The Changing Retail Environment and Restructuring Consequences

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Changing Retail Environment and Potential Restructuring Consequences

Many blame the paucity of retail reorganizations and the proliferation of liquidations on the 2005 Amendments to the Bankruptcy Code. While there has been an undeniable impact on the way chapter 11 retail cases proceed, one has to really look at the change in economic conditions, the regulatory impact on lending practices, the changes in consumer preferences, the omni-channel trends in retailing, and the make-up of ownership of retail entities. There is an argument the legal issues that exist in retail bankruptcies have not changed versus ten years ago or in the last ten years rather the macro environment has changed

How are retail bankruptcies conducted today versus 10+ years ago?

- Changes in the law (2005 Amendments) in particular the change in Section 365(d)(4) from virtually unlimited extensions to assume or reject leases "for cause" to a 120-day fixed period with an additional 90-day period "for cause". Is this a red herring?
- Shorter case duration (Restructuring/Plan Support Agreements, DIP milestones, prearranged sales)
- Increase of asset liquidations or very quick sales
- Increased involvement from bondholder constituencies and other alternative lenders versus 10+ years ago it was traditional money center banks/ABL lenders
- Dominance of large discount retailers at the expense of specialty stores?
- Declining real estate values and lease values?
- More active role of State AGs
- Are there lessons to be learned from "Macyification", i.e., a retailer trying to brand all of its chains that it may have acquired under one banner when each chain had its own personality and consumer following? Hudson Bay appears to have opted to not do that with Lord & Taylor and Saks.

How are future retail bankruptcies likely to look?

- Continuing trend of sale cases or liquidations driven by the liquidators
- Occasional reorganizations likely to be accompanied by plan support agreements or pre-arranged plans (American Apparel, Quicksilver).
- Continued effort to minimize the duration of the bankruptcy case by way of aggressive DIP milestones and other financing conditions
    - Typical retail case files with only a three month carve out for sale required by the lenders with the residual four months utilized to conduct a GOB liquidation of there is no sale (210 days as dictated by 365(d)(4)
- Retail is bi-furcated – chains below 250-300 stores, more often than not, liquidate in part because of the amount of money offered by the liquidators

- Continuing stigma that costs of chapter 11 do not support going through the process
- Role of liquidators including their capacity to make first out loan pieces, fee proposals versus agency proposals and the role of augment

What are the macro trends in retail and what are the consequences to traditional brick-and-mortar retail?

- Consumer shift to online shopping is reducing the need for large retail footprints and traditional malls in general
  - If you have not invested in capex and your physical locations are run down does that impact consumer behavior because your locations are less inviting
  - Do consumers care anymore about a retailer, such as Toys R Us or Walmart, carrying everything under the sun, i.e., is price and convenience more important than anything including assortment?
- Macro changes in consumer behavior
  - Impact of Millennials – more emphasis on experiential spending then on acquiring "stuff"? Does this mean that brick and mortar retailers need to deliver an "experience" in order to survive and thrive not just goods
  - Impact of "fast fashion" – short lived trends and the importance of social media and brand image
  - Impact, if any, of carrying too many unknown brands on a retailer
- Impact of the internet and consumer access to information; "showcasing products" in the store and purchasing on line
- Industry consolidation, e.g., supermarket consolidation, sporting good consolidation – with Sports Authority with the space shrink to two major players – Dick's and Modells.
- Regulatory environment hamstrings what money center banks can do with a problem credit or retail loan, i.e., pressure to exit a problem credit sooner rather than later
  - In the past a lender might stretch to do something or lend more to avoid a filing. Today the federal lending regulations restrict the ability to lend more or stretch
  - Additionally, lenders now have such good models and information that they are covered to within 1-2 percentage points of their debt. Any stretch lending is consuming whatever cushion may remain. Also a shift in covenant packages in terms loans to a tightening. Seeing senior secured positions reduced with term loans with tight covenants that put more capital to work but that eat up an Asset Based Loan cushion that may exist at many leveraged retailers.
- Role of the high yield market-place. Toys R Us high yield financing. Is it a test case?

- Pressure for retailers to be “omni-channel” in order to best serve their particular consumer demographic where, when and how they want to shop. It’s not enough to have a website now – the trends for non-store purchases show a significant amount of growth in purchases made on mobile devices and tablets. Retailers need to adapt. Is there less of an emphasis on brick and mortar or more of an emphasis? Does moving online put pressure the overall performance of the chain as online sales are less profitable than brick and mortar channels?
- Is there a trend for potential acquirers to get restricted upfront prior to a chapter 11 so they can thereby do their diligence on the capital structure, take out the lender(s), do the DIP and wringing all of the liquidity (there is typically more than meets the eye) out of the borrowing base, e.g., unused liquidity on a revolver, prior to a chapter 11 filing
- What will be the long term effect of speedier delivery? USPS delivers seven days a week now. In major metropolitan areas Amazon will deliver next day and even same day. Other delivery options are proliferating including web-based delivery services and ride-sharing such as Uber. Will these help smaller retailers and harm bigger less nimble retailers? Will this force retailers to fix or alter their distribution and supply chains so you can get to your customer in two days because Amazon forces you to do so?
- Do retailers need to give up on the idea that they can “grow out of their problems”?

What will be the dominant types(s) of retail platform(s)?

- Websites and increasingly mobile applications
- Social media
- Omni-channel – retailers like Bloomingdales, Nordstrom and Saks have opened up their own discount outlets or have acquired or partnered with websites, e.g., Haute Look and Gilt. Are these channels competing against themselves? Or, are they liquidating excess and dated inventory more lucratively by selling the goods themselves rather than through discounters such as Century 21, Marshall’s? What is the effect of doing so on discounters?

Who will be buying or investing in retail assets?

- Alternative investors such as bond holders and private equity funds with a focus on value or absolute returns. The question often becomes whether PE funds/bondholders can effectuate a retail turnaround from an operational perspective. Will they hire the right management team? What is the timeline for them to flip the asset?
- Many strategic acquirers are dealing with their own financial/operational difficulties and are not currently interested in acquiring competitors out of bankruptcy.

