

# The Details of Retail: Can You Reorganize Middle-Market Retailers?

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12th Annual Mid-Atlantic Bankruptcy Workshop

August 4-6, 2016

Hyatt Regency, Chesapeake Bay

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**“If the economy and the Bank Group’s ‘DIP Financing’ did not destroy any chance of Circuit City having sufficient time to achieve an internal reorganization by downsizing or selling Circuit City’s businesses, Bankruptcy Code §503(b)(9) was the final death knell.”<sup>[1]</sup>**



**“Perhaps most importantly for a retail debtor, the addition of §503(b)(9) to the Code represented a sea change that resulted in retail debtors having insufficient capital to reorganize their businesses.”<sup>[2]</sup>**



**“Lenders are simply disinclined to finance a retailer’s bid for reorganization in the light of the fact that a debtor must now be positioned to pay in full at confirmation a massive class of claims traditional entitled to no more than a discounted unsecured distribution. And, as noted above, to the extent that lenders continued to refrain from providing sufficient post petition financing, the benefits of section §503(b)(9) will rarely be reaped by creditors.”<sup>[3]</sup>**

[1] Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. On Commerical and Admin Law (2009) (prepared statement of R. Pachulski).

[2] Wilson, Michael & Long, Toby. "Section 503(b)(9)'s Impact: A Proposal to Make Chapter 11 Viable Again for Retail Debtors." ABI Journal, Vol. XXX, No. 1, February 2011

[3] Gottlieb, Lawrence. "Resolved: Congress Should Eliminate the Special BAPCPA Protections for Lessors and Providers of Goods." ABI 14<sup>th</sup> Annual ABI Great Debates 2010.

## Origins of §503(b)(9)

-  **Prior to enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), suppliers that sold goods to debtors immediately before filing could assert their state law reclamation rights under §546(c).**
  - **Logistics of asserting reclamation rights were cumbersome and difficult for vendors.**
  - **For goods sold within the reclamation period but not reclaimed, suppliers normally had general unsecured claims that were to be paid pro rata with all other general unsecured claims in accordance with confirmed Plans.**
-  **BAPCPA added §503(b)(9) which allowed as administrative expenses:**
  - **The value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor’s business.**

## Implications to Debtors

-  **Retailers likely receive a high volume of inventory in the 20-day period prior to bankruptcy, particularly under “just in time” supply chain models.**
  - **Accordingly, the addition of §503(b)(9) created a new and potentially large class of administrative claims.**
  - **§503(b)(9) elevated a potentially sizeable portion of debtors’ otherwise general unsecured claims to administrative status.**
  - **Unlike secured and priority claims which debtors can pay over time, debtors must pay §503(b)(9) to emerge.**
  
-  **Claims with administrative expense status are meant to provide post-petition benefit to debtors— thereby increasing debtors’ chances of reorganization.**
  - **With rapid inventory turns, debtors might not receive post-petition benefit (i.e., cash flow) from a large percentage of claims that receive §503(b)(9) treatment.**

## Implications to Debtors (continued)



### §503(b)(9) burden might also:

- **influence other vendors' decisions re extending post-petition credit and continuing supply relationships;**
  - **Critical vendor status (and attendant favorable trade-terms for debtors) largely obviated by administrative status of §503(b)(9) claims.**
- **increase the amount of exit financing required to clear emergence requirements – while providing no post-emergence benefit to the company;**
- **consume liquidity a debtor would otherwise have to fund its post emergence operations; and**
- **influence lenders to push for liquidation sooner, knowing the debtor risks administrative insolvency if permitted to attempt a reorganization.**

## Has §503(b)(9) contributed to a higher rate of retailer failures?

- There is little empirical evidence to link §503(b)(9) with case outcomes.
- However, in the first two years after enactment of BAPCPA, retail chapter 11 debtors liquidated at a very high rate.
  - §503(b)(9) claims were high as i) a percentage of total trade claims and ii) when compared to distributable assets.
  - Both measures of §503(b)(9) have declined since the early BAPCPA years.
  - It's unclear whether these declines are coincidence, a result of better economic conditions than in 2008 / 2009, debtors being more prepared to address / mitigate §503(b)(9), or a combination.

