THREE ISSUES TO NAVIGATE

to Avoid a Retailer's Liquidation

BY FRANK MEROLA AND GABRIEL SASSON, PARTNERS & SAMANTHA MARTIN, OF COUNSEL, PAUL HASTINGS LLP

Retail reorganizations fail at an alarming rate. While nearly half of all large retail Chapter 11 cases that begin with aspirations of reorganizing ultimately liquidate, only a small fraction of mega cases in other industries end in a liquidation.

As a result of the retail business model and certain requirements of the U.S. Bankruptcy Code, the fate of nearly all retailers is dependent upon their ability to (i) timely analyze the profitability of their brick-and-mortar footprint, (ii) stay ahead of their ongoing administrative costs, and (iii) demonstrate to creditors that a capital structure reorganization will yield greater returns than a liquidation of inventory.

Right-Sizing the Retail Footprint

Retailers typically lease nearly all of their stores. Consequently, retail cases are driven by the timetable imposed by Bankruptcy Code Section 365(d)(4), which leaves a retail debtor with a limited runway. Prior to the 2020 Bankruptcy Code amendments, a debtor only had 120 days from the petition date to assume or reject a store lease, subject to a one-time 90-day extension of time upon demonstrating cause for such extension. The 2020 amendments extended the initial deadline to assume or reject a store lease to 210 days, subject to the one-time 90-day extension. Within these statutory deadlines, a retail debtor usually needs to obtain court approvals and conduct in-store going-out-of-business sales that can take up to 90 days to implement.

With this timeline in mind, the first step to a retail restructuring is a store-by-store profitability analysis. While such an analysis will quickly reveal those stores that are keepers and those that will be promptly liquidated and rejected, it will also expose a set of marginal stores that could be made profitable with landlord concessions. Unfortunately, the timetable dictated by Bankruptcy Code 364(d)(4) and, as discussed later, the lenders, places the landlord squarely in control of the lease modification negotiation.

Moreover, given these timelines, the retail debtor has no real time to develop or implement an operational restructuring—no time to test new retail concepts and no opportunity to remix inventory. If the retail debtor is to reorganize, it will do so on a *pro forma* projection of the historical operations of the retained stores. The decisions of what stores remain in that footprint need to be made almost immediately upon filing to timely complete the going-out-of-business sales in stores to be rejected, and there is little opportunity for a second guess.

In addition to the tight timeline set forth in the Bankruptcy Code, postpetition lenders frequently impose case milestones that further limit the statutory runway, either by requiring the debtor to assume or reject leases by an earlier date, or to conduct sales on a shorter timeline, or both. In one extreme case, H.H. Gregg (2017),[1] the debtors were limited to 14 days to market their business and select a stalking horse purchaser and only 49 days thereafter to solicit alternative bids and complete an auction.

Thus, the ability of a retail debtor to quickly analyze its footprint and determine which stores to close and

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which to leave open will significantly impact its chances of reorganization, and retail debtors often attempt to complete this review before commencing a bankruptcy case.

Unpaid Administrative Expenses

Control over, and proper budgeting of, certain administrative expenses also play an important role in the success of a retail reorganization. To confirm a Chapter 11 plan, including a Chapter 11 plan of liquidation, a debtor must provide for the payment of all administrative claims, in cash, in full, on the effective date, unless an individual creditor agrees otherwise. While "ordinary course" administrative claims, such as post-petition wages, inventory purchases, etc., are usually budgeted and paid as they are incurred, other administrative claims arise and are not timely satisfied, creating a barrier to confirmation of a Chapter 11 plan at the end of the case.

Often in retail cases, landlords hold many of the larger unsatisfied administrative claims, and in many jurisdictions, landlords are entitled to an administrative claim for a *pro rata* portion of the rent accruing during the month of the bankruptcy filing, so-called "stub rent." Retail debtors and their secured creditors typically do not volunteer to timely pay stub rent, and in many cases, the payment of the stub rent is not included in the cash collateral or DIP loan budget. This unpaid stub rent claim can be substantial, imposing a significant barrier to confirmation[2]—particularly for retailers operating on a shoestring budget.

The Bankruptcy Code also provides for administrative claims for some goods delivered in the weeks leading up to the bankruptcy filing. Bankruptcy Code Section 503(b)(9) grants an administrative claim for the value of goods sold to a retail debtor in the ordinary course of business within 20 days of the petition date. Like the stub rent claim, retail debtors and their secured creditors do not volunteer to timely pay Section 503(b)(9) claims, and, in many cases, the payment of Section 503(b)(9) claims is not included in the cash collateral or DIP loan budget.[3]

Accordingly, it is important that creditors—and in particular, unsecured creditors—ensure that a company accurately reflects the need to pay known and knowable administrative expenses at the start of a case, so such claims do not later impede confirmation of a Chapter 11 plan. By way of example, at the start of a case it is fairly simple to estimate the accrual of stub rent claims and 503(b)(9) claims. A company should account for payment of these anticipated expenses in its cash collateral or DIP loan budget. Often, the official committee of unsecured creditors will take a lead role in analyzing any such budget to ensure that these known or knowable costs are accounted for and that the case is not simply being run for the benefit of secured creditors.

