

Trends in Retail Bankruptcies

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I. Introduction

Over the past two to three years, there has been an increase in Chapter 11 retail bankruptcy filings, with high profile cases such as Sports Authority, Wet Seal, the Great Atlantic & Pacific Tea Company, Aeropostale, and Pacific Sunwear among them. The success rate for retail bankruptcies has been increasingly spotty over the past ten years, for a variety of reasons. In 2005, numerous changes were made to the Bankruptcy Code which have been unfriendly to debtors pursuing reorganization objectives, retail debtors in particular. Lenders have reacted accordingly, and Chapter 11 financing usually provides a shorter runway for retail debtors to make critical decisions as to the path the case will take. There is also no way to ignore macroeconomic changes and factors which have impacted the retail landscape. This article will explore all of these factors and evaluate recent trends in retail filings.

II. Bankruptcy Code Issues Affecting Retail Debtors

A. Timing of Lease Assumption

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) condensed the timeline for retail debtors to assume or reject their leases of nonresidential real property to 120 days, with the right to seek extensions for an additional 90 days, for a maximum period of 210 days absent further consent of the landlord. Prior to the enactment of BAPCPA, the Bankruptcy Code allowed debtors an initial period of 60 days to assume or reject nonresidential leases of real property, but this 60 day deadline could be extended indefinitely. In many retail cases, debtors successfully extended the deadline to assume or reject real estate leases for years, which provided debtors a far greater window to evaluate store profitability, test alterations of product type and product mix in marginal stores, delay payment of prepetition arrearages on leases that are assumed, and most importantly, avoid committing to the obligations under an assumed lease without an approved reorganization plan. These options for a retail debtor were dramatically curtailed with the enactment of BAPCPA. The 210-day window for lease assumption or rejection can be extended with the agreement of the landlord, but unless these agreements are reached in advance, all constituents in the bankruptcy case must assume that the 210-day window will govern.

The 210 day lease assumption/rejection deadline has had a dramatic effect on retail bankruptcy financing alternatives. In the event a restructuring or going concern sale cannot be accomplished, the retail debtor will likely be liquidated through some sort of going out of business (GOB) sale. The GOB sale process can often take 90 days or more to be completed.

The approval of the GOB itself by the Court can take up to 30 days. Therefore, as a practical matter, a retail debtor might have as little as 90 days to make decisions and obtain Court approval for a restructuring plan or going concern sale before a GOB alternative is foisted upon it.

These concerns have necessarily impacted the parameters of retail lending. Secured creditors do not want to run the risk of their collateral evaporating because valuable leases have not been assumed within the statutory period, and inventory cannot be sold from the existing location. In cases where there is no white knight investor supporting the debtor through the Chapter 11 process, lenders typically require a tight timeline for a confirmed plan or sale process as a condition to their agreement to lend. For example, in Sports Authority which filed for Chapter 11 on March 2, 2016, the initial debtor financing documents called for the debtor to achieve the following, which is not atypical:

- (i) file a motion to close or liquidate 180 stores on the petition date;
- (ii) obtain an order on the store closing motion within two weeks of the petition date;
- (iii) obtain an order extending the lease assumption/rejection deadline to 210 days within four weeks of the petition date;
- (iv) schedule an auction to be held by April 25, 2016;
- (v) obtain a hearing on the sale transaction by April 27, 2016;

The debtor financing was scheduled to expire by June 30, 2016, or 120 days after the filing.

Attached as Exhibit “A” are case studies for Wet Seal, Great Atlantic and Pacific Tea Company, and Aeropostale, which include backgrounds of the respective debtors, capital structure, and timelines for achieving sale/reorganization objectives.

