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Perfect Storm: Lessons For Distressed Retailers, Part I

Law360, New York (October 29, 2010) -- In the approximately five years since the Bankruptcy Abuse Prevention and Consumer Protection Act's amendments to the Bankruptcy Code took effect, one general consensus has emerged: the effects of BAPCPA on distressed retailers have been profound. The combination of a truncated timeline for dealing with leases, a limited ability to extend plan exclusivity, and expanded rights of vendors to assert administrative priority claims all work together to create a rushed process with very little room for error.

Independent of BAPCPA's changes, the trend of some courts to question "critical vendor" orders and increased bankruptcy court deference to state laws in the conduct of "Going Out of Business" sales further constrict the ability of retailers to keep their operations running or to realize value when they have to close a location or liquidate entirely.

As a result, only retailers with a solid, workable business model and reorganization plan and the support of their major constituencies — particularly secured creditors, vendors and landlords — have been able to hope to emerge from the restructuring process. Indeed, 2008 and 2009 both saw in excess of 400 retailers filing for bankruptcy protection, and only a small percentage of these companies have emerged as going concerns. Thus far in 2010, only approximately 50 retailers have filed for bankruptcy protection, a sharp decline from the 2008 and 2009 numbers.

Although retailer filings appear to be down, the small number of retailers emerging from bankruptcy demonstrates that for the vast majority of retailers in this economy, distress means either a liquidation or an extremely quick sale — the functional equivalent of a liquidation.

Ironically, however, the dire condition of the retail sector may have provided some of the stronger companies with an opportunity to achieve a successful restructuring. Although retailer bankruptcy filings are trending downwards in 2010, vacancies in shopping centers persist and continue to drive financial distress in the commercial real estate sector. Landlords have become more open to renegotiating leases with their tenants teetering on bankruptcy in order to try to stay afloat themselves.

A landlord's willingness to engage in discussions with a distressed retailer may enable the parties to modify the lease outside of the bankruptcy court process or reduce the burden of BAPCPA's deadlines. In turn, having a consensual arrangement with its landlords may enable the retailer debtor to negotiate better terms — principally, a longer maturity — with its debtor-in-possession lender, providing more time to attempt a reorganization and, ultimately, maximize the value of the bankruptcy estate.

It is worth noting a recent development that could change the legal landscape again. On April 2, 2009, Representative Jerrold Nadler, D-NY, introduced a bill entitled the Business Reorganization and Job Preservation Act of 2009.[1] The bill would, among other things, undo BAPCPA's changes regarding the deadline to assume or reject leases, the expanded reclamation period, and the creation of section 503(b)(9) claims. However, there has been no activity reported on the bill since May 26, 2009. Thus, as Congress wraps up business, the bill appears dead, at least for now.

This article considers the major issues facing distressed retailers today, including challenges imposed by BAPCPA and the current economic climate and how these issues are shaping the bankruptcy experience and outcome for retailers in Chapter 11. Although the improving U.S. economy will afford some relief to retailers, the recovery is still fragile, and the retail environment is expected to remain difficult for the next several quarters.[2]

Already, many well-known retailers have been unable to cope in the current economy, with companies such as Circuit City Stores Inc., Crabtree & Evelyn Inc., Eddie Bauer LLC, Filene's Basement Inc., Finlay Enterprises Inc., Fortunoff Brands LLC, KB Toys, Linens 'n' Things Inc., Movie Gallery Inc., Ritz Camera Centers and Sharper Image Corp. all filing for Chapter 11 protection during the 2008 to 2010 period. Therefore, careful strategic planning will be key for all players in the retail sector.

The first part of this article considers the effects of the Bankruptcy Code on retailer debtors and their respective landlords, as well as the need for a retailer debtor to consider the holiday sales season in determining when to file for bankruptcy protection. This first part also examines the issues retailer debtors face when deciding whether or not to honor gift cards.

