American Bankruptcy Institute
Commission to Study the Reform of Chapter 11
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First of all I'd like to thank ABI and ABI's Commission to Study the Reform of Chapter 11 for allowing me to speak today. My name is Joe McNamara and I'm the director of financial services at Samsung Electronics America. I have responsibility for financial services throughout the United States of America for all Samsung products with the exception of cell phones. I have been at Samsung for ten years beginning in a senior manager position before moving up to become the director of financial services. My role encompasses the entire credit, collections and accounts receivable function. Prior to Samsung, I worked at several companies, including BP Castrol Oil and Crown Vantage Paper, but have maintained a position in the management of trade credit for the last 20 years.

During the last 10 years, twenty five of Samsung's customers have been debtors in Chapter 11 proceedings. There was one filing in 2004, none in 2005 or 2006 and three accounts that filed in 2007. Then, between 2008 and the present, there have been 21 filings: six in 2008, three in 2009, five in 2010, three in 2011 and three in 2012. Electronics Expo was the most recent filing and our first this year, as the company sought Chapter 11 protection at the end of March.

Three of these accounts involved second filings for the same company on so called "Chapter 22's": Tweeter Entertainment, Ultimate Electronics and Ritz Camera. In my experience, over the last half decade, companies have had a harder and harder time successfully reorganizing their debt using the Chapter 11 process, and thus are more prone to either fold their reorganization procedure into liquidation, or successfully exit, and then re-enter bankruptcy a few short years later.

I am going to address several issues today that I think are important for the Commission to consider. My testimony will include reclamation, Section 503(b)(9) claims and the importance of creditors' committees in the Chapter 11 process.

Reclamation

Reclamation is a remedy that was designed to prevent fraud on vendors. It once was a fairly effective remedy in that vendors could reclaim goods shipped to a potential debtor. If the seller became aware that the debtor was insolvent, it could reclaim the goods that hadn't been sold or consumed. In the pre-2005 Bankruptcy Code, sellers of goods making valid reclamation claims were often granted administrative claims or liens subordinate to the primary lender. If a vendor was confident that it might be given an administrative claim for its reclamation rights, it would be more willing to continue shipping goods during a period prior to a prospective filing. If a vendor did not have this confidence, it was unlikely that it would ship without an agreement for cash-on-delivery (COD) or cash-in-advance (CIA) payment for the goods. If there was no satisfactory reclamation process or treatment, those vendors supporting the potential debtor by shipping on open credit terms found their claims treated as general unsecured claims while the secured lender and debtor benefitted from the inventory which may have assisted the debtor with a higher going concern value.

Reclamation claims had limitations that became more pronounced over time. The remedy was often illusory since reclamation claims are subordinate to the liens of senior secured lenders, and subject to a limited 10-day reach back. Also, as companies became less liquid and more highly leveraged, the value of reclamation as a remedy became negligible. Finally, the extremely limited reach-back period was oftentimes inadequate.

Section 503(b)(9)

Section 503(b)(9) was added to the Bankruptcy Code in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) and provided protection for sellers of goods on credit making deliveries to the debtor during the 20 days prior to a bankruptcy filing. It grants an administrative claim for the value of the goods even if the goods have been sold or consumed. There has

been lots of criticism of this addition to the Code as having caused numerous liquidations since its enactment, but I believe such criticism is overstated and outweighed by the many benefits of 503(b)(9) both for unsecured creditors and the debtors struggling to avoid bankruptcy. First, it really put some teeth into the ineffective force of reclamation by allowing sellers of goods to proceed to ship on open credit terms with the knowledge that if they assisted the buyer/debtor during its darkest days, it would be paid as an administrative creditor if the debtor was able to reorganize or liquidate through a plan. Second, I believe that it really protects sellers of goods from the fraud that can occur and often has occurred when customers—fully aware that they were about to file bankruptcy—bulked up on inventory or simply continued to purchase goods without any intention to pay just prior to filing a bankruptcy petition. Third, it prevents the unfairness that resulted before Section 503(b)(9) where debtors and secured creditors would benefit with a higher going-concern value from goods the debtor had purchased from its vendors that the debtor had no intention of paying at the expense of unsecured creditors who, in more and more bankruptcy cases, may only be paid pennies on the dollar for their claims, if that much. Fourth, while Section 503(b)(9) has created higher administrative expense in Chapter 11 cases, without it, many debtors would proceed into Chapter 11 more rapidly as debtors would be forced to purchase inventory on a cash-on-delivery or cash-in-advance basis if sellers had no protection under the Code and believed that their customers were financially unstable.