B. Section 503(b)(9) Administrative Claims

A second key headwind for retail debtors arising from BAPCPA was the insertion of Section 503(b)(9) into the Bankruptcy Code, which provides that vendors who deliver goods to the debtor within 20 days of the petition date are entitled to an administrative claim for the cost of such goods. Section 503(b)(9)'s impact was seen most clearly in the Circuit City bankruptcy case. In that case, the debtor faced up to \$350,000,000 in vendor administrative claims when it filed in November 2008. The company initially intended to close some stores and emerge as a more lean entity but ended up liquidating all of its stores, and the \$350,000,000 in vendor claims is believed to have significantly influenced that decision.

The treatment of Section 503(b)(9) administrative claims varies from jurisdiction to jurisdiction. In Massachusetts, local rules establish a deadline for filing 503(b)(9) claims but do not address terms for payment of such claims.

For their part, bankruptcy courts have varied as to when, if ever, a debtor must ensure payment in full of section 503(b)(9) claims. In *In re Global Home Prods LLC*, 3791955 (Bankr. D. Del. 2006), the Court considered the following three factors in determining the timing of payment of allowable Section 503(b)(9) claims: prejudice to the debtor, hardship to the claimant, and potential detriment to other creditors. The Court also noted that the outside date for payment would appear to be the plan effective date, as Section 1129(a)(9) of the Bankruptcy Code requires that administrative claims be paid in full on the effective date.

Other cases have found the timing of payment of Section 503(b)(9) claims to be within the discretion of the Court. *See, e.g., In re TI Acquisition, LLC*, 410 B.R. 742 (Bankr. N.D. Ga. 2009)(timing of payment within discretion of the court; because lender consented to payment of allowed administrative claims and debtor had an avoidance action pending against claimant, court deferred payment pending outcome of adversary proceeding); *In re Modern Metal Products, Co.*, 2009 WL 1362632 (Bankr. N.D. Ill. 2009)(timing is within discretion of court; court may take into account potential for additional administrative claims prior to reorganization and risk that debtor would be unable to pay all administrative claims in full); *In re Bookbinders' Restaurant, Inc.*, 2006 WL 3858020 (Bankr. E.D. Pa. 2006)(court would hold evidentiary hearing to further develop record before determining whether to compel payment; decision within discretion of the court);

In the sale context, treatment of Section 503(b)(9) claims has varied. In *In re Townsend's, Inc.*, No. 10-14092(CSS), the Bankruptcy Court for the District of Delaware initially refused to approve the debtors' post-petition financing package, finding that the prospects for payment of Section 503(b)(9) claims were slim. *In re Townsend's, Inc.*, No. 10-14092(CSS) (Bankr. D. Del.). The court later approved the financing once the debtors' lender and the creditors' committee reached an agreement to pay Section 503(b)(9) claims from the proceeds of the sale. By contrast, in *Allen Family Foods*, No. 11-11764 (KHC), the Delaware bankruptcy court approved the sale of the debtors' assets despite there being no assurance of full payment of allowed Section 503(b)(9) claims due. *In re Allen Family Foods, Inc.*, No. 11-11764 (KJC) (Bankr. D. Del.). Similarly, in *In re Real Mex Restaurants Inc.*, Case No. 11-13122(BLS), the Delaware bankruptcy court approved a sale under Section 363 despite the fact that the case was administratively insolvent. *In re Real Mex Restaurants Inc.*, Case No. 11-13122 (BLS) (Bankr. D. Del.).

A third alternative in the sale context has been the establishment of a reserve from sale proceeds to fund allowable Section 503(b)(9) expenses. In *In re Blitz USA, Inc.*, Case No. 11-13603 (PJW), the Delaware bankruptcy court approved the sale of a division of the debtors' business and required a reserve pending a determination of the final outcome of the cases. *In re*

Blitz USA, Inc., Case No. 11-13603 (PJW) (Bankr. D. Del). In *In re AFA Investment Inc.*, Case No. 12-11127 (MFW), the bankruptcy court approved the sale, but also required the debtors to reserve the sale proceeds above the amount necessary to satisfy the debtor-in-possession financing and the first lien lenders in order to determine whether Section 503(b)(9) claimants were entitled to such amounts above the second lien lenders. *In re AFA Investment Inc.*, Case No. 12-11127 (MFW) (Bankr. D. Del.). The bankruptcy court reserved judgment on the question of whether the 503(b)(9) claimants were entitled to be paid from sale proceeds prior to payment of the second lien lenders. *See id.*

