

American Bankruptcy Group
Delaware Views From The Bench And Bar

Views on Retailer Bankruptcies

November 3, 2008
Hotel du Pont
Wilmington, Delaware

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I. Introduction

As retailers prepare for this critical holiday season amidst chaotic market swings and continuing financial upheaval, the unfortunate question facing many of them is not whether they should expect to see a decline in sales from years past, but whether they can expect to survive such losses. Retail sales have now fallen for three consecutive months, the first time that has happened on government records that date back to 1992. Retailers of “discretionary” goods, including fashion, home furnishings, jewelry and consumer electronics, continue to face uncertain futures as the shaky national economy continues to drive consumer spending towards national discounters. A retrenched credit market has further compounded the retail crisis, as distressed retailers contemplating a bankruptcy solution to their problems have been unable to find the cash needed to take them through the process. Clearly, it would be impossible to understate the impact of the current financial crisis and sub-prime mortgage meltdown on the seemingly lost ability of retailers to use the Chapter 11 process to restructure their debt and rehabilitate their businesses. However, the current state of the economy has just exacerbated a trend that predates these challenging economic times by a significant margin; the great decline in the ability of retailers to emerge successfully through bankruptcy.

On April 20, 2005, President George W. Bush signed into law the Bankruptcy Abuse Prevention and Consumer Act of 2005, S. 256 (“BAPCPA” or the “Act”). While much of the initial publicity surrounding the Act was focused on certain provisions affecting individuals seeking relief under the Bankruptcy Code (the “Code”), the Act contains a myriad of provisions which have so significantly impacted retail insolvencies that it appears that only three retailers – Hancock Fabrics, Movie Gallery and Goody’s Family Clothing – have successfully emerged from Chapter 11 as unimpaired reorganized entities in the three years since BAPCPA took effect.

In the past year alone, numerous prominent retailers have disappeared after filing for reorganization under Chapter 11, including Sharper Image, Levitz, The Bombay Company, Domain Furniture, Whitehall Jewelers, Friedman’s Jewelers, Lillian Vernon. The liquidation of just these seven retailers alone has resulted in the loss of approximately 15,000 jobs.

Today, retailers almost invariably begin the Chapter 11 process with little hope of emergence. Numerous economic factors – the credit crunch, the subprime lending crisis, the slowdown of the housing market and eroding value of retail commercial leases – have clearly contributed to this downward spiral. But to pin the disappearance of retail reorganization solely on one or more of these economic factors would be to ignore the adverse impact wrought by BAPCPA in the healthier economic climates of 2006 and 2007¹ and the many successful and important retail reorganizations achieved in recent years, including Federated Department Stores, Macy’s, Stage Stores, PA Bergner, Kmart and Zales.

It certainly appears that BAPCPA, with its numerous provisions impacting corporate insolvencies, has made it extremely difficult for retailers to emerge from Chapter 11 under any economic condition. BAPCPA’s amendment to, and introduction of, some of the more crucial Code sections affecting the retailer’s ability to meet its liquidity needs and obtain necessary postpetition financing – the lynchpin to any successful retail reorganization effort – has had a devastating effect on the retailer’s ability to reorganize. Now almost three years removed from the enactment of BAPCPA and having observed its impact on numerous retail Chapter 11 cases, it is fair to say that BAPCPA has so negatively impacted the retailer’s ability to meet its liquidity

¹ Although BAPCPA was signed into law on April 20, 2005, most of its provisions did not become effective until October 17, 2005. It is telling that a number of large companies that have either reorganized or are in the process of reorganizing, including Delta, Northwest and Delphi, filed their Chapter 11 cases in the month prior to BAPCPA’s effective date.

needs in Chapter 11 that the decline of retail reorganization should be expected to continue even in healthier economic times.

