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Business Track

Retail Restructuring and Liquidation

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Survival Tips for the Mounting Retail Woes: Some Practical Considerations

By: Clinton E. Cutler & Steven R. Kinsella, Fredrikson & Byron P.A.

Over the past few years, the retail industry has seen a seismic change in the market. While retail sales in the United States exceeded $5.08 trillion in 2017[1] and saw year over year sales growth of 4.2%,[2] the past year also saw over 9,600 stores close and former retail leaders, such as Toys "R" Us, Bon-Ton, and RadioShack, file for bankruptcy protection.[3]

What are some of the possible causes of this changing retail landscape?

The growth of online sales is likely the largest factor. Online sales currently constitute approximately 13% of all retail sales and grew over the past year at a rate of 16%.[4] The rise in online sales is based in part on consumers placing increased value on speed and ease of delivery. Major big box retailers are thus forced to compete in the online arena against companies that are not burdened by the operational costs related to large brick and mortar stores (such as building leases and store employee expenses). Many traditional large retailers were also late to the online shopping game and did not have the initial capability to compete with the price, speed, and ease of delivery offered by original online retailers.

Another factor is the entry of individual vendors into the market. Many vendors have opened their own stores or are selling the same products online as their customers. These vendor-operated stores directly compete with larger retail stores, all while the vendor continues to supply the retailers with less exclusive products. The vendor profits from sales at either store and can be price-competitive based on lower operating costs. Individual vendors also have the ability to compete directly with large retailers online.

Finally, there is a current overall shift in consumer spending, with consumers moving towards valuing service and experience over goods. Growth in sales in the travel and restaurant industries has substantially outpaced the growth seen in the retail industry.[5]

How do you advise a large retailer facing significant financial hurdles?

First, you need to complete an initial financial assessment with the aid of a strong financial consultant, examine the overall debt structure, and evaluate lender and creditor fatigue. Then you need to conduct a strategic review of all potential options. Ultimately, the possible options are necessarily limited by available capital and projections for how long that available capital will last. While filing bankruptcy may become a necessity, some non-bankruptcy options include downsizing by closing poor-performing store locations, growing the online presence, and building around successful brands offered by the retailer.

During this process, you will have to manage information and publicity. Many vendors communicate with each other and information on retailers' financial performance is widely available. Traditionally, many retailers have sought relief under the Bankruptcy Code after the holiday sales season, and vendors know that filings often occur in the first calendar quarter of each year. In addition, a wrongly-timed public disclosure will negatively impact consumer shopping decisions. For instance, hearing that a retailer is closer to liquidating may cause consumers to wait for a liquidation discount or decide against purchasing a warranty plan on a product. While the retail industry is a national industry, it is also a surprisingly small community with multiple relationships between different parties in interest, making it difficult to keep information secret. Additionally, large retailers have teams of thousands of employees and consistency in message is extremely important. A major part of advising a large retailer in this early stage is balancing the strong tension between full disclosure and information control.

If bankruptcy appears to be necessary, pre-bankruptcy planning plays a major role in a successful retail bankruptcy case. Many retailers have limited time in chapter 11 to decide on a course of action. This is often because of the interaction between the deadlines of § 365 to assume or reject leases (usually an outside date of 210 days from filing absent landlord consent to extend the deadline) versus the time needed to complete a liquidation or going out of business sale before leases need to be rejected. Usually the liquidation process for retail will take about 10-12 weeks from start to finish. Therefore, using the pre-filing period to settle on a course of action for the bankruptcy case is crucial. At this early stage, a decision must be made regarding the overall strategy of the bankruptcy filing—attempt to reorganize with a plan or sell the assets through a § 363 sale either on a going concern or liquidation basis. A plan of reorganization resolves a wide range of issues and is more likely to result in a return to junior creditor classes and equity, but it can be slow, cumbersome, with high costs, and require creditor approval. A sale of assets moves faster, is less costly, and turns property quickly into cash, but it does not resolve all case issues and a poor sale result may render the bankruptcy case administratively insolvent. Due to the normal debt structure and inventory issues, the majority of large retail cases end up proceeding with an asset sale.

After selecting an overall strategy, the next key decision is when to file the bankruptcy case. Ultimately, cash is king, and the availability of liquidity will be the most determinative factor in deciding when to file. Especially in large retail cases, filing too late can result in running out of cash, limiting access to DIP financing and thereby limiting strategic options, and possibly forcing a liquidation. If there is sufficient cash to provide for some flexibility regarding the timing of the filing, some factors to consider include filing later in a month to minimize stub rent and timing the filing based on product delivery dates to minimize 20-day and reclamation claims. Large retail bankruptcy cases involve numerous moving parts, so it is extremely difficult to perfectly time the filing, but doing appropriate pre-bankruptcy planning may save all parties involved headaches once the case is commenced.

While it is impossible to predict the future, the quickly shifting retail market and the overall economics of large brick and mortar retailers continues to signal financial trouble for these historical large retailers. Understanding these market conditions and selecting the appropriate strategy are keys to surviving a retail bankruptcy case.

Navigating the Case

Once the petitions are filed, the debtor usually has a short window to seek approval of the course of conduct it wishes to pursue. Importantly, the debtor must manage creditor expectations regarding post-petition operations and the ability to generate cash to pay administrative and priority claims, satisfy pre-petition and DIP lender concerns, and maintain operations. Below are a few of the issues that must be managed:

- <u>Secured Lender Financing:</u> Many retailers finance their operations using credit secured by inventory and most other assets. Lender financing is usually based on a formula that estimates the liquidation value of the merchandise. Lenders will frequently seek to reduce the percentage of eligible inventory they are willing to lend against, thereby reducing liquidity at a time when many debtors need access to additional liquidity. As a result, most retail debtors seek access to DIP credit in order to have adequate access to cash to fund operations and additional costs imposed by the bankruptcy process.

- <u>Vendors:</u> Vendors typically seek allowances for administrative expenses for reclamation and § 503(b)(9) claims. Vendors or the unsecured creditors committee will likely pressure the debtor and lenders for carve-outs from existing credit facilities or set asides of cash to ensure payments on these claims can be made later in the case.

- <u>Landlords:</u> Likewise, landlords will seek allowance and payment of claims under leases, including stub rent, and may audit past lease performance and seek allowance and payment of episodic payments due under the lease, such as annual common area maintenance ("CAM") charges and adjustments, property taxes, repairs, and maintenance.

- <u>Customers:</u> Customer deposits and gift card treatment will need to be addressed. Many retailers will have significant booked liabilities for gift cards issued in the years before the filing that have not been redeemed. Legal issues will arise concerning whether the cards are entitled to treatment as a priority customer deposit under § 507 or are unsecured claims without priority. The decision to redeem pre-petition gift cards versus not redeeming the cards can raise difficult issues regarding liquidity (will there be a rush to redeem cards if the debtor decides to do so) versus maintaining going concern good will.

- Employee Claims and Morale: Usually pre-petition employee claims, especially those that are within the priority caps in § 507, will be paid. But employees will want to know what the future holds for their jobs and benefits. Having a communication plan in place regarding the employees is of critical importance, especially where operations may be far flung. Usually the debtor will want to employ KERP and KIEP plans and will need to navigate the limitations on such plans contained in § 503 of the Code.

The Sale Process

For reasons expressed above, the timeline in a retail case can be very compressed. Consequently, most retailers employ a § 363 sale process either to implement going concern sales of some or all of the assets or to approve a whole chain liquidation. Below are some practical considerations for sales.

Debtors are usually confronted with a short time frame (30-60 days) to complete a sale approval process. The reason is the need to complete disposition of the assets before the deadline to assume or reject leases. For example, running a whole chain liquidation can take 10-12 weeks from final sale approval.

Depending on the size of the debtor's operations there may only be a handful of liquidators with the resources to undertake a liquidation or the ability to make an upfront guaranteed payment. This may practically limit the competitive landscape and consequently the prices received for the merchandise.

Many liquidators employ either an agency model or a consulting model for disposition of merchandise. Under the agency model, the liquidator is appointed as the sole agent to take charge of the merchandise and process, and utilize debtors' stores, employees, and systems to conduct the sale. The debtor's main role in such a process is to support the operations and manage costs. Under the consulting model, the debtor pays the liquidator for services to support a sale that the debtor conducts. Many retailer management teams have experience with store closing sales but not with whole chain liquidations.

Liquidators typically reimburse or pay for costs on a per diem or less than full month basis. Most debtors do not have cost information structured that way, thereby making it challenging to know if they will be subsidizing costs in the sale or will be fully reimbursed. Budgeting and accurately forecasting the costs of the sale are critical in negotiating terms with the liquidator.

