year. Congress is taking a look at § 365(d)(4) again, and looking at whether § 365(d)(4) has been the cause of these cases that have gone from reorganization very quickly to liquidation.

I want to ask a couple of follow-up questions, Mr. LeHane, to your point about landlords being very cooperative right now with debtors about the extensions under § 365(d)(4).

Let us talk about whether landlords are even asking for concessions, and if so, what kind of concessions are they getting from the debtor in granting these extensions where the landlords consent to the extensions? It is a question that goes, both to the request when made during the case, and, as you mentioned, requests that are made before the case. Regarding the comments here about whether the statute has benefited landlords or been detrimental to the debtor or vice versa, I think that retail debtors, who have been on the sidelines and have been watching what has happened with cases, are learning a lesson from them.

You mentioned all these requests by retailers who are not in chapter 11 bankruptcy, but who are approaching their landlords very proactively and saying, "Hey, what kind of rent concessions can we get? What kind of modifications can we make?" I have clients who have received those requests,

⁹ The "6000 Rules" refers to Part VI of the Federal Rules of Bankruptcy Procedure, which relate to "Collection and Liquidation of the Estate." FED. R. BANKR. P. PART VI.

¹⁰ FED. R. BANKR. P. R. 6003.

and we have tried to build in a response in which we are happy to cooperate on a modification, and the contingency is going to be that the modification does not kick in until you are in bankruptcy and you have assumed the lease.

MR. LEHANE: Right. There are a number of ways to structure those responses to a rent relief request, and I typically get them after we are in bankruptcy.

Let me answer your first question. We are not getting any requests in the bankruptcy for the extension of the time to assume or reject, because, frankly, we are not getting there. I am on the creditors' committee in a number of these retail cases, because some of my landlord clients are significant enough that they get on the creditors' committee. In these cases, we had significant conversations with debtor's counsel about it, and they said, "Well, yeah, we want to have those discussions, but we've got a significant issue with our vendors that we have to overcome first. We have to deal with the banks, if we get there. If we get through the next thirty-five days, then we're ready to talk to you guys about the extension of time to assume or reject." But in the past four or five months debtors just have not made it past those "thirty-five" days.

Prior to that, Linens 'n Things was a good example, and so was Hancock Fabrics. You know, "What do you have that you can give me? I'm a landlord." In Delaware, it is a building date jurisdiction. We can talk about that later. "But you owe me some stub rent. I would like that paid now, before I give you an extension of time to assume or reject. I don't want to wait until the end of the case."

MR. MEYERS: Not a chance.

MR. LEHANE: And why not?

MR. MEYERS: Because the banks—

MR. LEHANE: Said no.

MR. BERLIN: Well, that is right, because the bank said no.

MR. MEYERS: I need the money.

MR. BERLIN: We're going to loop Mr. NeJame into this part of the discussion too, because I'm curious whether any of you have seen, even maybe not in court-filed papers but in behind-the-scenes discussions, how that very concept

of, “No, because the bank said no,” plays into the standards under the Bankruptcy Code for the debtor to be doing the things that it’s doing.

When the debtor says, “I want to reject a lease,” there is a legal standard that applies to that, and the debtor is supposed to be exercising its own independent, sound business judgment. The debtor says, “I want to close stores and stop operating at certain locations.” That is supposed to be based on the debtor’s sound business judgment. What we have here are situations that appear to be situations in which the debtor is saying, “Look, my hands are tied. It is not even my decision. It’s the bank’s decision.”

Has an argument been made that it does not really meet the standard? I made that argument in a pleading in the *Linens ‘n Things* case, but it ended up getting resolved, so it was never really brought to the court for a ruling.

MR. MEYERS: Earlier I was going to say that if the answer of the debtor to a landlord’s request for a concession is “I can’t because the lender won’t let me,” that if the lender is acting within its right, the debtor’s business judgment includes the practical reality of the situation. So as a debtor in bankruptcy, I might love to assume all my store leases and give all my employees bonuses. But even if I show that if I pay my salesmen more they will do better and we’ll have more sales, if the bank won’t give financing to provide the liquidity necessary to take those actions then it is my business judgment to tell the landlord “I can’t do that.”

MR. LEHANE: With respect to the request for an extension of time and the request for a stub rent, in *Linens ‘n Things*, for instance, all the landlord creditors asked for stub rent, and the debtor said, “No. The bank won’t let me.” So, we were getting up to this period when the debtor was under an obligation under its DIP facility that eighty percent of the landlords had to agree to extend the time to assume or reject. What the debtor did to induce some landlords to grant the extension was to go ahead and file a motion to reject the leases for all the landlords who had not yet granted the extension. Some of them said, “Oh, they were serious, and they’re really not going to pay the stub rent, they’re just going to reject my lease.” So I had about five frantic phone calls after I said, “By the way, they weren’t kidding. Here’s the rejection notice,” from landlords saying, “Oh, okay. We’ll grant the extension.” After that, they got taken off that list of leases to be rejected.

So, it is not that a decision to grant the extension or to not pay the stub rent should be separated from the decision to assume or reject the lease. That is the

decision the debtor went ahead and made and said, “They’re not going to give me an extension of time to assume or reject. It’ll be deemed rejected anyway, so I’ll go ahead and send a notice out that I’m rejecting this lease, and maybe that will incentivize my landlords to provide me that extension.”

