

SOS for Retail: Only the Strongest Survive¹

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I. Introduction

As retailers assess the impact of the worst holiday season in a quarter of a century amidst continued market swings, rising unemployment, financial upheaval and an unprecedented lack of credit, the question confronting too many struggling retailers is whether there is any possibility of successfully reorganizing in this economic environment under the current version of the Bankruptcy Code. Supplementing the article by Larry Gottlieb, Jay Indyke and Seth Van Alten prepared for the ABI's *Views from the Delaware Bench* in November 2008 (the "November Article"), this article updates the current state of retail bankruptcy cases as we work through the first quarter of 2009 and discusses recent case law addressing issues under §§ 503(b)(9), 366 and 365(d), as well as some interesting issues involving trust fund taxes and gift certificates that impact virtually every retail bankruptcy case.

Since November 2008, despite massive government intercession and the inauguration of the new administration, the credit markets have thawed only slightly, if at all, and consumer spending has continued to decline. Retail sales continue to plummet and more retailers have filed for bankruptcy, including Circuit City, Gottschalk's, KB Toys, National Wholesale Liquidators, Fortunoff's and S&K Famous Brands. As of the second week of February, as many as a dozen retailers are poised to file for bankruptcy within the next 30-60 days. In addition, several companies that completed reorganizations or going concern transactions in the last year have re-filed. As detailed in the November Article, the provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") continue to significantly impede the ability of retailers to secure financing and provide adequate time to reorganize business operations after filing for bankruptcy. In short, BAPCPA "has had a devastating effect on the retailer's ability to reorganize."

II. Liquidity and the Unintended Consequences of Revised 365(d)(4)

The biggest problem confronting retailers is the impact on liquidity of revised § 365(d)(4), which creates a firm deadline by which a debtor must reject, assume or assign its leases. Debtors now have an initial period of 120 days to decide whether to assume or reject their leases and the bankruptcy court is limited to granting the debtor only one supplemental 90-day extension.² Subsequent extensions may only be granted with the prior written consent of the landlord.³ The statute was not intended to put even more power in the hands of lenders, but to the detriment of retail debtors, that is precisely the result.

Without sufficient liquidity to make post-petition payments to vendors, common carriers, utility providers, employees and professionals, there is no way for a retailer to reorganize. Generally, lenders refuse to permit the use and disposition of their collateral, or to extend additional financing unless they have confidence in a debtor's ability to reorganize effectively without diminution in the value of their collateral. Lenders have little or no incentive to participate in a reorganization process that will not result in repayment of the present value of their indebtedness, which in most cases includes significant pre-petition borrowings. Wary of

² 11 U.S.C. § 365(d)(4)(B)(i).

³ 11 U.S.C. § 365(d)(4)(B)(ii).

the looming tidal wave of liquidations, post-petition lenders push for an immediate sale of their collateral under § 363(b) rather than gamble on a going concern marketing effort or reorganization process that jeopardizes the value of their collateral.

Under § 365(d)(4) as it existed prior to BAPCPA, the debtor was required to decide whether to reject, assume or assign its leases within sixty days after the bankruptcy filing, unless otherwise extended by the court based on a showing of “cause.”⁴ The purpose of § 365(d)(4) was to impose a fixed deadline for the time to reject, assume or assign leases thereby reducing the “likelihood that provisions of the bankruptcy code will themselves add to the economic distress of retail merchants in shopping centers.”⁵ Notwithstanding Congress’ intent, debtors routinely obtained numerous extensions of the § 365(d)(4) deadline beyond the initial 60-day period. Many debtors requested and were granted open-ended extensions of the deadline until plan confirmation, which was the law prior to the 1984 shopping center amendments, particularly in the Southern District of New York.⁶ Other jurisdictions granted routine extensions, but usually limited them to 60 to 90 days at a time.⁷

Prior to BAPCPA, this willingness of bankruptcy judges to continuously extend the time to assume or reject leases had become a powerful tool that allowed debtors to downsize operations while sometimes adding considerable value to the estate. Retailers had enough time to analyze the value of their leases before making the decision to assume or reject and lenders had assurance that there would be adequate time to conduct orderly “going-out-of-business” (“GOB”) sales in the event the reorganization process was terminated and the company had to liquidate. Although both issues are important, lenders demanding time to conduct GOB sales in post-petition lending arrangements since BAPCPA has had the most significant impact because it further reduces the already shortened time to assume or reject by an additional 10-12 weeks.

The impact on post-petition lending and liquidity resulting from revised § 365(d)(4), together with the unprecedented market conditions, has had a profound negative impact on the ability of retail debtors to reorganize. Most retail debtors, despite their best efforts to reorganize or effectuate a going concern transaction, see their assets sold to liquidators under § 363 of the Bankruptcy Code. Frequently, existing lenders are willing to provide only enough financing to position the debtor for a liquidation in the first few months of the case. Amended §365(d)(4) substantially enhanced lenders’ leverage, enabling them to impose restrictive conditions in post-petition financing agreements that either direct an immediate liquidation of the company or include covenants or borrowing reserve rights that effectively allow the lender to pull the plug on

⁴ 11 U.S.C. § 365(d)(4) (1984) *amended by* 11 U.S.C. § 365(d)(4) (2005).