Specific topics or issues including

- IP and other technology issues including valuation and liens on IP, customer lists, domain names
- lease issues
- privacy issues
- credit cards and gift cards
- impact of international operations

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Retail bankruptcies and the circle of life

MARCH 7, 2016 | BY KENNETH A. ROSEN (/AUTHOR-INFORMATION/506795)

The last several years have seen numerous chapter 11 bankruptcies with the most recent being The Sport Authority. It may seem counterintuitive, but bankruptcies are a sign of vibrant industry and give rise to new opportunities for those who know where to look.

The Sports Authority is the most recent example, but other bankruptcies the past few years have included Border's, RadioShack, Circuit City, Loehmann's, Coldwater Creek, Mandee Shops, Frederick's of Hollywood, Body Shop, Cache, Dots, Love Culture, Alco Stores, Ashley Stewart, Deb Shops, Syms/Filene's, Fortunoff's and Anna's Linens.

Today there is a new breed of lender to retailers. No longer are the only options for financing traditional lenders such as JPMorgan Chase, Citibank or Wells Fargo. Hedge funds have entered the lending business and so have specialty lenders that are more comfortable lending to retailers- and particularly comfortable with the risk of having to liquidate retailers. In addition, in the last two decades we have seen more retailers acquired by hedge funds as portfolio companies. Such owners have a greater willingness to acknowledge when a company is broken and when the cost of repair is not worth it. Therefore, they just cut their losses and move on to the next investment. Finally, as the cost of chapter 11 bankruptcies (professional fees, especially) has increased and the likelihood of a successful restructuring has declined (perhaps due to fierce competition), more retailers are being liquidated than are being reorganized.

We see more retailers today making a valiant attempt to find a buyer as a going concern; but, then commencing a chapter 11 case wherein the goal is a speedy liquidation.

Liquidating a chapter 11 debtor's inventory now is a big business. Liquidators fiercely compete for the right to conduct "GOB" sales. The purchase price of the debtor's inventory may go up at auction in increments of one-tenth of a cent. It is not uncommon that inventories will yield close to 100% of the debtor's cost. Part of the reason is "augmentation." A liquidator can be permitted by the Bankruptcy Court to bring in additional inventory to the debtor's stores just for the liquidation and going out of business sale. And, the Bankruptcy Court can authorize a liquidation sale or going out of business sale at the retail sites despite prohibitions in leases to the contrary.

Retail liquidations provide opportunities for other retailers and for suppliers to retailers. Liquidators must line up a flow of merchandise very quickly. The time between when the liquidator wins an auction and when the liquidator commences sales can be just a few days. So, suppliers of goods can reach out to the major liquidators (often known well in advance of the auction) in order to offer goods to the liquidator contingent upon the liquidator winning the auction. This is an opportunity for the supplier to sell goods – especially goods manufactured for the debtor or for retailers similar to the debtor. Of course, one retailer's bankruptcy is another retailer's opportunity to buy debtor-owned goods in bulk at prices well below cost. Chapter 11 debtors, their banks and liquidators all like an opportunity to sell early and in bulk.

The purchase and sale of leases of retail space in bankruptcy cases today is a big business. Despite a lease having language in it stating that the lease is not assignable, or is not assignable without the landlord's consent, the Bankruptcy Court has the power to permit the assignment of the lease. The Bankruptcy Court also will review any use restrictions in light of the assignee's intended use and decide if the intended use violates a use restriction. And, note that Courts, banks and creditors committees usually favor assignments if they result in sale proceeds that increase the recovery to creditors- which means that close calls may be decided in favor of the debtor and assignee rather than the landlord.

Retail bankruptcies present an opportunity for a retailer that is anxious to enter a market to achieve almost instant critical mass by purchasing a group of leases all at once while avoiding the expense and time of seriatim lease negotiations over time to ramp up. The savings of management time and negotiating costs (legal fees) can be substantial even if the leases are purchased at a price equal to market rents. The Bankruptcy Court can enter an order protecting the assignee from disputes over arrears, over use of the premises and against claims by third parties -- which also is of substantial value.

Once a retailer files a chapter 11 bankruptcy petition, it has a finite amount of time before it must either affirm the lease or else reject the lease. "Rejection" simply means that the debtor is allowed to disavow its obligations under the lease. The typical time period is nine months from the date of bankruptcy. But, a secured lender will be very conscious of the time that it would take to sell off its collateral in the stores. As a result, the lender may require that an inventory liquidation program begin far in advance of the nine month anniversary so as to be out of the stores by the nine month anniversary.

No prudent debtor would assume a real estate lease unless it knows that it definitely will be continuing in business or that it has an assignee lined up to purchase the lease. Consequently, each day that the bankruptcy case grows older, the debtor (and its creditors) grows more anxious to find someone who will pay for an assignment of the leases. The opportunity that this presents to a potential acquirer is that the debtor's options to the acquirer's offer may decline with the passage of time. And, no debtor or secured creditor ever wants to pass up getting something in favor of risking getting nothing. "A bird in the hand...." Further, bulk bids for multiple leases are extraordinarily tempting even if on an individual basis the leases justify a higher aggregate price.

There is more to a retailer than inventory and real estate leases, though. Intellectual property (trademarks, copyrights, patents, logos, customer lists) can have value and may be purchased separately from the inventory. The "Loehmann's" and "Coldwater Creek" names are good examples. A former competitor's intellectual property may be valuable to a buyer that has a similar customer base as that of the bankrupt retailer. We also have seen examples of intellectual property being acquired for internet and catalog usage. Not 100% of the public knows that a retailer filed a bankruptcy petition or that the retailer actually was "dark" for a period of time. They just know that they recognize the name.

And, warehouse/distribution machinery and systems that have very little value if removed often can be acquired at a fraction of their purchase price. Better yet, a buyer may be able to acquire the underlying lease for the premises and step into a turnkey warehouse/distribution center.