Liquidity is the lifeblood of reorganization. Absent the ability to pay certain postpetition debts as they come due, including sums owed employees, vendors, common carriers, utility providers and estate professionals to name just a few, the prospect of a retail reorganization is little more than a pipe dream. Moreover, the question of whether these obligations can be met is rarely left to the discretion of the debtor. Most retailers contemplating a Chapter 11 filing have experienced sustained periods of liquidity problems and have relied on the secured lending of banks and other financiers for years preceding their bankruptcy filings.² Consequently, at the commencement of most retail cases, substantially all of the retailer's assets will be subject to the prepetition liens of its lenders and may not be used or sold without their consent.

Lenders are disinclined to permit the use and disposition of their collateral and, just as important, to extend additional financing absent a firm belief in the debtor's capacity to effectively reorganize and thereby avoid any diminution in the value of their collateral. Lenders have little to gain from the reorganization process unless it yields sufficient funds to repay the present value of their indebtedness, which, in most instances, includes significant amounts of outstanding prepetition loans. Where a prepetition lender does not possess the requisite level of

² The growth of the second lien lending market over the past five years has compounded these liquidity problems for distressed retailers. Not only must retailers position themselves to pay the present value of the often substantial secured claims of their senior lenders upon confirmation of a Chapter 11 plan, but many now face a relatively new and additional layer of secured debt that must also be paid in full upon emergence. Second lien lending originated in the early 1990s when the debt market stalled as a result of increased conservatism among banks and other traditional senior lenders. Second lien holders, in contrast to mezzanine loan holders, invariably play an active role in the Chapter 11 process because, in the event of a borrower default, the second lien holder can exercise its remedies (including foreclosure) against the debtor. While the second lien market has benefited distressed retailers by providing new channels of liquidity, it has also created more difficulties for those companies attempting rehabilitation in the face of both senior and second lien debt. Second lien loans have increasingly become a favorite investment vehicle of private equity firms who are judged by their internal rate of return on investments. These firms profit from generating quick returns on investment and, accordingly, are inherently less willing to endure the reorganization process than banks and other financial institutions.

confidence in a given debtor prior to or during the Chapter 11 process, it will inevitably attempt to force a sale of the collateralized assets pursuant to section 363(b) of the Code.

As discussed herein, BAPCPA's amendments to the Code have stifled prospective retail reorganizations at the ground floor and beyond. New restraints on a debtor's liquidity reserves have quelled the appetites of already cautious lenders to provide the requisite levels of postpetition financing to even attempt reorganization. Furthermore, new provisions expanding the universe of claims entitled to administrative priority treatment have created an atmosphere of doubt as to whether a retailer could possibly possess enough cash at the end of a reorganization to pay such claims in full at confirmation. But perhaps the most troubling aspect of BAPCPA is its revision to section 365(d)(4) of the Bankruptcy Code.

II. Revised Section 365(d)(4): The Primary Liquidity Obstacle

Prior to BAPCPA, section 365(d)(4) of the Bankruptcy Code was a powerful tool used by retailers to downsize operations while simultaneously adding considerable value to the estate. Under the old regime, a debtor had 60 days to decide whether to assume or reject its commercial real estate leases, without the consent, and often over the objection, of its lessors. This 60-day period was subject to extension "for cause." Such extensions were routinely granted by courts presiding over mid-size and larger cases, where the requesting debtor was continuing to perform its lease obligations. Furthermore, the Bankruptcy Code placed no limit on the duration or number of extensions that could be sought.

From the lender's perspective, the retailer's ability to routinely obtain extensions of the assumption/rejection period provided two critical protections. First, a lender could be assured that the retailer would be provided with sufficient time to analyze the value of each individual

store lease before making the critical decision to assume or reject. Second, lenders were also assured of sufficient time to conduct “going-out-of-business” (“GOB”) sales at the retailer’s store locations in the event a decision was subsequently made to terminate the reorganization process. Although both protections play important roles in the lender’s decision to provide postpetition financing, it is the latter protection which is most crucial. Absent the ability to conduct GOB sales from the debtor’s store locations, the lender is deprived of the most commercially viable location to liquidate the collateralized inventory.

