



# Retail Bankruptcies: THREADING THE NEEDLE IN A TATTERED INDUSTRY

BY JENNIFER FELDSHER AND MARK E. DENDINGER, PARTNERS &  
LOGAN S. KOTLER, ASSOCIATE, BRACEWELL LLP

**T**he U.S. retail industry is tattered and torn, and Chapter 11 continues to be an inevitable ending for many distressed retailers struggling in the post-Amazon world. Indeed, despite the recent uptick in the U.S. economy, retailer woes have continued unabated, with sales for many continuing to suffer despite wage improvements and the stock market's upward movement.

Since the beginning of 2016, there have been more than 60 retail bankruptcies, making it the second most active sector in total bankruptcy filings during this stretch, behind only the oil and gas sector. Yet, studies show that retailers fare far worse in bankruptcy than their counterparts in other industries. Nearly 49 percent of retail cases end in liquidation as compared to 21 percent of cases involving companies in non-retail

sectors.<sup>1</sup> This article looks at some of the unique issues facing retailers that make reorganization challenging and some of the lessons learned from recent success stories where liquidation was avoided.

Industry experts and bankruptcy professionals place much of the blame for the high rate of retail liquidations on the U.S. Bankruptcy Code amendments enacted in the

Bankruptcy Abuse Prevention and Consumer Act of 2005 (BAPCPA), including revisions to Section 365(d)(4) regarding assumption and rejection of nonresidential real property leases and Section 503(b)(9), which expanded the definition of administrative claims.

Empirical data lends support to the theory—with one notable industry study of 20 of the largest pre-BAPCPA retail bankruptcy cases finding that 10 of the cases (50 percent) reached a confirmed Chapter 11 plan, three (15 percent) involved Section 363 sales, and seven (35 percent) ended in liquidation.<sup>2</sup> Post-BAPCPA, however, only three of 25 large retail bankruptcy cases (12 percent) reached a confirmed Chapter 11 plan, 10 (40 percent) involved Section 363 sales, and 12 (48 percent) ended in liquidation.<sup>3</sup>

Another study by AlixPartners and Fung Global Retail & Technology examined 93 filings by 80 different retailers—13 of them having entered bankruptcy twice during the period—after enactment of BAPCPA and found that a staggering 55 percent of cases ended in liquidation.<sup>4</sup>

Retailers suffer from a host of externalities in the current economic climate that have nothing to do with the Bankruptcy Code, yet retail debtors continue to have a particularly difficult time using Chapter 11 effectively to reorganize. That's because retail debtors, as compared to their counterparts in other industries, must contend with a unique set of challenges in Chapter 11, including: (i) Bankruptcy Code provisions that accelerate their Chapter 11 cases and negatively impact key estate assets; (ii) onerous debtor-in-possession (DIP) financing terms and tight milestones; and (iii) viable liquidation alternatives that can be used to avoid the need to pay the increased administrative costs associated with reorganization.

### Challenges Facing Retail Debtors

Before 2005, retailers, like other debtors, often remained in bankruptcy for an extended period of time before committing to a path of resolution, be it a traditional plan of reorganization, a Section 363 sale, or liquidation. In

the old regime, Section 365(d)(4) of the Bankruptcy Code technically required unexpired leases of nonresidential real property to be assumed or rejected within 60 days of the petition date, but courts could—and routinely did—extend that time through confirmation of a Chapter 11 plan, and even beyond in some cases. As a result, retail debtors had time in bankruptcy to review and analyze their lease portfolios to ascertain and monetize any pockets of value without being subjected to overwhelming pressure from their lenders and landlords.

Through BAPCPA, however, Congress amended Section 365(d)(4) to provide an outside limit of 210 days by which a debtor must assume or reject its nonresidential real property leases, absent landlord consent.<sup>5</sup> Although the revisions were designed to provide a firm, bright line deadline on a debtor's ability to assume or reject its leases,<sup>6</sup> in practice, the rule change has yielded unintended consequences as well.

First, the 210-day cap forces debtors into hurried and frequently economically unsound decisions that too often erode and destroy value that could otherwise be available to fund restructuring alternatives. Because 210 days is hardly enough time to implement meaningful restructuring initiatives, a debtor's senior lenders often require retailers to pursue going-out-of-business (GOB) sales soon after filing so they can be completed well in advance of possible lease terminations.

Second, the limited time afforded a debtor in Section 365(d)(4) to assume or reject leases has triggered extremely stringent DIP lending terms in the retail sector. Recent cases reveal that retail debtors continue to receive short lending timeframes, less new money, and more aggressive milestones in their DIP financing agreements than other debtors.

For example, outside DIP maturity dates for major retailers, such as Remington Outdoor Company, KIKO USA, The Bon-Ton Stores, Claire's Stores, Samuel's Jeweler's, and rue21, ranged from as low as 90 days to as much as 270 days from the petition

date, depending on whether the case was prepackaged or prearranged. Most of these DIP financings also included strict financial covenants and exacting milestones geared toward an expedited reorganization or affording store liquidators just enough time to complete store closing and GOB sales aligned with net orderly liquidation values before the debtor's leases were deemed rejected under the provisions of Section 365(d)(4).