Another decision the debtor will confront is whether to negotiate for a guaranteed up-front payment from the liquidator or accept more risk from the outcome of the sale without a guaranty. Lenders typically prefer the up-front guaranty payment because of the certainty it provides and timing on receipt of the funds (although guaranteed payments can be subject to adjustment). Debtors and committees usually prefer to maximize the recovery.

Going concern buyers may be financial buyers or strategic buyers. The main difficulty with both is getting them up to speed in time to compete in the sale process and be ready to close quickly on a transaction once approved. Both buyers will want to take time to negotiate with landlords and vendors on go-forward terms of leases or supply arrangements. Landlord negotiations can be particularly protracted if the buyers want significant concessions.

Conclusion

Large retail bankruptcy cases involve a number of complex legal and strategic issues. Pre-petition planning, always important in successful chapter 11 cases, is even more critical for retail cases because of the compressed timetable in the typical retail case. These types of cases move quickly and often end in going concern sales or liquidations as a result of the compressed timeline.

Anatomy of a Retail Bankruptcy:
The Gander Mountain Case Study

By: Clinton E. Cutler & Steven R. Kinsella,
Fredrikson & Byron P.A.

Gander Mountain Company and Overton's, Inc. (together, the "Debtors") were jointly one of the nation's largest specialty outdoor sporting goods retailers for hunting, fishing, camping, shooting, and outdoor lifestyle products. The Debtors each filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code on March 10, 2017. In the five years prior to the bankruptcy filing, the Debtors had expanded rapidly, adding 50 new stores, but in the two fiscal years immediately prior to the filing the Debtors accumulated substantial operating losses as a result of the shifting market trends in the retail industry. In their 2016 fiscal year, which ended on January 28, 2017, the Debtors recorded consolidated sales of approximately $1.323 billion, with 162 stores in 27 states. On the date of filing, the Debtors had approximately $450 million in secured debt and approximately $115 million in trade debt, and was dealing with a landlord group of over 80 separate landlords.

Pre-Bankruptcy Planning

Prior to filing, the Debtors' board appointed a chief restructuring officer, and retained an investment banker and bankruptcy counsel with the goals of (1) preserving and maximizing the value of the Debtors' business and assets, (2) complying with the provisions of the Debtors' various secured credit agreements, (3) protecting the interests of the Debtors' other secured and unsecured creditors, and (4) protecting the interests of the Debtors' shareholders and all other stakeholders. The Debtors, along with their professionals, conducted a strategic review of their businesses and operations and ultimately determined that the best available path forward to maximize the value of the Debtors' assets and protect the interests of stakeholders was a sale of a substantial portion of all of the Debtors' assets to one or more buyers on a going concern basis. The Debtors additionally determined that, if no going concern sale materialized, they would engage one or more third parties to assist in conducting a "going out of business" sale process through their retail store and online sales channels.

Shortly after arriving at this decision, the Debtors began soliciting indications of interest from strategic and financial investors regarding a potential acquisition on a going concern basis. In addition, the Debtors also developed a "Store Closing Plan" designed to provide an orderly exit from certain underperforming or unprofitable store locations. Pursuant to the Store Closing Plan, the Debtors identified 32 underperforming or unprofitable store locations at which post-filing closing sales would be immediately commenced in order to conserve resources and also supplement the Debtors' operating liquidity. The Debtors began soliciting proposals from retail liquidation consultants to assist the Debtors in conducting the closing sales at the 32 stores.

The timing of the filing was partially based on the Debtors' analysis of the "stub rent" issue. "Stub rent" is the common term for the amount of rent owed for the period of time between the filing date and the first post-petition rental payment due date. Some courts have held that, under 11 U.S.C. § 365(d)(3), stub rent must be paid immediately and be the prorated amount of the monthly rent based on the number of days remaining in the month.[6] Other courts have determined that 11 U.S.C. § 365(d)(3) necessitates a billing approach, which involves the payment of only rent obligations that become due and payable upon or after the filing date.[7] In planning on the filing, the Debtors determined to file on March 10, 2017, which was beyond the date for payment of March rent (including any grace periods). Consequently, the Debtors felt confident that the bankruptcy filings would not immediately give rise to stub rent claims from landlords.

Store Closing Sales

As one of the Debtors' first day motions, the Debtors sought approval of the Debtors' Store Closing Plan and authority to implement the Store Closing Plan for the 32 underperforming or unprofitable stores pursuant to 11 U.S.C. § 363(b)(1). Additionally, the Debtors sought approval to enter into a consulting agreement with a liquidator, whereby the liquidator would (1) supervise the store closing sales, (2) assist with advertising for the sales, (3) advise on appropriate discounts, staffing levels, and incentive programs, (4) oversee display of merchandise at the closing stores, (5) evaluate sales reporting and monitor expenses, and (6) assist with managing and controlling loss prevention and employee relations, among other things.

Various liquidation laws exist at both the state and local levels that relate to permitting, licensing, signage, bonding, waiting periods, time limits, bulk sale restrictions, and other related laws governing the conduct of store closing, liquidation, or other inventory clearance sales. Many leases contain similar contractual restrictions. In the motion, the Debtors sought waiver of the liquidation laws, arguing that the sales were subject to the Court's supervision under 28 U.S.C. § 1334 and that the Bankruptcy Code preempts state and local laws in conflict with the Bankruptcy Code's policies.[8] The Debtors further argued that bankruptcy courts generally refuse to enforce lease restrictions on going out of business sales because such restrictions "contravene overriding federal policy."[9]

The Bankruptcy Court granted the first day motion and the Debtors entered into the consulting agreement with the liquidator and began conducting going out of business sales at the 32 stores. The Debtors realized approximately $94,189,959 from the store closing sales.

The Auction Process

Due to the Debtors' pre-petition efforts, at the time of the bankruptcy filing, multiple prospective purchasers were conducting significant due diligence, but the Debtors had not received any stalking horse bids. There were three types of prospective purchasers interested in bidding on the Debtors' assets: (1) purchasers interested in buying a substantial portion of the business on a going concern basis, (2) liquidators interested in entering into an agency agreement to liquidate the remaining inventory, and (3) purchasers interested in buying a small subset of assets, such as the e-commerce platform, or taking assignment of specific store locations.

In order to maximize the value of the assets, the Debtors constructed a bidding and auction process that would permit all three types of prospective purchasers to participate. The Debtors ultimately entered into a stalking horse bid from a consortium of liquidators which served as a baseline. The Debtors negotiated a somewhat unique feature which allowed them to remove stores and related merchandise from the liquidation bid, which resulted in an agreed upon formulated reduction in the stalking horse bid price, and also provided for only limited bid protections. This feature allowed the Debtors to continue pursuing going concern bids for a critical mass of stores.

By the bid deadline, the Debtors received 12 distinct bids from various groups. Bids included going concern bids for up to 60 of the stores, plus a competing liquidation bid from a different group of liquidators.

The Debtors convened the auction on April 27, 2017, and the auction ran continually for 29 hours through April 28, 2017. The Debtors recognized the difficulty in comparing bids for different types of assets and structured the auction around bidding on certain lots of assets, beginning with the smaller lots and eventually reaching bids for all assets. The idea behind this structure was to determine if sales of certain smaller lots could be fit within the larger asset bids by carving out those smaller lot assets or combining the bids.

As the auction process moved forward, it became clear that no going concern prospective purchasers would want the Debtors' entire store footprint. Therefore, the Debtors actively worked with going concern buyers to pair them with liquidation bids. This teaming-up process eventually resulted in two main competing groups consisting of at least one going concern bidder teamed with a consortium of liquidators. At the conclusion of the auction, the Debtors agreed to a transaction which paired the highest remaining going concern bid with a contractual joint venture composed of the four national liquidators. Interestingly, while no initial bid sought to purchase lease designation rights, the final going concern bid did include the right to cause the Debtors to assume and assign all of its retail and warehouse facilities on a store by store basis to the going concern buyer once the liquidation sale in the particular store was completed.

To complete the transaction, the Debtors negotiated an agency agreement with the liquidators and a separate asset purchase agreement with the going concern buyer, with attendant transition services agreements so the Debtors would have adequate resources to support the liquidation sale.

The asset purchase agreement provided for the sale of the majority of assets related to Overton's business, the Debtors' intellectual property, and designation rights for all of the Debtors' executory contracts and unexpired leases to the going concern buyer in exchange for $33,021,520.15 in cash, $1,334,238.84 in cure cost payments, and an agreement to pay any further cure costs for executory contracts or unexpired leases the buyer designated, including a guarantee that the buyer would designate at least 17 store leases.