BAPCPA revises section 365(d)(4) to place an outside limit of 210 days on the time by which a debtor must assume or reject a commercial real estate lease. Specifically, section 365(d)(4) now provides that a commercial real estate lease is deemed rejected if not assumed by the debtor by the earlier of (i) 120 days after the petition date; or (ii) confirmation of a plan. Courts are authorized to extend the 120-day period for up to an additional 90 days for cause shown. Extensions beyond 210 days – irrespective of whether the retailer operates 10 stores or 1,000 stores or has 50 employees or 5,000 employees – are not within the discretion of the bankruptcy court and may only be granted upon the consent of the landlord.³ The effect of revised section 365(d)(4)’s limitations on the time and manner by which commercial leases must be assumed or rejected has dramatically reduced the debtor’s ability to obtain postpetition financing sufficient to fund a reorganization. The 210-day limit leaves little room between the commencement of a case and the time by which GOB sales must be implemented so as to

³ Recent experience reflects that landlords have become increasingly willing to consent to such extensions, among other concessions now being granted to debtors, presumably because most leases contemplate payment of above-market rent in the now depressed real estate market. However, this trend also appears to have had virtually no impact on lenders’ willingness to provide postpetition financing sufficient to fund a reorganization process. Lenders have thus far refused to extend greater financing based upon the assumption that landlords will ultimately consent to extensions of the assumption/rejection period.

conclude within the 210-day limit. Consequently, most lenders now refuse to provide any more postpetition financing than necessary to fund an immediate sale or liquidation process.

Moreover, a lender's traditional willingness to advance postpetition financing was rooted in part on the value of a debtor's commercial leases that could be monetized in the event of a failed reorganization effort. Prior to BAPCPA, lenders were far more willing to finance a debtor's reorganization, partly because the Code essentially provided them with an indefinite period of time to assign the debtor's below-market commercial leases to third parties at a premium in the course of a subsequent liquidation. Revised section 365(d)(4) appreciably lessens the residual value of a debtor's commercial leases because lenders are left without sufficient time to market those leases in the event the reorganization stalls.

Retail cases filed over the past three years have invariably taken one of two forms: either the case is filed as a liquidation or the debtor is given a window of no more than three to four months to complete a reorganization process that history dictates takes at least three times that amount of time to accomplish. The most compelling explanation for this development is that both retailers and their lenders are acutely aware that even a full seven months in the life of a retail debtor is not a long time, as most retailers and their lenders cannot judge the vitality of the business without going through at least one Christmas season. Absent the ability to extend the assumption/rejection period beyond the 210-day limit, a debtor will often be forced into the position of having to prematurely determine whether to assume or reject its commercial leases – decisions of critical importance to the ultimate success of any reorganization. Accordingly, even in those cases where the lender has agreed to provide financing on a preliminary, “wait-and-see” basis, such willingness has invariably been tempered – if not extinguished – by the very nature of

the retail industry. Lenders are simply not willing to bear the risks associated with financing a reorganization for fear that the retailer may lose its store leases before GOB sales are completed.

Perhaps the past practice of some courts of providing unlimited extensions of the assumption/rejection period was excessive, as this practice created a substantial backlash among landlords and others that ultimately produced the truncated assumption/rejection period provided under BAPCPA. But the pendulum may have swung too far in the other direction. The fixing of a one-size-fits-all deadline for the assumption or rejection of commercial real estate leases has devastated the retailer debtor's ability to obtain financing sufficient to fund a reorganization process. Returning discretion to the bankruptcy judge hearing the case who would consider the impact on all constituencies of providing or limiting lease extensions (including landlords) would go a long ways towards fixing this problem.

III. BAPCPA's Other Liquidity Drains

Beyond the impact of commercial lease issues on the reorganization process, BAPCPA places new and severe handicaps on the retail debtor's liquidity through various amendments, including those concerning the treatment of trade creditors, utility providers, *ad valorem* tax claims and employee wage and benefit priorities.

