American Bankruptcy Institute
Commission to Study the Reform of Chapter 11
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First, I'd like to thank the Commission and the American Bankruptcy Institute for having me here to speak today. My name is Sandra Schirmang and I am the Senior Director of Credit at Kraft Foods. I am also a former member of the American Bankruptcy Institute's Board of Directors, and a former Co-chair of the Institute's Unsecured Trade Creditor Committee. In the near 30 years that I spent working for Kraft, I've seen a number of bankruptcies, and it's safe to say that Kraft has been involved in every major bankruptcy case in the food industry because our products are so ubiquitous.

Fleming Companies' filing in 2003 was probably the largest bankruptcy case that I participated in and also has the distinction of being the last case that I can remember where Kraft was able to successfully leverage the Bankruptcy Code's reclamation provisions as a creditor remedy. In the Fleming case I served as the co-chair of the general unsecured creditors' committee. In that case a separate reclamation committee was also formed. I supported its formation and ultimately benefited from its work. In Fleming, reclamation claims were paid. The reclamation committee promoted a pragmatic reconciliation of all claims of those creditors against the debtor, using a three-prong approach that simultaneously addressed reclamation claims, unsecured claims and preferences. Considering that the Fleming case was essentially a liquidation, where the company was reorganized around its Core-Mark subsidiary and then its remaining assets were sold, the allowance of reclamation claims provided unsecured creditors with a rare and remarkable recovery.

Since then, however, and particularly since the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, I have not had any success using reclamation as an unsecured trade creditor remedy. Reclamation was always a risk because of the way it was structured, but it seemed that, as case law developed, any lien wiped out reclamation rights and these claims are now secondary to the interests of a secured lender's liens in inventory. Coupled with the growth in secured debt, this fact has essentially made reclamation claims valueless. It used to be that a bank would liquidate the debtor's inventory and there would still not be enough remaining to pay unsecured creditors' reclamation claims. However, in recent cases, there are several competing levels of secured credit with priority over unsecured creditors. Typically there isn't anything left at the end of the case to pay suppliers. Debtors often have to incur second and in some cases even third-lien debt to stave off bankruptcy. While the acquisition of this type of financing is often used by debtors to reassure trade creditors like me, it often has the opposite effect. With each new tier of debt, my chances of getting paid get slimmer.

Ultimately I believe that the growth in secured debt has actually pushed more companies into liquidation, because as their secured debt level increases debtors find it more difficult to purchase inventory on credit. Vendors are less willing to sell on credit when they are not convinced that they will receive payment if the shaky debtor ends up in bankruptcy. Too often in the past, unsecured suppliers have sold to debtors and have been left with little or nothing in a bankruptcy proceeding. The frustration of unsecured creditors may also make it hard for debtors to get the unsecured credit they need to successfully function after emerging from bankruptcy.

Even before BAPCPA, in my experience, reclamation claims were often paid because the debtor felt compelled to maintain the good will of their suppliers. Payment of reclamation claims wasn't necessarily a certainty, but it was something that a debtor had to consider doing if they still wanted credit after making it out of Chapter 11. Generally speaking the company that's emerging from a reorganization is not the strongest, so if a supplier is owed $1 million prepetition and then the supplier, if lucky, winds up being paid 10 or 20 cents on the dollar from their customer, which then emerges from bankruptcy needing credit again, it's difficult for the supplier to agree to sell on the same terms and essentially double down on their initial credit extension.

It's hard for suppliers to come to the table and take that risk. This fact then makes it even harder for the company that just went through reorganization, raising questions about whether or not the debtor will be able to get the inventory that they need in order to function on open unsecured terms. Their new line of credit from their unsecured suppliers might be tighter, which makes it harder for the new debtor to operate effectively and could send the debtor back into liquidation eventually.

Since BAPCPA, although we do still send out reclamation letters, we rarely actually fight for payment on these claims, choosing instead to focus our recovery efforts on the Section 503(b)(9) 20-day administrative priority claim. This is a remedy that's much more straightforward than reclamation, which has evolved into an ineffective remedy.

The 503(b)(9) process provides a much-needed dose of certainty for unsecured suppliers to continue shipping to a company in the days leading up to their bankruptcy. In consumer products industry we sell on reasonably short terms so the implications of 503(b)(9) are very important to us from a financial standpoint. I would imagine that it's even more important to smaller companies. Kraft is certainly big enough to absorb any reasonably-sized loss without too much pain, but when you think about smaller companies and other businesses that are operating on thinner margins, the disallowance of their 503(b)(9) claim, or the elimination of the statute altogether, would cause a great deal of damage to them if, say, one of their biggest customers were to file bankruptcy.

For large suppliers like Kraft, our ability to rely on Section 503(b)(9) allows us to continue selling to a customer that might be circling the drain. Before 503(b)(9), we'd have to try to see into the future and judge whether or not a company was ten days away from filing for bankruptcy, and hope to stop shipping to them before that time. When a company like Kraft pulls the plug on a customer, it can often speed the customer's descent into bankruptcy. For instance, for Fleming and A&P, if the debtors' major suppliers had abruptly restricted credit, those companies would have been forced into bankruptcy more quickly, not just because of Kraft's decision to stop shipping, but also because eventually other trade creditors would have found out that our company had pulled credit, or become more restrictive with credit themselves. Once a company starts having its credit lines reduced, it can greatly affect that company's ability to even perform in the marketplace, thereby pushing them into bankruptcy even faster.