## Debtors are better able to address §503(b)(9) than in the early years

-  **Bankruptcy Court opinions have removed much of the uncertainty as to what constitutes goods, delivery dates, interplay with recovery actions, and other issues surrounding [potential] §503(b)(9) claims.**
-  **With several years of §503(b)(9) experience, advisors are able to help debtors implement strategies to:**
  - **Minimize purchases in the 20-day window – if possible given inventory constraints and uncertainty re filing date;**
  - **Offset §503(b)(9) claims against receivables from affected creditors; and**
  - **Negotiate down / away §503(b)(9) claims**
    - **For critical vendor consideration;**
    - **In order to have a confirmable plan (and ongoing relationship with creditor); and**
    - **Against recovery actions vs the affected creditors.**

## Final Thoughts

-  **While enactment of §503(b)(9) became a huge obstacle, it appears to be one of several – and not the only– impediment to retailers’ ability to reorganize.**
-  **The benefit §503(b)(9) conveyed to one subset of trade creditors has penalized other case constituents -- e.g., landlords, service providers, contract parties, employees, etc. -- by contributing to the demise of retail chapter 11 debtors.**
-  **Effects of §503(b)(9) are likely to continue.**
  - **ABI Commission to Study the Reform of Chapter 11 voted to retain this Code section.**

# CONSIGNED GOODS IN BANKRUPTCY

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# What is Consignment?

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- UCC §9-102(a)(20): "Consignment" means a transaction where a person delivers goods to a merchant for the purpose of sale
- and:
  - (A) the merchant:
    - (i) deals in goods of that kind under a name other than the name of the person making delivery;
    - (ii) is not an auctioneer; and
    - (iii) is not generally known by its creditors to be substantially engaged in selling the goods of others;
  - (B) with respect to each delivery, the aggregate value of the goods is \$1,000 or more at the time of delivery;
  - (C) the goods are not consumer goods immediately before delivery; and
  - (D) the transaction does not create a security interest that secures an obligation.
- UCC §9-102(a)(19): "Consignee" means merchant to which goods are delivered on consignment.
- UCC §9-102(a)(21): "Consignor" means a person that delivers goods to a consignee on consignment.
- UCC §9-102(a)(73)(C): "Secured Party" means a consignor.
- UCC §9-103(d): Consignor's security interest is a purchase money security interest (PMSI).
- UCC §9-109(a)(4): Article 9 applies to a consignment.
- "Consignment" narrowly defined by UCC. Non-Article 9 Consignment: Bailment for the purpose of sale or "sale or return" under UCC §2-326.

# Steps to Protect Interest in Consigned Property under the Uniform Commercial Code

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- 1. Written consignment agreement.
  - Consignee grants Consignor a security interest in the consigned inventory.
  - Title and ownership remain with consignor until sold, risk of loss with consignee.
  - Inventory control.
- 2. **Before** Consignor ships goods to Consignee
  - Consignor files a UCC-1 financing statement, describing the consigned inventory.
  - Consignor sends written notice to all parties with liens on the consignee's inventory describing the consignment arrangement, the consigned inventory and the date on or after which the consigned inventory is to be delivered to consignee.
- 3. Every five years, Consignor files a continuation statement and new notice to all parties with liens in Consignee's inventory. UCC §9-324(b).
- 4. **If the Consignor has not properly perfected its interest prior to Consignee's bankruptcy filing, it is at considerable risk of being relegated to status of a general unsecured creditor with no ownership interest in the consigned goods.**

# Parties with competing claims in the consigned inventory

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## ■ Trustee/Debtor

- UCC §9-317 (a) provides that “A security interest ... is subordinate to the rights of ... a person that becomes a lien creditor the earlier of the time ... the security interest or agricultural lien is perfected ...”
- UCC §9-102(52) defines a lien creditor as: “... a trustee in bankruptcy from the date of the filing of the petition.”
- Article 2: Sale of Goods
  - UCC §2-326: “sale or return” goods subject to buyer’s creditor’s claims.
  - UCC §2-401: title not retained; only reservation of a security interest.

# Parties with competing claims in the consigned inventory

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## ■ Secured Lender

- Debtor's secured lender(s) typically have a "blanket lien" on all of the debtor's assets, including inventory.
- UCC §9-319 provides "while the goods are in the possession of the consignee, the consignee is deemed to have rights and title to the goods identical to those the consignor had or had power to transfer."
- Lenders argue that based on UCC §9-319 that while a debtor retains possession of consigned goods and notwithstanding that "title" remains with the consignor, the debtor may transfer to any creditor a security interest in such consigned goods.