Finally, timing is everything. No landlord wants a dark hole – especially during the fourth quarter of the year. As a result, landlords may provide concessions to an assignee that can move expeditiously in getting open. The flip side of that coin is that the purchaser of a lease will pay less if it cannot open in time to capture a major season.

While it always is distasteful to prey on a carcass, the parties with a stake in the outcome of the debtor's bankruptcy usually welcome a buyer's interest and the purchase price of the assets purchased may be a bargain.

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Rotten Bananas

By Kenneth A. Rosen

Section 363 of the Bankruptcy Code was created to help debtors shed assets rapidly, before they fall in value. Think a supermarket with perishables (such as bananas) on the shelves.

But with Chapter 11 often too onerous for small companies – particularly retailers – Section 363 has become an alternative that poses significant problems. Put another way, except for very large companies, Chapter 11 commonly leads to liquidation for retailers.

It's important to note that debtors aren't the only drivers here. Liquidators actually compete at auctions for the rights to run going-out-of business sales and sometimes include assets in those sales that were never actually owned by the debtor. Lenders with a security interest in the inventory are also fans of the 363 approach because they can quickly get a good price from the sale of the assets.

Debtors, meanwhile, know that when you throw in fees, time spent and reputational damage, among otherings, attempting a reorganization through Chapter 11 is often not worth the effort. Indeed, more Chapter 11 debtors fail than reorganize.

Increasingly, a pattern has emerged in retail bankruptcies: A company files for Chapter 11, proceeds with liquidation through Section 363 and then converts the case to Chapter 7 (or has the case dismissed). The problem is that this approach goes against the original idea behind Section 363 -- which is supposed to be a step *toward* confirmation of a plan of reorganization with proceeds going toward the turnaround. It is not intended for use by debtors when a lender simply wants to cash out quickly.

Chapter 11 is the reorganization chapter – the "fresh start" -- of the Bankruptcy Code. Debtors in Chapter 11 are supposed to fix their businesses and/or balance sheets and then emerge stronger, leaner and maybe smaller, having shed burdensome leases and contracts and reconfiguring their businesses to eliminate broken or underperforming pieces.

Another problem is that debtors often seek expedited approval of 363 sales from courts, who are then put in the unenviable positon of having to accept the debtor's *assertions* with limited insight from the creditors' committee. Speed often trumps due process because of a lack of complete information.

The court is often told – without an analysis of other possible right-sizing moves -- that the debtor is hemorrhaging, that the bleeding will continue and that a prompt liquidation is necessary to avoid further harm to creditors' interests. As Alla Raykin, writing in *Emory Bankruptcy Developments Journal*, put it, "The section 363 process heavily favors debtors; dissatisfied creditors must produce very compelling evidence before their interests could counter the debtor's assertions. Unfair treatment would be curbed by imposing a more rigid burden of evidence to speed past due process safeguards."

It's important for the creditors committee to determine whether a debtor's leap to immediate liquidation was prompted by an impatient lender and whether there is a core group of stores that can be the foundation of a reorganized company and if profitable stores are being liquidated. The debtor's burden should be to demonstrate that downsizing and reorganization will likely lead to failure. It should not simply be that the chain as a whole is losing money – like a "melting ice cube." The problem with such thinking is that the debtor can easily unplug the freezer.

To be sure, struggling retailers must deal with lender impatience, the risk of failure, the high cost of Chapter 11 and reluctance to go to war with lenders. But the solution is not – or shouldn't be -- to mangle Section 363 and Chapter 11. The answer is to fix underlying problems with the Bankruptcy Code. It should be more cost effective for small and middle-market debtors to better protect unsecured creditors during a fire drill early in a case so it enables the court to make fully informed decisions and does not unduly prejudice the interests of lenders.

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What retailers should know about gift cards

NOVEMBER 10, 2015 | BY KENNETH A. ROSEN (/AUTHOR-INFORMATION/401943)

Gift cards continue to grow in popularity – a fact especially noticeable now, during the holiday season. Retailers and consumers should be aware of problems gift cards can create – notably regarding money left unredeemed by card holders and what happens when an issuing company goes into bankruptcy.

Unredeemed gift card money is commonly called "breakage," and the Securities and Exchange Commission says retailers can recognize that money as income when it's unlikely that cardholders will spend it -- typically after two years. Otherwise, retailers can recognize an unused percentage as breakage income based on historical patterns.

That said, not all companies recognize gift card sales the same way. A recent trend is to treat gift cards as accounts receivable, so companies use historical experience to determine when cards likely won't be redeemed. If a card goes unredeemed for two or three years, or if it has a very small balance, retailers typically feel safe removing the cards from unearned revenue accounts.

States sometimes get involved, too, as about half have escheat laws, which send unused gift card funds to state control after a mandated period, with the stated hope that unused money will return to consumers. But even states with escheat laws handle things differently – creating jurisdictional issues.

Federal law says that the funds from unused gift cards belong to the state of the last known address of the consumer, as shown in the retailer's books and records. If there is no known address, or if the card owner's address is in a state that does not take control of abandoned gift cards, then the state where the debtor is incorporated wins -- unless another state can prove it has superior rights.

When can retailers claim revenue from unredeemed gift cards not covered by escheat rules? In accounting terms, the funds received from customers are unearned revenues – balance-sheet liabilities. That means revenue from a gift card sale is not income until a consumer redeems the card or the seller declares the card "unused." A company also can recognize revenue when the likelihood of the card being redeemed is remote based on an inactivity for an unusually long period.

But what happens to consumers and their gift cards if a retailer that issued the card goes bankrupt – as quite a few retailers have done in the past few years. Some huge names have filed for Chapter 11, including Borders, Sharper Image and Radio Shack.

The amount on each card may not be large, but the aggregate amount on all gift cards issued by a retailer can be huge. Sharper Image had about $19 million in unused gift cards when it filed for bankruptcy. At one point in Radio Shack's bankruptcy case, there were $46 million in of unexpired outstanding gift cards.