However, these strict milestones and short maturities can serve to deprive a debtor of the bankruptcy "breathing spell" and foreclose the opportunity for retail company management to create, implement, and execute meaningful operational changes or explore alternatives.

Restructuring a retail debtor also comes with additional costs for senior lenders that may be avoided in a liquidation. Unlike funded debt, the principal and scheduled interest payments of which are tolled during the bankruptcy, lease operating expenses are paid on a current basis during the bankruptcy until a lease is rejected.<sup>7</sup> Thus, the longer the period prior to emergence or rejection is, the higher the lease costs.

Similarly, Section 503(b)(9) of the Bankruptcy Code grants administrative priority status to claims for the value of goods received in the 20 days immediately preceding the petition date,<sup>8</sup> making their satisfaction a prerequisite for a retail debtor to confirm a Chapter 11 plan. These obligations can be significant for retailers with large turnover in goods. Toys R Us, for instance, incurred more than \$200 million in 503(b)(9) expenses immediately prior to its filing.<sup>9</sup>

Finally, many retailers lack long-term agreements that obligate their vendors to continue supplying merchandise or SKUs on favorable, or even reasonable, terms. As a result, vendors can demand payment of prepetition claims as quid pro quo for providing goods or services postpetition. Since merchandise is the lifeblood of retailers' continued operations, retail debtors (and lenders) often have little choice but to pay these claims if they want to reorganize.

At the same time, one of the bright spots in the current retail apocalypse is the creation of a competitive market of store liquidators paying close to or in excess of 100 percent of the purchase price of retailers' inventories.<sup>10</sup> Inventory can make up as much as 50 percent of a retailer's assets and can usually be sold quickly. Given these high liquidation returns, the currently depressed market for sales at traditional brick-and-mortar retailers, and the large administrative expenses associated with a Chapter 11 plan, retail lenders often elect the relative certainty of liquidation over funding a recapitalization. Indeed, to avoid the tight deadlines of BAPCPA, hiring a liquidator may very well be the easiest path to bring large sums of money into the estate fairly quickly.

Despite these challenges, recent bankruptcy filings demonstrate that retail Chapter 11 cases do not have to end in liquidation and that following certain guiding principles can enhance a retailer's prospects for a successful outcome. These include:

### 1 Filing Before a Liquidity Crisis.

Recent trends make clear that those retailers that planned ahead and filed before liquidity crises fared better in Chapter 11 than those that did not. Retailers such as rue21, True Religion, and Claire's all filed in advance of debt maturities and despite posting reasonably healthy sales figures. By filing early, when they were still in the black, these companies were able to negotiate better outcomes with their creditors and used Chapter 11 to trim their operations and balance sheets without having to liquidate.

### 2 Having an Agreed Restructuring Plan Prior

to Filing. If a retailer must file for bankruptcy, companies such as Payless, Gymboree, rue21, True Religion, and Nine West have all demonstrated that having a restructuring plan supported by key constituencies in place prior to filing is integral to avoiding liquidation. In the retail context, these constituents include trade vendors and landlords, who must also make concessions, in addition to a retailer's senior lenders.

### 3 Securing Ample DIP Financing Tied to the Reorganization.

To gain consensus from key constituencies, debtors often need to obtain adequate financing first. Not surprisingly, therefore, retail debtors that file for bankruptcy already having secured an agreement on a restructuring plan with key creditors typically also obtain DIP financing on more reasonable terms than those who file without pre-agreed plans.

For example, in *Eastern Outfitters*, the debtors were able to secure DIP financing from their stalking horse bidder when their prepetition lender, which preferred a speedy liquidation of the company, refused to fund a sale process or be primed. In that case, the stalking horse bidder provided financing on a junior basis. Such favorable financing terms would not have been available in the absence of an agreement on the sale process. Ultimately, Eastern Outfitters' prepetition efforts to locate a stalking horse bidder and secure DIP financing on these terms were essential to the company's successful Section 363 sale.

### Conclusion

As the retail sector continues to fray, bankruptcies seem primed to continue at record-high rates, with Sears the latest mega-retailer to file. However, the

idea that bankruptcy spells liquidation for retailers is starting to change as the overall economic climate improves. Although retailers continue to face significant hurdles, both in and out of Chapter 11, creditors are starting to fund recapitalizations in the sector and support reorganizations, rather than opt for accelerated liquidation options. Recent cases such as *Eastern Outfitters* reveal that the keys for retail debtors to achieve success in Chapter 11 are proactive measures, advanced planning, and consensus. ■

<sup>1</sup> Chuck Carroll and John Yozzo, "Why Are U.S. Retail Reorganizations So Hard?," XXXV *ABI Journal* 10, 13 (October 2016), available at [abi.org/abi-journal](http://abi.org/abi-journal) (analyzing FTI Consulting, Inc.'s report on Chapter 11 cases between January 1, 2000, and June 30, 2016, involving debtors that held at least \$100 million in debt or assets at the time of filing).