A. New Section 503(b)(9): 20-Day Claims

The addition of section 503(b)(9) of the Code creates an administrative claim, not available prior to BAPCPA, for goods actually received by the debtor within the 20 days prior to the Chapter 11 filing. For large retailers receiving high volumes of inventory with a reasonable turnover (often a significant portion of a retailer's trade debt arises in the month prior to bankruptcy) this new provision creates a large class of administrative claims that gives rise to

severe liquidity concerns. Because the so-called absolute priority rule prohibits the confirmation of a plan of reorganization where administrative priority claims are paid less than full value at confirmation, section 503(b)(9) creates an enormous obstacle to any retail reorganization effort.

Lenders are further disinclined to finance a retailer's bid for reorganization in light of the fact that a debtor must now be positioned to pay in full at confirmation a massive class of claims traditionally entitled to no more than a discounted unsecured distribution. Indeed, prior to BAPCPA, a debtor's failure to pay for goods received within the 20 days preceding the commencement of its case gave rise to an unsecured prepetition claim, subject to very limited reclamation rights. These prepetition claims would ordinarily be paid by a debtor on the same *pro rata* basis as other unsecured claims under a confirmed plan.

Although trade creditors initially rejoiced at the prospect of receiving an elevated priority for goods sold within the 20 days preceding the Chapter 11 filing, this amendment will rarely inure to their benefit in liquidating retail cases that often fail to achieve administrative solvency. As a practical matter, nothing in section 503(b)(9) requires *immediate* payment of these 20-day claims and courts have thus far not required that these administrative claims be paid prior to confirmation. In fact, two fairly recent decisions from Third Circuit bankruptcy courts have addressed and denied motions of trade creditors seeking immediate payment of administrative claims pursuant to section 503(b)(9).

In the *In re Bookbinders' Restaurant*⁴ case, the Bankruptcy Court for the Eastern District of Pennsylvania addressed a trade creditor's motion seeking immediate payment of a 20-day claim on the ground that such administrative claims must, as a matter of law, be treated in the

⁴ *In re Bookbinders' Restaurant*, 2006 WL 3858020, No. 06-12302 (Bankr. E.D. Pa. Dec. 28, 2006).

same manner as trade creditors holding section 363(c)(1) claims.⁵ The Court rejected the creditor's argument and denied the motion, reasoning that section 503(b)(9) claims must be compared to other section 503 claims and not section 363(c)(1) claims. The Court held that trade creditors are not entitled to immediate payment of their 20-day claims *as a matter of law*, but left open the issue of whether a court could exercise its discretion to compel immediate payment of a section 503(b)(9) claim if warranted by the applicable circumstances. The Court reasoned that in exercising such discretion, it would consider three factors: (1) the prejudice to the debtor; (2) the hardship to the claimant; and (3) the detriment to other creditors. Without a sufficient record to weigh the enumerated factors, the Court ordered an evidentiary hearing to determine whether to compel payment in advance of confirmation.

In the *Global Home Products*⁶ case, the parties agreed that the issue of payment timing is within the court's discretion and the Bankruptcy Court for the District of Delaware was required to address whether the factual circumstances at issue warranted an exercise of its discretion to compel the debtors' immediate payment of the applicable 20-day claim. Relying on the same three factors identified in the *Bookbinders*' decision, the Court found that the debtors' "tenuous financial position" suggested that they would suffer significant prejudice if required to pay the 20-day claim in advance of confirmation. Importantly, the debtors' postpetition lender objected to the trade creditor's motion on the ground that the court-approved postpetition financing agreement prohibited the debtors from paying any expenses not included in the postpetition financing budget without the lender's consent. Accordingly, a court order authorizing payment

⁵ Section 363(c)(1) permits a debtor to enter into postpetition transactions in the ordinary course of its business and authorizes immediate payment for goods purchased postpetition. Payments made under section 363(c)(1) are considered "operational" payments, which "by their nature, enjoy a de facto priority over administrative expenses, without any express provision for superpriority." *In re Telesphere Communications, Inc.*, 148 B.R. 525, 531 (Bankr. N.D. Ill. 1992). Accordingly, section 363(c)(1) requires immediate payment for goods received by a debtor in connection with a postpetition transaction.