The discussion of retailer bankruptcies will continue in Part II of this article, which will provide an overview of the recent developments concerning vendors involved in retailer bankruptcies — such as the disfavor for critical vendor motions. Additionally, Part II of this article will examine the amended section 503(b)(9) regarding reclamation claims, the ability of a retailer debtor to return goods to a vendor, and the issues retailer debtors face in obtaining DIP financing and ascertaining what inventory should ultimately be liquidated.

Landlords Feel Pain Too: Keeping the Lights on Past the 210-Day Period

Prior to BAPCPA, a retailer in bankruptcy could expect to have a generous amount of time to decide whether to assume or reject its nonresidential real property leases. Although section 365(d)(4) of the Bankruptcy Code required debtors to assume or reject these leases within 60 days of the petition date, courts routinely authorized generous extensions of this time period, frequently until confirmation of the plan of reorganization.[3] Courts recognized that these leases would be critical to the reorganized entity and that the ability to assume and assign the leases would provide value for the estate to distribute to creditors.[4]

Although the debtors were required to pay rent for these properties during the bankruptcy, the indefinite extension of the time to assume or reject the leases created an option for the debtors and imposed commercial uncertainty on the landlords. The passage of BAPCPA marked a drastic change on this front. Today, section 365(d)(4) provides only 120 days for the debtor to assume or reject, or assume and assign, its nonresidential real property leases. Courts are authorized to provide a single, 90-day extension of this time period upon a showing of cause. Any further extension beyond 210 days from the petition date requires the written consent of the landlord.

In the pre-BAPCPA era, retailers often evaluated their stores for at least one commercial cycle — including a holiday shopping season — before deciding a store's fate and frequently needed several years to figure out their overall reorganization plan. Now, retailer debtors must evaluate their lease portfolios without the time to conduct any significant analysis as to whether changes they are implementing will return stores to profitability or whether the economic climate is improving such that their business model will again be viable.

The difficulty imposed by this timetable, however, is not faced solely by the retailers. In a thriving commercial real estate market, the relatively short 210-day period might further complicate dealings with rent-maximizing landlords looking to cut their losses and find new tenants. However, in the current market, landlords need to consider carefully their options in the event space becomes vacant. Can the landlord find a replacement tenant? Will the vacancy of the store affect other leases and thus further erode the profitability of this mall?[5]

With a commercial real estate market awash in empty retail space, the landlord cannot be sanguine about its ability to find a comparable replacement tenant — or indeed, a replacement tenant at all.

The uncertain commercial environment that retailers face today raises yet another issue. What happens to the retailers when a landlord files for bankruptcy protection? Section 365(h) of the Bankruptcy Code offers some protection in this situation and permits the tenant to retain the right to possess the property for the period of the original lease, including any extension rights, upon rejection of the lease by the landlord.[6]

This protection, however, is unlikely to be as useful as it might seem — the landlord is excused from providing any services under the lease after rejection and is merely required not to interfere with the tenant's use of the premises, and the tenant, in turn, is allowed to deduct from its rent any costs associated with obtaining the services no longer provided by the landlord. Whether the tenants of a mall can successfully provide the cleaning, security and similar services that the bankrupt mall owner declines to supply seems doubtful.

A further risk to tenants when their landlords experience trouble is illustrated by the decision in Precision Industries Inc. v. Qualitech Steel SBQ LLC (In re: Qualitech Steel Corp.).[7] In that case, the court found that a debtor landlord could sell the leased premises under section 363(f) of the Bankruptcy Code free and clear of any leasehold interest in the property.[8]

So, although section 365(h) provides the tenant the option — however limited as a practical matter — of remaining on the premises for the duration of the original lease's terms, in cases where the landlord disposes of the property pursuant to section 363(f), the only protection afforded to the tenant is a damages claim for the lost lease.

