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American Bankruptcy Institute

Commission to Study the Reform of Chapter 11

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Thank you for giving me the opportunity to testify before the Commission today. My name is David Pollack and I am a partner in the Philadelphia office of Ballard Spahr LLP. I do not appear before you today in any representative capacity, either for my firm, for any clients or for any organization of which I am a member. Although by my count I have appeared in matters with, or before, at least 10 members of the Commission let me, nevertheless, take a brief moment to tell you about my practice.

I am member of the Real Estate Department of my firm and was previously the partner-in-charge of our Leasing Practice Group. My work tends to be centered around the shopping center industry, representing both landlords and tenants. For more than 25 years I have devoted a substantial amount of my time to representing landlords in retail bankruptcy matters. Indeed, I have also served as the partner-in-charge of our firm's Bankruptcy, Reorganization and Capital Recovery Practice Group. I currently serve as the Chair of the International Council of Shopping Centers' Bankruptcy Task Force, but reiterate that I am not here representing that organization. Rather, my comments derive for having been involved in virtually every major retail bankruptcy for more than the last 25 years.

In the brief time allotted, I would like to address three specific areas: (a) the misconception that the 2005 amendment to Section 365(d)(4) of the Code was a mistake and has somehow made it virtually impossible to confirm a Chapter 11 retail case and is the prime factor leading to that result; (b) the problems associated with the current language of Section 365(d)(3) and the split among the Courts between the "billing date" approach and the "accrual/proration" approach to a lessee's fulfillment of its post-petition obligations under non-residential real property leases; and (c) the issue of adequate assurance of future performance for the assumption and assignment of leases.

The Time to Assume or Reject Leases

I am here to explain to you why it is time to stop taking the easy route of blaming landlords for all that is wrong with retail bankruptcies. Landlord-bashing has been in vogue ever since the first Shopping Center Amendments to the Bankruptcy Code took effect. That unrelentless attack was stepped up even further following the 2005 amendments to the Code, with dire predictions that no one would ever be able to confirm a retail bankruptcy case again. As a knee-jerk reaction by many, it was suggested that the change in Section 365(d)(4) from virtually unlimited extensions of time to assume or reject leases "for cause" to a 120-day fixed period and an add-on 90-day period "for cause" was certainly going to wreak utter havoc in "bankruptcy-land". Well, that just is not the case and that has not happened. It is time that everyone sit back and look at the change in economic conditions, the change in lending practices, the changes in inventory financing and the make-up of ownership of retail entities to see what has really happened in this arena.

Much has been made of the failure of electronic retailer ***Circuit City***. Indeed, Congressional hearings were held to delve into the causes of that massive retail failure and its "collateral damage" resulting in the loss of a tremendous number of jobs. Little attention, however, was paid to the multi-million dollar losses suffered in the real estate market by the closure of the Circuit City stores, many of which lie vacant today. Indeed, many of the losses, as was also the case in the ***Kmart*** bankruptcy, were suffered by individuals who put their entire savings into a property and lease they thought was a safe investment for their retirement years.

The landlords did not cause ***Circuit City*** to fail. The landlords did not prevent ***Circuit City*** from reorganizing. The "210 Day Rule" did not prevent ***Circuit City*** from reorganizing. In point of fact, when Circuit City's counsel rose to explain to the Court that the company was going to have to shut down, and would not be able to reorganize only a few months after having filed its Chapter 11 Petition, he stated to the Court that the lender was unwilling to lend without trade support and that the trade was unwilling to support ***Circuit City*** without adequate financing from the lender. Not once was the word landlord or the "210 Day Rule" mentioned. And indeed, it could not have been mentioned as a cause for the failure since the landlords *en masse* had approached the debtor on more than one occasion, both early in the case and again several months later, to assure the Debtor that they would be willing to grant extensions of time to assume or reject their leases. Although there may have been some exceptions, landlords in general did not want their Circuit City stores closed in an already troubled real estate market.

Instead of taking the easy route and blaming landlords, the focus should have been in the change in available financing, the change in the consumer electronic market in general and the overall change in the economy. ***Circuit City*** was the number two big box category killer behind ***Best Buy***. ***Circuit City*** failed. ***Linens 'n Things*** was the number two big box retailer behind Bed Bath & Beyond. ***Linens 'n Things*** failed. ***Borders*** was the number two big box retailer behind Barnes & Noble. ***Borders*** failed. Do we see a pattern here? In the years since those failures, no one has stepped into what one might have assumed to be a retail void. Perhaps those failures were not caused, and the inability to reorganize was not caused, by the number of days that the debtor had to reorganize but, rather, by the economic conditions, by the merchandising, by the consumer attitude and by financing. Therein lays the true reason for the failures, not a number of days to assume or reject leases which landlords would have gladly extended.

