

II Positioning for Retail Bankruptcies

Retail Bankruptcies Are Skyrocketing: Creditors, Protect Your Rights!

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2017 has been a tough year for the retail industry. At least a dozen major retailers have filed for bankruptcy this year, including The Limited, Wet Seal, Eastern Outfitters, RadioShack, MC Sports, BCBG Max Azria, hhgregg, Gander Mountain, Gordmans, Payless, rue21 and Gymboree. We are only halfway through the year and have already seen a greater number of major retail bankruptcies than in all of 2016.

Several causes have been attributed for the surge in bankruptcy filings. Clearly, online retailers such as Amazon are partly to blame. Some have speculated that consumers no longer find shopping in malls entertaining, and others point out that online comparison-shopping has created additional competition for brick-and-mortar stores. Whatever the reasons, retail bankruptcy filings are unlikely to slow down in the near future, and those directly affected by them, such as a retailer's vendors, must act quickly to protect their rights and maximize their recoveries.

My Customer Filed for Bankruptcy. Now What?

When a retailer files for bankruptcy, there are four possible outcomes: a complete liquidation, a sale of the business as a going-concern, a reorganization of the retailer's business or, most common, a hybrid of one or more of these outcomes. Each of these four outcomes almost always includes the closure of a significant percentage of the retailer's stores and/or business segments.

In a complete liquidation, the bankrupt retailer (known in bankruptcy parlance as the "debtor") will usually hire a liquidation consultant to conduct "going out of business" sales at each of the debtor's stores. All of the debtor's inventory and other assets will be sold, the debtor will no longer remain in business after the bankruptcy case, and each of the store leases will either be sold (if the lease is below market) or terminated (if the lease is at or above market).

From a vendor's perspective, a complete liquidation is the worst-case scenario. As in most retail bankruptcy cases (regardless of the outcome), the vendor's recovery on its pre-

bankruptcy claims will likely be minimal—because higher ranking claims against the debtor, such as secured claims, administrative expense claims and priority claims, usually exceed the amount of liquidation proceeds—but the additional downside of a complete liquidation is that the vendor will no longer have a customer to work with post-bankruptcy.

Although some retailers file for bankruptcy with the stated purpose of liquidating and closing all of their stores—such as Wet Seal did this year—many retailers file bankruptcy with the intention of reorganizing or selling their business as going concerns only to switch gears to a complete liquidation when these initial efforts are unsuccessful. For example, The Sports Authority's 2016 bankruptcy filing concluded with a liquidation and closure of all 464 of its stores, even though it had originally planned to close less than half of them and sell the remaining stores as a going concern. Similarly, electronic retailer hhgregg is currently in the process of liquidating all 220 of its stores after it was unable to reorganize or find a purchaser of its business as a going concern.

Many retail bankruptcies do not end in a complete liquidation. Oftentimes a debtor's profitable stores or business segments will be sold to a purchaser (usually a competitor or similar retailer looking to expand its business) through an auction process supervised by the bankruptcy court, and the debtor's unprofitable stores will be liquidated.

Gander Mountain's currently pending bankruptcy case is an example of a partial liquidation, partial going-concern sale outcome. In that case, Gander Mountain retained liquidation consultants to liquidate all inventory at Gander Mountain's approximately 160 stores. At the same time, Camping World purchased Gander Mountain's intellectual property and rights to its store leases, which will allow Camping World to continue to operate as many Gander Mountain stores as it chooses (Camping World has indicated it will keep open at least 70 Gander Mountain stores). Teaming up with the liquidation consultants to

liquidate the inventory enabled Camping World to effectively purchase Gander Mountain's stores as a going-concern at a significantly reduced price.

The sale of a retailer's business through the bankruptcy process is better, from a vendor's perspective, than a complete liquidation, even if the vendor's recovery on its pre-bankruptcy claims may not be significantly greater. After the retailer's business is sold, the vendor may have a new (and, hopefully, more creditworthy) customer to work with. In addition, if the purchaser of the business wishes to take an assignment of a vendor's contract, the Bankruptcy Code requires that the vendor's claims (including any arrears) related to that contract be paid in full.

The least common outcome in a retail bankruptcy case is a reorganization (also known as a restructuring) of the retailer's business. Reorganization allows a debtor to reduce its debt and other obligations, liquidate or sell its unprofitable stores or business segments, and maintain downsized operations. To effectuate the reorganization, the debtor will propose a Chapter 11 plan of reorganization (which is usually the product of negotiations with the debtor's creditors) that will govern the treatment of creditors' claims. Creditors are entitled to vote whether to accept or reject the plan, and the plan must ultimately be confirmed by the bankruptcy court.

For example, Payless, which is in the process of closing more than 500 of its approximately 3,500 North American stores, recently filed a Chapter 11 plan of reorganization that proposes to pay a portion of most creditors' claims. If confirmed by the bankruptcy court, the plan will allow Payless to reduce its debt, obtain new financing for its reorganized entity and maintain operations.

Protecting Creditors' Rights and Maximizing Recoveries

A vendor must act quickly as soon as it learns that its customer has filed for bankruptcy. An inattentive vendor will likely receive little or no recovery on its claims, but there are several things a vendor can do to protect its rights and maximize recoveries on its claims.