Other requests that we have made—landlords are sometimes the subject of preference actions. They will have always almost invariably have received rent during the ninety days.¹¹ Some of that may or may not have been late, but I would say, as a landlord, “If I’m going to grant you an extension of time to assume or reject, I want you and the committee to agree that you’re not going to try and sue me for a preference action, period.” So the debtor then has to go back to the committee, and get court approval for that, because that is really a compromise of a claim. That is a pretty significant request.

MR. BERLIN: We saw that in Linens ‘n Things, right?

MR. LEHANE: Right.

MR. BERLIN: Mr. NeJame, from the lender’s perspective, these things that Mr. Meyers and Bob are saying, do they sync up with what the lenders are thinking about it?

MR. NEJAME: Well, let’s put it this way: to the extent this is playing itself out in the early days of the bankruptcy, this is making your DIP lender watch you make the sausage, which is exactly what you’d like to avoid, and which goes to your point about preparation. The preparation for a retail bankruptcy is going to be that much more onerous and exhaustive in order to do it right because of all the different constituencies. The complexity of these discussions as you are going through them illustrates the fact that you need to be set with all your ducks in a row before you step in so that these types of contingencies and questions are known variables when you are negotiating your DIP agreement. To the extent, they are not, and in the absence of a known quantity, DIP lenders are going to try to protect themselves with deadlines and a rigorous, quick process for resolving things, curtailing the debtors’ flexibility to actually reorganize.

MR. BERLIN: It may be a good sign that we’ve observed what we’ve talked about, with retailers approaching their landlords now on a very proactive basis and trying to work these arrangements out before—

¹¹ See 11 U.S.C. § 547(b) (allowing the trustee, with some exceptions, to avoid transfers made by the debtor within the 90 days before the debtor’s filing date).

MR. LEHANE: Well, the question my landlord clients all have is, “What’s real and what’s not?” It seems like everybody has got their hand out now for rent relief. So, yeah, they are being proactive, but is that the thing to do this season, “Since other guys are getting rent relief, we’d better go ask for some too”? It is a problem because there are a lot of headlines about some of my clients being on the verge of chapter 11, and if some of the big developers file for bankruptcy, there will be a significant and dramatic decline in the value of a huge collateral base. The drop in the value of shopping centers across the country will be significant if we start to see some of these developers actually going into chapter 11 because they will not be able to get refinancing because they are also up against the credit crunch.

MR. BERLIN: I do not think some people may even be aware of the extent to which malls and shopping centers around the country are within consolidated ownership. For example, how many shopping centers, lifestyle centers, and malls are under the General Growth name?

MR. LEHANE: General Growth, I believe, is two to three hundred shopping centers. Simon Properties, considered the largest mall owner in the country, I think has 100 or so more than that. Those are the enclosed, regional malls. Developers Diversified owns 800 properties across the country which range from strip malls, CBs [commercial buildings], and power centers. There are some significant companies out there that have very extended holdings. At the same time, there are many small families or small development companies with two, three, four, ten, or twenty shopping centers. I had these facts at my fingertips at one time, and I have not prepped them today, but I would not be surprised if there are in excess of 50,000 shopping centers across the country. It is something that we interface with, and it really was the engine of the whole boom for years and years, this consumerism.

It all happens in the shopping center. If the whole financial crisis now is a significant market drop maybe we are just overbuilt in shopping centers. Maybe we have ten, fifteen percent too many shopping centers, or maybe rents are ten or fifteen percent too high. Those are really challenging questions facing that whole industry right now.

MR. BERLIN: It is not as if you can just close one shopping center or specific shopping centers to get that number back down. When the individual retailers are going out of business, it is just leaving gaps and closed doors within a shopping center.

MR. LEHANE: That is right, and those questions go far beyond the scope of this discussion.

MR. BERLIN: Right.

MR. LEHANE: I could literally talk about § 365(d)(4) and (d)(3) for hours. One of the things I do want to note is that those two sections of the code, §§ 365(d)(4) and (d)(3), are coming up in every retail case, and we can wait and discuss them, but Congress really is moving on this. They have subpoenaed many of the lead attorneys on the creditor committee side. I know Larry Gottlieb has appeared before Congress on this issue of how long the debtor should have to assume or reject, and I believe Richard Pachulski has also made an appearance before Congress because they wanted to know what happened in Circuit City.

So, I will not be surprised if we do get some activity on this. One of the suggestions Mr. Meyers had mentioned is making the standard irreparable harm. Another one is, rather than seven months, why not make it fifteen? Fifteen months really gives you one full cycle of seasonality and three months for the bank to have its liquidation. Putting my landlord hat on, I think the hard-and-fast deadline is good because it is only hard and fast to the extent that landlords do not want to continue to go forward with that. If you have been in bankruptcy for a year, I believe that is sufficient time to do your real, hard turnaround work, which you probably should have commenced before bankruptcy.

The problem with seven months, minus the time to liquidate, is that there is really no time to do that very difficult turnaround work, to really right-size your business. With respect to vendors and the number of stores that are open, it is a lot of analysis that you have to do. Fifteen months, I do believe is an appropriate time. But, I think a hard-and-fast deadline is appropriate.