⁶ *In re Global Home Products, LLC*, No. 06-10340 (Bankr. D. Del. Dec. 21, 2006).

of the creditor's 20-day claim would have constituted a breach of the postpetition financing agreement and would thereby have prejudiced the debtors' estates and creditors. The Court ultimately denied the trade creditor's motion, reasoning that the "substantial harm" that would befall the debtors' estates and creditor bodies outweighed the "little prejudice or hardship" to be suffered by the trade creditor in having payment on its 20-day claim deferred until confirmation.

The *Bookbinders'* and *Global Home Products* decisions indicate the reluctance of bankruptcy courts to require immediate payment of section 503(b)(9) claims absent extraordinary circumstances. Indeed, one would be hard pressed to imagine a single scenario where the "balance of the hardships" would favor immediate payment of a 20-day claim over the substantial harm to be suffered by a debtor's estate and creditors, as a whole, to the extent a debtor is required to make administrative claim payments not accounted for in a negotiated postpetition financing arrangement. Accordingly, to the extent that lenders continue to refrain from providing postpetition financing sufficient to fund a reorganization, the benefits of section 503(b)(9) will rarely be reaped by trade creditors simply because retailers will be deprived of the requisite funding needed to attain administrative solvency.

B. New Section 366(c): Utility Deposits

Pursuant to section 366(a) and (b) of the Code, utility providers (e.g., electric, gas, water, telephone) are prohibited from altering or discontinuing service to a debtor unless the debtor fails to provide "adequate assurance" of future payment within 20 days after the petition date. BAPCPA's addition of section 366(c) provides new statutory parameters for determining what constitutes adequate assurance in the context of a Chapter 11 case, imposes a significant burden on debtors by removing much of the court's discretion with respect to the determination of what constitutes adequate assurance of future payment, removes the possibility of using administrative

expense priority as such adequate assurance, and effectively compels the placement of a cash deposit (or equivalent) with all utilities.

The burden of new section 366(c) is particularly onerous in the context of retail debtors who, with numerous locations served by multiple utilities, are now required to make large outlays of cash, or provide reserves for such payment, at the beginning of the case. Additionally, section 366(c)(4) eliminates the effect of the automatic stay and permits a utility to effectuate a setoff of a prepetition deposit against prepetition amounts owed by the debtor without notice or court order, thereby eliminating any bargaining power the debtor may have had to negotiate an agreed offset and relief from stay in the context of a global resolution of postpetition adequate assurance.

The revision abrogates the long-standing practice that adequate assurance of future payment does not require a guarantee of payment, courts routinely held that administrative priority claims granted to utility providers were sufficient assurances of future payment. Revised section 366(c)(1)(B) expressly prohibits the granting of an administrative priority claim as adequate assurance of future payment. The effects of this revision on a debtor's liquidity at the very beginning of a case are severe, particularly for retail debtors with numerous locations requiring multiple utility services. Such retailers are now required to disburse what could be millions of dollars to utility providers, and deal with the associated administrative burdens of making and tracking such deposits, within the first 20 days of its case and without any corresponding offset to its obligation to pay such providers on account of their postpetition services. Consequently, revised section 366 has an adverse impact on a debtor's preliminary liquidity. Retail reorganization prospects have dwindled in light of the genuine concerns of postpetition lenders that they must now make a greater percentage of their loans available to the

debtor (or increase the total amount of the loan from what would have been expected to be necessary prior to BAPCPA) at a point in time where any debtor's reorganization prospects must be viewed as suspect.

C. Amended Section 503(b)(1)(B): *Ad Valorem* Tax Claims

BAPCPA also makes notable changes to the Code provisions governing the subordination and priority of *ad valorem* tax liens on a debtor's real and personal property. Prior to the passage of BAPCPA, the payment of *ad valorem* taxes was usually subordinated to prior-filed secured claims. However, pursuant to amended section 503(b)(1)(B) of the Code, *ad valorem* tax claims incurred postpetition may prime secured and administrative priority claims, regardless of whether the claim is secured or unsecured or whether the liability for the property tax is *in rem* or *in personam*. The revisions to the Code sections governing *ad valorem* tax liens further compress liquidity, as postpetition *ad valorem* tax claims are afforded a greater priority for distribution purposes. Accordingly, a lender would likely reserve against loan availability an amount up to one year of a debtor's estimated *ad valorem* taxes, at the expense of cash made available to finance a reorganization.