⁵ 130 *Cong. Rec.* S8891, S8894-95 (daily ed. June 29, 1984) (Statement of Sen. Orrin G. Hatch), *reprinted in* 1984 *U.S. Code Cong. & Ad. News* 590, 598-601; *see, e.g., In re Channel Home Centers, Inc.*, 989 F.2d 682, 686 (3d Cir. 1993); *In re Sea Harvest Corp.*, 868 F.2d 1077, 1079 (9th Cir. 1989).

⁶ *See e.g. Nostas Associates v. Costich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18 (2d Cir. 1996) (dicta suggests that a debtor should not be compelled to decide whether to assume until the moment of confirmation of a plan of reorganization).

⁷ *Compare In re Ames Dept. Stores, Inc.*, 2002 WL 511556 (S.D.N.Y.) *with In re Victoria Station, Inc.*, 875 F.2d 1380, 1384-5 (9th Cir. 1989) *and Matter of American Healthcare Management, Inc.*, 900 F.2d 827 (5th Cir. 1990).

the retailer only a few months into the case. The result is the continuing trend of prominent retailers disappearing after filing for a Chapter 11 bankruptcy with Linens ‘n Things, Steve & Barry’s, Circuit City, Mervyn’s, and KB Toys all liquidating in the past three months. The liquidation of just these five retailers resulted in more than 70,000 lost jobs. Goody’s,⁸ one of only three retailers to emerge from Chapter 11 since BAPCPA,⁹ has since been forced back into Chapter 11 bankruptcy and is in the process of liquidating all of its assets.

III. Section 503(b)(9) Issues as a Result of BAPCA

As discussed in the November Article, the enactment of § 503(b)(9) under BAPCPA¹⁰ creates, especially in retail cases, a potentially tremendous tranche of administrative expense claims. Section 503(b)(9) is commonly cited as one of the principal hurdles placed by BAPCPA in the path of the successful reorganization of a large retailer (along with the unrealistically short period for lease assumption or rejection under the amended § 365(d)(4)). Not only may an ailing retailer lack the wherewithal to satisfy § 503(b)(9) claims on the effective date of a plan, but that very prospect may reduce the availability and tighten the terms of any debtor-in-possession financing it might otherwise have been able to attract.

The limited authority addressing § 503(b)(9) since its enactment is only beginning to address the nuances of its application.

A. Applicability of Section 502(d) to § 503(b)(9) Claims

In *Plastech Engineered Products*¹¹, the court held that § 502(d) of the Bankruptcy Code may not be used to disallow an administrative expense claim under § 503(b)(9). Section 502(d) disallows “any claim of any entity from which property is recoverable” under the avoidance provisions of Chapter 5 of the Bankruptcy Code. The court surveyed the mixed authority on whether § 502(d) applies generally to bar administrative expense claims requested under § 503(b),¹² then analyzed whether § 503(b)(9) claims in particular should be subject to such a defense.

Although there are a number of reported decisions that address the issue of whether § 502(d) generally applies to § 503(b)

⁸ *In re Goody’s Family Clothing, Inc., et al.*, Case No. 08-11133 (CSS) (Bankr. D. Del. 2008).

⁹ *See also In re Hancock Fabrics, Inc., et al.*, Case No. 07-10353 (BLS) (Bankr. D. Del. 2008); *In re Movie Gallery, Inc., et al.*, Case No. 07-33849 (DOT) (Bankr. E.D. Va. 2008).

¹⁰ Section 503(b)(9) allows an administrative expense for “value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor’s business.” 11 U.S.C. § 503(b)(9).

¹¹ *In re Plastech Engineered Products Inc.*, 394 B.R. 147 (Bankr. E.D. Mich. Sept. 16, 2008).

¹² *See, e.g., MicroAge, Inc. v. Viewsonic Corp. (In re MicroAge, Inc.)*, 291 B.R. 503, 508 (B.A.P. 9th Cir. 2002) (“Section 502(d) by its terms applies to ‘any claim’ of an entity that received an avoidable transfer, and the definition of a ‘claim’ in § 101(5) is sufficiently broad to include requests for payment of expenses of administration.”) vs. *Camelot Music, Inc. v. MHW Advertising and Public Relations, Inc. (In re CM Holdings, Inc.)*, 264 B.R. 141 (Bankr. D. Del. 2000) (§ 502(d) does not apply to § 503(b) administrative expenses).

administrative expenses, none of those cases involve its potential application to a § 503(b)(9) administrative expense.

What makes the § 503(b)(9) wrinkle to this issue more complicated is the hybrid nature of this new § 503(b)(9) expense: it is a prepetition obligation of the debtor that is now elevated to an expense of administration of a bankruptcy estate by § 503(b)(9).

Because of this wrinkle, the question also arises whether § 502(d) should apply to § 503(b)(9) administrative expenses even if it does not otherwise apply to § 503(b) administrative expenses.¹³

The court held that § 503 makes no distinction between § 503(b)(9) claims and other § 503 administrative expenses and thus “believes nothing to suggest that § 503(b)(9) claims are to be treated any differently than other administrative priority claims. Thus “[t]he distinction urged by the Debtor — *i.e.*, that § 503(b)(9)’s are pre-petition in nature — although factually true, is not a distinction that makes any difference under § 503(b), or is even recognized by § 503(b). Nor is there any legislative history to suggest that Congress intended there to be such a distinction.”¹⁴ The court held that (1) the allowance of claims under § 502 is entirely separate from the allowance of administrative expenses under § 503, and (2) nothing about § 503(b)(9) changed this conclusion. “[A]lthough most of the cases that have considered the application of § 502(d) to § 503(b) administrative expenses have done so only where the administrative expense at issue arose as a post-petition obligation, their logic and reasoning are sound and should apply with equal force to this new class of administrative expenses under § 503(b)(9). The mere fact that § 503(b)(9) administrative expenses arise pre-bankruptcy does not change the analysis.”