Under the agency agreement, the liquidators agreed to jointly act as the Debtors' exclusive agent and conduct going out of business sales of entire remaining inventory. In exchange, the liquidators agreed to pay a headline price of 92.5% of the Debtors' inventory costs (subject to certain adjustments and deductions). At the conclusion of the sale of inventory, the total amount due to the Debtors was $346,804,969. The sale of FF&E, which the liquidators received a 17.5% commission from, resulted in the Debtors realizing an additional $12,455,967.

The Debtors faced a number of objections to the sale from mainly the FF&E lenders and landlords concerned about the terms of the liquidation sales. The FF&E lenders objected based on concerns over the valuation of their collateral and how sale proceeds would be tracked. The Debtors and the objecting FF&E lenders negotiated a deal whereby the FF&E lenders could elect to pick up their collateral at a given store, permit the sale of the collateral and share in the proceeds, or allow the collateral to be abandoned at the stores. The bankruptcy court approved the sale.

The Debtors commenced the liquidation sales in early May 2017 and the sales were concluded by August 31, 2017, all within the time period provided by § 365 for the assumption or assignment of leases. The sale to the going concern buyer was closed by the end of May 2017. The net proceeds of the two sales, plus the early store closing sale, yielded enough cash to pay the secured lenders in full, pay accrued administrative claims (including stub rent claims of the landlords) and leave approximately $27 million for distribution on other claims.

Conclusion

The Debtors' liquidation plan was confirmed in January 2018. All of the' secured lenders were paid in full and, based on current projections, all administrative expense claims will likely be paid in full, with the remaining balance to unsecured creditors. In addition, the going concern buyer announced a program of re-opening up to 80 stores. The opening of the stores commenced in late 2017 and is expected to be completed in 2018.

Deciphering the Damage Cap

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The recent wave of retail bankruptcies, and the store closings they have left in their wake, has many landlords on unfamiliar turf: the bankruptcy court. Not only is the turf unfamiliar, it is unfriendly. The Bankruptcy Code's[11] provisions governing landlord claims are poorly written and sharply limit the damages a landlord can claim when a debtor-tenant terminates its lease. In addition, the landlord's capped claim will be paid in bankruptcy dollars, likely to be mere pennies on the dollar. Therefore, an understanding of the Bankruptcy Code's limitations on a landlord's lease rejection damages is important to properly counsel landlords at lease inception, in the shadow of a tenant bankruptcy, and in the bankruptcy itself, to maximize the landlord's recovery from the bankruptcy estate. This section summarizes the law relevant to filing a landlord's claim in the bankruptcy of a debtor-tenant that has rejected its lease.

Lease Rejection

A debtor, or trustee on a debtor's behalf, may assume or reject any unexpired real property lease of the debtor.[12] A debtor-tenant's rejection of its lease gives the landlord a claim that the landlord must preserve by filing a proof of claim with the bankruptcy court. When a lease is rejected, it is deemed breached and the landlord has a claim for damages as an unsecured creditor.[13] Any claim arising from the breach is deemed to have arisen before the date the debtor-tenant filed its bankruptcy petition.[14]

Section 502 of the Bankruptcy Code addresses the allowance of claims against a debtor.[15] A landlord's proof of claim, like all proofs of claim filed in a bankruptcy case, is *prima facie* evidence of the claim's validity and amount,[16] and is deemed allowable unless a party in interest objects.[17] If an objection to a landlord's claim is raised, subsection 502(b)(6), which limits the amount of the landlord's claim for future damages against a debtor-tenant, determines the extent to which the landlord's claim will be allowed by the bankruptcy court.

The Cap—11 U.S.C. § 502(b)(6)

Section 502(b)(6) of the Bankruptcy Code imposes a limit or cap on the future damages a lessor of real property may claim as a result of a debtor-tenant's lease rejection:

> *(b) [I]f such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—*
>
> ***
>
> *(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds-*
>
> *(A) the rent reserved by such lease, without acceleration, for the greater of one year, of 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of–*
>
> *(i) the date of the filing of the petition; and*
>
> *(ii) the date on which such lessor repossessed, of the lessee surrendered, the leased property; plus*
>
> *(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates;*
>
> ***

That is, the landlord's future damages are limited to the greater of one year's rent or 15 percent of the total rent remaining for the duration of the lease up to a maximum of three years. The landlord's damages for unpaid pre-petition rent due are not capped.[18]

The purpose of the cap is to compensate a landlord for its loss from a debtor-tenant's rejection of the landlord's lease without giving the landlord such a large damage claim in the case of rejection of a long-term lease that the dividend paid by the debtor-tenant's bankruptcy estate to other creditors would be excessively diluted.[19] The Sixth Circuit Court of Appeals expressed this public policy: "Congress intended to compensate landlords for their actual damages while placing a limit on large future, speculative damages, which would displace other creditors' claims."[20]

It is important to note that the cap limits only a landlord's claim for future damages sustained after its tenant files a bankruptcy petition. While these post-petition damages are limited, the damages the landlord incurred up to the earlier of the date of the petition filing and the date of repossession or lease surrender are not.[21] In sum, the landlord receives actual past damages and limited future damages.[22]

Calculating the Damage Claim—Actual Damages

Section 502(b)(6) simply limits the amount of damages a landlord may claim in a debtor-tenant's bankruptcy and is premised on the existence of a damage claim of the landlord. It is not a formula for calculating the landlord's damages.[23] If the landlord's aggregate actual damages from debtor-tenant's lease rejection are less than the amount allowed by the cap, § 502(b)(6) does not apply. Therefore, the first step in calculating the landlord's claim is to calculate the actual damages to determine if they are subject to the statutory cap.

Courts uniformly hold that a landlord's damages are to be computed in accordance with the lease terms and applicable state law, and are then limited by application of § 502(b)(6).[24] Whether a landlord has properly mitigated its damages must be determined by referring to state law.[25] Michigan, like most states, requires the landlord to use reasonable efforts to minimize the damages caused by the debtor-tenant's breach of the lease.[26]

Any rent a landlord receives from a replacement tenant will be deducted from the landlord's actual damages before application of the cap.[27] If the landlord succeeds in mitigating its damages and immediately upon lease rejection re-leases the premises at an equal or higher rent than the debtor-tenant was paying, the landlord generally will not have a § 502(b)(6)(A) claim for future damages.[28] Most landlords will not be so lucky, and will be forced to dive into the murky language of § 502(b)(6) to determine the amount of their claim.

Capping the Damage Claim

Once the landlord's actual damages are calculated under state law, the next question is whether these damages exceed the damages the landlord may claim under § 502(b)(6). The Sixth Circuit in *In re Highland Superstores, Inc.* outlined a four-step process for applying § 502(b)(6) to determine the landlord's allowable claim in the tenant's bankruptcy:

- The court calculates the total rent due under the remaining lease term from the earlier of the date of filing or the date on which the landlord repossessed or the tenant surrendered the leased property.
- The court determines whether 15 percent of that total is greater than the rent reserved for one year following the debtor's filing.
- The 15 percent amount is compared to the rent reserved under the applicable lease for three years following filing.
- The court, on the basis of the foregoing calculations, arrives at the total allowable amount of the landlord's rejection damages, which is the greater of one year's rent or 15 percent of the total remaining rent (up to a maximum of three years), plus any unpaid pre-petition rent.[29]

"Rent Reserved"

Section 502(b)(6)'s one year versus 15 percent comparison is based on "the rent reserved by such lease, without acceleration . . . ."[30] While a fixed monthly payment over the course of a lease is clearly "rent reserved," today's sophisticated leasing arrangements often include rent based on a percentage of the tenant's gross sales, and payments by the tenant for taxes, insurance, common area maintenance, attorney's fees, janitorial services, and other items that may blur the distinction between rent and non-rent charges.

A bankruptcy court will typically require the following for a charge to qualify as "rent reserved" under the lease. First, the charge must be expressly designated as "rent" or "additional rent" in the lease or be designated as the tenant's obligation in the lease. In addition, the charge must be related to the value of the property or to the value of the lease on the property. Finally, the charge also must be properly classifiable as rent; it must be a fixed, regular, or periodic charge.[31]

Damage Cap Calculation Example

An example helps to illustrate the cap's application. Tenant BrokeCo. leased property from a landlord for a five-year term at a monthly rental of $10,000. BrokeCo. filed for bankruptcy at the end of the first year, immediately rejected the lease, then abandoned the premises. BrokeCo. owed two months' rent ($20,000) when it filed for bankruptcy.

The first step is to determine the landlord's actual damages under the lease and state law to determine if the cap will limit those damages. Assume that, despite the landlord's commercially reasonable attempts to re-lease the property, the landlord has been unable to find a replacement tenant. The remaining term of this five-year lease is four years, or 48 months, at $10,000 per month, totaling $480,000 in future damages. Adding the $20,000 in unpaid rent to the $480,000 in future damages, the landlord's actual damages under state law total $500,000.

