Remain on Guard: Lessons for Trade Creditors in a post-Toys "R" Us World

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As originally published in the Credit Research Foundation 2Q 2018 CRF News

In today's retail bankruptcy environment, obtaining "critical vendor status" is not enough. Many predict that 2018 will continue being an active year in retail bankruptcies, especially for highly leveraged retailers. Since our last article, numerous well-known retailers have filed for protection under the Bankruptcy Code, including: Bon-Ton, Claire's, Nine West, and Toys "R" Us. Not even one of the most profitable holiday seasons in recent history should put retailers at ease. For trade creditors, one overarching theme remains the same: be on guard, and protect your rights.

The Retail Bankruptcy Surge Continues

Without a doubt, market pressures have intensified the trend of failing retailers. In a recent study of 100 retail CEOs, CIOs, and CFOs, 94% of these executives believe that 2018 retail bankruptcies will, at a minimum, maintain their 2017 levels (40% of these believing that retail bankruptcy levels will increase). During late-2017/ early-2018, numerous high profile retailers filed for bankruptcy. These include:

- **The Bon-Ton Stores**

The department store giant filed its bankruptcy petition on February 4, 2018. It owns multiple department stores, such as: Bon-Ton, Bergner's, Boston Store, Carson's, Elder-Beerman, Herberger's, and Younkers. The company is currently in the process of winding down its business after two liquidating firms won an auction for its assets.

- **The Walking Company**

The shoe seller filed for bankruptcy protection on March 6, 2018. The Walking Company operates approximately 208 stores nationwide. After entering bankruptcy with the support of its major shareholders and financing commitments, The Walking Company plans to exit bankruptcy quickly.

- **Claire's**

On March 19, 2018, the jewelry chain filed for bankruptcy due, in part, to sharp decreases in consumer traffic in shopping malls. Claire's plans on closing many of its stores, most of which are in shopping malls. The company also plans on exiting from its Chapter 11 case in September 2018 with a large reduction in debt.

- **Nine West Holding**

This well-known footwear and clothing company filed for bankruptcy on April 6, 2018. The company listed over $1 billion in debts. Nine West filed with: (i) what is known in bankruptcy parlance as a "stalking horse" asset-purchase offer (subject to a competitive sale process) for its flagship brands; and (ii) a plan for its creditors to take over its remaining business.

- **Toys "R" Us**

With over $7 billion in total liabilities, Toys "R" Us filed for bankruptcy on September 19, 2017. As discussed below, this toy giant's bankruptcy should serve a cautionary tale for trade creditors.

Toys "R" Us' Bankruptcy Implications for Trade Creditors

This iconic brand's bankruptcy has taught us that not even critical vendors are safe. Toys "R" Us filed for bankruptcy right before its high sales season: the holidays. Upon filing, the company sought billions of dollars in financing and reassured its trade creditors that, while unprecedented, the amount sought would provide Toys "R" Us with sufficient liquidity to ensure a successful holiday season and provide additional capital to reinvest in unsecured creditors' businesses. However, such was not the case.

With Toys "R" Us' sales plunging approximately 15% from the previous year, the holiday season delivered another blow to the distressed company. Immediately after, Toys "R" Us missed payments to its suppliers without any explanation, and the company's CEO delivered somber news to his 30,000 employees: Toy "R" Us would close shop. Trade creditors quickly shifted gears to maximize value and seek further protections. At the time, Toys "R" Us had over $450 million in post-bankruptcy petition unpaid merchandise payables, and had defaulted on around $150 million in post-bankruptcy petition trade obligations. Most disturbing was the fact that goods shipped to Toys "R" Us on unsecured trade credit were destined for liquidation via going-out-business sales for secured creditors' benefit.

While larger and more stable trade creditors may find a way to weather the Toys "R" Us storm, numerous smaller trade creditors find themselves in precarious situations given their significant losses in revenue and inventory. Moving forward, trade creditors must: (i) go to great lengths to understand their clients' financial state; and (ii) adopt practices that ensure their account receivables are protected.