B. Availability of § 503(b)(9) to Secured Creditors

Can a creditor whose claim is secured also assert a right to administrative priority under § 503(b)(9)? *Brown & Cole Stores*,¹⁵ says it can. The debtor argued that a claim that is secured cannot also be allowed as a § 503(b)(9) administrative expense. It observed that other § 503(b) claims are unsecured except for certain tax claims under § 503(b)(1)(B)(i), which BAPCPA amended by inserting “whether secured or unsecured,” after “any tax [] incurred by the estate,” and that the absence of the word “secured” in § 503(b)(9) creates an inference that such status was intended only for unsecured claims. The majority of the panel rejected that argument, finding that the language of the statute is plain and unambiguous.¹⁶

Judge Jaroslovsky dissented on this issue, based on the use of the phrase “whether secured or unsecured” in § 503(b)(1)(B)(i) but not in § 503(b)(9), invoking the tenet of statutory interpretation that it is “generally presumed that Congress acts intentionally when it includes

¹³ *Id.* at 154

¹⁴ *Id.* at 163.

¹⁵ *In re Brown & Cole Stores LLC*, 375 B.R. 873 (9th Cir. BAP 2007).

¹⁶ *Id.* at 878.

particular language in one section of a statute but omits it from another.”¹⁷ As a matter of policy, Judge Jaroslovsky noted that the issue could have a substantial impact in a chapter 11 case, because secured claims can be crammed down, whereas § 503(b)(9) claims must be paid upon confirmation, giving a secured creditor with a § 503(b)(9) claim far greater leverage than one whose claim can be paid over time.

The majority responded that this increased leverage is what Congress intended, and that the position advocated in the dissent would make no difference – if a secured creditor wished to avail itself of such power, it could waive its security:

Congress gave tremendous leverage to a twenty-day sales claimant such as AGI by permitting it to demand full payment as of confirmation, and in doing so, perhaps dramatically affecting the outcome of the case. The fact that the claim is also secured represents less leverage (albeit more than held by non-priority general unsecured claims) than having administrative priority. It is not our place to reallocate that leverage. In any event, if the dissent's view were the law, the holder of a twenty-day sales claim could simply waive its security, obtain administrative priority, and have equally powerful influence over the outcome of the case.¹⁸

C. Applicability of Setoff Rights to § 503(b)(9) Claims

Brown & Cole Stores addresses a second issue: whether § 553(a), which permits the setoff of mutual claims of a debtor and a creditor that “arose before the commencement of the case”, applies to § 503(b)(9) administrative expenses. The debtor sought to reduce a § 503(b)(9) claim by the amount of its prepetition breach of contract claim against the supplier. The supplier argued that such a setoff was improper because its claim was an administrative claim. The panel ruled that the debtor could take such a setoff, reasoning that while other subsections of § 503(b) pertain to postpetition administrative expenses,¹⁹ § 503(b)(9) claims do not arise postpetition, but are prepetition claims that Congress simply elevated in priority. Accordingly, the court held that debtors may setoff prepetition claims against § 503(b)(9) claims pursuant to § 553(a).²⁰

The analysis adopted by the court in *Plastech Engineered Products* might be read to suggest the possibility of a future split in authority on the setoff issue, inasmuch as the

¹⁷ *Id.* at 881.

¹⁸ *Id.* at 878 n. 8. The majority view is arguably supported by *In re Rio Valley Motors Company LLC*, 2008 Bankr. LEXIS 959 (Bankr. D. N.M. 2008), in which an administrative claim was asserted both as a §503(b)(1)(A) claim and a §503(b)(9) claim. While not directly addressed, no issue was raised that the claim could not be asserted on alternative grounds; in fact, the court resolved the issue by ruling that it did not matter which party's account was accurate because the creditor dealership would be entitled to either a §503(b)(1)(A) claim or a §503(b)(9) claim.

¹⁹ There is one minor exception: Section 503(b)(3) and (4) confer such status upon fees and expenses incurred by petitioning creditors.

²⁰ *Supra* n. 14 at 878-79.

Michigan court reasoned that there was no basis for distinguishing § 503(b)(9) claims from other § 503(b) administrative expenses (and thus no basis for treating it any differently for setoff purposes).

Interestingly, however, it is unclear why the *Brown & Cole Stores* court undertook this analysis in the first place, inasmuch as the case involved a debtor's setoff rights. Section 553 addresses a creditor's setoff rights. Courts hold that a debtor's setoff rights are among the defenses preserved under § 558, and that the distinction between administrative and prepetition claims makes no difference in that context (since the amount owed to a creditor for postpetition goods or services is properly reduced by any amount owed to the debtor, whether it arose prepetition or postpetition.²¹

D. Pay to Play

An issue yet to be addressed is whether any distinction may be made between § 503(b)(9) claims and other administrative claims when a secured creditor consents to a carve-out from the proceeds of sale of its collateral. To grease the wheels of a sale of their collateral under section 363 (and obviate objections that the sale is being conducted solely for their benefit), lenders have accepted the “necessity of making some distribution available to other creditors as the price of a court-approved sale.”²² While this frequently entails the payment of administrative expenses, lenders will seek to avoid any obligation to pay what may be very substantial § 503(b)(9) claims, on the basis that such claims are not incurred administering the estate and thus are not a true cost of conducting a § 363 sale, nor are such claims for postpetition shipment of goods that added value to the estate. The *Plastech Engineered Products* analysis, however, would suggest that all § 503(b) claims should be treated alike. It may also be argued that goods received within 20 days prior to bankruptcy are likely to still be on hand, and so enhance the asset base just as much as postpetition sales, and that there is therefore no reason to disregard the equal priority status placed upon them by Congress.