Of the bankruptcies I've been involved with, Circuit City's filing was the largest and most noteworthy, and from what I understand has become a poster child for how retailers are often unable to successfully navigate their way through Chapter 11. Samsung was a member of the unsecured creditors' committee of Circuit City and I was Samsung's representative on the committee. Among the reasons floated by legal pundits for Circuit City and other retailers' demise is the fact that Section 503(b)(9) of the Bankruptcy Code provides goods sellers with an administrative claim on any goods shipped to the debtor in the 20 days preceding their bankruptcy, and that this burden proves to be too much for the

debtor to bear because they have to pay these claims in full as administrative claims for a Chapter 11 plan to be approved. When they cannot do this, the argument goes, it forces them to liquidate. However, suggestions that Section 503(b)(9) is responsible for the demise of companies like Circuit City ignores several fundamental facts specific to these cases that precluded their success. A closer look at Circuit City—both from Samsung's perspective and more generally—is helpful to understanding the big picture.

Samsung was one of Circuit City's largest unsecured trade creditors, and was owed $122 million at the time that the company filed in Richmond, Virginia. Samsung had a Section 503(b)(9) administrative priority claim of roughly $19 million. However, by the end of the proceeding, that claim was rendered valueless for two reasons. First, Circuit City successfully offset its claims against Samsung for deductions, chargebacks and other amounts that Circuit City claimed were owed by Samsung. Samsung was also hamstrung by the bankruptcy court's order, relying upon Section 502(d) of the Code, that temporarily disallowed the 503(b)(9) claims pending resolution of the debtor's alleged preference claims.

The judge effectively denied Samsung's 503(b)(9) administrative claim using Circuit City's other alleged claims against Samsung and also on the mere allegation of a preferential payment, even before Circuit City was required to prove that Samsung actually received a preference . In reality, except for a couple of rogue invoices that added up to approximately $1 million, the preference claim asserted against Samsung was meritless: we never changed our terms with Circuit City and they made their payments as scheduled without issue. Still, Circuit City argued that all of the payments that they made to us on open terms during their 90-day preference period were preferential, without any justification. Based in part upon the mere assertion of Circuit City's bogus preference claim, the court tossed out

Samsung's legitimate 503(b)(9) claim. Technically speaking Samsung's 503(b)(9) claim was valid and 100% recoverable, but practically speaking it was completely null and void.

Samsung's claim was for $122 million which we filed as two separate component claims: one for the 503(b)(9) for $19 million, and a second for the remainder of the claim at $103 million. Circuit City asserted a baseless preference claim against Samsung of approximately $50 million and argued the preference offset our 503(b)(9) claim and sought to disallow it. Circuit City was also seeking to disallow Samsung's 503(b)(9) claims based upon its claim for recovery of deductions, chargebacks and related claims against Samsung. Rather than attempt what would have been the protracted and expensive process of litigating these issues, Samsung ultimately chose to settle with Circuit City in such a way that reduced its 503(b)(9) claim to zero and reduced its unsecured claim in exchange for a release of Circuit City's preference claims against Samsung.

Samsung's experience in the case was not unique. Many creditors' 503(b)(9) claims weren't paid for the same reason Samsung's wasn't: because their 503(b)(9) administrative claims were denied due to alleged preference claims, or they were unpaid based on Circuit City's pre-bankruptcy deduction, chargeback and related claims against the creditor. Considering that the debtor never had to pay many of these 503(b)(9) claims, I personally cannot see how Section 503(b)(9) contributed to Circuit City's demise.

My experiences dealing with Circuit City provided a whole host of reasons why the company was bound to fail in Chapter 11. In addition to the weakened U.S. economy and global credit meltdown that was in full swing at the time, Circuit City was a poorly managed company. Although they did bring in competent management during the case, it was too little, too late. Second, their stores were older stores and not in the best locations. If you can recall in your own experience, where there was a Circuit City in your area, usually it wasn't located in the most popular shopping mall. They were often found in

odd locations that were hard to get in and out of. This might have been a good strategy for Circuit City 25 or 30 years ago because it gave them more favorable pricing on real estate and leases. But once other competitors, such as Best Buy, entered the market, they took the opposite strategy and became anchor stores in every high-end strip mall. There might be a Dick's Sporting Goods, a Costco, a Home Depot, a Lowe's or a Best Buy, but that was never the case with Circuit City, and the company did not do enough to improve even as they filed Chapter 11.

Third, Circuit City also made a major mistake when they exited home appliance sales. They thought that such a sector wasn't a benefit for their business, but by exiting that sector, their stores missed out on a great deal of foot traffic. At home when your dishwasher breaks, or your refrigerator, or your washer and dryer, you need to do something. Instead of repairing it many people opt to purchase a new one. You would go to a store like the former Circuit City to buy that appliance, and when you're there, you'd walk past the TVs or the computer section or some other portion of their business that wasn't strictly what brought you to the store in the first place. Many times this increased foot traffic led to additional sales. After getting out of home appliances, Circuit City lost all of that attach-on clientele and their business suffered.