MR. BERLIN: You've mentioned that you've had the opportunity to serve on several committees, and as we were talking about with mall owners like General Growth or Developers Diversified, a particular retailer, chapter 11 bankruptcy, might bring as many as thirty, forty, or fifty of their locations into issue in the case. What has been the dynamic, serving as the landlord in the creditors' committee, with the trade debtors, the bondholders?

MR. LEHANE: It obviously varies from case to case. Simon Properties has been on creditors' committees for years and years now, and they probably led the way in participating. Keep in mind that a landlord in a retail case always

sort of has two hats on. What will typically happen is a retail debtor will file, and it may have to close some stores right away, or may have already closed some stores. So, that landlord will have claims against the debtor that are general unsecured claims.

They may be unpaid, prepetition debt, and they may be claims that are capped by § 502(b)(6).¹² As soon as you get several locations lined up, you may not have been listed in the top twenty or thirty creditors on the debtor's first-day affidavit or petition, but when you add up the numbers and what those rejection damage claims are, any of these big landlords are immediately moved into the top four or five creditors in the case.

They also have the role of being an administrative creditor because the debtor is still occupying and using their space, so they have an interest in making sure that their administrative claims get paid, and they have an interest in seeing, presumably, that the debtor succeeds and reorganizes and has a going-forward business.

Some would say that conflicts with their interest as being an unsecured creditor and having a fiduciary duty serving on that creditors' committee to maximize value for the unsecured creditors, but invariably, in any creditors' committee, it's made up of a cross section of the top creditors. So, we will include vendors that are also in, to a certain extent, the same position.

They are probably shipping goods to the debtor now. They also have a claim for any goods that they shipped within the first twenty days before the bankruptcy case was filed. Those vendors have administrative claims. They may have unsecured claims for insignificant goods that they shipped prepetition, and they presumably have an interest in seeing that there is a company that successfully reorganizes, that they continue to do business with going forward.

So, those vendors are in the same situation. We could get to the specific type of vendor, consignment vendors, and maybe Mr. Meyers wants to talk about that a little bit. They also have a particular type of claim. If they are a consignment vendor, they may have shipped goods that they continue to believe they own.

What does that do to their position of vis-à-vis the debtor and/or maybe participating on a creditors' committee?

¹² *Id.* § 502(b)(6) (setting caps on landlord's claims for past due and unpaid rent against a debtor).

MR. MEYERS: It gives them a lot more leverage in the proceedings because they've got a good ability to hold up § 363 sales¹³ while they argue about whether they own the property, whether it can be sold, and whether their agreement doesn't allow it to be sold by liquidators or at a discount.

As someone who represents creditors' committees, you never just have seven trade vendors all doing business with the debtor or all not doing business with the debtor so that they are all moving in exactly the same direction. You have got that dynamic. You have got some vendors, some of which may or may not be doing business with the debtor. You have got some landlords. You might have bondholders.

Managing that body is really what I do for a living, and it's always unique, because they are supposed to be focused on maximizing return, but they can consider, "Well, maybe there will be a plan that will take care of all the trade creditors even though the bondholders will get equity." You used to argue about whether you could do that, but under the Code now, you see that the result of every prepackaged bankruptcy tends to be that trade creditors are going to ride through unaffected, and bondholders are going to get equity. That is generally accepted.

So, dealing with landlords on committees, or people with different interests, it is a challenge, but usually we prevail. Guiding that is always a challenge.

MR. LEHANE: One of the things that I think being a landlord counsel and serving on committees entails is trying to help the process along and make sure that the landlord issues, with respect to these stub rent issues the assumption or assignment of leases, the sale process and the GOB process, are dealt with in a smoother fashion, without as much litigation. Having a voice on that committee and being able to say to committee counsel and debtor's counsel, because you have access to them, "Hey, guys, before you file your lease auction procedures motion, maybe you can send me a copy of it or we can sit down and go over it, and we can avoid some unnecessary noise that you're going to get from us."

There is this small group of landlord attorneys that are in every case. For instance, Circuit City filed in Richmond, Virginia, and there were about forty-five other landlord attorneys at every hearing. We were very successful in

¹³ *Id.* § 363 (covering the trustee's authorization to use, sell or lease the estate's property).

hammering out lease auction procedures, lease rejection procedures, in a way that avoided a lot of discourse before the court. That was very beneficial to the case as a whole. That is something that the landlords participating in the committees bring to the case.

Also, in any retail case, large landlords have a working relationship with not only that debtor but also retail in general, because we are the other partner to retail.

MR. BERLIN: In fact, tying those comments back to questions that were coming up earlier along the theme of is it § 365(d)(4) or the lender that's causing these retail cases to deteriorate into liquidation instead of reorganization, you were mentioning the Circuit City case. There was a lot of public commentary on the record at the hearing when Circuit City had to announce that it was not going to be able to reorganize and that it was going to begin closing all of its stores. The finger pointing, not by the landlords, but just in general, was at the trade vendors, saying in this particular case, the reason this result came about, according to some people's point of view, was because of the noncooperation of trade vendors in the program that the debtor had established to try to emerge from bankruptcy.