IV. Stub Rent and § 365(d)(3) (another source of liquidity ?)

With liquidity in short supply, retailers and their landlords continue the ongoing argument in several jurisdictions over the application of § 365(d)(3) to stub rent (rent accruing under the lease from the first day of the case through the end of the first month of the case) and whether the “billing date” method or the “accrual/pro-ration” approach is the correct interpretation. A quick recap: § 365(d)(3) of the Bankruptcy Code directs a trustee or “debtor in possession” to, “*timely* perform all the obligations of the debtor... arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding § 503(b)(1).”²³ A slight majority of the jurisdictions follow the “pro-ration” or “accrual” theory, which allows the debtor to pro-rate obligations under its leases and

²¹ *In re PSA, Inc.*, 277 B.R. 51, 54 (Bankr. D. Del. 2002); *In re TSLC I, Inc.*, 332 B.R. 476, 478-79 (Bankr. M.D. Fla. 2005).

²² *In re Encore Healthcare Assocs.*, 312 B.R. 52, 57 n. 10 (Bankr. E.D. Pa. 2004).

²³ 11 U.S.C. § 365(d)(3).

pay only that portion of an obligation that accrued after the bankruptcy filing.²⁴ In contrast, under the “billing date” theory, adopted by a substantial minority of the courts, if an obligation becomes due, or is billed, after the date of the bankruptcy filing and before the effective date of a rejection or assignment of the lease, regardless of when the obligation accrued, it is an obligation that the debtor must timely perform.²⁵

A. Goody’s - the Billing Date Approach in Delaware

In *In re Goody’s Family Clothing*,²⁶ (“Goody’s”) the Delaware Bankruptcy court followed the well established billing date rule in the Third Circuit and denied landlord motions to compel immediate payment of stub rent, but held that such claims are entitled to administrative priority under § 503(b)(1). The debtor has subsequently taken appeals from these Orders granting administrative priority under § 503(b) where the lease was rejected, arguing that § 502(g) renders claims for stub rent under rejected leases pre-petition general unsecured claims.²⁷

B. In Re Stone Barn f/k/a Steve & Barry’s - Pro-ration Endorsed in Manhattan

On December 17, 2008, Judge Gropper in *In re Stone Barn f/k/a Steve & Barry’s*²⁸ firmly endorsed the pro-ration approach in a detailed Memorandum of Decision that canvassed most of the case law on the issue. Judge Gropper focused on congressional intent to avoid forcing landlords to become involuntary post-petition unsecured lenders by requiring payment for the post-petition use and occupancy, and the fact that pro-ration is easy to apply and consistent with the overall goals of the Bankruptcy Code. Judge Gropper also noted that the billing date approach leads to absurd results, such as converting pre-petition tax obligations into administrative claims because they are due under the lease post-petition. Hoping for a decision from the Second Circuit on the issue, Judge Gropper stayed the enforceability of his order *sua sponte* and invited an appeal directly to the Second Circuit. To date an Order has not been entered and no appeal been filed.

C. Circuit City - Pro-ration With a Twist in Richmond

In *In re Circuit City*,²⁹ filed in the Eastern District of Virginia (Richmond) on November 10, 2008, Judge Huennekens issued a ruling on numerous landlord motions to compel payment of stub rent that does not fit nicely into either the pro-ration or billing date approach. Judge Huennekens held that despite the company’s agreement with the landlords that the pro-ration approach would apply and that stub rent is entitled to administrative priority under §

²⁴ *In re Furr’s Supermarkets, Inc.*, 283 B.R. 60, 65-66 (10th Cir. 2002); *In re Handy Andy Home Improvement Ctrs., Inc.*, 144 F.3d 1125, 1126-27 (7th Cir. 1998).

²⁵ *In re HA-LO Indus., Inc.*, 342 F.3d 794, 797 (7th Cir. 2003); *In re Montgomery Ward Holding Corp.*, 268 F.3d 205, 211 (3d Cir. 2001).

²⁶ *In re Goody’s Family Clothing, Inc., et al*, No. 08-11133 (CSS) (Bankr. D. Del. 2008).

²⁷ *See, e.g., Goody’s Family Clothing, Inc., et al., v. Mountaineer Property Co. II, LLC, Stafford Bluffton, LLC, and Eastgate Mall, LLC*, Civil Action No. 08-585 (RMB) (D. Del. 2009).

²⁸ *In re Stone Barn Manhattan (a.k.a. Steve and Barry’s)* Case No. 08-12579 (ALG) (Bankr. S.D.N.Y. 2008).

²⁹ *In re Circuit City Stores, Inc.*, et al., Case No. 08-35653 (KRH) (Bankr. E.D. Va. 2008).