Several other courts, however, have taken the opposite position and refused to follow Precision Industries.[9] For example, in In re: Haskell LP,[10] the court ruled that section 363(f)(5) of the Bankruptcy Code did not authorize the debtor landlord to sell the property free and clear of the tenant's leasehold interest because: 1) the tenant could not be compelled to accept a monetary satisfaction of its claim as a) the claim amount could not be quantified, and b) the tenant had a right to remain in the premises under section 365(h) and thus could not be compelled to accept money for its rejected lease under section 363(f)(5); and 2) the debtor landlord had not offered or provided adequate protection of the tenant's interest in the lease, which could only be achieved through the tenant's continued possession of the leased premises.[11]

Although in good economic times the landlord may have the stronger position in negotiating with its retail tenants, the combination of the current economic difficulties and the BAPCPA-imposed limitations on retailers' time to deal with their leases should cause these two parties need to find ways to work cooperatively. Deferrals of rent obligations, consent to additional time to assume or reject, and other yet-to-be-imagined strategies for ways to share the pain will help influence whether retailers — or their landlords — file for bankruptcy and whether they emerge on the other side of the process.

Jingle Bells and Christmas Sales, or Dreidels and Dispositions: Holiday Sales and Successful Reorganization

Timing of the retailer's bankruptcy filing is also of the essence. Having only 210 days to work with because of BAPCPA's limitation on the time to assume or reject leases, the decision of when to start the clock running by filing the petition assumes a critical importance.

Whether to file before or after the holiday season is an all-important consideration for a retailer debtor. A debtor that files in the months leading up to the holiday season may have a better opportunity to line up DIP financing from a lender eager to utilize the holiday selling season to launch a rapid GOB sale. The steep discounts offered (or perceived by customers assuming that anything sold at a GOB sale is a bargain) as the retailer liquidates should permit a relatively low-risk, short-term DIP loan.

For a retailer looking to reorganize, however, it may make more sense to file after holiday sales have enabled the retailer to build up a war chest of cash to fund the case. That cash will almost certainly be encumbered by liens, but the debtor may be able to persuade its lenders to let it use cash collateral to operate during the Chapter 11, and the access to cash collateral may reduce the need for additional DIP financing.

Given the tighter credit markets and the scarcity of DIP financing from lenders who are not already involved with the borrower, the current lenders may be more willing to fund a DIP and provide the debtor with breathing room if there is some cash on hand at the beginning of the process. Of course, the retailer still needs to contend with the 210-day limit on assuming or rejecting its store leases.

The 2009 holiday season saw both of these strategies at work. For instance, Crabtree & Evelyn filed for bankruptcy before the start of the 2009 holiday season, in July 2009, and has already emerged, while certain other retailers, including Daphne's Greek Cafe, Bernie's Audio Video TV Appliance Co. Inc., Davies-Reid Stores, Taco Del Mar, and Uno Restaurant Holdings Corp., filed in January 2010 after the close of the 2009 season.

In fact, this same pattern occurred during the 2008 holiday season as well. Indeed, Circuit City was one of the major filings that occurred just prior to the start of the 2008 holiday season, ultimately ended in a liquidation, while approximately 40 other retailers, including Against All Odds USA Inc.; Blue Tulip Corp.; Land of Leather Holdings PLC; and Priceless Shoes Properties Ltd. filed in January 2009, after the close of the 2008 season.

Someone to Sell to: Gift Cards and Customer Loyalty

When a retailer files for bankruptcy, it likely has sizeable outstanding obligations owed to its customers in the form of gift cards and other customer credits and faces an immediate decision about whether to continue honoring gift cards and other consumer claims. Gift cards in particular have assumed greater importance in recent years, as they have become an increasingly significant component of retailers' holiday sales.