Holders of gift cards either become priority status creditors (who get paid ahead of other unsecured creditors) or they become general unsecured creditors, not entitled to priority treatment. States' attorneys general have become more aggressive in protecting the interests of gift card holders and now regularly appear in bankruptcy courts.

Retailers in bankruptcy often seek to limit the time in which gift card holders can redeem their cards. They may require the holders to make additional purchases in amounts exceeding the value of the gift card, or they may require the gift card to be fully redeemed at one time.

The treatment of gift cards is driven by the needs of the bankruptcy case – whether the debtor deems preservation of its brand reputation as critical to continuation of the business, whether the debtor believes that preservation of its brand reputation is critical to selling its intellectual property or whether the debtor just wants to achieve the best recovery for creditors without enabling too many dollars to "come off the top."

A National Retail Federation study earlier this year found gift cards to be the most requested gift in America, a position they've held for eight years. Even if gift cards pose challenges regarding federal rules, varying state laws and bankruptcy proceedings, retailers need to be careful to avoid mistakes. Otherwise, an audit or government inquiry could be around the corner.

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The Gift Card Problem For Retailers In Chapter 11

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Kenneth A. Rosen

Gift cards are very popular. They can be highly profitable for a retailer. In bankruptcy cases, the amount of outstanding gift cards can be substantial. In the Sharper Image bankruptcy case, they aggregated $19 million. At one point in the bankruptcy case of Radio Shack there were $46 million of unexpired outstanding gift cards.

Bankruptcy cases for retailers are different than other bankruptcy cases in several ways. One way is the treatment of gift certificates, gift cards, credits and refunds.

The Bankruptcy Code lays out a priority scheme for which creditors get paid before other creditors. This is called the Rule of Absolute Priority. Essentially, it is like a tower of champagne glasses. The top glass must be filled before champagne fills the second tier of glasses. And, the second tier of glasses must be filled before the third tier of glasses can be filled. Generally, the highest tier is the secured creditors' claims. If the secured creditor has a security interest in all assets of the debtor (the company in bankruptcy), then the secured creditor must be paid in full before any money is distributed to other creditors. Behind the secured creditors, but ahead of general unsecured creditors, are priority creditors.

Priority creditors are unsecured creditors who do not have collateral but get paid ahead of other unsecured creditors. Some examples are claims for customer deposits, claims for goods received by the debtor within the 20 days preceding the date of bankruptcy, claims for unpaid wages and claims for taxes. Even within the class of claims that are entitled to priority in payment, there is a ladder of priority — in other words, some priority claims get paid ahead of other priority claims.

The priority scheme of the Bankruptcy Code can be modified if the parties all agree to do so and if the modification is approved by the bankruptcy judge. Therefore, a secured creditor may allow money to flow to a creditor that is junior to it if the secured creditor thinks that, by doing so, there is benefit to the secured creditor. One example might be the secured creditors' desire to make an accommodation to the junior creditors in order to avoid future litigation and in order to bring the bankruptcy case to a more rapid conclusion. In Chapter 11 cases, the likelihood of a successful reorganization rarely increases with the age of the case. It is a rare bankruptcy case in which a party cannot find something to contest and thereby drag out the case.

In strategizing a Chapter 11 case, one of the most important things to be done by the debtor's financial adviser and attorney is to project the amount of claims likely to be asserted against the debtor. Quantifying the claims in each class is critical to formulating a repayment plan. Accurate budgeting is critical in a Chapter 11 case and knowing what the cost will be to emerge from Chapter 11 never should come as a surprise. Plans of reorganization are based on assumptions as to the cost of administration, the cost of paying priority claims and the cost of fulfilling promises to general unsecured creditors. Administration claims are claims that are entitled to be paid 100 percent — normally in cash at confirmation of the reorganization plan. Examples are professional fees and the claims of vendors who delivered goods to the debtor within the 20 days preceding bankruptcy. Payment of some priority claims such as taxes can be stretched out. A calendar of cash outflows must be developed that synchronizes with projected inflows.

When a retailer commences a Chapter 11 case creditors and lenders look at a "waterfall." That is an estimate of the value of the debtor's assets and a projection of how much value must be realized from the assets in order to pay the various layers of creditors. The debtor also takes these numbers into account in evaluating the cost of reorganizing its business. In other words, can a downsized and reorganized business generate the necessary cash flow in order to pay the claims of creditors (presumably at a negotiated discount) and also enable the reorganized debtor to have sufficient working capital for growth? Are creditors better off seeing the company liquidated than seeing the company reorganized? The first step in this analysis is determining the amount of claims in each class of creditors.

A proponent of a plan of reorganization must estimate the amount of cash needed to pay the claims that must be paid when the reorganization plan is approved (confirmed) by the Bankruptcy Court. And, the proponent must calculate the cost of the post-bankruptcy deferred payments promised to creditors. A mistake could be disastrous. Reorganization plans are premised on projected cash flow. Post-bankruptcy strategies to rehabilitate the debtor are based on assumed amounts of working capital. So, underestimating claims can cause plans to go awry.

The matter of the amount owed by a retailer on account of outstanding gift cards, refunds due, gift certificates and open credits is a big issue today in bankruptcy cases. Lately, many (if not most) retail Chapter 11 cases yield a small dividend for trade vendors. If the amount of priority claims senior to trade creditors balloons, then the amount of dollars available to pay trade creditors can evaporate.

In most bankruptcy cases, the debtor will seek permission of the court to continue honoring customer programs — such as gift cards and entitlements to refunds — as if the bankruptcy case never was commenced. The justification to the court is that, unless customers are treated in this manner, the debtor's ability to reorganize will be jeopardized. It is the same justification used to pay pre-bankruptcy employee obligations after the petition date — reorganization will be much more difficult with disgruntled employees. No debtor wants to turn off customers by telling them that their gift certificate is not being honored. Customer loyalty is jeopardized when gift cards are declined.