D. Revised Sections 507(a)(4) and (5): Employee Priority Claims

Revised sections 507(a)(4) and (a)(5) of the Code further compress the debtor's liquidity by raising the aggregate monetary limits on employee wage and benefit priority claims. Formerly, the aggregate amount that an employee could assert as a priority wage or pension benefit claim was limited to \$4,925 in wages and pension benefits earned within 90 days prior to the filing. BAPCPA increases the aggregate cap to \$10,950 for wages and pension benefits earned within 180 days prior to the filing. While it may be difficult to protest this revision from

a moral perspective, the ramifications of revised section 507(a) on a debtor's liquidity are obvious, as these claims are generally paid within the first days of a Chapter 11 case.

IV. The Rise of Section 363(b) Asset Sales

As discussed above, BAPCPA has left retailers without adequate time and money to effectuate operational initiatives and cost cutting measures needed to resuscitate their businesses. Retailers now enter the Chapter 11 arena with little choice but to narrowly tailor their strategy to ensure that their lenders are not deprived of the substantial benefits and protections conferred by section 363(b) of the Code, which authorizes the use, sale or lease of estate property outside the ordinary course of business upon court approval. Section 363(b) offers the unique ability to cleanse the assets of a distressed company by permitting debtors to convey assets "free and clear," thereby maximizing value by removing the uncertainty of such stigmas as successor liability, fraudulent transfer claims and lien issues that often accompany asset purchases. Prepetition lenders, cognizant of this powerful liquidating tool and mindful of the numerous liquidity hurdles that the debtor must now clear as a result of BAPCPA, have little to gain by risking their collateral in pursuit of a reorganization process now widely perceived as hopeless.

Accordingly, the constricted time frames and liquidity problems created and imposed by BAPCPA have effectively eliminated the need for existing lenders to provide any more financing than necessary to position the debtor to liquidate its assets in the first few months of the case. Today, the debtor is no longer "in possession" of its assets or its future upon the commencement of its Chapter 11 case. BAPCPA's constrictive liquidity provisions and the enormous leverage handed to secured lenders as a result thereof have eliminated the ability of retailers to control the Chapter 11 process as a "debtor-in-possession." Rather, the process is now controlled almost

exclusively by prepetition lenders, who have essentially assumed the role of “creditor-in-possession.”

The increasing influence of prepetition lenders has fundamentally changed the reorganization dynamic, with wide-ranging and far-reaching effects both prior to and during the Chapter 11 case. Because retailers that file for Chapter 11 protection today increasingly have balance sheets that are encumbered by ever growing amounts of secured debt, there is virtually no ability for these companies to survive on cash collateral alone. Retailers today invariably need to turn to postpetition financing immediately upon the commencement of the case. Postpetition financing arrangements generally take the form of a revolving credit facility, with amounts borrowed due on a regular and relatively short-term basis, typically including regular reporting requirements to allow the lender to evaluate the debtor’s performance frequently and to determine whether the loan should be “rolled over” (i.e., to apply the proceeds of the lender’s postpetition loans against the lender’s prepetition indebtedness).

As a result of the liquidity and timing problems imposed by BAPCPA, negotiations over DIP financing agreements have become more and more one-sided, with lenders’ leverage substantially enhanced by their vast prepetition liens and claims. Such leverage has enabled lenders to impose increasingly severe conditions on retailers and their Chapter 11 activities. Lenders now routinely negotiate critical provisions into postpetition financing agreements that either direct the retail case towards an immediate liquidation or include covenants or borrowing reserve rights that effectively permit the lender to cease lending only a few months into the case. Although the latter scenario provides a temporary breathing spell for the retailer, the reality is that three or four months into a Chapter 11 case is vastly insufficient for the retailer to even attempt to restructure its business and gain the support of its various creditor constituencies.