If the debtor expects to reorganize, or sell itself as a going concern, the failure to continue honoring these claims risks alienating customers and may effectively doom the retailer's chances of reorganizing. Even when a retailer is liquidating, ceasing to honor gift cards may not be a palatable option. When Sharper Image filed for bankruptcy protection, the company immediately stopped honoring gift cards. Customers holding the cards were outraged, and the negative publicity became so great that the company was forced to reverse its decision and honor the gift cards under the condition that the customer must spend more than the face amount of the card.[12]

Whether a retailer debtor should seek authority to continue honoring gift cards is, therefore, a critical decision that must be made at the outset of the case. When Fortunoff sold itself as a going concern at auction, part of the pre-negotiated terms of the sale included that the buyer agreed to assume, inter alia, liabilities for merchandise credit, store gift cards and deposits.[13] Even this step of trying to ensure customer loyalty may not be enough to ensure success: earlier this year Fortunoff became one of several recent retailers commencing cases under "chapter 22," seeking bankruptcy protection again only one short year after being sold as a going concern.

This time, the company immediately decided that it was going to stop honoring gift cards. Under heavy pressure from consumer groups and the New York state attorney general, the purchasers of the company's inventory agreed to a limited window during which they would honor gift cards.[14]

Few reported decisions squarely address the question of the priority of a consumer credit claim. In In re: WW Warehouse Inc.,[15] the court held that gift certificates, merchandise credits and partial payments on layaway items gave rise to claims entitled to priority under section 507(a)(7) of the Bankruptcy Code.[16] That section provides a priority claim for a limited dollar amount — currently $2,600 per individual for claims "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."[17]

However, in In re: Utility Craft Inc.,[18] another bankruptcy court declined to expand section 507(a)(7) priority to store credit provided by the debtor after delivery of a defective product. That court construed the statute strictly and found that store credit was not entitled to priority status.[19] Specifically, the court held that the store credit at issue was not a gift certificate because the consumer did not pay a deposit for an item or service that was either never received or only partially fulfilled.

Rather, the creditor paid a deposit, received the good, and paid the remaining balance owed at the time of delivery. “Neither the statute, nor the legislative history, contemplates the statute’s application when a product is purchased, discovered to be defective, and then returned.”[20] The court noted that whether the creditor decided to use the store credit was not part of the inquiry and, ultimately, declined to further expand the breadth of the statute.[21]

Northwest Fin. Express Inc. v. JWD Inc. (Northwest Financial Express)[22] is not quite a gift certificate or customer credit case. The debtor marketed money orders, which were sold by other retailers. The stores that sold the money orders would remit the proceeds back to Northwest Financial Express. The money orders, which were good for redemption at the Northwest National Bank in Fayetteville, Ark., were purchased mainly by persons without checking accounts in order to pay for goods and services supplied by third parties.

When Northwest Financial Express failed to honor money orders, the store owners honored the money orders in exchange for an assignment of the customers’ claims, and sought to recover on the claims in the bankruptcy case. The claimant store owners argued that the customers had a priority claim for the money orders that Northwest Financial Express had failed to honor.[23]

The court denied the claimants’ argument for a priority claim. In support of its ruling, the court held that the transaction between the bankrupt organization and its customers more closely resembled a purchase of a product for immediate delivery, which product was tradable for cash, rather than a deposit with the bankrupt’s agent for a future service to be rendered by another one of the bankrupt’s agents.

Given the low dollar amount typically at stake for any one gift card creditor, it is not surprising that there are few decisions regarding the priority of these claims. With the increasing number of retailer bankruptcies, however, we may see further developments on this front in this current economic cycle.

In Part II, this article will continue with a discussion of recent developments affecting vendors involved in retailer bankruptcies and the issues retailer debtors face in securing DIP financing, facilitating GOB sales and determining which assets they may liquidate.

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[1] H.R. 1942, 111th Cong. (2009).

[2] A recent U.S. Department of Commerce report indicated that overall retails sales in May 2010 had declined 1.2 percent from the April 2010 levels. However, “[e]xcluding the often-volatile categories of building materials, autos and gasoline, ‘core’ retails sales were up 0.1 percent — a rise that some economists saw as a sign of underlying strength.” Justin Lahart & Rachel Dodes, Consumers Tighten Belts — Surprise Drop in Spending Adds to Doubts about the Recovery’s Strength, Wall

St. J., June 12, 2010, at A1, available at http://online.wsj.com/article/SB10001424052748703509404575300380133852708.html.