The bankruptcy court puts this $500,000 actual damage claim on the chopping block and ultimately limits it to a $140,000 general unsecured claim. Here is how. The first step under the *Highland Superstores* four-step process is to calculate the "rents reserved" under the remaining lease term from the date tenant filed its bankruptcy petition, which total $480,000 (48 months X $10,000 per month). The second step is to calculate 15 percent of that amount ($480,000 X .15),[32] which is

$72,000. That amount is then compared to the rent reserved for one year (12 months X $10,000), which is $120,000. The court will use the greater number, in this case, $120,000.

The third step only comes into play when 15 percent of the total rents due under the remainder of the lease term is greater than the rent reserved for one year under the lease, which, when the monthly rent does not change during the lease, will occur only when the remaining lease term exceeds 80 months. If the 15 percent figure is used, the landlord's claim cannot exceed three years of rent. In this case, because the remaining lease term is only 48 months, the one year of rent figure ($120,000) is used, and a comparison to the three-year total is unnecessary.

The last step of the *Highland Superstores* process is to calculate the total allowable amount of the landlord's rejection damages, which includes unpaid rent of $20,000 and future rent capped at $120,000, for a total unsecured landlord claim of $140,000.

The contrast between a landlord's damage claim inside and outside of bankruptcy is stark: $140,000 versus $500,000. Not only is the landlord's damage claim greatly reduced in bankruptcy, but the landlord will likely be paid in "bankruptcy dollars," that is, at a fractional rate per dollar where the debtor-tenant's assets are insufficient to pay unsecured creditors in full after payment of secured creditors and other creditors with priority over unsecured creditors.[33] For example, if unsecured creditors receive a distribution of ten cents on the dollar, landlord will receive a grand total of $14,000, perhaps over time, which will not even compensate the landlord in full for the $20,000 of unpaid rent BrokeCo. owed when it filed for bankruptcy.

Security Deposits

A landlord cannot avoid the Bankruptcy Code's limitation on post-petition future rent damages simply by taking a large security deposit from a financially suspect tenant. Section 502(b)(6) does not refer to security deposits, but its legislative history makes clear that a security deposit must be applied against a landlord's claim as capped under § 502(b)(6), not against a landlord's actual damages.[34] Bankruptcy courts have followed this legislative history and it is well settled that a security deposit held by a landlord on a rejected lease must be applied against the landlord's maximum claim for lease termination damages allowed under § 502(b)(6).[35]

Further, the House and Senate reports provide that "to the extent that a landlord has a security deposit in excess of the amount of his claim allowed under this paragraph, the excess comes into the estate."[36] Thus, a sizeable security deposit may ensure that the landlord recovers all or a portion of its capped claim, but any excess security deposit cannot be retained and applied to the landlord's actual damage claim.

Some landlords have begun to require their tenants to post a letter of credit for the landlord's benefit in an attempt to avoid § 502(b)(6)'s damage cap. Whether a landlord can draw on a letter of credit to its fullest extent, regardless of the claim cap under § 502(b)(6), is an evolving issue, and the few courts that have addressed the question have disagreed.[37] A better solution to protect the landlord may be to obtain a third party's guaranty of the lease because the guarantor's liability should not be affected by the tenant's bankruptcy or § 502(b)(6).[38]

In the above example, if the landlord held a security deposit from BrokeCo. of $15,000, the landlord would have a secured setoff claim of $15,000 and an unsecured claim of $125,000. If the landlord had coerced a $150,000 security deposit from BrokeCo., landlord's capped claim of $140,000 would be fully secured, but the remaining $10,000 would go to BrokeCo.'s bankruptcy estate, and could not be used by the landlord to off-set actual damages that exceed the cap of Section 502b)(6).

ABI Suggestions

The ABI conducted a comprehensive, three-year study of Chapter 11 of the Bankruptcy Code. In light of enduring difficulties interpreting § 502(b)(6), the ABI Commission's Final Report included the following recommendation for changes to the statute:[39]

> *The claim of a lessor for damages resulting from the termination of a lease of real property shall not exceed:*
>
> *(i) The greater of (A) the rent reserved for one year under the lease following the termination date and (B) the alternative rent calculation; plus*
>
> *(ii) Any unpaid rent due under the lease on the termination date.*

The "termination date" is the earlier of the petition date and the date on which the lessor repossessed, or the lessee surrendered, the leased property. The "alternative rent calculation" is the rent reserved for the shorter of the following two periods: (a) 15 percent of the remaining term of the lease following the termination date and (b) three years under the lease following the termination date. The Commission also suggested codifying a definition for "rent" as any recurring monetary obligations of the debtor under the lease. This definition would bring clarity when a lease agreement does not explicitly state whether a payment may be considered rent. While the definition of "termination date" would clarify the date of surrender, bankruptcy courts would still need to analyze, under relevant state law, whether a pre-petition surrender or repossession occurred in order to determine the beginning of the § 502(b)(6) calculation. To date, these recommendations have not been adopted by Congress.

Conclusion

An understanding of the limits on a landlord's damage claim in the event of a tenant bankruptcy is essential to counsel the landlord and properly file and preserve the landlord's claim in the bankruptcy court.

Fallout of the Retailer's Demise

By: Bernadette M. Barron,
Barron Business Consulting, Inc.

Massive retail reorganizations and liquidations adversely affect other related industries. The fallout is seen in other industries when they do not react quickly or effectively enough to counteract the negative consequences of retail failures.

Private Equity

Private equity invested heavily in retail (e.g. Gymboree, Toys "R" Us, Payless, rue21, and True Religion) and is being held in some circles as a major contributor to the downfall. Retail companies are loaded up with debt in LBO purchases and then burdened by periodic debt such as dividend payments and management fees. Toys "R" Us is the latest example of a profitable company filing bankruptcy because they cannot service debt payments. While some will argue that retail and management should be aware of market trends and change with the times, the impact of large debt service obligations is undeniable. In 2018, there is $5.6 billion in retail debt coming due, with another $13 billion in 2019 and $18 billion in 2020 as compared to $100 million in 2017. There is no question that the retail industry is overleveraged and cannot sustain the amount of debt outstanding and coming due.

As the private equity companies fail to collect debt payments, dividends, and management fees from the retail sector, they will begin to face their own financial stress. In addition, private equity funds are facing the threat of fraudulent transfer claims, and are often required to return funds to bankruptcy estates. In Payless, the private equity firms and lenders contributed more than $20 million to settle disputes with creditors.

Shopping Center Owners

It goes without saying that the loss of stores in malls and shopping centers has a devastating effect on owners. Not only do owners lose rental revenue when stores close, but they will continue to lose revenue as the decrease in foot traffic causes the remaining stores struggle. In addition, retail leases often contain rent and termination provisions with options that vary based on the quality of anchors and co-tenants.

The timing of a store closing can also affect a mall. In the past, it was very common to delay closing stores until after the holiday season, sometimes even for two holiday seasons. However, with many bankruptcies now coinciding with defaulted debt payments, the holiday season does not hold the magic it once did. Also, retailers often find that the liquidation value exceeds the going concern value, which negates the necessity of having that final holiday season.

Shopping centers typically split the overhead costs of running the mall among all the stores, separately charging each tenant CAM. When a store closes, one of two parties must pick up the expense: the real estate owner or the remaining stores. In either case, the additional cost can be substantial, especially a mall anchor bearing a large share of the CAM closes down.

BAPCPA made changes to the Bankruptcy Code in relation to accepting or rejecting non-residential leases, often requiring the tenant/debtor vacate the property within 120 days following their filing. If the store is closing, the lease will be rejected, and the space returned to the landlord. Most stores attempt to run a going out of business or liquidation sale in the space prior to turning over possession. If the store leaves behind inventory, fixtures, sale debris or environmental problems, the landlord is faced with the clean-up costs which, depending on the amount, can substantially add to the damages incurred by the landlord.

One unique strategy employed by landlords appeared in *Aéropostale*, where Simon, General Growth, Gordon Brothers, and Hilco purchased the company out of bankruptcy. However, they are only retaining 229 of the approximately 800 stores; so 570 became vacant space. The advantage in this instance, in addition to retaining the tenant, will be the ability to relocate inventory, manage the liquidation and receive the liquidation proceeds.

The distressed waterfall continues as these shopping malls become unable to meet their financial obligations, which will in turn affect values of other types of commercial real estate.