Linens 'n Things provides another example where the landlords' willingness to extend the 210 day deadline was ignored. ***Linens 'n Things***' lender apparently told the debtor that it would not extend further credit unless the debtor was able to secure additional extensions of time to assume or reject its leases from at least 80% of its landlords. ***Linens 'n Things*** hired a real estate consultant to approach its landlords and that consultant was able to achieve agreement from more than 90% of the Debtors' landlords. Nevertheless, the lender pulled the plug on financing. The conventional wisdom at the time was that the lender had secured a particularly good return from its initial round of liquidation sales at debtor's closing stores and decided that it did not want to take further risk by extending additional credit to the debtor, instead liquidating the company. Nevertheless, the standard comment at the time was that this was further proof that a retail tenant debtor could not reorganize with the 210 Day Rule hanging over its head and once again the landlords and 210-Day Rule were blamed for this failure.

In the ***Borders***' case landlords once again offered extensions of time to assume or reject. Indeed, there was a stalking horse bidder who was going to acquire more than 100 of the debtor's retail locations. However, the stalking horse and the trade could not come to an agreement on a guaranteed number of stores to be acquired and that, among other issues, caused the potential sale to fall apart. Once again a major retailer failed and it was not the landlords or the 210-Day Rule which were at fault.

If we look back over the history of retail cases we can find numerous examples of debtors reorganizing (and I use the term reorganization loosely to include both an actual reorganization of the debtor company as well as liquidating plans involving sales of substantially all of the debtor's assets or a sale of the business as a going concern) where the reorganization was followed by a subsequent failure of the reorganized entity . . . all prior to the 2005

Amendments to the Code. For example, ***Bradlees*** reorganized in 1995 and ultimately failed in 2000; ***Crown Books*** in 1998 and 2001; ***Custom Shops*** in 2000 and 2001; ***Drug Emporium*** in 2001 and 2003; ***Zany Brainy*** (and ***FAO***) in 2001, 2003 and 2003; ***HomePlace*** in 1998 and 2001; ***Montgomery Ward*** in 1997 and 2000; and ***Warehouse Entertainment*** in 2001 and 2003.

Other companies successfully reorganized after a second Chapter 11 filing which post-dated the 2005 amendments such as ***Eddie Bauer*** initially filing in 2003 and then filing again in 2009 and still existing; ***KB Toys*** initially filing in 2004, filing again in 2008 and still in existence. Successful post-2005 reorganizations, all in different industries, have included ***The Disney Store, A&P (***including ***Pathmark, Walbaums*** and ***Super Fresh); Sbarro's*** and ***Bally's.*** I do not believe that the 210-day rule made a significant difference one way or the other as to whether the cases survived reorganization. In most cases of failure, the retail cycle simply ran out for the tenant. ***Montgomery Ward*** is a prime example where the debtor had all the time in the world to reorganize on two separate occasions and yet ultimately failed -- and the marketplace probably does not miss it. Record/entertainment stores, electronic stores, various food fads (such a frozen yogurt, which has now been making a revival) bookstores, *etc*. all have simply run their course.

While there are probably examples where the 210-day rule has put additional pressure on retailers to reorganize more quickly than they would have cared to do, those are the rare cases. As one of the leading individuals involved in real estate dispositions said to me at the ICSC convention just two weeks ago, there is no retailer that hopes to be able to reorganize or sell its business that does not know going into bankruptcy what it wants to do with at least 90% of its locations. Indeed, those real estate experts are regularly engaged, prepetition, to negotiate lease buyouts, rent relief and other restructurings. In today's economy, and with today's lenders, retailers know that they do not have time to simply wallow away in bankruptcy testing different possible solutions to a failing business plan.

It must not go unmentioned that we have also seen a great change in both the ownership of many retailers as well as the way they finance their businesses. Today many retailers are viewed as strategic investments by various types of funds rather than sector-share companies operated by those who built them from ground up. The mentality and focus of ownership has changed dramatically. Similarly, the ability to finance business has also changed with a dramatic shift in the type of entities willing to lend as well as the narrowing of the marketplace of those willing to engage in this type of financing.

