Tough Choices Confront Trade Creditors When a Retailer Faces Bankruptcy

BY DANIEL A. LOWENTHAL, PARTNER, PATTERSON BELKNAP WEBB & TYLER LLP

The Great Recession, which began in December 2007 and officially ended in September 2009, has been especially hard on U.S. retailers, and its impact likely will be felt for many more years. Retailers sustained record-breaking declines in sales, inventories, and consumer confidence. The housing market crash, layoffs, and higher gasoline prices all hurt consumer spending and have had a disproportionate impact on retail businesses. And competition among retailers in the U.S. for fewer consumer dollars is fierce, with superstores putting local merchants out of business and, in turn, being hurt by internet retailers that are capturing business previously handled by brick and mortar stores.

Trade creditors that supply struggling retailers face tough choices. Typically, trade creditors are aware that a retailer might file for bankruptcy protection, but do not know precisely when that may occur. Yet the filing date is important because, under the U.S. Bankruptcy Code, what trade creditors do both prepetition and post-petition can impact how they might fare in a retailer's bankruptcy.

When a retail customer faces potential bankruptcy, trade creditors may want to stop doing business with the retailer. However, if the retailer is still paying for goods, then having the account is usually preferable to foregoing the business. Revenues received through sales to a troubled counterparty are better than no sales. Even so, trade creditors must be cautious and plan properly in case the retailer does file for bankruptcy.

Trade creditors can seek to negotiate security interests with retailers and secure collateral to protect their credit. They might also try to enter into letters of credit. Those, too, provide security and can help protect trade creditors from liability for preferential transfers. Moreover, trade creditors can demand cash on delivery.

When retailers do poorly because they have a bad or obsolete product or can't fund their debt, trade creditors doing business on an unsecured basis often come up short, particularly when the retailer files for bankruptcy. Retailers that file for bankruptcy protection often don't survive. They're pressured by landlords to reject leases and close stores. They sell off assets and liquidate. Going-out-of-business sales are common. A debtor's vendors and customers lose a counterparty. Employees lose their jobs.

Debtors might also have complicated capital structures characterized by multiple layers of secured debt. Someone has joked that there's no longer Chapter 11 for the debtor in possession but rather for the "secured creditor in possession." To trade creditors, this is no laughing matter. When a retailer files for bankruptcy, the trade often loses a customer, receives minimal recovery on goods delivered, and loses revenue for their businesses. Unless trade creditors have valid priority claims, they might recover just pennies on the dollar for what they are owed. They might even have to return funds to the bankruptcy estate that they received as payment for goods they supplied to the debtor before the case was filed.

Rights of Trade Creditors

A trade creditor that supplies goods to a retailer that files for bankruptcy should seek to enforce certain rights in the Chapter 11 case. For instance, Bankruptcy Code Section 546(c) preserves a creditor's right of reclamation under state law. The applicable state law statute concerning reclamation is Uniform Commercial Code Section 2-702. The two statutes together permit a supplier to reclaim goods provided to an insolvent debtor in the ordinary course of the debtor's business when such goods are identifiable.

Section 546(c) permits reclamation of goods supplied within 45 days before the bankruptcy petition date or, if the 45 days expires after the case begins, no later than 20 days after the start. The trade creditor (or its counsel) should send the debtor a letter demanding reclamation as soon as possible after the Chapter 11 case is filed.

However, trade creditors can't always reclaim goods they provided prepetition. In many instances, the goods might be subject to a secured creditor's lien, or the goods might not