503(b)(1), that the company was not required to pay the stub rent immediately, or even within 60 days after the petition date. The Judge found that he had no evidence of what ‘timely performance’ meant on a lease where the stub rent is due before the petition date on the first day of the month. Judge Huennekens also held that immediate payment of the stub rent, or even payment within the first 60 days of the case, would improperly elevate stub rent claims to “super priority” status, contrary to prior decisions of the bankruptcy Court in *In re Trak Auto Corp.*³⁰ and *In re Virginia Packaging Supply Co.*³¹ Finally, Judge Heunnekens agreed with the company that under *Trak Auto*, he had the discretion to order that stub rent be paid with other allowed administrative claims under § 507(a) of the Bankruptcy Code on the effective date of any plan of reorganization.

For debtors, the Circuit City stub rent decision represents the best of both approaches; avoid paying any charges that accrue pre-petition or post rejection and get a significant liquidity boost by delaying the obligation to pay stub rent until the end of the case. In contrast, aside from the finding that stub rent is entitled to priority as an administrative claim under § 503(b), this decision is a very troubling development for landlords. Facing their own liquidity issues, Circuit City’s landlords are forced into the exact position that Congress intended to avoid when enacting § 365(d)(3) in 1984: involuntary interest free unsecured post-petition lenders. Several landlords have appealed.

D. Bally Total Fitness – Let’s Just Wait and See What Happens

Bally Total Fitness,³² (“Bally’s”) filed for bankruptcy protection on December 3, 2008. Immediately after the case was filed, Bally preempted the stub rent issue by filing a motion to defer payment of January rent until the 60th day of the case for cause and a motion to establish procedures for responding to anticipated landlord motions to compel immediate payment of stub rent under § 365(d)(3). Bally cited both the inability to obtain post-petition lending and a general lack of liquidity as cause for the extension and claimed that it would need months to respond to the dozens of landlord motions to compel payment of stub rent as the basis for a proposed briefing schedule stretching over 90 days. Although the company reported sufficient cash to immediately pay January on January 9, the Court granted Bally’s request for an extension to pay by January 16. As of the second week of February, Judge Lifland has declined to rule on the substantive issue of whether stub rent must be paid immediately or at the latest within 60 days of the petition date and has also declined to set a briefing schedule or rule on the debtor’s § 365(d)(3) procedures motion.

V. Adequate Assurance of Utility Payments Under § 366

In re Circuit City Stores,³³ rejects the argument that under the amended § 366, as amended by BAPCPA, a bankruptcy court may not determine the appropriate amount of

³⁰ *In re Trak Auto Corp.*, 277 B.R. 655, 668 (Bankr. E.D. Va. 2002), *rev’d. on other grounds*, 367 F.3d 237 (4th Cir. 2004).

³¹ *In re Virginia Packaging Supply Co.*, 122 B.R. 491, 494-95 (Bankr. E.D. Va. 2002).

³² *In re Bally Total Fitness of Greater New York, Inc., et al.*, Case No. 08-14818 (BRL) (Bankr. S.D.N.Y. 2008).

³³ *Supra* n.12.

adequate assurance until the debtor has first paid whatever amount the utility has demanded.³⁴ The debtor in *Circuit City* proposed in its first day motion to place \$5 million in a blocked account as adequate assurance of payment of future utility bills, requested the court find that this constituted adequate assurance of payment, and proposed procedures for the resolution of future disputes.

The problematic language is contained in § 366(c)(2), as amended by BAPCPA, which provides: “Subject to paragraphs (3) and (4) . . . a utility . . . may alter, refuse, or discontinue utility service if, during the 30-day period beginning on the date of the filing of the petition, the utility does not receive from the debtor or the trustee adequate assurance of payment for utility service that is satisfactory to the utility.”³⁵

Notwithstanding this seemingly plain language, the court rejected the argument that adequate assurance must be satisfactory to the utility:

Such an interpretation of § 366 is simply unworkable. It could lead to absurd results. For example, a utility may simply fail to respond to a debtor’s offer of adequate assurance, or it may choose to respond on the thirtieth day. In either event, the result would be calamitous for a debtor in the throes of bankruptcy. The calamity is compounded for a debtor with thousands of utility accounts. Congress cannot have intended to place in peril the entire reorganization process by prohibiting courts from fashioning reasonable procedures to implement the protections afforded under § 366 of the Bankruptcy Code. *See In re Syroco, Inc.*, 374 B.R. 60 (Bankr. D.P.R. 2007).³⁶

Parsing the statute, the court observed that, notwithstanding the wording of § 366(c)(2), it is by its terms subject to subparagraphs (3) and (4), and § 366(c)(3)(A) provides that “[o]n request of a party in interest and after notice and a hearing, the court may order modification of the amount of an assurance of payment under paragraph (2).” Therefore, the court concluded, “the plain language of § 366 of the Bankruptcy Code allows the Court to adopt the Procedures set forth in the Utility Order. The statute does not prohibit a court from making a determination about the adequacy of an assurance payment until only after a payment “satisfactory to the utility” has been received from the debtor under § 366(c)(2). The first clause of § 366(c)(2) clearly renders the entire section subject to the court’s authority outlined in § 366(c)(3).”³⁷

³⁴ *See In re Lucre*, 333 B.R. 151 (Bankr. W.D. Mich. 2005) (holding that a debtor has no recourse to request a court order modifying the assurance of payment demanded by the utility until the debtor first pays what the utility demands, while arguably imposing a duty upon the utility to bargain in good faith).