Obtain Critical Vendor Status

After it files for Chapter 11, a retailer will typically file a motion on the very first day of the bankruptcy case seeking authority to pay all or a portion of the claims of its "critical vendors." These favored vendors are typically suppliers of goods or services that the debtor cannot easily

obtain elsewhere and are critical to the operation of the debtor's business. Because vendors are almost never contractually obligated to continue to provide goods or services to a debtor, the debtor will seek authority to pay its critical vendors' claims in exchange for the vendor's agreement to continue to do business with the debtor for the duration of the bankruptcy case. The amount the debtor will pay, and the credit terms the vendor will be required to extend, are usually negotiated.

Being part of the critical vendor "club", which, depending on the case, may include many or just a few vendors, has obvious benefits. Critical vendors are paid earlier and substantially more on their pre-bankruptcy (known in bankruptcy parlance as "pre-petition") claims—which are usually general unsecured claims that would otherwise likely be paid, at most, cents on the dollar—than vendors that are not treated as critical vendors. Upon learning of its customer's bankruptcy filing, a vendor should immediately reach out to the debtor's businesspeople and/or bankruptcy professionals to request that the vendor be treated as a critical vendor for purposes of the bankruptcy case. The greater the debtor's need for the vendor's goods or services during the bankruptcy case, the greater the likelihood that the debtor will agree to provide a vendor with critical vendor status. The decision whether or not to treat a vendor as critical is typically within the debtor's discretion, subject to the bankruptcy court's oversight and a cap on the aggregate amount a retailer can pay to critical vendors. Thus, a vendor should request treatment as a critical vendor as early in the case as possible to ensure that the debtor has not already committed its limited funds to other critical vendors.

Assert Section 503(b)(9) and Other Claims

Most of a vendor's pre-petition claims will be general unsecured claims, which are entitled to payment only after other higher ranking claims are paid in full. Section 503(b)(9) of the Bankruptcy Code, however, grants a goods seller an administrative expense priority claim for the value of goods sold to the debtor in the ordinary course of such debtor's business that the debtor had received within 20 days prior to its bankruptcy filing. Section 503(b)(9) priority claims are valuable because they must be paid prior to payment of lower ranking unsecured claims, and the Bankruptcy Code requires the full payment of all Section 503(b)(9) claims as a condition for approval of a Chapter 11 plan.

In most Chapter 11 cases, the debtor will file a motion to establish a deadline and procedure for filing pre-petition claims, including Section 503(b)(9) claims. If a creditor does not file its claim by the deadline and in the manner required by the bankruptcy court, the creditor is at risk of not receiving any recovery on account of its pre-petition claims.

The Bankruptcy Code also provides a vendor with an administrative expense priority claim for any goods or services sold and delivered to a debtor after the bankruptcy filing, and a debtor is required to pay such claims in the ordinary course of business. Before delivering any goods or services, however, a vendor must consider the debtor's ability to pay for them. After a bankruptcy filing, a debtor is no longer required to pay most pre-petition claims, which will enhance the debtor's cash flow, but the vendor must assess whether the debtor has sufficient liquidity during the bankruptcy. Most debtors obtain financing from lenders during the bankruptcy, which will usually provide the debtor with sufficient liquidity to pay its vendors for goods or services provided during the bankruptcy case. Although uncommon, if the debtor defaults under the terms of financing, or if administrative expense claims exceed the amount of financing, administrative expense claims may not be paid in full. Vendors are sometimes required to file requests for payment of their post-bankruptcy administrative expense claims (to the extent the debtor did not already pay them in the ordinary course), so vendors must monitor the bankruptcy court's docket to ensure they do not miss any important filing deadlines.

Assert Reclamation Rights

A more limited right is a creditor's right of reclamation. The Uniform Commercial Code provides goods sellers with a right to reclaim (i.e. demand the return of) goods its customer received on credit while insolvent. Bankruptcy Code Section 546(c) recognizes a creditor's reclamation rights under state law. Under Section 546(c)(1), a creditor can reclaim goods that it had sold in the ordinary course of its business on credit to the debtor that the debtor had received within 45 days prior to bankruptcy. A creditor's reclamation rights are contingent upon the creditor sending a written reclamation demand to the debtor identifying the goods not later than 45 days after the debtor's receipt of the goods. If the 45-day period expires after the bankruptcy filing, the creditor has up to 20 days after the bankruptcy filing to send a reclamation demand. The reclaiming creditor must also prove

the debtor was insolvent when the goods were received and that the goods were identifiable and on hand when the demand was made.

A reclaiming creditor's rights are subject to the prior rights of a secured creditor (such as a lender) with a security interest in the debtor's inventory. Put another way, a secured creditor with a lien on the debtor's inventory that arose before a reclamation demand has priority over the goods sought to be reclaimed because those goods are part of the debtor's inventory. In most cases, the debtor's secured lender has a lien on nearly all of the debtor's assets, including inventory, which may render reclamation claims worthless. Several bankruptcy court decisions, however, have upheld reclamation rights under certain circumstances even where a lender had a prior lien on the debtor's inventory. Thus, to preserve its reclamation rights, a vendor should consider sending a reclamation demand to its customer immediately upon learning of its bankruptcy filing.

Conclusion

The surge in major retail bankruptcies is not likely to subside in the near term. Proper pre-petition planning is crucial to reduce a vendor's exposure in the event its customer files for bankruptcy. But even after the customer's bankruptcy filing, all is not lost. A vendor should act quickly to assert its rights and maximize recoveries on its claims.

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