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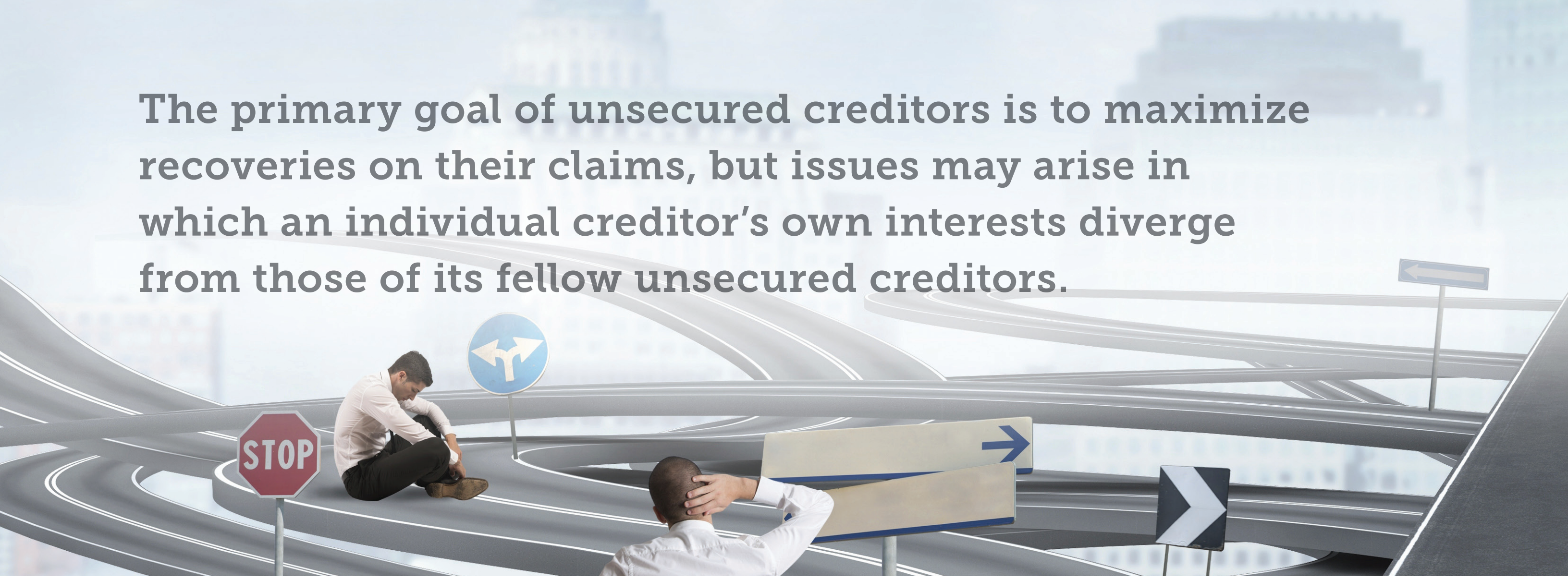

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be identifiable. A carton of shoes stored in a warehouse might be identifiable, but oil that flows through a pipeline with other suppliers' oil might not be.

In 2005, Congress amended the Bankruptcy Code to afford an additional protection to trade creditors that supply goods to debtors pre-bankruptcy. Section 503(b)(9) gives suppliers a priority administrative claim for the value of goods they supply to debtors in the ordinary course of the debtors' businesses within 20 days before the filing date. Trade creditors that can't reclaim goods under Section 546(c) can at least benefit by filing a claim under Section 503(b)(9) in the bankruptcy case.

A trade creditor might also seek to stop delivering goods under Uniform Commercial Code Section 2-705. The automatic stay in Bankruptcy Code Section 362 bars creditors from trying to obtain property of debtors' estates. Even so, some courts have allowed creditors to invoke their delivery stoppage rights. The theory is that the creditor is not seeking to obtain estate property, but rather suspending its performance while the debtor considers if it wants to assume or reject an executory contract with the creditor/supplier.

The Bankruptcy Code also provides that the seven largest creditors by claim amount can serve on the official committee of unsecured creditors, which is formed by the U.S. Trustee's Office soon after a bankruptcy case is filed. Although a seven-member committee is the rule, the U.S. Trustee has appointed committees with as few as three members and others with 11 or more members. The size of a committee is influenced by the number of creditors willing to serve and the size of the case. In retail bankruptcy cases, trade creditors often hold some of the largest unsecured claims, and one or more of them is appointed to the committee.

There are pros and cons to serving on a creditors' committee, so creditors holding large claims should determine if serving makes sense for them. Committee members gain access to a debtor's confidential information and receive cash flow forecasts, business plans, and more. They learn more about the debtor's reorganization or liquidation goals than they would if they didn't serve.

Yet committee members also must also be mindful that they serve as fiduciaries for all unsecured creditors. The primary goal of unsecured creditors is to maximize recoveries on their claims, but issues may arise in which an individual creditor's own interests diverge from those of its fellow unsecured creditors. For instance, bondholders or governmental agencies might pressure a committee to pursue goals on certain issues that differ from what the trade would want. As fiduciaries to all creditors, committee members must deal with those tensions.

If a debtor has secured debt, the creditors' committee investigates whether the security interests were properly perfected and related matters concerning the validity of the secured creditor's priority claims. Trade creditors that serve on a creditors' committee review the results of an investigation and help decide if litigation should be brought against the secured creditor.

Debtors' Options

Retailers that file for bankruptcy might also seek court permission to pay their critical vendors amounts owed pre-bankruptcy. Debtors identify in their moving papers, or subsequent to the motion being approved, which creditors they believe are critical to their business. The motion includes a total amount that the debtor wishes to pay those creditors.