Most debtors should know the amount of outstanding gift cards. And, they should know the typical amount of "breakage" — the amount of gift cards that are lost and never presented. The projected amount of cards expected to be honored during the budget period (normally 13 weeks initially) affects a debtor's cash flow because all or a portion of the sales to future customer will not generate any cash. The sale proceeds previously were collected and spent. In a bankruptcy case, cash flow is paramount. Lenders, debtors and creditors committees care first and foremost about cash flow and of the debtor's ability to service bank debt, pay timely for post-petition goods and services and, especially, pay professional fees.

One should not expect a secured creditor to have much compassion for consumers with outstanding claims for gift cards. The secured lender wants to be paid first. It perceives every dollar of credit given for a gift card as a dollar less in its pocket.

In retail cases that are liquidations or "GOBs", the question arises as to whether the professional liquidator who is conducting the liquidation sale will honor gift cards for goods sold at the GOB sale. If the liquidator must do so, there will be less cash proceeds for the debtor and its bank. Consequently, a retailer may decide (with the urging of the secured creditor) not to operate in the ordinary course while in Chapter 11 and to proceed directly to a liquidation. A retailer is more likely to be able to not to honor gift cards (and not require that the liquidator to honor outstanding gift cards) if the retailer is in a "GOB" mode.

A threat sometimes heard is that officers and directors of the debtor have individual liability for the amounts due to gift card holders. The theory, apparently, is that the money received from the sale of gift cards are trust funds that should have been segregated rather than comingled with other funds of the debtor. This is a legal theory that no prudent attorney wants to test. Debtors have dealt with this problem in different ways. Therefore, debtors may seek to amicably resolve gift card claims by agreeing to honor them in full, by honoring them for a limited time period, by honoring them provided that no "change" is given for the unspent portion of the gift card or by requiring that the holder of the gift card spend a minimum amount in order to utilize the gift card. The treatment of gift cards is driven by the needs of the case — whether the debtor deems preservation of its brand reputation as critical to continuation of the business, whether the debtor believes that preservation of its brand reputation is critical to selling its intellectual property or whether the debtor just wants to achieve the best recovery for creditors without enabling too many dollars to "come off the top." If someone is seeking to purchase the intellectual property of another retailer in bankruptcy, knowing the treatment of gift cards, credits and refund claims in the bankruptcy case is important to understanding whether the brand's reputation has been tarnished.

States attorneys general and also the Federal Trade Commission care strongly about gift cards. Attorneys general often will appear in Bankruptcy Court to argue in favor of consumers being given priority treatment for their gift cards before any money flows to general unsecured creditors (trade vendors). The justification is that the Bankruptcy Code treats customer deposits as priority claims pursuant to section 507(a)(7) of the Bankruptcy Code. However, not all bankruptcy courts have found that gift cards are deposits. Some have held that they only are unsecured claims.

For a retailer contemplating a Chapter 11 filing, it is important to know the amount of claims that will have to be paid before dollars can trickle down to trade creditors. Trade creditors are the primary body of creditors with whom a debtor will negotiate over a plan of reorganization. Accurately projecting the amount of allowed claims in each class directly affects the analysis of what a reorganized debtor can afford to repay creditors after bankruptcy and also retain sufficient working capital to grow the business.

Finally, when consumers become aware of a retailer's bankruptcy, there may be a burst of utilization of gift cards. These "noncash" payments for goods must be incorporated in the cash flow projections provided to the various constituents in the case. Usually, such projections contain limited permissible variances. Meeting sales targets but missing cash flow projections places a debtor in a position of weakness vis-à-vis other constituents. Whether to honor gift cards, the risks associated with not doing so, the impact on brand value, the demands of the secured creditor and the costs of litigation all must carefully be balanced.

—By Kenneth A. Rosen, Lowenstein Sandler LLP

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What suppliers need to know about retailer bankruptcies

AUGUST 10, 2015 | BY **KENNETH A. ROSEN (/AUTHOR-INFORMATION/401943)**

The rise of e-commerce has made life increasingly difficult for shopkeepers of every size and shape. The continuing shift to online shopping, and the failure of many retailers to adapt, has pushed many retail chains into bankruptcy. Radio Shack, Wet Seal and Deb Shops are just a few once-popular merchants that have declared Chapter 11 in recent years.

But for retailers in particular, Chapter 11 does not always mean a true reorganization, with inventory sell off, lease terminations and dividend payments to creditors. Traditional reorgs have become too expensive for many retail debtors, and banks often prefer to sell off the inventory, suffer their losses and move on quickly rather than slog through a Chapter 11.

Still, if you're supplying a company that is at risk of going bankrupt, it's important that your company takes certain step to protect itself. Don't assume that there's a court-ordered payment down the line that will help make your company whole. Instead, insulate yourself against potential losses before your customer goes belly-up.

The 20-day Rule: When suppliers line up to collect on goods delivered but not paid for, the bankruptcy code gives priority to those who made deliveries within the 20 days preceding the date of bankruptcy Those debts are supposed to be paid "off the top," right after the payment of secured claims. So when you begin to doubt a customer's solvency, start demanding payment within 20 days of delivery.

Reclamation: This is when a seller of goods demands return of the goods upon learning of the buyer's insolvency. Outside of Bankruptcy Court, return of the goods probably requires seeking the help of a State court. Sending out your reclamation letter quickly is important because goods that the buyer has already sold when the reclamation letter is received can't be reclaimed. The bankruptcy law also has deadlines by which to file reclamation claims. And, a vendor's reclamation claim is junior to a bank's secured claim.

Aggressive repayments: The best way to avoid an outstanding balance with a customer sinking into bankruptcy is to avoid letting the balance become outstanding in the first place. The best time to be aggressive in a looming bankruptcy is while it's still looming. Demand payment on past-due balances and consider switching to cash-upfront terms for current shipments. You may lose part of those payments if they're made within 90 days of the bankruptcy filing (this is called a "preference" payment). But you're better off fighting to keep what's in your bank account than fighting over Chapter 11 scraps. Don't worry about preferences.