Shopping Center Construction

Historically, constructing shopping centers has been very lucrative for developers, construction companies, and their employees. In addition, new shopping centers represent neighborhood growth and spur other development at the same time, such as nearby malls, restaurants, gas stations, home development, etc. With retail constricting, there are very few new malls being built, which is adversely affecting the construction industry.

In addition to bankruptcy, new construction has become riskier because many retailers are closing stores to increase profitability. Several household name brands are closing stores in droves (e.g. Michael Kors, 100; J. C. Penney, 138; Crocs, 160, Kmart, 100; and Abercrombie & Fitch, 60.)

Customer Programs (e.g. Gift Cards, Rewards Points, & Registries)

Customers can lose opportunities to use their gift cards when stores close. There are no regulations for honoring outstanding gift cards—they become an unsecured claim in the bankruptcy. For various reasons, gift cards will sometimes be honored in the liquidating sale, but come with time limits for redemption. One of the primary considerations in deciding to honor gift cards is whether the retail operation is expected to continue. For full liquidations, such as Bon-Ton, it is expected the Bon-Ton stores will honor gift cards for the first 10 days of the liquidation sale; after that the opportunity to use them may be lost. RadioShack also had a limited redemption period and it is estimated that approximately $46 million was not redeemed.

When stores are large enough to have gift registries when they close, the historical data of what has been purchased often becomes unavailable to the consumer.

Warranties and returns are other consumer benefits that disappear with store closings, especially when all of the stores are permanently closing.

Credit Cards

Many large retailers offer brand credit cards and sell receivables or offer cards through a financial institution. When a consumer maintains a credit card at a certain level by purchasing the equivalence of what their monthly principal payment is, they can continue to purchase goods without going further into debt. Once the store closes, the consumer needs to continue to make that monthly payment, but without the benefit of purchasing goods. This causes the consumer to have two monthly credit card payments assuming they need (or want) to continue to purchase goods at the same rate. This will lead to consumer credit card defaults as the consumer finds it difficult to maintain two monthly payments in lieu of the previous one monthly payment.

Municipal and State Tax Bases (e.g. TIF, Real Estate, Sales)

Shopping malls pay substantial taxes to both the local and state municipalities, including sales, personal property and real estate taxes. As malls fail, municipalities may abruptly find themselves trying to balance budgets with less tax revenue. While states are getting better at capturing sales taxes on catalog and internet sales, they incur an additional collection expense, and of course, those sales tax dollars are lost forever to the local community. Lower operating profits will also result in fewer income taxes paid on the federal, state, and local levels.

As mentioned above, it is not just the retail space that is affected by the closings, but also the nearby stores, restaurants, and entertainment venues. They all experience lower sales, and pay less in taxes as a result.

The tax base is affected in two other ways by employee terminations. First, former employees collect unemployment and utilize local and state job training programs. Second, the federal, state, and local governments lose income tax dollars previously paid by those employees who fail to find new work.

Job Market

Retail jobs make up 8% of the employment market, with approximately 8 million workers, 30% of whom are part-timers. The hourly wages of part-time workers is less than full time workers, and of course, stores don't have to offer the same benefits to part-timers. There are inherit difficulties in being a part-time worker including the overall wage, the ability to schedule your workday, the ability to find other part-time work that coincides with the other part-time schedule, finding daycare, etc. Furthermore, as the full-time workers are reduced to part-time status, the opportunities for students and others to work part-time dramatically decreases.

In addition to workforce reduction and shifting towards part-time schedules, commissions paid to retail employees are decreasing along with foot traffic. In turn, some employees earn significantly less, while still maintaining "full-time" jobs. When stores close, other related jobs, such as warehouse workers, truck drivers, and restaurant staff, also disappear.

Vendors

Retail vendors have priority in bankruptcy for some reclamation claims and for goods delivered within 20 days prior to the filing under § 503(b)(9). However, as part of their pre-petition planning, retailers control when and what they purchase, nullifying some of the vendors' advantages. Also, as consignment vendors learned in the Sports Authority case, their position may be at risk if their security interest has not been properly perfected.

Is Retail a Dinosaur?

By: Bernadette M. Barron,
Barron Business Consulting, Inc.

Industries of the "Past"

Many sectors of the retail industry are consolidating and may be on their way to being the "horse and buggy whip" of today. The "Walmarts and Targets" now offer groceries, oftentimes with groceries taking up to 50% of their floor space. In addition to offering lower prices on items, they allow the consumer to do one-stop shopping, thus reducing the need for separate grocery stores. Plus, there has been a growth in upscale grocery stores such as Trader Joe's and Whole Foods, putting further pressure on neighborhood stores and grocery chains.

Best Buy, Circuit City, RadioShack were all stable electronic stores that experienced massive growth. But as more and more electronic chains sprouted up, the revenues and profits declined. Right now, Best Buy appears to be the survivor—the problem is that it is the only survivor, and in order to remain a giant it will need to adapt and compete with growing online sales.

Like the electronic stores, specialty stores that focused on products such golf equipment and teen clothing have come and gone. Their failure is partially due to limited offerings, but they also fell victim to market oversaturation after others recognized the opportunity.

As demonstrated by Bon-Ton Stores, the general department store has also fallen on hard times. Even when customers visit stores, approximately 66% of shoppers check prices online before purchasing. Consumers also do the opposite—comparison shop in store, then purchase online. J.C. Penney and Macy's are just a couple examples of general department stores that are racing to find profitable alternatives to the previous brick and mortar shopper.

Brick and Mortar Makeover

Despite the reduction in brick and mortar shopping, online-only stores are ironically turning back to brick and mortar. For instance, Amazon is opening stores to have nearby warehouse capabilities, offer one day delivery on certain items, allow for in-person product returns/exchanges, and picking up online orders.

Bonobos, Warby, Parker, and Birchbox are online retailers that have opened stores. Like Amazon, the purpose is to offer limited inventory, the opportunity for customers to see and try on samples of the product, and the ability to offer a pick-up location for online sales. Interestingly, on average, Bonobos customers order twice as much when in the store than when online.

The Administratively Insolvent Retail Liquidation

By: Judge Janet S. Baer & Ryan Chapin

Ok, your client is a retailer in big trouble. The financing has dried up. The vendors have put your client on C.O.D. They are behind several months' rent and the landlord has filed an eviction action. Your client has a great business, but it just did not quite keep up with the changing landscape. If the right buyer comes along, this business could be saved and creditors could get a substantial return—over time.

Voila! File chapter 11 and do a § 363 sale, right?

Perhaps a good idea, but if you know that the present liquidation value of your client may be zero, and you likely have an administratively insolvent estate on your hands, is it really appropriate to file a chapter 11 case? Especially if you do not have an obvious buyer lining up to be the stalking horse?

Who pays for the liquidation?

A. Section 363 sales take time and money. At a minimum, you will need to hire and presumably pay debtor's counsel, creditors' committee counsel, and financial consultants. You will also need to finance the debtor's operations if you are trying to do a going concern sale. In addition, the loan documents very likely provide that any fees and expenses incurred by the lender are added to the secured debt. So those fees keep mounting!

B. Who will benefit from the § 363 sale?

1. The Lender?

a. How do they benefit?
b. What if they are opposed to the chapter 11 case and the sale proceeding? Do you have any leverage?
c. What is the likelihood you will get the use of cash collateral under these circumstances?
d. DIP financing—who would be that dumb?
e. Carve-out for professionals?

2. Founder/Private Equity/REIT?

a. Who believes in this business?
b. Are they willing to pay for this last shot at preserving it?
c. Is the owner looking for continued employment with the purchaser? Under what terms? Does that create a conflict of interest?
d. Who is a fiduciary duty owed to? If solvent, the shareholders. If insolvent, you need to also consider the creditors.
e. Does the risk of a fraudulent conveyance action relating to the leveraged buyout by private equity now serve as incentive for private equity to support the § 363 sales approach?

3. The Unsecured Creditors?

a. They are completely out of the money. So, what's the risk?
b. Is this sale simply putting the secured lenders and professionals at risk?
c. Are there causes of action to preserve for the unsecured creditors to get a potential dividend down the line?
d. Is counsel willing to take this "on a contingency?"
e. Should there even be a committee if the estate may be administratively insolvent?

4. Litigation Financing Source?

a. The third party litigation funder—could be answer if there is an inability to obtain contingent fee representation.
b. Interested party financing—there may be causes of action someone will want to fund for potential recovery.
c. *See In re Quality Stores, Inc.*, 01-BK-10662 (Bankr. W.D. MI) (secured lender and CRO contingency agreement; litigation funding in exchange for percentage sharing on recoveries on causes of action.).