Lessons for Trade Creditors Moving Forward

In addition to our previous recommendations – namely, obtaining critical vendor status, raising section 503(b)(9) claims, and asserting reclamation rights – the following are other ways trade creditors can protect their rights in a post-Toys "R" Us retail environment:

1. Know your customers better than they know themselves.

Trade creditors must do their homework, and learn as much as they can about their customers. While the internet may be a reason for brick-and-mortar retailers' demise, it is trade creditors' best resource for information. If the retailer is a publicly traded company, the Securities and Exchange Commission's website will have the details on said retailer's financial health. Additionally, the internet – along with trade creditors' legal and financial professionals – is a great source for finding lawsuits and/or liens filed against retailers.

Trade creditors must use this information, in addition to their internal business observations, to spot signs of financially distressed retail customers. Among others, these signs include:

a) Substantial operating losses and/or negative cash flow;

b) The taking out of excessive loans, leading to an increased default risk;

c). An increase in past due payments for merchandise;

d). If the retailer has issued securities, falling stock and/or bond prices;

e). Credit agencies downgrading the retailers rating to "junk status";

f). The restriction or loss of the retailer's credit insurance coverage;

g) If the retailer is a public company, a delay in the releasing of financial information;

h). Resignations by the retailer's CEO/CFO/CIO and/or other significant management or executive officials; and

i) The hiring of a Chief Restructuring Officer.

2. Consider implementing aggressive repayment practices.

Stricter repayment practices include: cash on delivery, cash in advance, or payment of all outstanding obligations. The best way to avoid an outstanding balance on trade credit agreements is to avoid the balance becoming outstanding altogether. This is particularly advisable if one of the previously mentioned warning signs manifests itself.

Of course, if payments are made within 90 days of a retailer's bankruptcy filing, then they are susceptible to preference actions. The Bankruptcy Code, via these preference actions, allows a debtor-in-possession or a trustee to avoid and recover transfers made to creditors within 90 days of the bankruptcy filing to the extent that these payments give creditors an advantage over other creditors. However, trade creditors may be better off raising preference action defenses to keep what is in their bank accounts than fighting over scraps in the reorganization or liquidation process.

It may be a challenge for some trade creditors to implement aggressive repayment practices with strategically important retailers – like Toys "R" Us – due to their negotiating power. In which case, there are other solutions that protect trade creditors from the losses resulting from a retailer's default, such as obtaining trade credit insurance.

3. Obtain trade credit insurance.

Trade credit insurance will allow a trade creditor to protect itself from a major retailer's default and/or the risk of a preference action. Trade creditors must make sure that their trade credit insurance includes preference coverage, as some insurers omit this coverage altogether. Additionally, trade creditors must ensure that their trade credit insurance policy's protection from a retailer's nonpayment is as broad as possible. Consulting with the right attorney and broker is advisable when considering buying these policies. Lastly, trade credit insurers can be a great source of information on a retailer's financial health. Even if trade creditors decide against buying this type of insurance, the information obtained from trade credit insurers could be quite valuable.

4. Demand adequate assurance for due performance.

Pursuant to § 2-609 of the Uniform Commercial Code, if a trade creditor has doubts about a retailer's ability to perform its obligation under a contract between the parties, the trade creditor may demand adequate assurance of future performance. Essentially, the trade creditor would suspend its performance under its contract with the retailer until the retailer makes assurances of its ability to pay. In making a demand for adequate assurance, trade creditors should request the type of assurance that is reasonable under the circumstances. This is usually determined by using the good faith commercial standards between the retailer and the trade creditor.

The right to adequate assurance under the Uniform Commercial Code remains the same after the retailer files for bankruptcy. However, if the retailer is in bankruptcy, trade creditors would be wise to file a motion in the bankruptcy court seeking adequate assurance and, if it is not received, a motion to terminate a trade creditor's obligation to supply the goods.

Conclusion

If 2018 has taught trade creditors anything it is that the retail bankruptcy surge has not subsided. Distressed retailers have discovered new ways to avoid paying even their most critical vendors. In order to survive the current retail bankruptcy pandemic, trade creditors must: (i) know their retail customers better than they know themselves; and (ii) act quickly to assert all of the available remedies when dealing with a financially distressed retailer. In essence, trade creditors must always be on guard, or risk realizing small or no recoveries on their claims.

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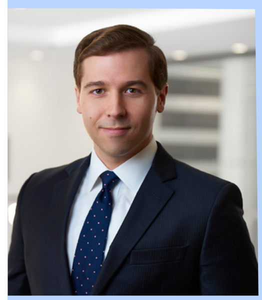

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