³⁵ 11 U.S.C. § 366(c)(2) (emphasis added).

³⁶ *Supra* n.12 at 5.

³⁷ *Id* at 8-9.

The court also invoked the tenet of statutory interpretation that Congress does not write on a blank slate, and it may be presumed that its retention of the preexisting language reflects an intent to maintain preexisting law:

Prior to the enactment of BAPCPA, courts had the discretion under § 366 to determine the amount, if any, of adequate assurance payments or collateral required to a utility company. [citation omitted] Section 366(c)(3) uses language almost identical as that employed in §366(b) in allowing courts to modify the amount of adequate assurance. It follows that courts retain similar discretion even after the enactment of BAPCPA. Congress is presumed to be aware of the state of the law when it amends a statute, and the legislative decision to retain the almost identical language evidences Congressional intent to maintain the state of the law post-amendment.³⁸

The court also cited § 105(d) as permitting it to “issue orders prescribing limitations and conditions as the court deems appropriate to ensure that the case is handled expeditiously and economically.”³⁹ Finally, it noted that it and several other courts had approved such procedures post-BAPCPA.⁴⁰

VI. Trust Fund Taxes

Payment of sales taxes is an important issue for all retailers (and their management). On the petition date in any retail bankruptcy, sales taxes will have accrued prepetition and be payable as of the petition date or shortly thereafter. The usual rationale for immediate payment of such claims rests on the assumption that such taxes are so-called “trust fund” taxes that are required to be collected from third parties and held in trust for payment to tax authorities.⁴¹ Funds held in trust for that purpose are not property of the bankruptcy estate.⁴²

³⁸ *Id.* at 8.

³⁹ *Id.* at 9 n. 17.

⁴⁰ “This Court and other courts within this district have entered orders establishing similar procedures for the implementation of § 366 of the Bankruptcy Code in large Chapter 11 cases subsequent to the enactment of BAPCPA. See, e.g., *In re Movie Gallery, Inc., et al.*, Case No. 07-33849 (Bankr. E.D. Va. Nov. 17, 2007); *In re Storehouse, Inc.*, Case No. 06-11144 (Bankr. E.D. Va. Oct. 23, 2006); *In re Rowe Furniture, Inc.*, Case No. 06-11143 (Bankr. E.D. Va. Oct. 23, 2006); *In re The Rowe Cos.*, Case No. 06-11142 (Bankr. E.D. Va. Oct. 23, 2006).” *Id.* at 11.

⁴¹ See, e.g., *DeChiaro v. N.Y. State Tax Comm’n*, 760 F.2d 432, 433 34 (2d Cir. 1985) (sales tax required by state law to be collected by sellers from their customers is “trust fund” tax); *Shank v. Wash. State Dep’t of Revenue (In re Shank)*, 792 F.2d 829, 830 (9th Cir. 1986); *Rosenow v. Ill. Dep’t of Revenue (In re Rosenow)*, 715 F.2d 277, 282 (7th Cir. 1983).

⁴² *Begier v. IRS*, 496 U.S. 53, 55-67 (1990) (taxes such as excise taxes, FICA taxes and withholding taxes are property held by debtor in trust for another and, as such, do not constitute property of estate); *In re Al Copeland Enters., Inc.*, 133 B.R. 837 (Bankr. W.D. Tex. 1991) (debtor obligated to pay sales taxes plus interest, because such taxes were “trust fund” taxes), *aff’d*, 991 F.2d 233 (5th Cir. 1993).

Understandably, senior managers are reluctant to risk incurring “responsible person” liability if the taxes go unpaid.⁴³ While a degree of influence and control over the payment of such taxes is required, the responsible individual need not retain absolute control over corporate finances; the individual need only have significant control over the disbursement of funds and priority of payment to creditors.⁴⁴

Sales taxes, however, are not trust fund taxes in all states. For an obligation to be a “trust fund tax,” the obligation must be both: (1) a “tax”; and (2) taken from a third party for remission to the taxation authority on behalf of that third party. In large cases where such tax liabilities are substantial, it may be worthwhile to evaluate this issue on a state-by-state basis. In *Circuit City*, for example, the debtors filed two motions to pay \$35 million in prepetition sales and use taxes within the first fifteen days of the case. The creditors’ committee objected to the premature payment of such tax claims to the extent the funds were not trust funds, and the parties set about analyzing whether sales taxes constitute trust fund taxes on a state-by-state basis. Ultimately, the debtors and the committee agreed, and the court found, that sales and use taxes levied by Arizona, Arkansas, California, District of Columbia, Hawaii and Michigan were not “trust fund” taxes because (a) the applicable statutes do not require the debtors to collect the taxes from third parties for remission to the state tax authorities on behalf of such third parties, and (b) the applicable statutes levy the contested taxes directly upon the debtors as taxes for the privilege of conducting business, regardless of whether the debtors collect reimbursement from any other party.⁴⁵

VII. Gift Certificates

While large retailers seeking to reorganize will seek authority in a first day motion to honor prepetition gift certificates, among other customer programs, the treatment of such claims in liquidation presents interesting unresolved issues.