Buy a put: If you're really concerned about your customer declaring bankruptcy, consider purchasing a put on your claim. Basically, this will give you the right to demand that the seller purchase your bankruptcy claim at a certain price within a predetermined period. Puts usually expire after 90 days. So if your customer goes bankrupt within those 90 days, you'll be able to convert your claim to cash immediately. Puts can be expensive but often the sellers know more about the financial health of your customer than you will, so even negotiating one can provide valuable information.

Credit insurance: Credit insurance is common among companies that manufacture things like paper, apparel and textiles. It's less common for other manufacturers, though that seems to be changing. If you're shopping for credit insurance, consider insuring healthy accounts along with problem accounts, which will help you reduce the cost. Credit insurers can also be another great source of information about the financial health of your customer.

Adjust the terms: The contract with your distressed customers probably specifies the credit terms. Normally you can't unilaterally change those terms. But the law makes an exception when your customer is known to be under duress. In that situation you can declare yourself insecure and demand assurances of payment — payment on past-due balances, collateral or a letter of credit, for instance — in order to continue extending credit.

Finally, do your homework. Learn as much as you can about your customers. The Internet might be killing the brick-and-mortar retailers, but it's a great resource for information. You can use it to look for lawsuits and liens that might have been filed against your customers. If a company is public, you can look up details of its financial health through documents on file with the Securities and Exchange Commission. Sites like CapitalIQ, Debtwire and Reorg Research are good sources if the company is private.

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The Quick Sale Devolution of Chapter 11: A Call to Amend Bankruptcy Code Sale Provisions

Lowenstein Sandler's Ken Rosen addresses section 363 of the Bankruptcy Code, a provision that permits a bulk sale of all debtor assets. He asserts that rapid sales deprive debtors of the ability to utilize the tools of Chapter 11, which is not what Congress intended.

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By Ken Rosen

Ken Rosen, *Partner*, Lowenstein Sandler

Chapter 11 of the U.S. Bankruptcy Code has become the "quick sale" chapter. Traditional reorganizations where debtors emerge from bankruptcy leaner, having shed burdensome assets with a deleveraged balance sheet and a fresh start, are fewer and farther between.

Most debtors wait too long before they file a Chapter 11 petition, and waste too much time pre-bankruptcy trying to effect a sale or refinancing of the business. When debtors do resort to a bankruptcy proceeding — often at the last possible moment — the potential value and benefit of that proceeding have been diminished. The cash burn has continued too long. Assets have depleted to the point where the secured lender simply wants out. Too often, the debtor commences its bankruptcy case at a point when it is too weak to benefit from what Chapter 11 has to offer and long after it has a realistic chance to reorganize.

This scenario has only increased the lender's leverage over the debtor when the Chapter 11 case is finally being planned, which is evident in the terms and conditions of the debtor-in-possession (DIP) financing or cash collateral order. This coincides with the peak of the investment banker's, chief restructuring officer's or financial advisor's frustration that there are no alternatives to DIP financing and/or use of cash collateral from the pre-petition lender.

Debtor's Syndrome

Debtors often suffer from a syndrome which is guided by the thought that if the lender gives just a bit more time, the business will turn around, there will be a successful sale of the company, or a friend will invest. In many instances, the debtor fails to take sufficient, definitive proactive steps that will result in a turnaround, sale or infusion of new capital. Thus, it has little leverage when the lender "recommends" that the debtor file a Chapter 11 petition. Lenders are typically reluctant to push a debtor into bankruptcy unless and until that option is the only resort. Lenders may be concerned about lender liability issues, and most debtors have difficulty seeing the upside of Chapter 11 and loathe the idea of a bankruptcy filing.

Sometimes the best thing that a lender can do for a borrower is push for a filing sooner rather than later — when the debtor still has availability under its credit lines, sufficient assets to comfortably provide adequate protection of security interests and enough credibility to argue that Chapter 11 will enable it to restructure. Too often, by the time the debtor files its bankruptcy petition, the lender is frustrated, the investment banker has deal fatigue and the cash burn has continued for far too long to enable the debtor to fully utilize Chapter 11 to fix its business and promulgate a plan of reorganization.

Expedited Sale of Assets

When the case commences, debtors increasingly assert on day one that a "Section 363" sale of assets and business must take place on an expedited basis and close within a much abbreviated time period or else the world will come to an end. In this common scenario, the debtor never has an opportunity to use the resources of Chapter 11 — lease rejection, sale of assets not necessary to an effective reorganization, claims estimation and cram down — to rehabilitate its business. The justification for an expedited sale process is the allegedly thorough pre-bankruptcy restructuring efforts and the current financial or liquidity crisis which supposedly prove that the debtor is at the end of its rope, all of which would have been much less had the debtor commenced its case sooner.

Once the "sale case" has started, the creditors' committee struggles to "catch up" and rapidly learn about the pre-bankruptcy efforts of the debtor's professionals. It is not easy. Every committee asserts that the sale process in Chapter 11 moves too fast and that, with more time, there would be better alternatives. Usually, there are not. The committee is left to search for causes of action and other means of inducing, or extorting, the secured creditor to free up dollars for unsecured creditors.

A Return to Restructuring Roots

I believe in Chapter 11 and in the likelihood that it facilitates a company's ability to reorganize and restructure. I do not believe that a rapid fire "Section 363" sale should be the end of the road for an honest debtor. However, at the same time, I recognize that a lender's patience can wear thin and that no lender can be expected to sit by and watch as it gets deeper into the danger zone.

Local rules or a statutory amendment can further the goals of Chapter 11 by requiring a minimum number of days — I suggest 75 — between the petition date and the date on which there can be a sale of the debtor's assets in bulk. First, this minimum waiting period assures that there is a better informed creditors' committee. Second, it reduces the pressure on the court to respond to alleged emergencies before the parties in the case, other than the lender and the debtor, are adequately informed. Finally, it guarantees that the debtor has an opportunity — albeit a relatively brief one — to utilize and benefit from the tools that the Bankruptcy Code provides. Of course, hopeless, hemorrhaging debtors, lenders and creditors' committees may resort to motions for relief from the automatic stay or to convert the case to one under Chapter 7.