A settlement involving a segregated escrow for 503(b)(9) claimants was approved in *In re NE Opco, Inc.*, No. 13-11483 (CSS). As is typical in many retail bankruptcy cases, the debtors had limited funds in their debtor in possession financing budget and a limited period within which to obtain a purchaser for their assets. Absent a prospective purchaser in place, the debtors negotiated a deal with the other constituents that provided for, inter alia, the funding of a segregated escrow account for payment of allowed section 503(b)(9) claims. The Debtors then filed a motion (the “9019 Motion”) seeking approve of the agreement under Bankruptcy Rule 9019. At the hearing on the 9019 Motion, several creditors asserting section 503(b)(9) claims objected, arguing that despite the Bankruptcy Code’s conferral of priority upon such claims, the settlement between the parties provided no assurance that such claims would be paid in full and, in fact, the financial constraints of the case made it speculative as to whether section 503(b)(9) claims would be paid at all. The bankruptcy court ultimately approved the settlement. Noting that a section 363 sale was the best way to maximize value for the estate and its constituents, the court found that the settlement was the most likely path to facilitate such a sale. The court rejected the notion that the settlement had to guarantee the payment in full of all section 503(b)(9) claims. Instead, the court looked to whether there was a reasonable likelihood that 503(b)(9) claims will be paid in full. The bankruptcy court found that it was more likely than not that section 503(b)(9) claims would be paid. The court acknowledged the concern that some administrative claimants may be paid more than others, but indicated that this was sometimes a business reality, but its mere possibility was not sufficient to decline to approve the settlement.

While recent developments indicate that assurances of full payment of section 503(b)(9) claims may not be necessary in order to obtain approval of debtor-in-possession financing or an expedited sale under section 363, the law remains far from settled. Accordingly, debtors, secured lenders and committees must be wary of potentially disgruntled section 503(b)(9) claimants when negotiating section 363 sales, especially in cases with limited funds or where a debtor may be close to administrative insolvency.

C. Impact of Gift Card Claims

Another important issue requiring resolution in the retail bankruptcy context is the treatment of claims of consumers holding unredeemed gift cards.

Section 507(a)(7) of the Bankruptcy Code provides a priority for certain unsecured claims relating to consumer deposits. Specifically, 507(a)(7) grants priority status to:

Allowed unsecured claims of individuals, to the extent of \$2,775 for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided.

In one of the few decisions on the subject, Judge Rosenthal found in *In re WW Warehouse, Inc.*, 313 B.R. 588 (Bankr. D. Del. 2004) that gift cards purchased prepetition were “deposits” within the meaning of 507(a)(7), and such claims should therefore be accorded priority unsecured status.

In August 2016, another Delaware Court came to the opposite conclusion. *In re City Sports, Inc.*, 2016 WL 4190090 (Bankr. D. Del. Aug. 4, 2016). In concluding that gift cards were properly treated as general unsecured claims, the *City Sports* Court concluded that gift cards were not “deposits” in the true sense, as the transaction was completed once the gift card was issued. Rather, the cards were similar to the purchase of a product, that being a transferable instrument, for immediate delivery. The term “deposit” connoted a ‘temporal relationship’ between the time the consideration was given and the time the right to use or possess is vested in the one providing the consideration. *City Sports* concluded that *Woodworkers Warehouse* wrongly focused on the ultimate purchase of goods, a vague concept with a potential unlimited time extension. The earlier Court should have focused on the confines of the gift card transaction.