The leading case on the treatment of gift certificate claims (actually, the *only* decision published in the official reports) is *In re Woodworkers Warehouse, Inc.*⁴⁶ Judge Rosenthal held that consumer claims on account of pre-petition gift certificates are entitled to priority status over general unsecured claims. Section 507(a)(7) gives priority status to:

⁴³ The term “responsible person” for trust fund tax purposes is defined under federal law by Internal Revenue Code §6672(a) as: “Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over....” Individual state and local statutes also impose liability on those responsible for withholding taxes.

⁴⁴ See, e.g., *Fernandez v. U.S.*, 130 B.R. 757, 761-63 (Bankr. W.D. Mich. 1991) (authority to bid and sign contracts and to make payments to employees and creditors represents control of the corporation sufficient for responsible person liability).

⁴⁵ See *Stipulated Order Regarding Payment of Certain Taxes Under Supplemental Order Pursuant to Bankruptcy Code Sections 105(a), 506(a), 507(a)(8), 541 and 1129 Authorizing the Debtors to Pay Prepetition Sales, Use, Trust Fund and Other Taxes and Related Obligations*, entered December 22, 2008.

⁴⁶ *In re Woodworkers Warehouse, Inc.*, 313 B.R. 588 (Bankr. D. Del. 2004).

allowed unsecured claims of individuals, to the extent of \$2,425, for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided.

In Woodworkers Warehouse, the creditors held unused gift certificates issued pre-petition. The court concluded the purchase of a gift certificate should be deemed a deposit entitled to priority under § 507(a)(7), rather than as a final and complete transaction giving rise to an unsecured claim.⁴⁷ In light of the legislative history,⁴⁸ the court opined that “to relegate gift certificate holders to the status of general unsecured creditors perpetuates the very problem Congress sought to remedy.”⁴⁹ Specifically the court stated that “customers do not purchase gift certificates ... as the ultimate purchase,” and that “[c]onsumers expect merchants to apply some or all of the face value of the gift certificate toward the ultimate purchase.”⁵⁰

Another court reached the opposite conclusion, on somewhat different facts. *In re Utility Craft, Inc.*,⁵¹ the court ruled that a claim based upon an unused store credit that was given to a customer on account of defective merchandise, which credit covered the amount of the deposit, was not entitled to priority under § 507(a)(7), because the original deposit, delivery and payment for the couch constituted a completed transaction for purposes of § 507(a)(7), and “whether the Creditor decided to use the Store Credit is not part of the inquiry.”

In the *Sharper Image* case,⁵² the committee has objected to the treatment of gift certificate claims as priority claims, raising issues that go beyond the deposit issue addressed in *Woodworkers*. These include:

- Whether the maker of the underlying deposit is an “individual;”

⁴⁷ *Id.* at 595.

⁴⁸ Congress stated that the section was “added as a result of testimony before the subcommittee on civil and constitutional rights concerning the problems that consumers have encountered with bankrupt retail businesses with whom the consumers have deposited money for goods and services.” H.R.Rep. No. 95-595. The enactment of the section was in response to the failure of retailer W.T. Grant to honor scrip purchased by customers for use in the future purchase of merchandise. *See Collier* ¶ 507.08[1] (stating that the “drafters of the Code believed that it was appropriate to provide some protection to consumers ... [u]nlike businesses that knowingly extend credit and run the risk of nonpayment, consumers that make advance deposits on merchandise do not typically realize that they are extending credit when they make an advance payment for goods or services.”). Specifically the legislative history cites to consumers paying money on a lay-away plan, placing a deposit on merchandise, buying a service contract, and buying a contract for lessons or a gym membership as examples of the sorts of situations section 507(a)(7) should remedy. *See* H.R.Rep. No. 95-595.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *In re Utility Craft, Inc.* Slip Copy, 2008 WL 5429667 (Bankr. M.D.N.C. 2008).

⁵² *In re Sharper Image Corporation*, 2008 WL 2795286.

- Whether the holder of the claim is an “individual;”
- Whether the maker of the underlying deposit and resulting claimholder is the same “individual;”
- Whether the deposit was made for the individual's “personal, family or household use;” and
- Whether the purchased goods or services were actually “delivered or provided” to the individual by Sharper Image.

The objection argues that § 507(a)(7), by its own terms, prioritizes the claims of “*individuals*” arising from the deposit of money in connection with the purchase, lease or rental of property or purchase of services, for the “*personal, family or household use of such individuals, that were not delivered or provided.*” This makes for several arguments: (a) corporations and other entities are not entitled to priority;⁵³ (b) an individual asserting a Certificate claim is not entitled to priority unless such individual actually made the deposit;⁵⁴ and (c) an individual asserting a Certificate claim is not entitled to priority if the purchased goods were actually delivered or provided to such individual.⁵⁵

VIII. Case Updates

The dismal success-rate of recent large retail filings highlights that the BAPCPA changes to the Code are compounding the impact of the economic downturn with terrible consequences for retail debtors. An update on the status of a few of the cases mentioned in the November Article and two other recent retail filings follows. Even though these cases are currently pending and their ultimate disposition has not yet been determined, none of them will result in the emergence of a reorganized company.

⁵³ *In re Carolina Sales Corp.*, 43 B.R. 596, 597 (Bankr. E.D.N.C. 1984) (corporations are not “individuals” entitled to this priority).