"Billing Date" v. "Accrual / Proration"

One of the more troublesome issues in the enforcement of Section 365 of the Code is the interpretation of the language "The Trustee shall timely perform all the obligations of the debtor,…, arising from and after the order for relief under any unexpired lease of non-residential real property…." In the hypothetical case, when the debtor files its voluntary petition on a day other than the first of the month, and the non-residential real property lease calls for the rent (used in the broad sense of rent defined in the lease, which usually includes other charges as reimbursement to landlords for amounts they have often advanced out of pocket) to be paid as of the first of the month, the Courts have variously interpreted the debtor's obligations to pay rent for the month of filing. Under the "Billing Date" approach, as espoused by the Third Circuit in ***Montgomery Ward*** [*CenterPoint Props. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.),* 268 F.3d 205, 209-10 (3rd Cir. 2001)], since rent was due on the first of the month and the debtor filed after the first of the month, the debtor would not be required to pay that month's rent on a current basis.[1] Had the hypothetical case arisen in an "Accrual/Proration" jurisdiction, the debtor would not have been required to pay the ***Montgomery Ward*** taxes post-petition since they arose or accrued prepetition; however, the debtor would have been required to pay rent from the filing date through the end of the month, the so-called "stub rent".

The result of these diverse holdings is that debtors often forum shop as well as hold off filing until the second or third day of the month in a "Billing Date" jurisdiction. Such actions by debtors secure for themselves extremely beneficial results while denying the landlords payment for the current use of their properties. As an example, in the ***Linens 'n Things*** bankruptcy, the debtors filed on the second of the month in a "Billing Date" jurisdiction. Having done so, the debtors avoided having to pay rent for that month, thereby resulting in an unsecured, interest free loan from their landlords of in excess of $20 Million. While supporters argue that this is simply a timing issue and that the landlords will eventually get their money, I suggest that the timing issue is not a simple one where the tenant, such as ***Linens 'n Things***, is the sole or major tenant on a property that is running barely cash-positive. Many Landlords have lost their properties to their lenders because the tenant was able to defer the payment of rent due. ***Linens 'n Things*** is not a unique case. In the oft-cited Circuit City matter the debtors were also able to initially avoid paying "stub rent" resulting, again, in an interest-free, unsecured loan of in excess of $20 Million.

Some would argue that a debtor needs a respite from the payment of rent in order to be able to catch its breath and fund its operations. And yet, virtually no other creditor is

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1 The ***Montgomery Ward*** case arose due to a controversy concerning the payment of real estate taxes which accrued prepetition but were not billed until post-petition. Following the "Billing Date" approach the Third Circuit held that the obligation to pay those taxes was a post-petition obligation and the landlord was entitled to payment in full.

placed in the position of being a compelled lender to the debtors. Just image what would happen if trade vendors were told that they have to continue to ship product to the debtor for 30 days without being paid. Certainly some vendors continue to provide credit to debtors when they are convinced that the post-petition financing is sufficient. Others, however, refuse to do so without their shipments being backed up by a letter of credit or receiving payment in advance. Certain allegedly "critical vendors" even require payment of prepetition amounts before providing product to debtors. Foreign vendors, customs agents, foreign taxing authorities and shipping companies often demand payment in advance as well as payment of prepetition amounts. Utility companies have secured special protections for the provision of their services. Landlords should not be compelled to be lenders to the debtor unless they are provided the same protection that other post-petition lenders receive. And yet, suggestions that the landlords be placed in that same position are usually met with derision and laughter.

The "Billing Date" approach presents additional issues regarding payment of the "stub rent". It has been held that even though Section 365(d)(3) does not require the payment of the stub rent in a "Billing Date" jurisdiction, the landlord may still be entitled to an administrative claim for that rent under Section 503 of the Code. Questions then arise as to whether or not the landlord is entitled to payment of its contract rent, must prove the fair value of the property or is subject to the debtor's proof that the property is not worth the contract rent. If such proofs are allowed, would the landlord also be allowed to prove that the property is worth more than the contract rent? Assuming that an administrative claim is established there still remains the issue of the timing of payment of that administrative claim. Flashing back to ***Linens 'n Things***, the landlords who provided in excess of $20 million in unsecured, interest-free financing, and were told that they had at least an administrative claim for their "stub rent", were eventually offered nine cents ($0.09) on the dollar for the payment of those administrative rent claims.