The issue came up again in the Radio Shack bankruptcy. The Texas Attorney General sought a determination that the gift cards be accorded priority status. The debtor sought and obtained a deadline for gift card holders to redeem their cards. Approximately \$46 million in gift cards purchases were not redeemed by the redemption bar date. The Texas Attorney General sought a determination that all unredeemed cards be treated as priority unsecured claims. A settlement was ultimately reached dividing the gift cards into those for which consideration was provided (which would be accorded priority unsecured status) and those for which consideration was not provided (which would take on general unsecured status). In terms of the requirement that there be a “deposit” for Section 507(a)(7) priority to apply, this seems to be a reasoned result.

D. Best Interests of creditors test

Retailers often have easily salable inventory, even in a liquidation context. Some retailers have inventory with a liquidation value equal to cost, or even above cost. For example, liquidators paid 111% of cost for Anna's Linens inventory in 2015 and 97% of cost for Coldwater Creek in 2014. Inventory can comprise as much as 50% of a typical retailer's assets.

The substantial liquidation value of retail inventory, and its value in the context of all of a lender's collateral, can adversely impact a retail debtor in two respects. First, the debtor must demonstrate in a confirmed plan that creditors will receive more from the reorganization than they would receive in a liquidation, which is often referred to as the "best interests of creditors test" set forth in Section 1129(a)(7) of the Bankruptcy Code. Any reorganization plan that contemplates continued operation of some or all of the debtor's store must evaluate projected sales and operating expenses against the benefits of an immediate liquidation. Secondly, if lenders believe that their collateral has substantial value at liquidation, this will provide a further disincentive for secured creditors to take risks on a reorganization with an uncertain outcome.

III. Trends in outcome of retail bankruptcy filings

Since the 2005 changes to the Bankruptcy Code, the majority of retail bankruptcies have ended in some form of liquidation, a much higher percentage than liquidations in large, non-retail cases. In April 2013, Fitch Ratings, one of three nationally recognized statistical ratings organizations, conducted a study involving 86 United States corporate bankruptcy cases filed since 2005, including 20 retail companies. Of all of the sample cases, 17% resulted in a liquidation. More than half of the retailers in the study, however, fell victim to liquidation. A similar study was performed by Alix Partners analyzing retail bankruptcy filings from January 1, 2006 through June 30, 2015, evaluating companies with more than \$50,000,000 in liabilities excluding restaurants and grocers. The study, which involved 80 companies, reflected a similar retail liquidation rate of 55%. Data for the eighteen months ending June 30, 2015 did not reflect any improvement in trends.¹

IV. Macroeconomic factors

In addition to the changes wrought by BAPCPA, macroeconomic trends have impacted retail filings and the time sensitive decisions that a distressed retailer must make respecting issues such as store closings and alteration of product mix. The macroeconomic landscape continues to be challenging. Online retailers continue to pose an existential threat to many industries, with lower cost structures and strong delivery capabilities. Conventional retailers also face stiff competition from pop up stores and specialty retailers that often eat into profitable product lines.

¹ For additional information on retail trends, see *The Disappearance of Retail Reorganizations Under the Amended Section 365(d)(4)*, Lawrence Gottlieb, http://commission.abi.org/sites/default/files/statements/04jun2013/Supplemental_Written_Testimony_of_L_Gottlieb_for_Commission_to_Study_the_Reform_of_Chapter_11.pdf and *AlixPartners Retail Bankruptcy Study*, <http://legacy.alixpartners.com/en/Publications/AllArticles/tabid/635/articleType/ArticleView/articleId/1795/AlixPartners-Retail-Bankruptcy-Study.aspx>

The landscape continues to evolve for the demand for commercial lease space. Many of the larger retail companies continue to maintain a sizable big box store presence. Leases for these types of locations may be less marketable when taking into account likely suitors and the altered retail landscape. While the diminished demand for big box lease space in some circumstances may provide an opportunity to negotiate more favorable terms on outstanding leases, these market conditions may also reduce prospects for generating much needed cash for retail debtors looking to exit marginal locations.

The marketplace continues to evolve, and retailers will need to remain nimble in responding to challenges brought by new and evolving competitors and changing customer tastes.

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