American Bankruptcy Institute
Commission to Study the Reform of Chapter 11
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Background

I am Paul Calahan and currently serve as senior credit consultant for Cargill Inc. and, prior to that, Divisional Manager of Credit for Continental Grain Company. I have worked in the agricultural industry for 37 years.

Cargill is the leading agricultural company in the world, with sales of $135 billion, and employs approximately 137,000 people. Cargill is heavily concentrated in human and livestock food production.

I serve as senior credit consultant for three major Cargill Business Units with aggregate sales of in low 11 figures. I serve on Cargill's Financial Risk Committee which reviews and approves all major requests for credit extension. In addition to credit and trade structured finance, I handle collection issues, workout plans and bankruptcies.

I've been a member of NACM for 37 years. I served on NACM's Legislative & Government Affairs Committee for several years and worked for many years for Bankruptcy reform.

Reclamation

During the past years the Bankruptcy Code and the economic environment have made it more difficult for unsecured creditors to realize fair payment of their claims. For this reason, when I evaluate a distressed debtor we become more restrictive in the extension of credit and credit terms. Frequently we withdraw credit altogether.

Years ago we could rely upon reclamation for payment of deliveries made within 10 days of the bankruptcy filing. Reclamation was designed as a remedy to protect sellers of goods from buyers purchasing goods when the buyers were insolvent and planning to file for bankruptcy or some other insolvency proceeding. Reclamation was really intended to prevent fraud against good-faith sellers.

Unfortunately, reclamation is no longer a remedy that protects sellers of goods. Reclamation claims are usually denied because most debtors have secured lenders who assert a blanket lien on all inventory. The distressed debtor typically does not have the inventory at the time the reclamation claim is even made. The inventory subject of the reclamation demand is also usually commingled with other inventory and cannot be identified.

For example, from the inception of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), my department has experienced 300 bankruptcies, of which Cargill was owed $19.2 million subject to claims of reclamation in 43 cases. It's generally our practice to file reclamation demands in each case where deliveries were made 10 days prior to the petition date. Cargill did not recover any goods or obtain any other recovery on any of the 43 reclamation demands. Generally, that was the result of (a) the lenders having exercised their lien rights on inventory, or (b) that the goods had been consumed.

In the case of Vera Sun (Case No. 08-12606-11 filed in October 2008 in the District of Delaware), we served a reclamation demand to recover 10 cars of ethanol, valued at $1.2 million delivered three days prior to the petition date. At the time Cargill delivered the 10 cars of ethanol to Vera Sun, it had stopped producing ethanol and was buying ethanol from other suppliers so that it could honor its commitments. We filed a reclamation demand immediately, but because the cars had been shipped and re-consigned to a third party for Vera Sun's account, we were not successful in reclaiming those goods.

The last major collection wherein the use of reclamation was successful was in the early 80s when Lane Processing filed bankruptcy and we were able to recover 100% of the value of a corn train which was approximately $800,000.

§503(b)(9)

While reclamation is really no longer helpful in recovering inventory shipped just prior to a bankruptcy filing, the addition of Section 503(b)(9) in 2005 did assist sellers of goods delivered to a debtor on the eve of bankruptcy. Section 503(b)(9) has encouraged Cargill to sell on credit to potential debtors knowing that the deliveries made within 20 days will be protected with an administrative claim. We often modify our credit terms knowing that our exposure will be somewhat protected.

As Hostess Brands edged closer to its second filing, Cargill was managing their exposure closely and continued to extend credit knowing that Section 503 (b)(9) was available. At the time of the second Hostess Brands filing, Cargill was owed $1.2 million in Section 503(b)(9) claims. Without the availability of a Section 503(b)(9) administrative claim, we would have withdrawn credit to Hostess.

Section 503(b)(9) has provided needed protection for unsecured trade creditors selling goods and likewise has enabled many potential debtors to continue buying on credit. Why should secured creditors or lenders agree with this clause? Simply, Section 503(b)(9) allows trade creditors to deliver value to the debtor's business. It is trade credit that often allows a debtor to maximize the going concern of the debtor's business—this in turn helps lenders protect the value of their collateral. When a distressed debtor is having liquidity issues, it is trade credit that keeps the debtor going.

Section 503(b)(9) allows unsecured sellers of goods to continue to work with the distressed debtor knowing that Section 503(b)(9) is a means to mitigate the risk. Without the provision, typically the response is to reduce or withdraw credit.

Currently Cargill is working with a company that is not yet and hopefully will never be in bankruptcy. For this reason, I won't mention their name. The company is a major retail chain and has made efforts to restructure and sell assets. Cargill has trimmed their credit line by $8,000,000 and reduced terms. Cargill's exposure is more than that as we speak. Section 503(b)(9) has been critical to our negotiations. As important as this major customer is, we're not going to willingly/knowingly throw millions away. Without the protection offered by Section 503(b)(9), shipments would have stopped and store shelves would not be replenished.

Get a flavor for what empty store shelves look like. When Hostess closed its doors a few months ago, many grocery store shelves were simply empty. Bread and snack foods were not in the place where they once were. There could have been disasters or storms and people would go to stock up their refrigerators and find shelves empty. The impact would've been similar had Cargill and other suppliers withdrawn credit and/or stopped shipment because of non-payment from Hostess.

Another example where Section 503(b)(9) made a difference was in the Townsends case. Townsends was a poultry company located in the southeast. The poultry industry for some years has struggled with over capacity, over supply and the inability to pass on increased ingredient costs to their buyers. Many poultry companies expanded in the wrong areas which increased debt on the balance sheet.