Three of the most recent large retail filings illustrate the various paths that are now taken by lenders to reach the common destination of a section 363(b) asset sale. It is important to note that each of these cases is currently pending and, accordingly, their ultimate disposition has not yet been determined. However, these cases provide helpful illustrations of the different ways in which lenders have assumed the reigns of the retail Chapter 11 process from the very outset.

A. Steve & Barry's

Steve & Barry's⁷ filed a voluntary Chapter 11 petition in the Southern District of New York on July 9, 2008. On the petition date, the Debtors filed a motion requesting authorization to use cash collateral. On July 11, 2008 (well before the creditors' committee was appointed and provided an opportunity to weigh in), the court entered an interim order granting the Debtors' cash collateral motion. The order provides that the Debtors' failure to perform any of the following "sale trigger events" by their respective dates would constitute an event of default:

- On or before July 24, 2008, unless the prepetition revolver agent and the Debtors agree otherwise, the Debtors, after consultation with the creditors' committee and the prepetition revolver agent, must have accepted a stalking horse bid from a stalking horse that is reasonably acceptable to the prepetition revolver agent.
- On or before July 29, 2008, the court must have approved and entered a sale procedures order with respect to a going concern sale or full chain liquidation, in form and substance satisfactory to the prepetition revolver agent.
- On or before August 12, 2008, the Debtors must complete the auction for a going concern sale or full chain liquidation.
- On or before August 14, 2008, the Debtors must receive the approval of the court for a going-concern sale or full chain liquidation, and the order approving such a going concern sale or full chain liquidation must be in form and substance satisfactory to the prepetition revolver agent.
- On or before August 15, 2008, the Debtors must have executed all of the agency documents, to the extent applicable, or purchase agreements and

⁷ *In re Steve & Barry's Manhattan LLC et al.*, Case No. 08-12579 (ALG) (Bankr. S.D.N.Y. July 9, 2008).

all other relevant documents in connection with a going-concern sale or full chain liquidation.

- On or before August 15, 2008, to the extent applicable, the going-concern sale shall have been consummated, or the full chain liquidation shall have commenced.

Pursuant to the interim order, upon the occurrence of an event of default, the lenders were entitled to declare a termination, reduction or restriction of the ability of the Debtors to use any cash collateral, and any automatic stay otherwise applicable would be modified so that five business days after the lenders' notice of such termination, the lenders would be entitled to exercise their rights and remedies to satisfy any obligations under the interim order. The Steve & Barry's case exemplifies the fast-track liquidation approach now taken by many retail lenders. As noted above, the sale transaction of Steve & Barry's as either a going concern entity or through an orderly liquidation under section 363(b) was required to be consummated *barely a month* into the case. The lenders provided the company with no breathing spell, no chance to implement strategic initiatives that might attract new financing, and no opportunity whatsoever to emerge as a rehabilitated company under existing management.

B. Mervyn's

In other instances, lenders give the appearance of being more willing to provide distressed retailers with an opportunity to reorganize, provided that such efforts do not interfere with the lender's ability to liquidate its collateral in a section 363(b) sale. For example, in the Mervyn's case⁸, filed in the District of Delaware on July 29, 2008, the retailer's senior lender agreed to provide postpetition financing through the continuation of a prepetition revolving credit facility under which the company's borrowing availability was calculated as a percentage of its inventory value. Importantly, however, the postpetition financing agreement, as ultimately

⁸ *In re Mervyn's Holdings, LLC, et al.*, Case No. 08-11586 (KG) (Bankr. D. Del. July 29, 2008).

approved by the bankruptcy court, empowers the lender to take various “reserves” against the company’s borrowing availability under the credit facility. Specifically, the senior lender was permitted to establish a reserve:

To reflect the value of inventory at leased locations with respect to which the lease therefore has not been assumed commencing on the date that is ten (10) weeks prior to the end of the one hundred twenty (120) day lease rejection/assumption period, as such period may be extended by the Bankruptcy Court or shortened by the Bankruptcy Court.