It is acknowledged that lenders should not suffer twice, once before bankruptcy and once post-petition. However, that is easily addressed. Lenders have many tools with which to convince a borrower to file a voluntary petition sooner rather than awaiting further erosion. Those tools include, but are not limited to, covenants and forbearance agreements. This effectively guarantees that the debtor will have an adequate opportunity to pursue rehabilitation and reorganization in Chapter 11. The debtor may have less time in its out-of-court mode to prove itself, or it will have to commence the restructuring/sale process sooner, but that sacrifice is made up by having precious time to benefit from the Chapter 11 toolbox.

Since the Bankruptcy Code was amended by BAPCPA in 2005 to include section 365(d)(4)(B)(i), which requires greater certainty for lessors of nonresidential real property that the debtor will make a decision to assume or reject the lessor's lease within 210 days after the petition date absent the lessor's consent to any further extensions, secured lenders and debtors routinely incorporate that time period in establishing milestones in DIP financing orders. For example, prudent lenders to retailers now take into account the time necessary to conduct a "GOB" sale and the outside date by which leased property must be surrendered in backing into the latest possible date by which the debtor must find a buyer or else commence the liquidation process. Lenders also can take into account a minimum time period in Chapter 11 before a "Section 363" sale can be held.

For some borrowers, this will mean commencing a reorganization case sooner and acknowledging that Chapter 11 is the best solution. However, the tradeoff is that the debtor will have a greater opportunity and ability to benefit from Chapter 11 to demonstrate that a turnaround or restructuring is feasible. The greater ability derives from a debtor that enters Chapter 11 before it has held out for so long trying to avoid bankruptcy that it is unable to utilize the tools of the Bankruptcy Code. In effect, this only moves up the combined out-of-court and in-court process. It does not necessarily extend it. Rather, it would facilitate greater use of Chapter 11 for its intended purpose and would increase the likelihood of a successful reorganization. Debtors would commence their bankruptcy cases sooner, before their resources were fully depleted, and debtors would be better able to utilize the Bankruptcy Code's tools.

Finally, courts should not penalize lenders for demanding more timely access to Chapter 11 by debtors. I am not promoting that Chapter 11 be skewed in favor of debtors as I have compassion for lenders. However, Congress' intent should be carried out. Currently, Chapter 11 is barely the reorganization chapter. If giving debtors a real opportunity for a fresh start means that debtors and lenders simply have to start and end the out-of-court restructuring process sooner, then so be it.

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October 2015

INSIGHT

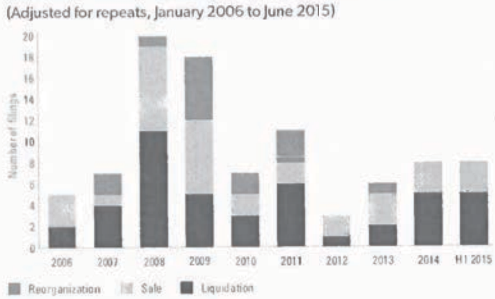
Retail

AlixPartners
When it really matters.

AlixPartners Retail Bankruptcy Insight

Since the 2005 changes to the US Bankruptcy Code, a staggering 55% of retail bankruptcies have ultimately ended in liquidation.[1] This is in marked contrast to other industries, wherein as few as one in 20 debtors faces the same fate;[2] and it is a trend that shows no sign of abating. Indeed, according to a recent AlixPartners study, in the past 18 months only six debtors successfully reorganized or were sold – the other 10 were liquidated.[3] There are clear causes for the high level of retail liquidations, but retailers can take several effective steps to improve their odds for successful turnarounds.

FIGURE 1: Retail bankruptcy outcomes by filing year
(Adjusted for repeats, January 2006 to June 2015)



Source: AlixPartners

The root cause of retail liquidations: A short runway

The reasons retailers enter bankruptcy are varied and complex, but the primary reason they struggle to avoid liquidation is consistent and simple: bankruptcy gives retailers only a very short time frame to execute a reorganization or sale.

Prior to the 2005 changes, retailers often spent *several years* in bankruptcy—time they could use to test merchandising changes, to turn around marginal stores, and to try out new concepts during a holiday season. The changes made by way of the 2005 Bankruptcy Code dramatically altered that timeline, effectively giving retailers only a *few months* to obtain approval for a sale or reorganization before getting forced into liquidation. This accelerated time is most clearly visible in the 16 full reorganizations in our study. (The other 33 going concerns took the form of Section 363 sales). Only Nebraska Book Co., Shane Co., and Hancock Fabrics, Inc., took more than 200 days between filing and plan confirmation; the other 13 reorganizations took an average of only 120 days to obtain plan confirmation.

The driver of that accelerated timeline is Section 365(d)(4) of the code, which provides a maximum of just 210 days before unassumed store leases are deemed assumed—absent individual landlord approvals. Given that rejecting leases *before* they are assumed creates a general unsecured claim that sits below senior lenders but that rejecting leases *after* they are assumed creates an administrative claim above senior lenders, senior lenders will typically enforce a timeline that ensures all unwanted leases get rejected well in advance of the 210-day deadline. And because it can take up to 90 days to run in-store going-out-of-business sales, senior lenders frequently attempt in as little as 120 days to

[1] AlixPartners' analysis includes all resolved retail bankruptcy filings from January 1, 2006, to June 30, 2015, that had more than $50 million in liabilities. Restaurants and grocers are excluded. Repeat filings are included even if liabilities were less than $50 million in the second filing. Study comprises 93 filings and 80 companies (Thirteen companies entered bankruptcy twice during the study period.)
[2] Fitch Ratings, April 2013: Based on bankruptcy case study database of 86 total US corporate bankruptcy cases, which includes 14 liquidations; 20 cases and 11 liquidations were retailers.
[3] Eighteen months, from January 1, 2014, to June 30, 2015.

mandate a decision on whether to liquidate or reorganize a debtor. For example, when Ritz Camera filed for bankruptcy on June 22, 2012, the provisions of its debtor-in-possession loan required it to have a stalking-horse bidder (an initial bidder chosen by the debtor to buy its assets ahead of a possible auction) by August 16 (just 55 days later), an auction by September 6 (76 days later), and a sale complete by September 14 (84 days later).