Fourth, Circuit City was considerably overleveraged and burdened by more than $1 billion in secured debt, while owning none of their real estate at the time of their filing. All things considered, it defies logic to blame Section 503(b)(9) claims, a portion of which were never paid, for Circuit City's demise when so many other factors had already left the company doomed.

Both the Circuit City court's treatment of our 503(b)(9) claims and the possibility of losing 503(b)(9) altogether has created a chilling effect on credit extension that will only hurt troubled companies. For instance it has negatively affected my ability, as a credit and risk manager, to feel safe selling on terms to our customers when they appear to be headed into financial trouble. Up until the

Circuit City case, Section 503(b)(9) enabled us, as a vendor, to sell more freely to distressed customers because it was a remedy that could be relied on, and an element of the statute that was part of our credit decision process. We could say that even if this particular customer were to file, we'd still be able to collect a certain amount of money, and secure ourselves with a higher claim position because of 503(b)(9). As it was in Circuit City, and as it has been in other cases, this claim could be worth millions of dollars, and so being able to rely on it makes us considerably more likely to ship product to a company that we wouldn't be able to ship to without knowing this remedy was available. Of course, in Circuit City, some of the claims were rendered valueless, including Samsung's, so what ends up happening is that after we've been stung by the court, and considering the differences from circuit to circuit , we're less able to rely on that 503(b)(9) priority claim, and thereby less likely to extend credit to distressed companies. The result is that our company will stop doing business with distressed customers faster, weakening their cash position more quickly, impairing their ability to transact business, accelerating their financial demise, and ultimately increasing the likelihood of them filing bankruptcy sooner than later.

The last creditors' committee I served on was Archbrook Laguna, which was an electronics and small appliance distributor in New Jersey. The company filed bankruptcy and ceased operating and there was nothing left after liquidation to pay the 503(b)(9) claims and general unsecured claims and in this case the banks that were secured were not even paid in full. The case was pretty much a mess from the get-go. We also filed a reclamation claim on Archbrook but it made no difference as there were basically no assets left to liquidate to make the banks whole. As you can see, even with 503(b)(9), unsecured creditors are often left with little or no payment for goods received—essentially through fraud—in the days leading up to a bankruptcy filing. 503(b)(9) is a useful tool, but not without its shortfalls. It is not, however, the reorganization buster that some pundits have suggested.

General Unsecured Recoveries

I disagree with policy arguments by some secured lenders that the repeal of 503(b)(9) is needed to once again restore balance to the relationship between secured and unsecured creditors. An April 16, 2013 study and report by Fitch Ratings suggested that a tremendous disparity remains—as one might expect—between payment of secured and unsecured claims. Specifically, Fitch studied bankruptcy case details for 20 large retail bankruptcies. While first-lien creditors experienced "outstanding" recoveries with at least one being paid in full in each of the 20 cases, unsecured recoveries were considerably lower, with the median recovery being about 10%, and the average recovery around 20%. When Samsung sees a customer's bankruptcy coming, we take steps to exit the market before the actual filing. Doing so has allowed us to avoid being left holding an unsecured claim in a majority of the 25 cases that we've seen since I joined the company in 2003. The only two cases where we held a general unsecured claim were Circuit City and Archbrook Laguna. In Circuit City, we settled our claim for about $50 million less than it was worth, and have so far received three installment payments for a total of 15% of our settlement value. In Archbrook, since the bank wasn't even made whole, I expect that we'll either receive less than 5% of the value of our claim or, most likely, nothing at all.

Creditors' Committees

Finally I would like to emphasize to the Commission the importance of strong creditors' committees in the Chapter 11 process. Chapter 11 is a process that works best when all parties are at the table, and part of that process involves funding an unsecured creditors' committee. If the goal of the proceeding is merely to sell the debtor's assets in order to satisfy the secured lender, there are other alternatives for companies and lenders hoping to do that. Debtors looking to successfully reorganize using Chapter 11 should be required to "pay to play," so to speak, and have the resources necessary to ensure that all parties are involved in the process.

There is certainly less liquidity and more secured debt in the market today and reorganization is more difficult as a result. Creditors' committees bring credibility to the process by allowing creditors to determine whether the liens of the secured creditors are valid, examine other assets which may have value, such as fraudulent conveyances and preferences and claims against insiders, and make sure that the process is fair and economical. Creditors' committees also bring a valuable perspective into the case for the court as the vendors, unions and other parties who are part of the committee body are knowledgeable of the debtor's industry and business.

Again, I'd like to thank the Commission for allowing me to speak here today, and I'd be happy to answer any questions.