5. The Landlord?

a. The landlord does not need another empty space in its shopping mall. Maybe it is worth investing some money to see if the sale will result in a new tenant?
b. Section 365(d)(4) does not give the debtor or court any wiggle room after the 90 day extension (total of 210 days). The power is then all with the landlord—blessing or curse?
c. How many tenants does the landlord have for yet another big box space?
d. See the discussion of *Aéropostale*. Two mall owners, Simon Property Group and General Growth Partners, and the liquidators purchased Debtor at auction, thereby enabling the mall owner to avoid having to fill more than 200 vacant stores.

6. A Strategic Buyer?

a. Is there a competitor out there who really wants to acquire this business and eliminate the competition?
b. Is there a supplier who would be better off financing this sale process then lose its best customer?
c. Is there someone else in the industry who could benefit from the synergies with your client's business?

7. Employees/Union?

a. Another employer may disappear. Is there a way to save jobs?
b. How often, if ever, does this group have any wherewithal to step in and step up?

8. Anyone else?

Does counsel have an ethical duty to NOT file an administratively insolvent case?

A. How clear is it with respect to the numbers?

B. Does disclosure solve the issue?

C. The lawyers know the situation and can decide if they want to become involved but how do you protect the other creditors who risk losing even more if the case goes forward?

Administrative Insolvency and Conversion

A. Courts have converted cases, in part, on the basis of administrative insolvency.

B. If the funding for administrative fees dries up, cause may exist to convert and the professionals could also be at risk for disgorgement. *See In re BH S&B Holdings, LLC*, 439 B.R. 342 (Bankr. S.D.N.Y. 2010).

Private Sale Alternative

A. The § 363 sale process is long and can be expensive.

B. Are there times when a private sale makes more sense?

1. Ability to do the sale more quickly.
2. Ability to avoid break-up fees and related expenses.
3. *See In re Eastern Outfitters LLC, et. al.*, 17 BK 10243 (Bankr. D. Del. 2017) (bought in private sale by obvious strategic buyer with vested interest).

War Stories of Marquee Retail Bankruptcies

By: Various Contributors

The past decade, and especially the last year, has seen an unprecedented influx of bankruptcy cases filed by marquee retail companies. Each case has been unique in its cause, course, and disposition. Some of the cases result in liquidation, some lay the groundwork for successful reorganization, and others end up with a hybrid reorganization-liquidation of the business and its assets. No matter the outcome, each case provides us with stories that are informative, often entertaining, and particularly useful to those who practice in the world of retail bankruptcy. Here are a few of the war stories.

Sports Authority: Consigned Canoes and Priority Too!

By: Anthony J. Kochis, Wolfson Bolton PLLC

The Sports Authority bankruptcy case involved many vendors that sold a range of products, such as kayaks and canoes, on consignment to Sports Authority. Of the approximately 170 consignment vendors with around $85 million in consigned goods on the floors of retail stores on the date of filing, only three were properly perfected. From that group of three, the vendor with the most money at stake was in the very unique position of being pitted against not only the Debtors and term loan agents, but also the rest of the consignment vendor community.[40]

When the case began, the Debtors proposed to continue to sell consigned goods in the ordinary course of business and to grant consignment vendors replacement liens on their consigned goods, but only if the vendors were properly perfected. The consignment vendors quickly organized into an *ad hoc* group and vigorously opposed the Debtors' motion. In essence, the argument was: Article 9 of the Uniform Commercial Code applies to consignments that fall within the definition of § 9-102(a)(20).[41] In turn, the scope of Article 9's reach for purposes of consignment transactions is limited to determining the rights and interests of third-party creditors of, and purchasers of goods from, a consignee.[42] Article 9 does not address the rights as between a consignor and consignee.[43] Accordingly, the rights that govern the relationship between Debtors and the consignment vendors must be evaluated under relevant state law. Under the applicable state law, consignment was a bailment arrangement, and the vendors could demand return of their goods because Debtors held nothing more than a possessory interest in the consigned goods.

The bankruptcy judge ruled on an interim basis, allowing Debtors to continue selling consigned goods while placing the sale monies in escrow. Debtors and the consignment vendors could not agree on the form of a proposed interim order and submitted competing versions. The court entered the consignment vendors' version, which allowed them to prohibit Debtors from selling goods, required the Debtors to segregate the consignment goods, and required Debtors to provide accountings to the vendors. After an oral motion for reconsideration, Judge Walrath relented and eliminated the vendor sale prohibition language, but made it clear that vendors had to be paid if their goods were going to be sold. The hearing was then adjourned for approximately one week.

During the next week, Debtors filed approximately 160 adversary proceedings against the consignment vendors seeking a declaratory judgment that the vendors were not properly perfected and that the consigned goods were property of the bankruptcy estate. It was clear that the adversary proceedings had been filed at the behest of the term loan lenders, who wanted the $85 million in consigned goods added to their collateral base and who sought to intervene in all of the adversary proceedings. In retaliation, the consignment vendors cut off the supply of new goods to the Debtors.

At the adjourned hearing, the judge ruled that the Debtors had three options: (1) settle with the consignment vendors; (2) return the consigned goods to the vendors; or (3) continue to sell goods under the terms of the relevant consignment agreements. This provided little comfort to the unperfected consignment vendors, because the monies that they were receiving from the sale of consigned goods were still subject to claw-back or disgorgement in the pending adversary proceedings. Plus, there was the added complication of price protection—meaning that if a vendor's consignment agreement did not specifically delineate the price at which goods could be sold, Debtors could theoretically sell consigned goods for pennies on the dollar and remit fractional pennies to the consignment vendor (still subject to claw-back).

The Debtors then filed a motion to sell all inventory, furniture, fixtures, and equipment to a liquidator. The courtroom was overflowing on the day of the sale hearing. Senior partners sent younger associates to save seats in the courtroom. At the beginning of the hearing, the Debtors and the term loan lenders presented a united front in an effort to obtain authority to sell all inventory, consignment or not. The consignment vendor *ad hoc* group argued against the sale motion, but all of their objections were overruled. Judge Walrath ruled that the liquidator could sell the consigned goods as long as it complied with the consignment order she had previously entered.

At this point, the properly perfected consignment vendors had to break from the rest of the community. Their position was much different. By this time, both the Debtors and term loan lenders had been forced to acknowledge that their security interests were properly perfected. Therefore, the perfected vendors argued that, unlike the other 167 consignment vendors, the Debtors could not sell their consigned goods to the liquidator under § 363(f) free and clear of liens without consent, because they were properly perfected secured creditors. And the vendors would not consent to anything less than the full amount of the wholesale price they were entitled to under the consignment agreements.

And, the properly perfected vendors' argument won.

With the exception of final accounting cleanup related to some "missing" canoes, the properly perfected consignment vendor with the most at stake was paid every dollar that it was owed under its consignment agreement. After some fits and starts, the unperfected consignment vendors ultimately agreed to a settlement ranging between 25-49 percent of the actual amount owed under their relevant consignment agreements.[44]

The scope of consignment interests in bankruptcy has many sides: consignor versus consignee, consignor versus secured creditor of consignee, and purchaser of consigned goods versus all of the above. Before Sports Authority, many viewed consignment as a safe and reliable method to sell goods. That may be one of the reasons why so many consignment vendors were unperfected. Sports Authority did not definitively resolve the many issues presented by consignment interests in bankruptcy, but the case serves as a warning of the risks of consignments.

Toys "R" Us

By: Judge Janet S. Baer & Ryan Chapin

A. What went wrong?

Toys "R" Us was acquired and taken private by a group of private equity sponsors in 2005 for $6.4 billion, including $5.3 billion of debt secured in large part by the company's assets. This debt required servicing at a rate of $400 million per year, impairing the company's ability to invest in its business and future. For years the company continued to use short term fixes for the horrible liquidity problem. However, in 2017 it decided to hire professionals to look at a long term financial restructuring solution. Then, disaster struck from several angles.

1. Toys "R" Us had a horrible 2017 holiday season that no one predicted. On September 6, 2017, a national news story was published that reported Toys "R" Us was considering chapter 11. This story started a domino effect that the company could never recover from.

   a. Within 72 hours, a significant number of vendors demanded C.O.D. to deliver product.

   b. Within a week, 40% of the Debtor's supply chain refused to ship product and 10 days later, practically all of the Debtor's vendors refused to ship without C.O.D.

   c. Thus, the company lost its access to product during the critical shipping period to build inventory for the holiday season.

   d. The holiday season, which historically contributes 40% of total revenue, was a complete bust.

      - 4th Quarter 2015 EBITDA = $374 million
      - 4th Quarter 2016 EBITDA = $347 million
      - 4th Quarter 2017 EBITDA = $81 million

   e. Holiday sales ended up to be $250 million below budget projections. This was a total and complete catastrophe which no one predicted and from which the company could not recover.