[2] An extension of the time to assume or reject leases to the confirmation of a plan offered little, if any, comfort to a landlord that the debtor would make a decision on the lease anytime soon. Prior to BAPCPA, debtors could — and frequently did — obtain lengthy extensions of the exclusive time to file a plan, and of the exclusive time to seek confirmation of the plan once filed. BAPCPA limited both of these times, capping the maximum extension of the exclusive period to file a plan at 18 months from the order for relief, and the maximum extension of the exclusive time to obtain confirmation of the filed plan at 20 months from the order for relief. 11 U.S.C. § 1121(d)(2).

[3] Indeed, some courts created a new asset that could be sold by debtors — "lease designation rights," or the right to determine to whom a particular lease would be assumed and assigned. In re: Caldor Inc.-NY, No. 95-B-44080 (JMP) (Bankr. S.D.N.Y. April 1, 1999) (Docket No. 3773).

[4] The loss of an important retailer may result in a decrease in traffic in the mall, thus affecting sales by other tenants and reducing rent received under a lease that relies in part on a percentage of sales. Further, some leases contain clauses that automatically reduce the rent paid if an anchor tenant or a specific named retailer leaves the mall.

[5] See 11 U.S.C. § 365(h).

[6] 327 F.3d 537 (7th Cir. 2003).

[7] Id. at 545-48.

[8] See, e.g., In re: Churchill Props. III, Ltd. P'ship, 197 B.R. 283 (Bankr. N.D. Ill. 1996); In re: Taylor, 198 B.R. 142 (Bankr. D. S.C. 1996); LHD Realty Corp. v. Metro. Life Ins. Co. (In re: LHD Realty Corp.), 20 B.R. 717 (Bankr. S.D. Ind. 1982).

[9] 321 B.R. 1 (Bankr. D. Mass. 2005).

[10] Id. at 8-10.

[11] See Mark Albright, Sharper Image Gift Cards' Value Gutted by Bankruptcy, St. Petersburg Times, Mar. 12, 2008, available at http://www.sptimes.com/2008/03/12/Business/Sharper_Image_gift_ca.shtml; Sharper Image Accepts Gift Cards Again, USA Today, Mar. 7, 2008, available at http://www.usatoday.com/tech/products/2008-03-07-sharper-image-gift-cards_N.htm.

[12] See In re: Fortunoff Fine Jewelry & Silverware, LLC, No. 08-10353 (JMP), 2008 Bankr. LEXIS 682, at *17 (Bankr. S.D.N.Y. Feb. 15, 2008).

[13] Cuomo Brokers Deal To Honor Fortunoff Gift Cards Thru 3/8, Times Newsweekly.com, Mar. 5. 2009, available at http://www.timesnewsweekly.com/news/2009/0305/Local_News/033.html.

[14] 313 B.R. 588 (Bankr. D. Del. 2004).

[15] Id. at 592-95.

[16] 11 U.S.C. § 507(a)(7).

[17] No. 06-10816, 2008 Bankr. LEXIS 3564 (Bankr. M.D.N.C. Dec. 29, 2008).

[18] Id. at *8-12.

[19] Id. at *12.

[20] In so holding, the Utility Craft court followed the reasoning of Northwest Fin. Express Inc. v. JWD Inc. (Northwest Fin. Express), 950 F.2d 561 (8th Cir. 1991).

[21] 950 F.2d 561 (8th Cir. 1991).

[22] Prior to BAPCPA, the priority for consumer deposits was found in section 507(a)(6). BAPCPA moved this priority to seventh position, in 507(a)(7).

[23] 359 F.3d 866 (7th Cir. 2004).