# Whitehall Jewelers Holdings, Inc., et al.

## Delaware Bankruptcy Court, Case No. 08-11261

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- Received consigned inventory from 124 consignment vendors for sale to Debtors’ retail customers.
- Consignment vendors opposed the GOB motion, arguing the consigned goods were not “property of the estate” and could not be sold by Debtors.
- Debtors argued they could sell consigned goods because there was a “*bona fide* dispute” under section 363(f)(4) with respect to the consigned goods.
- Court would not permit Debtors to sell consigned goods without first demonstrating to the Court that the goods were property of the estate.
- Recent Third Circuit precedent required adversary proceeding be commenced “to determine the validity, priority or extant of an interest in property” *SLW Capital, LLC v. Mansaray-Ruffin (In re Mansaray-Ruffin, 530 F.3d 230 (3d Cir. 2008).*

# The Sports Authority, Inc., *et al.*

## Delaware Bankruptcy Court, Case No. 16-10527

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- TSA moves to sell consigned goods, proposing to escrow sale proceeds.
- Lenders alleged that many consignors filed UCC-1s within preference period or not at all.
- Consignors objected, citing *Whitehall Jewelers*.
- TSA filed 160 adversary complaints and argued that the filing of the complaints created a *bona fide* dispute for purposes of 363(f).
- Bankruptcy Court ultimately determined that TSA had three options:
  - Settle with the consignors,
  - Don't sell the consigned goods, or
  - Sell and comply with consignment agreements:
    - Court deemed consignor consent to sale to be given by virtue of signing the consignment agreement - §365.
    - Proceeds had to be paid to consignor in the ordinary course.

# TSA (con't)

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- Motion to Approve Settlement; Withdrawn.
- Term Lenders appeal Interim Consignment Orders.
- Request for stay pending appeal denied.
- Consignors appeal Final Consignment Order.
  - Disgorgement and imposition of liens.
  - Jurisdiction.
- Appeals pending as of June, 2016.
- Mediation.
- Unclear what the impact has been on the sale process and value.
- Consignors have been getting paid but are subject to potentially costly and lengthy litigation and subject to disgorgement if the lenders prevail in the adversary actions.
- Debtors seek to abandon consigned goods.

## Consumer Privacy Ombudsman Overview

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 made several key revisions to the Bankruptcy Code that create a framework for selling or leasing customer information under Section 363 of the Bankruptcy Code.

- First, a new § 101(41A) defines the term “personally identifiable information (PII).”
- Second, amendments to § 363 limit the debtor’s ability to sell or lease personally identifiable information.
- Third, a new § 332 controls appointment of Consumer Privacy Ombudsmen and defines her role in the sale process.

## Bankruptcy Sales under Section 363

- Section 363(b)(1) of the Bankruptcy Code governs a debtor's ability to "use, sell, or lease" PII.
- Generally, a debtor may not sell or lease PII if, at the time of the commencement of a bankruptcy case, the debtor's privacy policy prohibits the transfer of PII to unaffiliated entities. See 11 U.S.C. § 363(b)(1).
- Notwithstanding this general prohibition, a sale is permitted, pursuant to section 363(b)(1)(B) of the Bankruptcy Code, if:
  - after the appointment of a consumer privacy ombudsman, the court approves the sale (i) giving consideration to the facts, circumstances, and conditions of the sale and (ii) finding that no showing was made that the sale would violate applicable nonbankruptcy law.

## **Consumer Privacy Ombudsman Appointment under Section 332**

- Section 332(b) of the Bankruptcy Code provides that the Ombudsman shall “provide to the court information to assist the court in its consideration of the facts, circumstances, and conditions of the proposed sale or lease of PII under section 363(b)(1)(B).”
- Among other things, the Ombudsman may present the following information to the Court:
  - the Debtors’ privacy policy;
  - the privacy impact on consumers if the sale proceeds; and
  - alternative solutions that might mitigate the privacy impact.

## *In re Toysmart*

- In *Toysmart*, the debtor sought bankruptcy court approval to sell certain assets, including its customer lists, through a public auction. However, this was directly contrary to *Toysmart's* privacy policy; the FTC sought to enjoin the sale.
- “Qualified Buyer” means an entity that is acquiring PII as part of a larger asset sale **and**:
  - (a) agrees to operate the acquired assets as a going concern concentrating in the same business or market as the debtor;
  - (b) expressly agrees to be bound by, and succeed to, the debtor's existing privacy policies;
  - (c) agrees to be responsible for any violation of existing privacy policies; **and**
  - (d) obtains affirmative consumer consent prior to making any material change to the debtor's existing privacy policies.

