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Risks for Chapter 11 Debtors Selling to Large Retailers

Chapter 11 bankruptcy filings often are triggered by a need to restructure secured indebtedness—either because the borrower cannot make principal and interest payments or cannot fund its cash flow needs or the lender deems itself insecure due to continued losses or some other precipitating event.

The debtor (borrower) typically turns to its financial advisor for guidance. Typical alternatives include a Chapter 11 bankruptcy filing, refinancing and taking out the lender, a forbearance agreement (with accompanying fees, additional collateral, new guarantee, etc.) or a commitment to sell the borrower's business.

When evaluating restructuring options, a vendor that sells to major retailers should analyze its options beyond simply looking at the law and professional fees. The mass merchant, big box retailer or supermarket chain has little patience if its reputation is at risk due to problems suffered by a vendor.

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Chapter 11 provides many positives. The "automatic stay" provided by the Bankruptcy Code freezes the lender in its tracks (at least until the lender seeks relief from the bankruptcy court). Unsecured creditors cannot press for collection; leasing companies cannot regain leased equipment on account of arrears; and, the law carefully considers allowing a debtor to downsize, restructure its debts and get a "fresh start."

For vendors to large retailers, analysis must go further. It does not end with the professional fee cost—which can be substantial. Besides paying its own attorney and financial advisor, the debtor also has the *privilege* of paying attorney and financial advisor fees for the unsecured creditors committee. Furthermore, the secured lender will seek reimbursement of its legal fees and financial advisory fees. Finally, the debtor pays quarterly fees to the U.S. Trustee (part of the Department of

Justice), which oversees the administration of bankruptcy cases. Even when the lender is not hostile, these fees can build up rapidly. And, if the debtor commences a Chapter 11 case without consensual financing from the lender, the costs of litigation can cripple a debtor in terms of professional fees and the debtor's officers time away from doing what they do best—which is running the debtor's business.

When considering alternatives for a distressed borrower, the benefits of a settlement with the lender are important to consider. Rest assured, I am not recommending that a debtor "roll over" too easily. I am merely suggesting that, in evaluating a settlement, one should consider the "fully loaded" costs of not settling. Oftentimes, the primary beneficiaries of not settling are the attorneys. So, what are the costs?

There are costs for professional fees of a Chapter 11 and also "management diversion" costs. The Chapter 11 process takes up a lot of management's time preparing financial projections, operating reports and liquidation analyses. In addition, there are meetings with the creditors committee, meetings with the lender and hearings in bankruptcy court. Then, perhaps most costly, is the time that management spends dealing with concerned customers and vendors, seeking to restore trade credit and addressing premature rumors of the debtor's demise circulated by competitors. Assume that every hour of management time is valued at $500. You can see where this is heading.

For debtors that sell to major retailers, there are additional considerations beyond dollar cost. There are unique problems faced by companies that sell goods or services to Chapter 11 debtors with significant lead time between order placement and delivery of the goods or services to the retailer.

Major retailers plan out their programs and promotions well in advance. Items selected for newspaper advertisements or seasonal promotions are chosen far ahead of delivery. A retailer does not want to risk promoting a product and then learning at the 11th hour that the debtor cannot deliver—leaving the retailer with a lot of explaining to do to customers and scurrying to find a suitable substitute.

The same problem occurs when a vendor is accused of product tampering, product mislabeling, unclean handling practices or unfair labor practices. Major retailers rarely give vendors a second chance, and Chapter 11 gives the retailer another reason to switch suppliers. Furthermore, the ability to sell vendor's assets or business is greatly diminished because there are two clouds over the vendor—financial and reputational.

Prospective clients often tell me that they have a long-term relationship with a particular retailer and that the vendor is important to their business. When the vendors call the retailers to ask for continued support, inevitably the buyers say "yes." But, behind the scenes, it is a very different story.

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I do not know any credible buyer for a retailer who would risk his or her job for a vendor. Buyers don't want to risk having to explain to their bosses why they did not second source when they knew that the vendor was in trouble. Retail buyers don't want to deal with having to run around sourcing a product that is key to a promotion. So, when a client tells me about the great relationship, I discount the statement. I then tell the client to expect a falloff in business. It may not occur immediately, but get ready for it. If it does not occur, it was still better to be safe than sorry.

So, what does this mean for potential Chapter 11 debtors selling to major retailers? First, when evaluating alternatives, one must consider not only the professional fees of the debtor, but also the fees of all other professionals owed by the debtor. Second, there is the cost value of management time spent on the Chapter 11 process. Third, weigh the opportunity cost of management spending time on the Chapter 11 process rather than on running the business. Finally, consider the potential "hit" to the business from customers that do not fully understand the Chapter 11 process, and that only hear the word "BANKRUPTCY" and panic.

This does not mean that Chapter 11 should never be employed. Given the choice between surrendering and closing the doors or fighting for survival (even against fierce competition), the smart course to follow may be to file. But, for a debtor in Chapter 11, the best way to reduce the harm that arises from nervous customers is to exit Chapter 11 as quickly as possible. In other words, be in a position to tell retailers promptly that you are emerging from the reorganization process and that their faith was warranted.

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To emerge from Chapter 11 relatively quickly, there are negotiations with the lender and with the unsecured creditors committee that must occur. Similar to evaluating the cost of an out-of-court resolution and a Chapter 11, you should carefully evaluate the negotiations over a plan of reorganization. Take into account the value of being able to cease the drain from professional fees, the cost of management's time being diverted and the inevitable risk of continuing to be a Chapter 11 debtor.

A debtor should not fear lenders, creditors' committees or the cost of Chapter 11. A smart vendor to a major food retailer evaluates the cost of Chapter 11 and then the cost of emerging in a holistic manner. Though I agree with Harry Truman about walking softly and carrying a big stick, when I am evaluating whether to use the stick or to settle, I want to completely understand the real cost of each.

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He has extensive experience helping companies develop viable solutions to financial crises, including Chapter 11 reorganization, out-of-court workouts, financial reorganization and litigation. Kenneth is a regular contributor to New York Metro area real estate publications and has written extensively about bankruptcy in the general business press.