2. Before the holiday season, in October 2017, Toy "R" us had launched new website.

   a. New infrastructure.
   b. Ill-timed and had growing pains.
   c. Website added complexities to already mounting shipping problems.
   d. Ultimately unsuccessful at key time in the business.

3. Toy "R" Us was no exception to the general decline in brick and mortar stores.

4. Innovative Competition.

a. E.g. Walmart, Target, and Amazon.
b. Walmart launched pricing war with Amazon.

i. Toys "R" Us could not compete.
ii. Walmart used toys as loss leader to sell other products like groceries. Toys "R" Us only sells toys.
iii. If is it a loss for Walmart, the loss for Toys "R" Us to compete on pricing is double.
iv. Toys "R" Us does not have the infrastructure to ship in 1-2 days (and at a loss) like Walmart and Amazon.
v. The pricing war with Amazon led to a horrible loss for Walmart. No way Toys "R" Us could play in that arena.

B. The post-2017 holiday business plan called for a reduction to 400 store platform (from 700).

1. 400 store footprint would permit savings in overhead and elimination of unprofitable stores.
2. The size was needed to preserve shipping logistics infrastructure and volume discounts.
3. Required $250 million in additional capital and $800 million in capital to exit chapter 11.
4. Creditors said NO. Lenders said liquidate.

C. Now, there appears to be an administratively insolvent estate.

1. $800 million in current post-petition unpaid trade.
2. DIP covenants are completely blown.
3. Carve-outs for professionals are being questioned—unpaid vendors are objecting to continued payment of professionals when their administrative claims remain unpaid.
4. So far, bids for U.S. operations do not appear to have adequate financial backing.
5. Canadian and other international operations appear likely to survive.
6. U.S. operations may end up as "holiday pop-up" stores.

Central Grocers
By: Judge Janet S. Baer & Ryan Chapin

The Central Grocers bankruptcy case was the result of a business hybrid gone wrong. The business consisted of a 100 year old grocery co-operative, Central Grocers, and approximately 36 brick-and-mortar retail grocery stores, Strack & Van Til and Ultra Foods. It is a classic example of a flawed acquisition, followed by an unsuccessful integration.

Central Grocers was a co-operative grocery wholesaler that supplied more than 400 independent stores in the Chicago area for years, including stores like Treasure Island and Sunset Foods.

Strack & Van Til and Ultra Foods were small chains with 34 grocery stores that Central Grocers acquired a few years ago. The Strack & Van Til's stores were generally operated in a "mom & pop" fashion. Each store was managed separately with individualized customer care, to the point of having the buyers for each store ordering product based on personal knowledge of their customers' individual needs.

The flaws in the merger involved both a failure to successfully combine the separate operational parts into a stronger whole, and actual conflicts of interest at the board level that emerged between the wholesale and retail operations. Those problems were then exacerbated by the hiring of a new CEO who attempted to change the entire culture of the grocery business to a mass market generic buying approach.

At the same time, while the integration was failing and the two different businesses were at odds with each other, Central Grocer's customers started seeing a slowdown and decrease in vital rebates from the co-op. That led the customers to exit in favor of other very aggressive wholesale competitors like Super Value. In a very short period of time, Central Grocer's lost approximately of 80% of their customers, the small independent grocers.

Finally, Central Grocers faced these issues while also having to deal with the same problem facing a great majority of retail today—no way to make the business "Amazon Proof." Online marketplaces are causing a ripple effect that starts with the loss of customer foot traffic in retail shopping centers. The decrease in business is not just because people are buying groceries online—they are buying a lot of everything online instead of visiting the local strip malls and other retailers near grocery stores. Thus, there is a reduction in foot traffic from those who come for one thing and then stop by the grocery store for something else.

Central Grocers is winding up its operations in phases. Early on in the process it shut down its Joliet warehouse, which had 550 employees and ultimately shuttered its wholesale operations. It also sold most of its Strack & Van Till stores and shut down many unprofitable Ultra stores.

The RadioShack Bankruptcies

By: Clinton E. Cutler, Fredrikson & Byron P.A.

RadioShack filed for chapter 11 bankruptcy twice—once in 2015 and again in March 2017. The reorganized company emerged from the second bankruptcy under a confirmed plan in the first quarter of 2018.

1. Operations at time of first bankruptcy. At the time of filing in 2015, RadioShack operated over 4400 company owned stores and had an independent dealer-owned network of another 1100 stores located throughout the United States, Mexico and Asia. RadioShack employed about 26,000 people.

2. Outcome of the first chapter 11. During the first case, the Debtors closed approximately 2,400 underperforming stores. Other assets were sold to General Wireless Inc. on a going concern basis. Post-closing, General Wireless bought the rights to and operated approximately 1,733 RadioShack stores throughout the United States, Puerto Rico, and the U.S. Virgin Islands, acquired the inventory, fixtures, and equipment associated with those stores, and bought certain intellectual property, including the ability to use the RadioShack name in the U.S. and certain foreign markets and online.

3. Relationship with Sprint Wireless. As part of the asset acquisition, General Wireless entered into agreements with Sprint Solutions, Inc. to establish co-branded stores for the sale of Sprint mobile devices in the RadioShack stores. The agreement allowed Sprint to operate Sprint stores within the RadioShack stores in exchange for picking up certain costs such as a portion of the rent for each store and a split of the profits.

4. Lead up to second bankruptcy case. In the two years leading to the second case, General Wireless continued to close underperforming stores and attempted to re-invigorate the independent dealer network, and achieved some operation improvements, but was only partially successful. General Wireless also reported that the relationship with Sprint did not produce expected revenue and disputes had arisen between the companies.

5. Second Bankruptcy Case. General Wireless filed for bankruptcy in March 2017 in the Delaware. At the time of the second filing, RadioShack consisted of approximately 1500 stores, 425 dealer owned stores and an online retail presence, with total employee headcount of about 5500 employees. General Wireless owed approximately $140 million in first lien, second lien and IP loans, and owed about $62 million to trade vendors and had accrued rent obligations of in excess of $10 million.

6. Major Events in the Second Case. Debtors conducted store closing sales across almost all of the company owned stores. In addition, Debtors had negotiated a settlement agreement with Sprint in the months before the filing and sought to implement the settlement agreement in the case. There were objections to the settlement and the terms were modified to provide for a challenge to be brought. Eventually, the creditors committee sued Sprint asserting claims for alleged breaches of the agreement. In addition, there were challenges to the extent of the property subject to the first lien. Debtors conducted auctions of the member interests of the entity owning the IP of RadioShack, and a limited auction of lease designation rights.

7. Outcome of Second Case. In August 2017, the parties in the case reached an agreement on a consensual plan of reorganization. Under the confirmed plan, the second lien lender received all of the equity of the debtors in exchange for $5 million of second lien debt. The reorganized debtors' business operations consisted of the e-commerce platform, the debtors' network and relationships, and up to 28 brick and mortar retail stores, and associated warehouse operations. Secured lender claims not converted to equity were paid off from the store closing liquidation process and other asset sales. Certain litigation claims, including litigation claims against Sprint, were channeled into a litigation trust for the benefit of unsecured creditors. Avoidance claims were waived.

8. Observations. RadioShack went from about 5,500 brick and mortar stores to mostly being an online presence. In essence, this is a recognition that only the brand may have some value. It also reflects the drastic change taking place in shopping habits where consumers no longer care if they live minutes from a RadioShack, but instead will shop for what RadioShack offers online. Finally, the notion of co-branding by having Sprint stores located in RadioShack brick and mortar stores was thought to be innovative, but in the end did not work out for either party.

Endnotes

[1] U.S. Department of Commerce, Quarterly Retail E-Commerce Sales 4th Quarter 2017, U.S. CENSUS BUREAU NEWS (Feb. 16, 2018) https://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf.

[2] Sarah Chaney, U.S. Retail Sales End 2017 on Solid Footing, WALL STREET JOURNAL, Jan. 12, 2018, available at https://www.wsj.com/articles/u-s-retail-sales-increased-0-4-in-december-1515763942.

[3] *In re Toys "R" Us, Inc.*, No. 17-32665 (Bankr. E.D. Va. Sept. 19, 2017); *In re The Bon-Ton Stores, Inc.*, No. 18-10248 (Bankr. D. Del. Feb. 4, 2018); *In re General Wireless Operations Inc.*, No. 17-10506 (Bankr. D. Del. Mar. 8, 2017).

[4] Stefany Zaroban, U.S. E-Commerce Sales Grow 16.0% in 2017, DIGITAL COMMERCE 360, Feb. 16, 2018, available at https://www.digitalcommerce360.com/article/us-ecommerce-sales/.