MR. LEHANE: Taking it from the trade vendor's point of view, and I'm happy to put that hat on, the largest unsecured creditors in Circuit City, HP, had \$116 million in prepetition debt; Samsung had \$115 million in prepetition debt.¹⁴ I don't think they had seen anything from Circuit City that looked like a real significant turnaround, a business plan that people had put thought into that was going to show them a way that the company could succeed going forward or bring forward any of the potential purchasers that the company asked the committee to wait for. "Give us another 30 days and we'll have a deal for you." That was the request that came to the committee, essentially, around January 16th when there was an auction.

I was there in the waning minutes when the CFO, and the company's investment banker said, "You know, we just need another thirty days." The financial advisor said, "If we wait thirty days, we'll lose another \$100 million in value," and that could mean the difference between some distribution to

¹⁴ *In re* Circuit City Stores, Inc., No. 08-35653 (Bankr. E.D. Va. Nov. 10, 2008). The exact numbers were \$118,797,964 for HP and \$115,925,716 for Samsung. *Id.* See also Mark Clothier & Dawn McCarty, *Circuit City, Electronics Retailer, Seeks Bankruptcy (Update 5)*, Nov. 10, 2008, <http://www.bloomberg.com/apps/news?sid=aXeltuiAOyzs&pid=20601087>.

unsecured creditors and no distribution to unsecured creditors. There was no coherent offer in writing or a business plan that showed anybody clearly how we could get to a closing as a going-concern that would keep the company going forward that would not be significantly detrimental to the claims of the unsecured creditors.

MR. BERLIN: So the result is “We’re closing all the stores.” That can segue us into this topic of how this process works when the debtor is—

MR. LEHANE: Just to underline that a little bit: So you may have some distribution to unsecured creditors; you may have none. Right above those unsecured creditors are the administrative claims, and I do not know the exact numbers, but there are the twenty-day claims before the bankruptcy is filed.¹⁵ I think they probably write off the prepetition in a retail case now, but that administrative claim, I do not think anybody wants to see those depleted. So—

MR. NEJAME: That is a great point to make, because I wanted to contrast that result with Movie Gallery, which I was actually involved in, advising the committee in that. The committee, like they always are, was a multiparty, various constituencies all put together, including bondholders, trustees, landlord representation, as well as trade. In the case of Movie Gallery, some of the more relevant trade and meaningful trade were the big—

MR. LEHANE: Studios?

MR. NEJAME: Yeah. I was going to say the theatre companies, but really they are studios. The integrated studios wielded a big stick, and actually were the cornerstone of the operating plan in terms of moving forward. So, once you locked them in, and I think the way they did that was by striking a deal early in the case that made sure they were going to get paid, and didn’t put at risk, in their mind, whatever administrative claim they thought they had.

As you know, the point about the risk of the administrative claim, especially for a retailer, that being so substantial, depending on when you do file, was the triggering of that. Fortunately, in Movie Gallery, because we had the key vendors in the barn, and, obviously, it is a much different model than most retailers because of the nature of the product, that really paved the way to a transaction. There were a lot of other things that had to go right, including a very big bondholder injecting a lot of equity into the capital structure, but that

¹⁵ 11 U.S.C. § 503(b)(9).

deal with those key vendors was a key cornerstone to the transaction that ultimately occurred.

III. RECLAMATION OF GOODS

MR. BERLIN: Mr. Meyers, from the debtor's perspective, this portion of liability that's assigned to these twenty-day claims and other administrative claims, how are debtors trying to cope with that now that this new structure is imposed on them under—

MR. MEYERS: Well, it's nice if you're in a situation where you've got enough DIP financing to be able to set forth procedures and maybe even pay § 503(b)(9) claims,¹⁶ but too often you don't have that kind of liquidity.

Section 503(b)(9) has presented a lot of challenges, but for bankruptcy lawyers, it is almost like our new § 547.¹⁷ You tell me any fact scenario, I will create whatever argument you want me to create, and I am ready to go litigate it. There are probably twenty great issues right now being litigated.

The first thing we saw, which I think the courts have come down pretty uniformly on, is when these claims have to be paid. While I do not want to say that issue is closed, it seems like courts are saying you pay them when you confirm your plan like you pay other administrative claims. So, it is one thing to get it allowed, but it is another thing as to when you get it paid.

Of course, under § 503(b)(9), we are talking about deliveries that were received by the debtor within twenty days of bankruptcy, and it gives administrative claim status to those. It is sort of like a super reclamation claim because it does not have a lot of the baggage that comes with reclamation claims. The debtor does not have to be in possession of the goods at the time of the bankruptcy. You do not have to make a demand within a certain period of time. It does not matter whether the lender has a lien on inventory that would trump a reclamation creditor. It is a great thing for vendors, but it is difficult for debtors to deal with.

But, again, first and foremost, it seems like you do not have to pay them immediately, but you are going to have to pay them as an administrative claim to emerge from bankruptcy. So in a lot of these cases, you're converting what

¹⁶ *Id.*

¹⁷ *Id.* § 547.

could have been, ten, twenty, fifty million or more in unsecured debt that you would have dealt with in a plan, and now you're having to deal with it as an administrative claim and pay it at least when you come out, if not earlier.