Inventory Liquidation vs. 'Best Interests of Creditors' Test

Most businesses hold substantial fixed assets, such as plants, property, and equipment, that are illiquid. Retail debtors, however, typically have a substantial amount of total capital (which may be more than 50%) in inventory that is relatively easy to sell. Professional liquidation firms are efficient and pay well for the ability to conduct in-store liquidation sales. For example, in the Anna's Linen case,[4] the debtor hosted an auction to retain a liquidator, and the successful liquidator guaranteed that the debtor would receive 111% of the aggregate cost value of the merchandise, as well as certain other consideration, in connection with any liquidation. Similarly, in the Coldwater Creek case,[5] the liquidator guaranteed that the debtor would receive 97% of the cost value of the merchandise included in the sale.

Where inventory liquidation is efficient and transacted at high ratios to cost, it creates both practical and statutory barriers to plan confirmation. From a practical perspective, it will be difficult to develop consensus across creditor constituencies on a recapitalization that achieves a higher return to creditors on a risk-adjusted basis, plus the plan process takes longer and costs more than an inventory liquidation.

From a statutory perspective, the "best interest of creditors" test set forth in Bankruptcy Code Section 1129(a)(7) is difficult to satisfy where the

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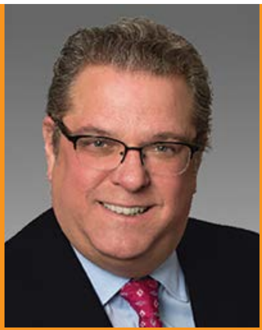

Frank Merola is a partner in the Financial Restructuring group at Paul Hastings. With nearly 30 years in practice, his legal and business acumen have earned him a reputation as a bold and tireless advocate in business reorganization who achieves clients' objectives, both in and out of court. Merola advises debtors, creditors, official and ad hoc committees, acquirers, and equity holders while servicing a spectrum of industries, including real estate, gaming and leisure, oil and gas, retail, healthcare, and communications.

Gabriel Sasson is a partner in the Financial Restructuring group at Paul Hastings based in New York. He concentrates his practice on bankruptcy proceedings and restructuring transactions and has extensive experience representing ad hoc groups of bondholders, secured lenders and other creditors, DIP lenders, official committees of unsecured creditors, indenture trustees, equity holders, and debtors in connection with in-court and out-of-court restructurings. Sasson also has experience in representing large insurance companies as creditors in Chapter 11 and Chapter 7 proceedings.

Samantha Martin is of counsel in the Financial Restructuring group at Paul Hastings and is based in New York. She has significant experience representing debtors, official committees of unsecured creditors, ad hoc groups of bondholders and lenders, individual creditors, purchasers, and liquidating trustees in all aspects of complex corporate restructurings, including Chapter 11 cases and out-of-court restructurings. Martin also has advised foreign representatives in Chapter 15 recognition proceedings. She currently serves as communications manager for ABI's Unsecured Trade Creditors Committee.

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debtor can easily recover "full value" for the bulk of its assets in an efficient liquidation. Specifically, to confirm a Chapter 11 plan, pursuant to Bankruptcy Code Section 1129(a)(7), a debtor must demonstrate that each creditor will receive under the plan at least as much as it would in a liquidation under Chapter 7 of the Bankruptcy Code. This best interest of creditors test protects each non-consenting creditor and is not negated by an affirmative vote of the class of claims. Thus, even a single non-consenting creditor can invoke the best interest of creditors test to block confirmation where it might be paid in full by an inventory liquidation.

Senior secured creditors often will latch on to the liquidation value of a retail debtor's inventory and the best interest of creditors test and demand a quick sale process that will pay them in full, in cash, leaving the bare minimum to confirm a Chapter 11 plan of liquidation. However, such a process often leaves nothing for junior unsecured creditors and ignores the value of a retail debtors' ongoing business.

To counter any senior secured creditors' demands for a quick liquidation that may seem advantageous to senior secured creditors in the near term, junior creditors often raise a number of arguments to demonstrate that the interests of all creditors are better served through a reorganization.

First, the liquidation value of a retail debtor's inventory does not include the value of its ongoing business, including goodwill and any trademark or other intellectual property rights, and Bankruptcy Courts, as courts of equity, may be swayed to favor a reorganization that promises distributable value for junior creditors. In addition, inventory liquidations often are conducted over a shorter period of time, which may result in depressed values that simply will not result in any distributions to junior creditors. Finally, liquidations may result in additional claims and expenses generated during the sale process, which may be avoided in a Chapter 11 reorganization, where leases and contracts are assumed.

These arguments, among others, are important tools that junior creditors and official creditors' committees will often need to utilize to preserve value and ensure distributions to junior stakeholders.

Although the deck is often stacked against junior creditors in any retail bankruptcy case, it is important that such creditors—either independently or through the official committee of unsecured creditors—take an active role in countering a debtor's and senior secured creditors' preference for a quick liquidation. J

[1] *In re: hhgregg, Inc., et al.*, Case No. 17-01302 (Bankr S.D. Ind.), ECF No. 18-2, pg. 103 and ECF No. 923.

[2] Though less typical, landlords also are entitled to administrative claims for rent obligations accruing under leases that are assumed but subsequently rejected.

[3] In the case of certain food inventories, a vendor may also be entitled to a limited priority claim. See Bankruptcy Code Section 507(a)(6).

[4] *In re Anna's Linens,* Case No. 8:15-bk-13008-TA (Bankr. C.D. Ca. 2015), ECF No. 468, pg. 15.

[5] *In re Coldwater Creek, Inc.*, Case No. 14-10867 (Bankr. D. Del), ECF No. 13, pg. 7.