[5] Derek Thompson, What in the World is Causing the Retail Meltdown of 2017?, THE ATLANTIC, Apr. 10, 2017, available at https://www.theatlantic.com/business/archive/2017/04/retail-meltdown-of-2017/522384/.

[6] *See In re Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998); *In re Furr's Supermarkets, Inc.*, 283 B.R. 60 (B.A.P. 10th Cir. 2002); *In re Stone Barn Manhattan LLC*, 398 B.R. 359 (Bankr. S.D.N.Y. 2008).

[7] *In re Goody's Family Clothing Inc.*, 610 F.3d 812, 816-17 (3d Cir. 2010); *HA-LO Indus. v. CenterPoint Props. Trust*, 342 F.3d 794, 798-800 (7th Cir. 2003); *Koenig Sporting Goods, Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.*), 203 F.3d 986, 989 (6th Cir. 2000); *In re Burival*, 406 B.R. 548, 554 (B.A.P. 8th Cir. 2009), aff'd *In re Burival*, 613 F.3d 810 (8th Cir. 2010).

[8] *Missouri v. U.S. Bankruptcy Court (In re Missouri),* 647 F.2d 768, 776 (8th Cir. 1981); *see also Aloe v. Shenango Inc. (In re Shenango Group, Inc.)*, 186 B.R. 623, 628 (Bankr. W.D. Pa. 1995) *aff'd* 112 F.3d 633 (2d Cir. 1997).

[9] *In re Ames Dept. Stores, Inc.*, 136 B.R. 357, 359 (Bankr. S.D.N.Y. 1992); *In re Tobago Bay Trading Co.*, 112 B.R. 463, 467 (Bankr. N.D. Ga. 1990).

[10] This article originally appeared in the Michigan Bar Journal in 2002 and has been updated by Kathleen A. Stearns of Wolfson Bolton PLLC.

[11] 11 U.S.C. § 101 et seq.

[12] 11 U.S.C. § 365(a); *Miller v. Chateau Communities, Inc. (In re Miller)*, 282 F.3d 874, 876 (6th Cir. 2002).

[13] See *In re Miller*, 282 F.3d at 877.

[14] 11 U.S.C. § 502(g); *In re Miller*, 282 F.3d at 878.

[15] 11 U.S.C. § 502.

[16] Fed. R. Bankr. P. 3001(f).

[17] 11 U.S.C. § 502(a); *Smith v. Sprayberry Square Holdings, Inc. (In re Smith)*, 249 B.R. 328, 332 (Bankr. S.D. Ga. 2000).

[18] Section 502(b)(6) also does not limit administrative expense claims by the landlord based upon the debtor-tenant's use of the premises following the filing of a petition. *See* 4 Alan N. Resnick, et al., *Collier on Bankruptcy*, ¶ 502.03[7][g] (16th ed. Rev. 2018).

[19] See *Unsecured Creditors' Committee of Highland Superstores, Inc. v. Strobeck Real Estate, Inc. (In re Highland Superstores, Inc.)*, 154 F.3d 573, 577 (6th Cir. 1998); H.R. Rep. No. 95-595 at 352 (1977); S. Rep. No. 95-989 at 62 (1978).

[20] *In re Highland Superstores, Inc.*, 154 F.3d at 577 (quotation omitted).

[21] 11 U.S.C. § 502(b)(6)(B).

[22] *In re Gantos, Inc.*, 176 B.R. 793, 795 (Bankr. W.D. Mich. 1995).

[23] *Id.*; *In re Andover Togs, Inc.*, 231 B.R. 521, 545 (Bankr. S.D. N.Y. 1999)

[24] *In re Highland Superstores, Inc.*, 154 F.3d at 579; *In re Gantos, Inc.*, 176 B.R. at 795 (stating that after the lessor computes the value of its claim under applicable nonbankrupty law, the claim is compared with, and limited by Section 502(b)(6)); *In re Smith*, 249 B.R. at 334; *Fifth Avenue Jewelers, Inc. v. Great East Mall, Inc. (In re Fifth Avenue Jewelers, Inc.)*, 203 B.R. 372, 376 (Bankr. W.D. Pa. 1996).

[25] *In re Merry-Go-Round Enterprises*, 241 B.R. 124,131 (Bankr. D. Md. 1999)

[26] See, e.g., *Shiffer v. Board of Ed. of Gibraltar School Dist.*, 393 Mich. 190, 224 N.W.2d 255 (1974); *Jefferson Development Co. v. Heritage Cleaners*, 109 Mich. App. 606, 311 N.W.2d 426, 428 (1981).

[27] *In re Fifth Avenue Jewelers, Inc.*, 203 B.R. at 381 ("[M]itigation shall figure into the calculation of [landlord's] damages prior to application of said cap.").

[28] *In re Highland Superstores, Inc.*, 154 F.3d at 577.

[29] *See id*.

[30] 11 U.S.C. § 506(b)(6)(A) (emphasis added).

[31] *See Kuske v. McSheridan (In re McSheridan)*, 184 B.R. 91, 99-100 (B.A.P. 9th Cir. 1995); *New Valley Corp. v. Corporate Property Assocs. (In re New Valley Corp.)*, No. Civ. A. 98-982, 2000 W.L. 1251858, at *13-14 (D. N.J. Aug. 21, 2000). While the three-part test remains, the Ninth Circuit has overruled the portion of *McSheridan* which held that all damages are encompassed by the statute, ruling that extending the cap to cover any collateral damage to the premises would allow a post-petition but pre-rejection tenant to cause any amount of damage to the premises without fear of liability beyond the cap. Specifically, the Ninth Circuit overruled *McSheridan* to the extent it held section 502(b)(6) to be a limit on tort claims other than those based on lost rent, rent-like payments, or other damages directly arising from a tenant's failure to complete a lease term. *Saddleback Vally Cmty. Church v. El Toro Materials Co. (In re El Toro Materials Co.)*, 504 F.3d 978, 981-82 (9th Cir. 2007).

[32] The majority of courts, including a bankruptcy court in the Western District of Michigan, applies the 15 percent cap to the total amount of rent remaining due, not the total amount of time remaining under the lease. *See, e.g.*, *In re Gantos, Inc.* 176 B.R. at 796 ("The 15% quantifies the aggregate rent remaining and not the time remaining under the lease.") For an example of courts applying the minority view that the 15 percent cap applies to the time remaining under the lease, *see In re Blatstein,* No. Civ. A. 97-3739, 1997 W.L. 560119, at *15 (E.D. Pa. Aug. 26, 1997) and *In re Iron-Oak Supply Corp.*, 169 B.R. 414, 420 (Bankr. E.D. Cal. 1994).

[33] *See* 11 U.S.C. § 507.

[34] *See* H.R. Rep. No. 95-595 at 352 (1977); S. Rep. No. 95-989 at 62 (1978).

[35] *See In re Handy Andy Home Improvement Centers, Inc.*, 222 B.R. 571, 574 (Bankr. N.D. Ill. 1998); *In re PPI Enterprises, Inc.*, 228 B.R. 339, 350 (Bankr. D. Del. 1998).

[36] H.R. Rep. No 95-595 at 352 (1977); S. Rep. No. 95-989 at 62 (1978).

[37] *See* Berman, Geoffrey L., P. Gilhuly, and S. Roth, *Landlords Use Letters of Credit to Bypass the Claim Cap of Section 502(b)(6)*, 20-JAN Am. Bankr. Inst. J. 16, 32 (2002).

[38] *See* 11 U.S.C. § 524(e) ("[D]ischarge of a debt of the debtor does not affect the liability of any other entity on . . . such debt."); *In re Modern Textile, Inc.*, 900 F.2d 1184, 1191 (8th Cir. 1990) [Section 502(b)(6)]; *Bel-Den Assocs. Ltd. Partnership v. Clark*, 83 B.R. 357, 358-59 (D. Md. 1988).

[39] The Final Report and Recommendations of the ABI Commission to Study the Reform of Chapter 11 (2014), *available at* commission.abl.org/full-report (last accessed April 10, 2018; printed copies are available for purchase at abi.org/bookstore).

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[40] I would be remiss if I did not recognize my law partner, Peter C. Bolton, who navigated Article 9 and properly perfected our client's consignment interest.

[41] *See* UCC § 9-109(a)(4).

[42] *See* UCC § 9-109, comment 6; UCC § 9-319.

[43] *See* UCC § 9-109, comment 6 ("The relationship between the consignor and consignee is left to other law.").

[44] *See* Sarah Beckett Boehm and Shawn R. Fox, TSAWD Holdings: When Is a Consignment Not a Consignment?, XXXVI ABI Journal 7, 36-37, 76, July 2017.