Debtors are reacting to that with all kinds of arguments. For one, a lot of debtors are objecting under § 502(d),¹⁸ which normally is what you use to object to the claim of someone who may have received a preference or another avoidable transfer. The courts have generally held that § 502(d) could not be used as an objection to an administrative claim. Well, § 503(b)(9) is an administrative claim, but it is a funny one, because it is the only one that deals with prepetition claims. So, cases have raised that. I believe the Plastech Engineering court addressed that, and they said, "No." You cannot use § 502(d) to object to a § 503(b)(9) claim.¹⁹

I have a case right now pending in Nashville, which has got maybe five or six million worth of § 503(b)(9) claims. What the debtor has done in that case is argue that the ordinary course provision of § 503(b)(9), which says you need to supply these goods in the ordinary course, is like the ordinary course in 11 U.S.C. § 547.²⁰ Therefore, the argument states that we are going to look at whether there was any collection activity and dunning letters and all the jurisprudence that has developed as to what takes a payment outside the ordinary course of business defense. Those apply for whether you shipped in the ordinary course of business, and they have got procedures now, and we are going to litigate that issue.

MR. MEYERS: I like my chances as the creditor on that one—

MR. LEHANE: Yeah.

MR. MEYERS: We have got another case here in Atlanta in which the issue is that companies are filing bankruptcy with assets worth far less than the secured creditor is owed. Generally speaking, the rule on those types of cases is, and it is not really in the Code, so to speak, is that judges are not going to let a case proceed in chapter 11 if it's going to be administratively insolvent. So, for example, if you have a company that's going to try to sell for \$50 million when its got \$100 million in secured debt, you say, "Well, then how are we going to pay the administrative expenses going forward?" Generally, you get DIP financing, and the judge will make sure that that financing is sufficient to

¹⁸ *Id.* § 502(d).

¹⁹ *In re* Plastech Engineered Prods., Inc., 394 B.R. 147 (Bankr. E.D. Mich. 2008).

²⁰ *Id.* § 547.

ensure, except for a complete meltdown, that administrative claims are going to be paid. From the minute you file the chapter 11, they want to make sure everybody gets paid. In § 503(b)(9), those were prepetition. Those are sort of “what’s done is done,” but they get administrative priority, just like the rest. How do you treat those any differently?

So, we’ve got issues in a case in Atlanta now about whether the lender, who’s going to come out, in this particular case, a good thirty or forty million short, still has to fund the § 503(b)(9) claims. They had to fund the administrative costs to get to the sale, but do they have to fund the § 503(b)(9) claims? The trustee is litigating that issue with the lender right now.

MR. BERLIN: I think we have got a lender who wants to answer that question.

MR. NEJAME: No. No, actually, we have a debtor advisor who is grappling with the same thing in another case. I guess the question there is, you’re trying to implement a plan, ultimately, either a liquidating plan after a sale, or—

MR. MEYERS: No. No. Convert it.

MR. NEJAME: So you are going to sell the assets and then convert—

MR. MEYERS: Assets were sold and then the case converted.

MR. NEJAME: To chapter 7?

MR. MEYERS: To a chapter 7. And there are probably \$5 million worth of § 503(b)(9) claims. The, sort of, quirk in this case is that the issue was raised, as it should have been at the DIP financing stage. This DIP financing is only being provided for the benefit of the lender because they want to fund this debtor so that it can sell as a going concern and get \$100 million rather than sell in piecemeal liquidation and get \$20 million. The argument is the case is being funded for the lender so “don’t approve the DIP financing unless the lender cleans up everything, and make sure all administrative claims are paid, including § 503(b)(9) claims.”

What the judge did in that particular case was to say, “I’m going to approve the DIP financing, and I’m going to reserve that issue until later.” But, in essence, at least this is the way I would construe it, he is going to interpret the issue of, “Well, was that a condition to the DIP financing?” If it was, then in essence, the lender submitted to the court ordering them to pay the § 503(b)(9) claims as a condition of DIP financing. He just kind of did after the fact, rather

than in the rush of approval of DIP financing. I think they are going to be subject to whatever he rules on that.

MR. BERLIN: I want to pick up on one point that came out only very briefly during that discussion, but it is an important one, at least to address for another minute or two. It is this idea that with respect to a reclamation claim, courts have been ruling in a lot of cases that the vendor's rights are wiped out by the DIP lender. If we could just briefly talk about that and explain to anyone in the audience who has not been following that topic, how it works. I do not know who wants to pick it up, maybe Mr. NeJame or Mr. Meyers, either from the debtor's perspective or the lender's perspective.

MR. MEYERS: You know, reclamation²¹ is a little tricky, and it all got changed in BAPCPA, but I will take a shot, and if I say anything wrong, you tell me. The good thing about BAPCPA for vendors is it extended the period out to forty-five days, meaning you can seek reclamation for any goods that were sold to the debtor within forty-five days prior to bankruptcy, as long as you make your demand within twenty days after bankruptcy. That is not exactly how it is written, but you have to make a demand within forty-five days, and if they file bankruptcy during the forty-five days, you get sort of a twenty-day freeze before you make your demand.

If you give written demand, you do not have to file a pleading, but you still give a written demand to the debtor to reclaim the goods. The debtor is then supposed to, if you have a valid reclamation claim, give you your goods back; or, if not, then the court should find that you get an administrative claim.

You have got a couple of big issues with reclamation claims. One is that under the Uniform Commercial Code and under § 546, the debtor must be in possession of the goods at the time of the demand. Depending on what kind of product you are selling to the debtor, it may be gone already. So, you make the demand, but it turns out that you sold \$500,000 worth of goods within forty-five days but they have got \$10,000 on the date of bankruptcy.