2011 was the worst year for the poultry industry. Anything and everything that could go wrong – did. All the factors mentioned above, along with a decline in exports, made losses astronomical. Townsends was one of many poultry companies that would seek bankruptcy relief in 2011.

Townsends had been distressed for some time and had hired a consultant to weigh their options which eventually led to bankruptcy. When they filed bankruptcy, Cargill was owed $1.3 million. Cargill was concerned about recovery as were the lenders who were owed approximately $73 million and were under-secured on their loans.

There was a near unanimous perception that Townsends was administratively insolvent because at the inception of the Chapter 11, the prevailing view was that the Debtor's business was worth about $30 million less than the amount of the lender's claim. Cargill and other creditors were also concerned that the Chapter 11 was filed to allow the lender to obtain a better recovery on a sale of the company than the lender would otherwise realize if it had foreclosed on its collateral outside of bankruptcy.

Impact of Creditors' Committees on Section 503(b)(9) Rights

I participated on the Creditors' committee, and as a committee, professionals were retained. To make a longer story short, the lenders did not want to carve out any monies for either Section 503(b)(9) claims or all administrative claims for goods sold and services provided to the debtor during the Chapter 11 case which were anticipated to exceed the DIP loan by millions of dollars. The committee objected to the financing and negotiated a settlement that assured the payment of Chapter 11 administrative claims and provided a graduated scale approach to recovery for Section 503(b)(9) claims, which provided for increased recoveries on Section 503(b)(9) claims as the sales price increased (e.g., if the business were sold for $x, Section 503(b)(9) claimants would receive $y; if sold for an increased amount, $a, Section 503(b)(9) claims would receive a larger recovery $b, and up to approximately $15 million if the sale price reached $62 million).

The recovery in Townsends was beyond everyone's expectations because the assets sold for far more than expected. Because of Section 503(b)(9), Cargill was able to recover $1.2 million, nearly its entire Section 503(b)(9) claim.

Townsends also illustrates the value that a strong and sensible creditors' committee can bring to a case, particularly a case that was at risk of administrative insolvency. Frequently there is discussion that creditors' committees increase the cost of Chapter 11 proceedings. A voice for unsecured creditors is clearly needed and provides valuable insight to the court and the other parties. Creditors' committees frequently explore transactions and underlying conduct which may not have any interest to the debtor's management and maybe not even to the undersecured lender. By pursuing those assets, the committee brings value to the unsecured creditors and perhaps even to the underwater lender.

Another favorable aspect of the Townsends case is that creditors were permitted to include their Section 503(b)(9) claims as part of their proof of claim. Creditors were permitted to assert their Section 503(b)(9) claims in their proof of claim because there was a court order permitting this. Creditors should be allowed to do this in every bankruptcy case so it is easier and less expensive to assert their Section 503(b)(9) claims. Unfortunately, there is nothing in the Bankruptcy Code or in the Bankruptcy Rules of Procedure that allows creditors to include their Section 503(b)(9) claims in their proofs of claim. This has created a lot of uncertainty on how creditors should be asserting their Section 503(b)(9) claims in bankruptcy cases.

Other Important Contributions by Creditors' Committees

Creditors' committees provide an essential role in the representation of all unsecured creditors and they bring balance to the proceedings that ensure a more equitable administration of the estate for all classes of creditors.
To strip away any rights and/or representation for unsecured creditors would deny unsecured creditors any role in many Chapter 11 cases.

Creditors' committees bring balance to a proceeding and will challenge the status quo positions of the debtor's secured lender and/or insiders where appropriate.

I'm currently involved in a bankruptcy proceeding with John and Catherine Burger where the debtor and lender decided not to fund a creditors' committee. Briefly some facts of that case include a debtor and his wife operating 5 LLCs. They did not (1) keep separate books, (2) operated all businesses from a single bank account, (3) commingled their assets, (4) had audited financials that were grossly inaccurate, and (5) not only was unable to pay Cargill and others, but originally had no intent to pay Cargill at all.

Because we could not get funding, the creditors' committee was formed, but could not retain professionals to raise such issues of (1) fraud, (2) insider trading, (3) the likelihood of improperly perfected lenders' liens in some instances, (4) officer/director insurance, (5) the reconstruction of the debtor's books in an attempt to see what had transpired, and (6) the fact that given that the debtor had lost a few million dollars, was unable to infuse money, was in poor health, and was unable to secure DIP financing, the most likely, best option in the case was to liquidate.

Let's just take one of those potential events – improperly perfected security interests. This would have the result of making the "secured lender" an unsecured creditor and subject to a pro-rata share of proceeds. However, given that the creditors' committee had no voice, most of these issues will not be explored and/or the debtor and lenders will just work it out among themselves, without any input from the unsecured creditors' committee, which will remain dormant through the case because it was not funded and was therefore unable to hire professionals that would've been able to file motions and make objections on our behalf.

I would further suggest that whether a debtor is administratively insolvent or not should not be the criterion to decide whether a creditors' committee should be formed. Simply, there would be no creditors' committees in most cases where, at the beginning of the bankruptcy, there is a risk that the debtor is administratively insolvent. That means unsecured creditors would have no vehicle for investigating and challenging secured lenders' unperfected security interests, improper conduct and the conduct of the debtor's insiders prior to the bankruptcy. These claims might be the only source of recovery for creditors in these cases.

<u>Conclusion</u>

Section 503(b)(9) is a valuable provision of the current Bankruptcy Code and should be retained to provide a meaningful incentive to sellers to continue selling on credit. It protects trade creditors from insolvent buyers of goods stocking up on inventory just prior to the filing of a Chapter 11 proceeding in the same way reclamation was intended to prevent fraud during the initial days of the Uniform Commercial Code.