VENDOR AND DEBTOR ISSUES AND POSSIBLE SOLUTIONS IN THE "MODERN" RETAIL CHAPTER 11

Are These Really New or Is This "Déjà Vu All Over Again"? *

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* The cases that will be addressed are primarily those commenced on or after January 1, 2008. Some of the comments and materials are not limited to those cases. However, the plethora of retail filings generally commenced after January 1, 2008

Although the Chapter 11 landscape is littered with many types of debtors, it is the "recent" spate of retailers filing for Chapter 11 that has garnered much attention. There are significant issues that confront all vendors and debtors in any Chapter 11 proceeding, yet the issues confronting the vendors and debtors in modern retail Chapter 11 cases are, arguably, more visible and more dramatic.

What confronts the parties in a modern Chapter 11 retail case?[1] Chapter 11 retail cases tend to be "high profile" as the result of traditional and electronic media news coverage, particularly since consumers are drawn more to reports about the stores they shop in than to the companies that manufacture the goods stocked on store shelves. All of this accounts for a high degree of visibility for the retail Chapter 11 case.

Moreover, many of the retailers (like other Chapter 11 debtors) are victims of the economic downturn, the sharp drop in consumer spending, the non-availability of new or renewed financing, and the inability upon filing to contend with the statutory provisions of BAPCPA.[2]

One of the main consequences of the above is the inability of a Chapter 11 retailer to receive goods on credit on normalized terms. Indeed, a modern Chapter 11 retail debtor bears little similarity to some of the "older" Chapter 11 retail debtors. A case in point is the Macy's

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[1] Some of the modern retail Chapter 11 cases are set forth on Exhibit "1."

[2] BAPCPA is the acronym for The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (April 20, 2005).

1992 bankruptcy filing.[3] When Macy's filed, its inventory was unencumbered; in contrast, and typical of a modern retail Chapter 11 debtor, when Linens 'N Things ("LNT")[4] filed sixteen years later, not only was the inventory and every other asset encumbered, but everything was encumbered "twice." This fact has repeated itself in many of the modern Chapter 11 retail cases. The consequences of such leverage translates into vendors/suppliers becoming unwilling to extend normalized credit, and in most instances, any credit (and certainly no material credit). As a result, without adequate financing (which as noted below is hard or impossible to obtain), the restraints on liquidity are intolerable. Combine all of these elements--the restraints on liquidity, the over-leveraged circumstances, the reluctance of the consumer to patronize a "bankrupt" retailer--and a "doomsday" scenario unfolds, resulting in the failure of most modern retail debtors.

There is no simple solution that addresses the problems of a modern troubled retailer. Some of the efforts to address the above problems are creative, some unfortunately are short lived, some work, some do not, but all attempt to try to answer the critical need of a retailer to lure the reluctant consumer with "fresh," seasonal and/or stylish inventory.

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[3] In re R.H. Macy & Co., Inc., et al., Case No. 92 B 40477 (BRL), United States Bankruptcy Court for the Southern District of New York; filed January 27, 1992. Otterbourg, Steindler, Houston & Rosen, P.C. ("OSH&R") represented the official unsecured creditors committee (the "Committee").

[4] In re Linens Holding Co., et al., Case No. 08-10832-CSS, United States Bankruptcy Court for the District of Delaware; filed May 2, 2008. OSHR represents the Committee.

CONSEQUENCES OF THE "CREDIT CRUNCH"

Beyond the Chapter 11 retailer succumbing to the economic climate, some lenders that provide financing to both the Chapter 11 debtor and the suppliers of the Chapter 11 debtor are also suffering similar pressures.[5] Such a scenario was uncommon in prior economic cycles.

One of the modern "tools" that have helped vendors are the "claims traders" that have provided both pre-petition and post-petition liquidity and financing, including the use of "puts." Puts are essentially another layer of protection for the vendor and come in many forms. Essentially the issuer of the "put," for a premium (*e.g.* two percent of an invoice price), provides credit protection/coverage to the supplier of the retailer. The coverage could be for 100% of the invoice price or a lesser amount, depending upon the provider's assessment of risk. In the current economic cycle, "put providers" are either experiencing their own liquidity crunch or, due to the vastly over-secured balance sheets of retailers, have ceased providing "puts" or have been so selective in providing puts so as to, essentially, eliminate the put provider as an available source of liquidity for the vendor and product for the retailer.

A good example of this change in circumstances is a comparison of two mega retail Chapter 11 debtors. In the Kmart case, puts, both pre-petition and post-petition, were widespread and provided significant economic protection for the vendor and fresh product for Kmart.[6] In comparison, LNT a modern retail Chapter 11 debtor, in effect, had no post-petition puts. The liquidity pressure faced by the "put" providers and the remarkable over-leveraged circumstances of LNT precluded any meaningful opportunity for puts.

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[5] See e.g., the articles comprising Exhibit "2," which are available on the ABI's CD-Rom and online at http://www.abiworld.org/Ny09/materials/.