The other thing, and as you mentioned, is this issue about the lender with a lien on inventory. Under the Uniform Commercial Code, reclamation claims are subject to the claims of a good-faith purchaser, and that includes a secured lender with a lien on inventory.²² Bankruptcy courts had made clear, prior to

²¹ 11 U.S.C. § 546(c).

²² U.C.C. § 2-702(3) ("The seller's right to reclaim upon seller's discovery that the buyer is insolvent . . . is subject to the rights of a . . . good faith purchaser . . .").

BAPCPA, and I think still do, that your reclamation rights are subject to the rights of a lender that's got a lien on inventory, and if that lender is not oversecured in inventory, then your reclamation claim may be valueless.

MR. LEHANE: I think that is right. I think that the debate in the discussion when BAPCPA was passed was, "Wow. Congress created a whole new reclamation right, where we did not really have this right before. We can now just reclaim our goods that we ship within 45 days before."

I was involved in one particular reclamation dispute after BAPCPA had passed, the AMS [Advanced Marketing Services] case. Simon & Schuster sent out its reclamation demand as soon as it possibly could have. However, it was after the interim DIP financing order had been entered on the first day of the case. They probably sent it out a day later. Judge Sontchi told them, "There's an interim DIP order entered that's prior to your claim, and they've got a lien on everything. You don't have any claim."²³ I think that has been the result, that there really is not any value to your claim. Unless you have a debtor that does not have a secured lender, you probably do not have any value to your reclamation claims.

MR. NEJAME: Does it matter for the lender, whether the claim is prepetition or postpetition? There is a particular situation I am involved with where we were shopping for DIP financing. We had cash on the balance sheet. We had motions for liquidation from our secured lender. But, we eventually struck a deal with them on cash collateral and adequate protection, and we never got a DIP. Is a reclamation claim better off, versus having gone to get a DIP?

MR. LEHANE: The reclamation claim may be valid if it was asserted before any postpetition financing demands have been entered. Even then, I think you would still have to test it. If you raised your objection to the entry of the DIP financing order and said, "Hey, I have a reclamation claim. I've asserted my demand," then I do not know if the bankruptcy judge would be forced by anything not to say, "I'm going to enter this order that's going to make their lien prior to everybody else's. I'm going to give them super priority." That would wipe out your reclamation claims.

²³ Simon & Schuster, Inc. v. Advanced Mktg. Servs. (*In re* Advanced Mktg. Servs.), 360 B.R. 421, 423 (Bankr. D. Del. 2007) ("Because the goods that [Simon & Schuster] seeks to reclaim are subject to prior secured liens [under the debtor's 'DIP Loan Agreement' and 'Interim DIP Order'], S&S is unable at this time to establish a likelihood of success on the merits of its reclamation claim.").

MR. NEJAME: Notwithstanding that, the change in law that helps support the vendor community and creates the administrative claim on the prepetition claim is a big obstacle. It is not just in retail. But I think you can point the finger at that change in the Code, in the case of Circuit City. There are a lot of other things contributing to some of the other liquidations we have seen. The law, however well intentioned to benefit vendors, makes it really tough to reorganize.

MR. BERLIN: I want to change gears a little bit, because we need to draw to a close in a few minutes. But I think it is important to talk for a few minutes about the store closing sale process, because that is such a key portion of these retail cases.

AUDIENCE MEMBER: Essentially, you were talking about the prior lien defense with reclamation under § 546(c). I was wondering what you thought the application could be to § 503(b)(9)? With that prior lien defense of § 546(c) with a secured lien, could that be extended to a § 503(b)(9) claim such that a prior secured lien could also extinguish, essentially, that right under § 503(b)(9) as well?

MR. MEYERS: No, I do not believe it can extinguish it as a technical legal matter, but it may functionally extinguish it. If there is not enough to pay the lender and you do not have some kind of deal where administrative claims are all being paid, the right becomes hollow.

Section 503(b)(9) is great for creditors. But there are still administratively insolvent estates where you have got assets that are worth less than what lenders are owed. So there are a lot less exceptions to getting a § 503(b)(9) claim in as an administrative claim. However, there may not be money to pay administrative claims. On day one, you may think, as a creditor with a § 503(b)(9) claim, that if this thing were liquidated today, there is enough money to pay the secured creditor and there is enough money to pay the § 503(b)(9) claims in full or in part. There may not be. In liquidation, there is rarely any money to substantially pay the general unsecured creditors, but there is generally going to be enough money to pay the lender. You get out a little bit over the lender and we will get paid. And, hey, I might like that result.

But the debtor is seeking to reorganize or get a going-concern sale. There is a risk there that they are going to get DIP financing, borrow money, and operate to try to get to a sale. If they can't get to a good enough sale that'll produce the money not only for the secured debt and all the administrative

claims, as well as to pay something to the unsecured creditors, they might have now just gone under water. Then the secured creditor is not going to get paid in full, and there is not going to be any money; so you lost out.

You can voice that opinion. Any creditor, whether it is the committee or an individual creditor, can take issue with what a debtor is trying to do in a bankruptcy case if they think the risk is being unfairly borne by them. But typically, a debtor is given a lot of deference. Your remedies are to move to convert or move for a trustee, and that is a pretty tough burden to meet. So there are cases where § 503(b)(9) creditors may have been in the money on day one and they are out on day 120.