⁵⁴ “The modifying phrase “for the personal, family or household use of such individuals” evidences an intent by Congress to limit the priority to instances where the individual asserting the claim is the same individual who actually made the deposit - i.e., where the consumer and the claimant are one in the same. Accordingly, the statute denies priority to two important categories of claims.” The objection contends that the same passage also “appears to limit priority entitlement to instances where the individual making the deposit is also the intended beneficiary (or at least one among a collective group of familial beneficiaries) of the goods or services to be provided on account of the deposit. Thus, an issue arises in the context of claims asserted on account of Certificates given to claimholders by friends, business associates, or even relatives that do not share a common household with the claimholder.” Put differently, the objection contends that gift certificate claims, even if otherwise entitled to priority, would not be so entitled if the gift was given to a non-family member.

⁵⁵ “The statute does not extend priority to individuals who receive, but then subsequently return, goods or services in exchange for the right to receive alternative satisfaction at some future time. *See In re Heritage Village Church & Missionary Fellowship*, 137 B.R. 888 (Bankr. D.S.C. 1991) (denying consumer deposit priority where claimants received bargained-for services prior to bankruptcy).”

A. Steve & Barry's

Steve & Barry's,⁵⁶ a case that exemplified the fast-track liquidation approach now taken by many retail lenders, included a post-petition financing arrangement that required the consummation of a sale transaction as either a going concern entity, or through an orderly liquidation under § 363(b), *barely a month* into the case. Less than 3 months after a sale transaction was approved by the Bankruptcy Court and consummated, and before the buyer, BH S&B had even exercised all of its lease designation rights, BH S&B filed a second Chapter 11 petition in the Southern District of New York and immediately liquidated all of the new company's assets.

B. Mervyn's

In the Mervyn's case,⁵⁷ the post-petition financing continued a pre-petition revolving credit facility with borrowing availability calculated as a percentage of inventory value, but the lender was authorized to take various "reserves" against the company's borrowing availability for, among other things, the value of inventory at leased locations with respect to which the leases had not yet been assumed, commencing 10 weeks before the deadline to assume or reject leases. The result was that Mervyn's had insufficient time to reorganize or market itself as a going concern, and the company was ultimately sold to liquidators. A small fraction of the 250 store leases were assigned to, among others, Forever 21 and Kohl's.

C. Boscov's

Boscov's⁵⁸ represents one of the bright spots in this season of retail failures. Although the post-petition financing arrangement provided an example of onerous liquidation-oriented covenants, which are now commonplace in post-petition financing language, the company was ultimately sold in a going concern transaction to a members of the Boscov and Lakin families.

D. Linens 'n Things

Linens 'n Things⁵⁹, which filed for bankruptcy May 2, 2008 in Delaware, entered bankruptcy with a post-petition financing facility that, among other restrictive covenants, required the company to obtain written consent from 80% of its landlords to extend the time to assume or reject leases from November 28, 2008 until March 9, 2009. Ultimately, over 90% of Linens 'n Things landlords agreed to the extension by the time to assume or reject imposed by the lenders. With the additional time under the lending facility, the company worked with vendors to build trade support around a \$100 million letter of credit carved out of the post-petition lending facility and negotiated rent concessions from landlords to try to identify the most profitable 250 stores around which the company could reorganize. Notwithstanding these

⁵⁶ *In re Steve & Barry's Manhattan LLC et al.*, Case No. 08-12579 (ALG) (Bankr. S.D.N.Y. July 9, 2008).

⁵⁷ *In re Mervyn's Holdings, LLC, et al.*, Case No. 08-11586 (KG) (Bankr. D. Del. 2008).

⁵⁸ *In re BSCV, Inc. (f/k/a Boscov's, Inc.), a Pennsylvania Corporation, et al.*, Case No. 08-11637 (KG) (Bankr. D. Del. 2008).

⁵⁹ *In re Linens Holding Co., et al.*, Case No. 08-10832 (CSS) (Bankr. D. Del. 2008).

additional reorganization efforts, the company's secured bondholders, which would have owned the company in a reorganization, decided that they would rather liquidate than risk owning a reorganized Linens 'n Things. Unable to find a going concern buyer, the company's inventory was sold to a consortium of liquidators and the leases were marketed for sale to end users. GOB sales concluded at most locations by December 31, 2008.

E. Circuit City

Circuit City⁶⁰, which filed in Richmond, Virginia on November 10, 2008, entered bankruptcy with a post-petition lending facility that required the company to file of a plan of reorganization or close on a sale transaction under § 363 by January 31, 2009, less than 90 days after the filing date. Under this timeline, the company continued turnaround efforts and a marketing campaign to sell the company as a going concern that were both commenced pre-petition. However, with the economy in free fall, the company's dismal post-petition performance made it almost impossible for the company to build the support of trade vendors or lenders to extend the deadlines imposed by the post-petition lending facility. Although the company was in discussions with several parties interested in purchasing significant portions of the company as a going concern, in the short time available, no hard going concern bid materialized, nor was there a clear path to a going concern transaction that justified extending any of the deadlines imposed by the lending facility. Delaying the liquidation would have significantly decreased the return to creditors. As a result, the company's inventory, valued at over \$1 billion at cost, was sold to a consortium of liquidators. GOB Sales will conclude at the end of March and the company is marketing the leases, intellectual property, fee owned real estate and miscellaneous assets for sale to the highest bidders.

⁶⁰ *In re Circuit City Stores, Inc., et al.*, Case No. 08-35653 (KRH) (Bankr. E.D. V.a. 2008).