This type of reserve is the direct result of BAPCPA’s condensed time frame within which a debtor must assume or reject its commercial real estate leases. The purpose of this reserve is to ensure that the lender will be well positioned to liquidate Mervyn’s inventory through GOB sales before such leases are rejected in the context of a liquidation. The reserve effectively provides the lender with the unfettered right to stop lending to Mervyn’s on the date that is 10 weeks prior to the conclusion of the 210-day lease assumption/rejection period.⁹ Thus, in order to stave off a lender-driven liquidation of its assets, Mervyn’s, a company that recorded net sales of approximately \$2.5 billion during the fiscal year ending February 2, 2008, would have no more than four months to, among other things, develop and initiate operational initiatives and cost-cutting measures sufficient to attract exit financing and entice its vendors to continue manufacturing and shipping product on customary credit terms.

C. Boscov’s

The postpetition financing arrangement approved by the bankruptcy court in the Boscov’s case provides an example of liquidation-oriented covenants that now regularly appear

⁹ Mervyn’s request for a 90-day extension of the lease assumption/rejection period was authorized by order of the bankruptcy court. As noted above, as a result of BAPCPA’s revision of section 365 of the Bankruptcy Code, the bankruptcy court is expressly prohibited from authorizing any further extension of this period.

in postpetition financing agreements. Boscov's¹⁰, which filed its Chapter 11 in the District of Delaware on August 4, 2008, became obligated under the court-authorized postpetition financing agreement to possess certain minimum levels of inventory, and to incur expenses no greater than 110% of the amounts specified in the accompanying budget, commencing on August 16, 2008. Further, beginning on September 6, 2008, Boscov's became obligated to achieve operating cash receipts of not less than 90% of the amounts specified in the budget. Failure to meet these covenants would constitute an event of default under the DIP financing agreement that would permit the lenders to terminate the credit facility.

Importantly, each of these covenants was tied to Boscov's actual experience during the weeks *preceding* its Chapter 11 filing. For example, Boscov's actual expenses would be measured against the expenses projected in the budget for the preceding four-week period. Because this multi-week "look back" would include the date of Boscov's Chapter 11 filing, the company was required under the postpetition financing agreement to achieve specified results for periods shortly before and after the bankruptcy filing, many of which were utterly unworkable given the disruption to Boscov's business that had been caused by the bankruptcy filing. In fact, Boscov's was plainly in default of these covenants *before* the bankruptcy court even approved the postpetition financing agreement because the company was clearly not positioned to even approach these targets until late September. The inclusion of these covenants in the postpetition financing agreement effectively positioned Boscov's as a borrower under an "at will" credit facility, with its lenders positioned to call the loan and trigger a liquidation process at any moment they perceived a risk to the value of their collateral base.

¹⁰ *In re Boscov's, Inc., et al.*, Case No. 08-11637 (KG) (Bankr. D. Del. August 4, 2008).

V. Conclusion

Following the passage of BAPCPA in April 2005, a time long before retailers fell victim to these challenging economic times, various commentators and practitioners predicted that the numerous changes impacting liquidity at critical points in the Chapter 11 process would ring the death knell for retail reorganization. With few retailers having successfully navigated the Chapter 11 waters since BAPCPA took effect, it has become increasingly clear that these predictions were correct. Perhaps the most unfortunate aspect of this result, and one that was apparently never considered by Congress, is that retail Chapter 11 failures tend to domino into other failures and losses. Employees lose their jobs. Landlords lose tenants. Vendors that supply goods to the retailer on credit do not get paid and often become distressed themselves. Communities are deprived of the benefits of having numerous and competing retailers at their disposal. Fortunately, the damage caused by BAPCPA to retail reorganization is not irreversible. But until such time as the Code is modified to improve the retailer's liquidity position in all phases of the reorganization process and once again whet the appetites of lenders to advance postpetition financing, we should expect to see a continued increase in the number of retail liquidations and a corresponding decrease in the number of retail reorganizations.