IV. THE STORE CLOSING PROCESS

MR. BERLIN: All right, so let us just take the last few minutes that we have available to us, and we will talk a little bit about the store closing process in these retail cases. It seems that the way this occurs is that the DIP lender expects the debtor to hire into the case one of the many third-party liquidator companies that are out there, that run liquidation sales as their business.

So let us start with talking about the use of these liquidators instead of having the debtor itself manage its store closing sales. I think hiring the third-party liquidator is usually something that the DIP lender is interested in seeing the debtor do. What are some of the reasons for that, Mr. NeJame?

MR. NEJAME: There are really two reasons. One is familiarity and consistency of expectation among the third-party liquidators, who, in some respects, are proprietary players here. They are not necessarily just providing a service. They are, in effect, in many cases, backing up their proposal with capital, and taking risk. Now, that comes at an expense. In the case of most lenders, if they have properly reserved and invested capital, they are willing to pay for that insulation against risk; whereas, having the debtor, on their own, manage this may be, arguably, a more efficient and less costly process.

But there are two real issues, I think, that lenders will always find with it. One is evaluating letting the debtor control a process that is out of the ordinary course of their business versus the professional liquidator coming in. So there is a question in terms of ability to execute. Then there is another argument. If you are deploying this management know-how and manpower at something other than focusing on the reorganization of the continuing operations, something has to suffer as a result of the management team engaging in that

process. Management can only do so many things at one time. If everyone is involved in GOBs (going-out-of-business sales), who is thinking about how we are restructuring and improving the balance of our business, which is going to continue on?

So I think managerial attention as well as the knowledge of a consistency in terms of the performance of a liquidator are two key elements that make DIP lenders engage professional liquidators.

MR. BERLIN: You mentioned that the liquidators often come into the situation and back up the process with some capital of their own. So just at a very simple level explain how that works, and then explain what the debtors piece is in terms of getting value for the estate out of the process.

MR. NEJAME: Well, I think in many instances the going-out-of-business (“GOB”) sales are actually structured as asset sales. So you go through an actual § 363 process in many cases, which is a modified version of what you might do when you hire them. You pay a fee and you are taking more of the risk. Depending on the situation, a DIP lender and a debtor may decide, “Let’s just do a sale and have certainty.”

MR. BERLIN: The liquidator is going to actually buy the inventory, in a sense.

MR. NEJAME: Yes.

MR. BERLIN: Right.

MR. LEHANE: Let us be honest about this. The bank’s owed \$50 million and the inventory may be worth \$100 million. And a liquidator is willing to come in and say, “I’ll guarantee \$51 million and I’ll pay it today.” And the debtor is saying, “But we can do this and just pay the liquidator 3% of whatever we make, and we may realize \$90 million or \$100 million. And you’re willing to take \$51 million from this liquidator?” And the bank says, “Yes. Because they’re going to pay us today, and we’ll be paid off and we’ll be out of the picture.” And the bank does not want any of the risk inherent in answering, “How is the sale really going to do?”

So we have got this difference between an equity deal where they actually buy the inventory and other arrangements. In an equity deal, they buy it, own it, and pay a guaranteed amount on day one versus a fee deal where the liquidator only gets a percentage of what is actually recovered. And for a long time, most of the sales favored equity deals. I think the DIP lenders had the

leverage to say, “We want you to do a fee deal. That’s what’s going to take us out of the picture as soon as possible.” And some of the other structures are complicated agreements: agency agreements, asset sale agreements, where the liquidators will come in and take over the operations of the debtor and pay some or all of the occupancy expenses or not pay them.

The interesting thing that you can track over the last six months is the guaranteed percentage. There are tricky definitions in all these agreements. Here it is what percentage of the cost of the inventory the liquidator is going to pay in a guaranteed deal. At one point about nine or ten months ago, you were seeing 107% of cost. Keep in mind there is a retail price, the price tag you see when you are in the store, and then there is cost, which is what they paid for it.

These goods were being sold to liquidators for 107, 109, 117 percent. I believe one of the first, either it was Mervyns or Linens ‘n Things, went for 117 percent of cost. The goods were being sold, and a good portion of the secured debt was being taken out right away. S&K just filed for bankruptcy and did a liquidation, and the guaranteed percentage was 24 percent of retail. Now, that is probably closer to 48 percent of cost. But still, there is a big difference between 117 percent and 48 percent. And the liquidator was not paying the occupancy cost. That is another big benefit to the estate. When you do a guaranteed deal, the liquidator comes in and pays the rent at those locations so that the debtor no longer has to pay the rent while the GOB sales are going on.

MR. MEYERS: Like a lot of things, you know, no two cases are the same. But you are looking at your appetite for risk and what the particular dynamics of the case are. It is usually a no-brainer in a retail case, to let a liquidator do the liquidation versus doing it on your own, if you cannot get a good going-concern sale. They are experts at it. But the question is the deal. Do you want to take a guaranteed 80% or 90%, or whatever the number is of retail off cost? You want to take a fixed deal. Basically, you have now just sold the assets, and you are going to get, no matter what, x-millions of dollars. Or do you want to do a deal where you, the debtor, take the risk? You say, “I’ll pay. Just go sell everything. You get 3% of everything you sell.”