<sup>2</sup> See Lawrence C. Gottlieb, "The Disappearance of Retail Reorganizations Under the Amended Section 365(d)(4)," available at [commission.abi.org/sites/default/files/statements/04jun2013/Supplemental\\_Written\\_Testimony\\_of\\_L\\_Gottlieb\\_for\\_Commission\\_to\\_Study\\_the\\_Reform\\_of\\_Chapter\\_11.pdf](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).

<sup>3</sup> *Id.*

<sup>4</sup> Deborah Weinswig, et al., "The Departure of Retail Reorganizations: Bankruptcy No Friend to Struggling Retailers," *Fung Global Retail & Technology* (April 3, 2016), available at [fungglobalretailtech.com/wp-content/uploads/2016/04/Retailers-in-Bankruptcy-Report-by-Fung-Global-Retail-Tech-Apr.-3-2016.pdf](http://fungglobalretailtech.com/wp-content/uploads/2016/04/Retailers-in-Bankruptcy-Report-by-Fung-Global-Retail-Tech-Apr.-3-2016.pdf).

<sup>5</sup> See 11 U.S.C. Section 365(d)(4).

<sup>6</sup> H.R. Rep. No. 109-31, at 86 (2005).

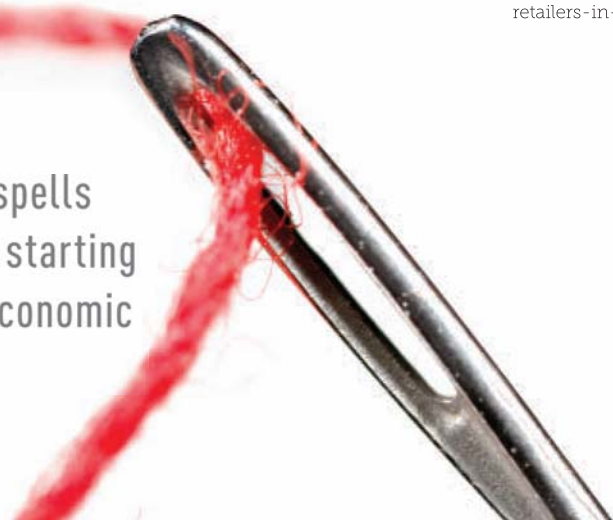
<sup>7</sup> Carroll & Yozzo, *supra* note 1.

<sup>8</sup> 11 U.S.C. Section 503(b)(9).

<sup>9</sup> See Supplement to the Debtors' Motion for Entry of Interim and Final Orders (I) Authorizing the Debtors to Pay Prepetition Claims of Lien Claimants, Import Claimants, and 503(B)(9) Claimants, (II) Confirming Administrative Expense Priority of Outstanding Orders, and (III) Granting Related Relief at 4, *In re Toys R Us, Inc.*, No. 17-34665-KLP (Dkt. No. 652) (Bankr. E.D. Va. Oct. 23, 2017).

<sup>10</sup> See "Retailers in Bankruptcy Report," Coresight Research (2016), available at [fungglobalretailtech.com/research/retailers-in-bankruptcy-report-2/](http://fungglobalretailtech.com/research/retailers-in-bankruptcy-report-2/).

The idea that bankruptcy spells liquidation for retailers is starting to change as the overall economic climate improves.







**Jennifer Feldsher** is a partner with Bracewell LLP. Her primary area of practice is corporate restructuring and insolvency law, and she represents troubled corporate debtors and interested parties in bankruptcy proceedings and complex corporate debt restructurings, as well as special situations investment firms on their investments and acquisitions. Feldsher also routinely advises on zone of insolvency issues and fiduciary duties. She has acted as counsel on prominent restructurings in the telecommunications, technology, healthcare, airline, automotive, and financial services industries, among others.



**Mark Dendinger** is a partner with Bracewell LLP. He focuses on all aspects of corporate restructuring, bankruptcy, and insolvency proceedings. Dendinger represents corporate debtors, senior and junior secured creditors, unsecured creditors, and private equity sponsors, negotiating out-of-court workouts and leading in-court Chapter 11 bankruptcy cases with total enterprise values ranging from \$20 million to more than \$1 billion. He has experience negotiating reorganization plans, structuring high-risk rescue financings and Chapter 11 DIP and exit financings, and representing buyers and sellers of financially distressed companies.



**Logan Kotler** is an associate with Bracewell LLP in New York. He focuses his practice on corporate restructurings and insolvency matters involving U.S. and international corporations, including representing corporate debtors and creditors in complex bankruptcy litigation matters. Before joining Bracewell, Kotler served as judicial extern to Magistrate Judge Alan J. Baverman of U.S. District Court for the Northern District Georgia.

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