The foregoing can lead to only one conclusion: Section 365(d)(3) should be legislatively amended to provide a uniform and fair approach to the payment of post-petition rents and charges under leases, and the employment of the "proration/accrual" method for all non-residential real property leases. This approach fairly and squarely puts the burden on the Debtors to "pay to play". Certainly some landlords who lose out on year-end billings or tax-billings, which come due post-petition but accrued prepetition, will not be happy. Nevertheless, it is only fair that, like almost everyone else, landlords should be paid on an ongoing basis for use of their property post-petition. While there will still be issues to be determined with the "accrual/proration approach", in the long run this approach will simplify the determination of the debtor's post-petition obligations, will allow for the uniform application of Subsection 365(d)(3) and will take forum shopping and "filing date holding" out of the bankruptcy petition equation.

One further issue deserves mention here. That is the necessity to put some teeth into the debtor's obligation to make its post-petition payments. Time and again, debtors simply fail to pay their obligations, or pay them late, with little or no consequence. By the time a landlord files a motion to compel and receives a hearing date, the debtor is often well into the second payment cycle, pays the first payment and then delays the second payment as it did with the first. If the landlord proceeds with a motion because the debtor still has not paid, the standard response from virtually every Court is that Section 365(d)(3) provides no remedy to the Court if the debtor does not pay the rentals when due. Counsel have been told repeatedly that they should file a motion to compel and if the debtor does not pay, the Court will either grant relief from the stay to allow the landlord to proceed with eviction proceedings in state court or will order the lease rejected. In most cases the landlord does not want its property back, it wants to be paid for the use of that property. The amendments to Section 365(d)(3) were enacted to "assure" that the landlords were paid timely the rentals due under their leases. Unfortunately, that has not turned out to be the case. That subsection should be amended to give the Courts the ability to ensure that debtors do timely fulfill their obligations.

Adequate Assurance of Future Performance

An issue that comes up repeatedly with regard to the assumption and assignment of leases is the requirement under Section 365 that the debtor and/or assignee prove adequate assurance of future performance. While this issue also arises where the debtor wants to assume its own leases in a reorganization matter, generally that does not prove to be nearly as significant as in 363 sales or liquidation plans where there is a proposed assumption and assignment of leases to a third party. The Code does not provide sufficient guidance with regard to the meaning of "adequate assurance of future performance". Accordingly, the Courts have been left to their own devices in attempting to structure same. Of particular concern are those cases, which tend to be the majority of cases, where the buyer is a "Newco" or "Opco". Single purpose acquisition companies are often formed by either companies in a similar business or pure investors who, understandably, do not want to put their other businesses or money at risk. Accordingly, they put together a *pro forma* showing how they will succeed where the debtor failed. Sometimes this works, as in the case of ***Eddie Bauer,*** which followed two Chapter 11 filings with the purchase by a Newco which has continued to operate the business for almost four years. In other instances, however, such as ***Steve and Barry's,*** the Newco lasted merely several months before throwing in the towel and the landlords were forced, once again, to go through the nonpayment of rent, closing stores, *etc.*

While the Code makes it clear that the Newco is required to show that its financial condition and operating performance are "similar" to those of the debtor at the time that the debtor entered into its lease, most Courts are loathe to read that language literally. Thus, where a 200 store chain with strong financials and capitalization when it entered into a lease ten years earlier is being purchased by a Newco with thin capitalization, and a desire to operate perhaps 100 stores, with sometimes little or no experience in the same retail sector, one might assume that the debtor and Newco would have difficulty proving adequate assurance of future performance, at least without a guarantee or other financial backing from a more solvent or experienced entity or other party. Nevertheless, Courts often look to the Code's employment of the word "similar" financial and operating performance to find adequate assurance because it will save jobs and provide a dividend to unsecured creditors. There seems to be little or no concern for the affect on the counterparty to the leases and other contracts. While this may certainly fall in line with general theories of bankruptcy protection, history points out very clearly that not every company can or should survive. While it may be heresy in this forum to posit that some companies simply need to be left to die because they are going to in the long run anyway, there are simply too many second and third failures out there to fail to acknowledge this reality. The language regarding adequate assurance of future performance should be clarified to provide meaningful benchmarks which will allow those that can survive to do so while avoiding simply delaying the inevitable for those companies which should not be either sold or reorganized.

Once again, I thank you for the opportunity of addressing these issues and I welcome your questions.