[6] In re Kmart Corporation, et al., Case No. 02 B 02474, United States Bankruptcy Court for the Northern District of Illinois; filed January 22, 2002. OSH&R represented the Committee.

Thus, while the modern Chapter 11 retailer confronts many of the same challenges that all types of modern debtors face in obtaining financing to file Chapter 11 or to emerge from Chapter 11, it also confronts the additional challenges noted above.

NEW TOOLS (OR, AS NOTED ABOVE, IS IT REALLY "DÉJÀ VU ALL OVER AGAIN")

Some of the "new programs" that have been created/implemented in the modern Chapter 11 retail cases are "creative tools" of the lawyers and other professionals to the estate, some are reconfigurations of traditional tools, but all represent efforts to overcome the challenges of today's retailers.[7]

Section 503(b)(9) Programs

In enacting BAPCPA, Congress "gave" vendors the benefits of Section 503(b)(9).[8] This section provides an extraordinary benefit to a supplier of goods, whereby that vendor is automatically granted an administrative claim for "the value of any goods received by the debtor within 20 days before the date of commencement of the case … in which the goods have been sold to the debtor in the ordinary course of such debtor's business."

However, the statute is silent as to when this new administrative claim will be paid, but subsequent judicial interpretation has made it clear that payment need not occur at the outset of the case.[9] What has evolved from this judicial gloss is, in part, an evolution from programs prior

[7] Though some of these "new programs" are available in non-retail cases, they are most prevalent and needed in the retail Chapter 11 cases.

[8] Unless otherwise specified, all statutory references are to the Bankruptcy Code.

[9] See e.g., In re Global Home Products, LLC, Case No. 06-10340 (KG), 2006 WL 3791955 (Bankr. D. Del. 2006)(court denied the request for immediate payment, finding that the harm to the debtor that would result from requiring immediate payment of amounts not provided for in its budget outweighed the hardship, if any, to the creditor). See also, In re Bookbinders' Restaurant, Inc., No. 06-12302 (ELF), 2006 WL 3858020 (Bankr. E. D. Pa. 2006).

to BAPCPA that addressed reclamation claims. Specifically, if liquidity exists, the modern debtor frequently implements a program whereby in exchange for the prompt, full or partial payment of the Section 503(b)(9) administrative claim, the vendor is required to provide ordinary trade credit. Such a program usually represents an obvious benefit for both the retailer and the vendor. Hypothetically speaking, in exchange for paying $100 in cash for a 20-day goods claim, the retailer would receive, say, a $100 credit line from the vendor on 30-day terms consistent with historical terms provided by this vendor to this retailer. To the extent that the retailer stays in business for six months and "turns" the product several times, the retailer, in exchange for the initial $100 payment would receive multiples of $100 and thus a clear liquidity benefit. The vendor receives the "upfront" payment and, if it ultimately gets "stuck" (*e.g.* conversion to Chapter 7), presumably, the vendor has not extended credit for more than the Section 503(b)(9) amounts it was previously paid. These new unpaid amounts, once again, constitute an administrative claim. In the interim, the vendor has received its profits on the goods that were sold during the Chapter 11 case and the retailer has had fresh inventory to sell to the consumer. A version of this type of program was employed in In re Buffets Holdings, Inc., et al., Case No. 08-10141, currently pending before the United States Bankruptcy Court for the District of Delaware.[10]

[10] A copy of the Order approving the Section 503(b)(9) program is found as Exhibit "3" which is available on the ABI's CD-Rom and online at http://www.abiworld.org/Ny09/materials/.

Reclamation Programs

Similar to the above, though not as common because of various factors, are reclamation programs that mirror the Section 503(b)(9) programs. However, because the allowance of reclamation claims is much more difficult, that is, you are not automatically entitled to reclamation rights as opposed to Section 503(b)(9) rights and reclamation claims are subject to various challenges,[11] there is limited use of reclamation programs to obtain credit. Similar to the Section 503(b)(9) programs, in certain cases, reclamation programs have been adopted whereby in exchange for treatment of reclamation claims (*e.g.* paid out over a year) the vendor agrees to provide ordinary trade terms.[12]

Preference Waiver Program

Another type of program that has been used occasionally is a program whereby the retailer, again in exchange for regular credit limits and terms, provides a waiver of preference claims as against the vendor. Assuming the vendor complies by providing product for a negotiated period of time, and absent a contractually-created default where the vendor can cease providing product (*e.g.* payment default, DIP financing default), the vendor gets its invoices paid, the retailer gets the product, and the vendor gets a waiver of the preference exposure.[13]

Critical Vendor Program

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[11] See, Phar-Mor, Inc. v. McKesson Corporation, 534 F.3d 502 (6th Cir. July 17, 2008), which is currently the subject of a petition for a writ of certiorari to the United States Supreme Court. OSH&R represented the Committee.