## Applicable Nonbankruptcy Law

Among other things, the following nonbankruptcy laws are generally applicable to a Section 363 sale involving PII:

- Section 5 of the Federal Trade Commission Act (the “FTC Act”)
- Children’s Online Privacy Protection Act of 1998 (“COPPA”)
- Gramm-Leach-Bliley Act (“GLBA”)
- Video Privacy Protection Act (“VPPA”)
- Applicable state consumer protection laws

# Lease Issues in Retail Bankruptcy Cases

- **Prepetition warning signs may include:**

- Failure to pay / delay in rent payment
- Inventory pile-ups
- Missing key finance deadlines
- Negative publicity relating to tenant
- Radio silence by tenant

- **Unexpired lease as of the bankruptcy filing:**

- Prepetition termination, in accordance with lease terms and applicable state law. However, the termination process must actually be completed prepetition and not subject to reversal.
- Postpetition termination, in accordance with lease terms (e.g., expiration of stated lease term). Also potentially, although not commonly, landlord may obtain relief from stay to terminate lease for cause.

- **Participation in bankruptcy process:**
  - Examining “first day” motions and orders including cash collateral /DIP financing motion and budget, to ensure sufficient liquidity for DIP to timely perform under lease and to understand direction of case. Landlord has leverage to object if there were prepetition and uncured defaults.
  - Possible participation as a committee member, to better ensure landlords’ interests are considered. Further, landlord may want to consider acting in collective manner with other landlords.
  - Protecting rights as landlord and creditor: Filing claims, motion for relief from stay to terminate lease, motion for timely performance of section 365(d)(3) lease obligations, objection to 90-day extension of time to reject/assume, objection to proposed sale/assignment of lease and cure amount, etc.

- **Disposition of lease during the bankruptcy case:**
  - **§ 365(d)(3):** Timely performance of lease obligations. Billing vs. accrual approaches by courts.
  - **§ 365(d)(4):** 120 days to assume or reject, plus DIP may seek further 90-day extension. Any additional extensions must be agreed to by landlord.
  - **Shopping centers - § 365(b)(3)** (adequate assurance)
  - **§ 363/365 sale:** Lease may be specifically assigned to buyer as part of auction or other sale process, or specifically rejected by DIP to minimize administrative claims. DIP may also sell lease designation rights. Landlord must ensure adequate assurance of future performance by proposed assignee. Adequate assurance package should include audited financials, intended use of space, cash flow projections / business plan, evidence of retail experience. Landlord may request guaranty by parent or affiliate if buyer's financial condition is not as viable as that of the DIP.

- **Disposition of lease during the bankruptcy case (cont'd):**

- **GOB sales:** More commonly, going-out-of-business (GOB) sales are being conducted. Communicating with operations personnel is important relating to condition of premises, maintenance, and handing over of keys. Landlord must ensure reasonable GOB sale guidelines and turnover process.
- **Other effects:** New tenant's identity and use of premises may impact (i) nonbankruptcy laws/regulations including zoning and use and other permits, (ii) potentially force landlord to incur significant expense and delay to reconfigure or alter property, and (iii) rights of other tenants, to possibly vacate or abate their rent due to loss of current tenant.
- Treatment under a Chapter 11 plan, including in particular the treatment of general unsecured claims including lease rejection claims and treatment of leases not specifically assumed or rejected earlier.

- **Claims:**

- **§ 502(b)(6) cap / rejection claim:** § 502(b)(6) provides a cap for the rent reserved under the lease for the greater of one year, or 15% percent, not to exceed three years, of the remaining term of the lease.
  - **Master leases:** Ability to bifurcate by location
- **Stub rent:** Rent claim for amount due to landlord for period of use/occupancy between bankruptcy filing date and first postpetition rent payment date. Third Circuit espouses “billing date” or “performance” approach with respect to § 365(d)(3) lease obligations, but also holds any unpaid stub rent may constitute administrative claim to be paid later. In contrast, some courts in other jurisdictions like Second Circuit courts espouse “pro rata” or “accrual” approach.
- **Administrative rent:** If a § 365(d)(3) obligation, performance by DIP should be timely in accordance with lease. If a postpetition claim but not a § 365(d)(3) claim, such claim is entitled to administrative priority and will likely be paid under a confirmed plan, rather than pursuant to lease-imposed dates.