Repealing 503(b)(9) would create so much more uncertainty in the supplier community. It would make such precautionary, damaging actions much smarter moves for suppliers, to the detriment of debtors. As unsecured creditors, we're willing to take on reasonable risk, but not to an outrageous extent and not if we think that money won't ever be paid to us. 503(b)(9) provides assurance for us to keep these companies afloat, since we can be certain that whatever we ship in that 20-day period has a good potential for recovery.

Section 503(b)(9) also provides incremental assurance for companies that don't provide their suppliers with financial statements. Many of our customers are small to mid-sized companies that are family-owned or otherwise private and don't release financial information. If there's no public debt on a company, then the supplier is essentially shipping into a black hole, and there are many customers out there that won't even provide financial information to a company as large as Kraft. We base our credit decisions for these companies on how they pay and what we hear in the industry, but we also rely on the Section 503(b)(9) 20-day administrative claim to give us the assurance we need to sell to such customers. Losing this creditor remedy could drive even more bankruptcies as suppliers are quicker to become more restrictive or pull credit altogether. The key with 503(b)(9) is that it creates a greater level of certainty, much greater than we have had with reclamation. It encourages trade suppliers, who really are the lifeline of the company, to continue providing support as the company tries to restructure outside of bankruptcy.. I think in a lot of ways the supplier class has a much closer relationship to the debtor in bankruptcy than the bankers and the bondholders do. Ours is a symbiotic relationship; my company can't sell any macaroni and cheese unless I've got shelves to sell it on, and they are less likely to attract shoppers without well-stocked shelves. I think we have a greater vested interest in the survival and reorganization of our customers, and in reorganization the debtor wants a strong relationship with their suppliers because they're going to need them to be successful after the bankruptcy.

In addition, sellers of goods are often asked to deliver goods to a party other than the debtor. This is known as drop shipping and various bankruptcy courts have taken the position that a drop shipment is not eligible for 503(b)(9) treatment because the goods were not received by the debtor. If the seller of goods does not deliver to the party the debtor directs them to, they would be in breach of contract, so to withhold the administrative claim provided by 503(b)(9) in a situation such as this is very unfair to unsecured sellers of goods. It would be my suggestion that in reviewing 503(b)(9) the Commission clarify that Section 503(b)(9) treatment should apply in drop shipment transactions.

One key element of the Code that allows debtors and the supplier class to work together, while preserving value for unsecured lenders, is through unsecured creditors' committees. I have served on several of these committees and chaired several others, and I can attest to how important they are and how worthwhile they can be when all of the players in the case are at the table.

Firstly, the unsecured creditors' committee serves as an important source of information about the case. In the initial confusion after a debtor's bankruptcy filing, it's difficult, especially in a potential liquidation scenario, to even find out what's going on with the committee and the case. The debtor's lawyers and the bank's lawyers are generally not as communicative with general unsecured trade creditors as they are with each other and with other secured lenders, so the committee provides unsecured creditors with the information they need but that they don't often get from other classes of creditor.

It also offers unsecured creditors a chance to work out problems that would've been more difficult to solve outside of a committee atmosphere. I served on the general unsecured creditors' committee in the Winn-Dixie Chapter 11 case, and in that case, the company's corporate and capital structure made arranging settlements very complex. Winn-Dixie was formed by the company buying up regional grocery stores. Some of these stores were still signatories on some of the company's loans and their assets were pledged, but other stores' assets were not pledged, so there was a question of how to figure out where these different types of stores were and which of them owed what debt and pledged what collateral. As a committee, we got together and negotiated with the different entities to come to an equitable agreement to divide the recovery up fairly, rather than try going through a big litigation and discovery process. Without the unsecured creditors' committee, such a process would've driven up legal costs and forced the case to drag on for much longer than was really necessary.

The creditors' committee also gives the unsecured creditor class the ability to push back against bigger lenders, providing us with an important mechanism for balancing out the divergent interests of these two parties. Our work on the unsecured creditors' committees in the Fleming Companies case and the Bi-Lo case allowed us to extract valuable concessions from the secured lenders, specifically in the form of a carve-out for reclamation claims in Fleming and other concessions in the Bi-Lo case that allowed unsecured creditors to receive payment in some form while giving the secured lender what they needed to keep Bi-Lo operating. Bi-Lo successfully reorganized even with these concessions made to unsecureds, and actually purchased Winn-Dixie last year.

I can't imagine why anyone at this stage would want to consider eliminating committees from the Code. In my experience they provide a necessary counterweight to the influence of secured creditors, one that provides unsecured creditors with better recoveries and helps create going concern value for the debtor.

With that, I'd again like to thank the Commission for offering me the chance to testify, and would be happy to answer any questions.