[12] See e.g., *Order Pursuant to 11 U.S.C. §§ 105(a) & 346(c)(3) Authorizing Debtors to Implement the Trade Lien Program, Grant Junior Liens, Waive Certain Avoidance Actions and Amend Reclamation Claims Order*, entered October 23, 2003 in In re The Penn Traffic Company, Case No. 03-22945-ASH, United States Bankruptcy Court for the Southern District of New York, a copy of which is found as Exhibit "4" and is available on the ABI's CD-Rom and online at http://www.abiworld.org/Ny09/materials/. Note: OSH&R represented the Committee.

[13] See e.g., the Penn Traffic Order found as Exhibit "4" and available on the ABI's CD-Rom and online at http://www.abiworld.org/Ny09/materials/.

The Seventh Circuit in its Kmart decision, In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004), was thought, by some, to have "killed" any future critical vendor relief. Rather, like most things, it simply caused it to evolve. Modern retail Chapter 11 debtors and others still use critical vendor programs. See e.g., the *Interim Order Pursuant to Bankruptcy Code Sections 105(a), 503(b) and 507(a) authorizing Debtors to Pay Prepetition Claims of Certain Critical Vendors Entitled to Administrative Priority*, entered August 12, 2008 in In re Mervyn's Holdings, LLC, et al., Case No. 08-11586, currently pending before the United States Bankruptcy Court for the District of Delaware.[14] The statutory authority for critical vendor relief is dissimilar to Section 503(b)(9) in that it is not expressly set forth in the Bankruptcy Code. It is, per various courts, including the Kmart court, resident in, among other sections, Sections 105 and 363 of the Bankruptcy Code. Regardless, the debtor that presents a critical vendor motion/program provides that in exchange for payment on the critical vendor amounts (similar to all the other programs noted above), the critical vendors are required to provide ordinary trade terms and credit limits.

Junior Lien Programs

This type of program is far more difficult to effectively implement in the modern Chapter 11 retail case. However, if there is some perceived value in a junior lien, such a program can induce vendors to supply credit. See e.g., the *Order Pursuant to 11 U.S.C. §§ 105(a) & 346(c)(3) Authorizing Debtors to Implement the Trade Lien Program, Grant Junior Liens, Waive Certain Avoidance Actions and Amend Reclamation Claims Order* entered in the Penn Traffic

[14] A copy of the Order is found as Exhibit "5," which is available on the ABI's CD-Rom and online at http://www.abiworld.org/Ny09/materials/. As of the time of publication of this article, a final order had not yet been entered.

case, and found as Exhibit "4." See also, the Junior Lien Program documents used in the Kmart Case, copies of which are found as Exhibit "6."[15]

Letter of Credit Program

As opposed to the above programs, a less visible non-statutory concept involves providing a letter of credit facility to protect a group of vendors (versus an individual vendor). This was utilized in the LNT case, where the over-leveraged LNT debtor was unable to obtain normal trade credit. Due to very successful liquidations of a sizable number of stores and realization of proceeds far in excess of the advance rate from the Chapter 11 lender, ironically, LNT had excess liquidity. However, vendors were still reluctant to ship on credit because liquidity does not necessarily mean payment if the case fails and the Chapter 11 lender ceases funding. Accordingly, utilizing part of the excess liquidity, the Committee and the debtor structured and implemented a letter of credit program whereby, initially, a $100 million letter of credit was issued and made available to qualified vendors[16] as protection for payment on their open accounts. Originally, the maximum open accounts that were to be "protected" by the letter of credit was $200 million of payables or, stated another way, the projected worst case recovery if the letter of credit was utilized (meaning the debtor had not paid its bills) was approximately 50%. In most forecasts, the projected recovery was close to 100%. However, even this protection proved insufficient to induce the vendors to ship on normal terms. The program was ultimately modified to provide $100 million of coverage for $100 million of maximum trade credit, or 100% coverage, and therefore no likely coverage risk. Unfortunately, by the time the

[15] Both Exhibits "4" and "6" are available on the ABI's CD-Rom and on-line at http://www.abiworld.org/Ny09/materials/.

[16] The debtor utilized specific criteria for a vendor to qualify as a beneficiary of the letter of credit.

program was fully implemented, other pressures of the case were too great for the company to overcome.[17]

CONCLUSION

What does it all mean? Retail Chapter 11 cases are challenging, possibly more so than other types of Chapter 11 cases. The consumer is fickle, requires fresh "fashion forward" goods, and can be "easily" spooked by media reports when a retailer files for bankruptcy. If the retailer cannot get the right product on the right terms, and its liquidity problems prevent it from advertising, such a combination can contribute to the downward spiral and demise of the distressed company. The programs discussed above are designed to assist the retailer in meeting these challenges in a pragmatic manner, as best it can. In limited cases, these programs will help a retailer survive and emerge from Chapter 11, though the prospects for many modern Chapter 11 retailers remain dim.

[17] Copies of the LNT pleadings and program documents are found as Exhibit "7" and are available in full on the ABI's CD-Rom and online at http://www.abiworld.org/Ny09/materials/; portions of Exhibit "7," including an excerpt of the motion to approve the letter of credit program and copies of the orders approving the first and second amendments to the program, are also annexed hereto.