In the second Friedman’s Jewelry case, the one that filed in Delaware, where we represented the debtor, we did sell some stores. Coincidentally, we sold them to Whitehall, who then filed bankruptcy three months later.

MR. LEHANE: Thank you.

MR. MEYERS: But the stores—the other 400 stores or so, or 300 stores, were being closed. It was no question we were going to hire a consortium of liquidators, but they came at us with a no-risk deal where they were going to buy the inventory. And I would like to say we were just brilliant in deciding “No. Let’s go with a fee deal,” but the real issue in this case was that the deal they were offering us was going to produce administrative insolvency. And so we and our other constituencies had little incentive to take that deal. So we went with a fee deal, and it turned out that they knocked it out of the park. Now, not only are they able to pay all administrative claims, but there is money for unsecured creditors.

MR. LEHANE: It is a significant return. I would say more than most of the retail returns you are seeing.

MR. NEJAME: Though one other dynamic to consider from the debtor’s perspective is evaluating the fee deal versus the no-risk deal. It is more of a dilemma when you somehow think the rest of the business is going to reorganize on an ordinary course basis. Given the pressures we have been talking about in terms of raising DIP financing and getting through that process and avoiding liquidation, I am going to cite Gottschalks again, if you are in a position where you are essentially going to be required to sell the company, a fee deal is a lot tougher to implement. It probably does not make as much sense if you are trying to make a clean transaction. So what one of the things you might often see are the liquidators teaming up with some sort of strategic party in a package bid for all the assets of a company, where whatever they’re closing down and cutting out is going to be a GOB sale. It is going to be bid on by the liquidator, and then the balance of the business will be, hopefully, a strategic—or a new investor that, you know, actually wants to run a retailer.

MR. LEHANE: Yeah. That is absolutely true. And there is the interesting tension that always exists between trying to either get to a sale or reorganize, and the interplay between the committee and the debtor and the lender. Those three entities all trying to say, “What maximizes value, but what really works?” The distractions of a GOB sale really could otherwise tank a process.

But you often times find the parties all pursuing dual-track processes. One, “What is the maximized value right now if we liquidated?” The other one, “Can we turn it around and reorganize, stand alone, and/or do we have an investment banker out there just trying to get us to a sale?”

MR. BERLIN: I think we are virtually out of time, but I do think we would be remiss if we did not let you take one to two minutes and talk about store closing sales from the landlord perspective in a nutshell. How does this work? What are the landlord's concerns with a store-closing sale? What about lease terms that say that the tenant cannot do a going-out-of-business sale?

MR. LEHANE: I will try to do this in one or two minutes. There is nothing in the Bankruptcy Code that invalidates those provisions that say you cannot do a GOB sale. Bankruptcy judges have said to maximize value, by judicial fiat, "None of those provisions are going to be enforceable." And there have been a number of cases that have backed that up but have also said that landlords are entitled to adequate protection.

So what happens is, there is a set of store-closing sale guidelines. And there is this set that is attached to the motion. It states that the debtor must ask for permission for the court to approve. Those are the guidelines. And if you do not have a lawyer that represents you and knows the liquidators, you are going to get stuck with those guidelines. They may say "We can have an auction; we don't have to stay open; we can put up balloons; we can put up banners; we can wrap your building in yellow paper and put sign walkers and everything else out there and make your store really, really ugly." From a liquidator's point of view, it grabs everybody's attention, and they need to do that, because they need to sell the inventory that is in the store. And from the debtor's perspective, the debtor needs to let the liquidators do that so they will pay more money. So it is for the good of the estate.

There are four or five, maybe six, liquidators that are known nationally who do the vast majority of this work. They are very good at what they do, but they also understand that the landlords need adequate protection, and they see the same landlords again and again in the same cases.

So there is this set of guidelines, and then there are the side agreements that landlords, who have counsel involved in the case, hopefully reach with those liquidators before the sale order so that they never have any of these arguments before the court. That being said, you may have individual issues that come up, and you may have a landlord that wants you to press those issues in court. The typical issues are: How big can the banners be? Can they have any streetwalkers or sign walkers outside my store on mall property? And can they have A-frames? Can they have people distributing flyers in the mall? The answer from me is always no.

But the attorney generals recently chimed in very loudly in the S&K case and said, “These street walkers are a public nuisance. You can’t have them.” And I thought that was a nice welcome additional voice to the dialog about what happens in connection with a GOB sale.

But there is a lot of negotiation as to what the ultimate end result is. The result is those store-closing sale guidelines that are set. And other things that will be in a GOB sale order, they may include the terms on which leases are rejected at the end of the GOB sale. If the leases are not sold and there is no auction typically, as a landlord, you are looking for the lease to be rejected. You want that rejection to be effective on the later of, whatever day Mr. Meyers actually said he rejected it, and the date that the company actually turned over the premises to me by delivering me the key or the key codes, because I’m entitled to an admin claim and to payment through the effective date of that rejection. So I want to beg that into the GOB order. I also want it to say, “Anything he left in my store, I can throw out without liability to any person or any third party that might claim an interest.” Because if I have to wait for somebody to come and pick up their stuff, he should be paying me rent for it.