Other challenges retailers face: a high bar to emerge

Within such a short window of time, a retailer must also jump over a high bar to successfully emerge from bankruptcy. The height of the bar is driven largely by the liquid nature of a retailer's assets. In contrast to other industries that are heavy in fixed assets, retailers typically have asset bases that are heavy in easy-to-sell inventory. Inventory can make up as much as 50% of a typical retailer's assets and can usually be sold at attractive prices. For example, liquidators paid 111% of cost for Anna's Linens' inventory in 2015 and 97% for Coldwater Creek's in 2014. This is problematic for a retailer looking to reorganize, because to emerge from bankruptcy, a debtor must pass the best-interests test, proving that each class of creditor does better under a plan of reorganization than if the company liquidated—a much higher bar whereby liquidation can be accomplished easily and with good returns.

In addition, another important 2005 change to the Bankruptcy Code was the introduction of Section 503(b)(9), which gives "administrative priority" status to vendor claims for the value of goods sold in the 20 days immediately preceding a bankruptcy filing. That effectively means a retailer must pay for those goods in their entirety in order to leave bankruptcy, because administrative-priority claims must be paid in cash on the effective date of a plan. That change raises a significant hurdle for many retailers' emergence. For example, Circuit City's 2008 slide into liquidation was certainly hastened by the $350 million of 503(b)(9) claims that had been filed with the court.

The importance of planning

If a best-case scenario for a retail debtor gives the debtor only three or four months before liquidation becomes almost inevitable, then prebankruptcy-petition planning is imperative. As such, distressed retailers should consider the following steps to potentially improve their prospects for a successful turnaround.

1. Buy time

Distressed retailers need the lengthiest runway possible to achieve an out-of-court turnaround or a well-planned bankruptcy. A critical first step is to develop a detailed understanding of the retailer's liquidity position, debt covenants, and other potential filing triggers. At the same time, so as to maximize the runway available, the company should also implement a variety of liquidity-generating initiatives such as curtailment of capital expenditures, reductions in general and administrative expenses, and optimization of borrowing base. The runway is important both because it provides time to negotiate a turnaround or planned restructuring and because it gives the flexibility to choose the best time to file—for instance, possibly before the winter holidays in order to maximize the ease of selling excess inventory or after the holidays, when retailers are likely to have more cash on hand.

2. Be realistic

Retail *turnaround successes* have advance planning in common. Retail *turnaround failures* share a predictable sequence of missteps: first, a company believes it can avoid a bankruptcy filing through an amendment to its existing debt facilities or through a debt refinancing or through a pickup in sales that never materializes; then it enters bankruptcy planning to close only its lowest-performing stores; and next, it announces that a reorganization couldn't be orchestrated and going-out-of-business sales begin at all stores. Perhaps the most important element of a successful turnaround is the development of a truly feasible plan from the start. If there's a prospect of achieving an out-of-court turnaround, then a strategy based on store closures, marketing optimization, and merchandising transformation may be right. But if a filing seems unavoidable, then preserving cash may help fund an in-court turnaround.

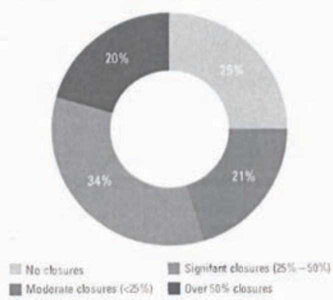
3. Understand the market

An understanding of viable capital markets options is a pillar of a sound plan. There are relatively few distressed retail investors, and based on a viable restructuring plan, it's vital to begin a dialogue with them well in advance of a filing. As time progresses, retailers should also make sure they consult existing lenders both to explore the potential structure of debtor-in-possession financing and to assess the lenders' appetite to support reorganization. The goal is to secure either a stalking-horse bidder or support for a prearranged plan prior to the point of filing. The importance of this is clear from the fact that in our study, every successful reorganization of a debtor with more than $500 million in liabilities was based on either a prearranged or a prenegotiated plan.

4. Focus on operations

Even though retail bankruptcies have become tougher since 2005, the bankruptcy process still offers valuable and otherwise unavailable tools for retail turnarounds. The ability to reject store leases is perhaps the most valuable of the tools, and store closures were used as part of almost every successful restructuring in our study. Of 44 store-based retailers that emerged as going concerns (5 of the 49 going concerns were online or catalog-based retailers), 33 of them closed stores in bankruptcy, and 24 closed more than 25% of their stores (figure 2). A retailer should conduct a four-wall profitability analysis well in advance of a filing and in many cases also initiate rent negotiations with landlords against the backdrop of a potential filing—both to achieve rent savings and to inform store closure decisions with an understanding of potential go-forward lease expenses. In addition to store closures, the ability to reject other executory contracts is a powerful tool for renegotiating and improving marketing, logistics, transportation, and other third-party agreements.

FIGURE 2: Extent of store closures in bankruptcy
(Sales and reorganizations only, excludes liquidations)



Source: AlixPartners

Plan, don't perish

Long after the Great Recession has ended, labor cost increases, declining mall traffic, spotty consumer demand, and the continued growth of e-commerce will ensure that retail remains a tough business. Indeed, retail bankruptcies have been on the rise since 2012, and *as many retailers filed for bankruptcy in the first six months of 2015 as in all of 2014*.

For retailers looking to manage the challenges associated with a potential filing, the key lies in planning. As tough as retail bankruptcies can be, almost half of all retailers in our study emerged as going concerns. Retailers that want to be able to do the same in the future should begin planning long before the bankruptcy filing date, should file with either a stalking-horse bidder or a prearranged plan, and should embrace a restructuring that incorporates significant operational improvement.

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