A proposed order spells out the terms these critical vendors must agree to before they will be paid prepetition amounts they are owed. For instance, the proposed order might require vendors to keep supplying a debtor according to certain specified business terms. Creditors identified as critical that agree to the proposed supply terms are eligible to receive amounts owed prepetition for which they otherwise might be paid at just a fraction on the dollar as unsecured claims in the bankruptcy case.

Trade creditors must also be sure to file timely proofs of claim. Typically in Chapter 11 cases, a debtor files a motion to set a filing deadline. Claims should identify amounts owed prepetition and include supporting documentation. In addition, a separate deadline is set for creditors to file administrative expense claims—claims for goods and services provided to a retailer post-petition. Administrative expense charges are the actual and necessary costs and expenses a debtor incurs to preserve its bankruptcy estate through Chapter 11. Creditors with valid administrative expense claims are paid in a bankruptcy case before distributions are made to unsecured creditors on prepetition amounts owed.

Certain trade creditors have contracts with debtors that qualify as executory contracts, which means that both the creditor and debtor still owe performance to one another, such that failure by either to perform would constitute a material breach of the contract. When a contract is executory, a debtor has the option to assume it, reject it, or assume and assign it to another party. Bankruptcy Code §365.

A debtor that assumes or assigns a contract (or the assignee) then must pay the creditor amounts owed prepetition and give adequate assurance that the debtor or assignee can continue to perform the contract. Bankruptcy Code § 365(b)(1). In contrast, rejection of a contract constitutes a material breach and affords the creditor an unsecured claim for damages as of the petition date. Bankruptcy Code § 365(g)(1). Therefore, creditors whose contracts are assumed or assigned recover more on their prepetition claims than do creditors whose contracts are rejected.

In addition to properly asserting their claims against a bankruptcy estate, trade creditors must also be mindful that the estate might have claims to assert against them. For instance, debtors can seek to claw back payments that were made to trade creditors in the 90 days before the bankruptcy case was filed. In virtually any retail debtor case, the estate will have preferential transfer claims to assert under Section 547 of the Bankruptcy Code.

Payments are preferential if a debtor can satisfy a five-part test examining if the payment (1) was made to or for the benefit of a creditor; (2) was made on account of an antecedent debt; (3) was made while the debtor was insolvent; (4) was made within 90 days before the bankruptcy case was filed; and (5) enabled the creditor to receive more than it would in a Chapter 7 liquidation.

As noted earlier, if a trade creditor has a letter of credit, then payment on its invoices in the 90 days before bankruptcy are not preferential. A payment by the issuing bank to the creditor does not constitute a transfer of property of the bankruptcy estate. The bank's obligation to pay on the letter of credit is deemed independent of the debtor's reimbursement obligation to the bank.

The fifth element of the test applies when a trade creditor supplies goods on an unsecured basis. Payment in full for those goods likely would exceed what an unsecured creditor would receive in a Chapter 7 liquidation case. Thus, this preferred creditor would have received a greater amount in the 90 days before bankruptcy than it and other trade creditors would receive as distributions on their prepetition claims in the bankruptcy case.

Even if a debtor can demonstrate all five elements, the Bankruptcy Code provides creditors with defenses to preferential transfer claims. The most common defenses asserted are the ordinary course of business defense, the contemporaneous new value defense, and the subsequent new value defense. These defenses prevent or reduce clawbacks of transfers because the creditors continued doing business with the debtor in the 90 days before bankruptcy in a manner that the Bankruptcy Code says should be respected.

The ordinary course of business defense applies when a transfer was payment for an obligation incurred by the debtor in the ordinary course of its business or financial affairs, made in the ordinary course or financial affairs of the debtor and the transferee, or made according to ordinary business terms. The creditor must show a consistent history of invoices to and payments by the debtor both during and before the 90-day prepetition period.

The contemporaneous new value defense applies when a debtor makes a transfer to a creditor, and at or about the same time, the creditor supplies the debtor with new value. The subsequent new value defense applies when a debtor makes a transfer to a creditor, and the creditor subsequently supplies new value to the debtor that remains unpaid. If a preferential transfer claim is brought against the creditor, the subsequent new value supplied would reduce the amount the creditor would owe on the claim.

Significantly, one federal appeals court has ruled that payment to a creditor on a prepetition wage claim does not reduce amounts the creditor can apply to its new value defense if it is sued for a preference. *Friedman's Liquidating Trust v. Roth Staffing Cos., LP (In re Friedman's Inc.),* 738 F.3d 547 (3d Cir. 2013). After the decision was issued, some bankruptcy practitioners questioned whether courts would apply that same analysis in preferential transfer cases to amounts trade creditors receive on Section 503(b)(9) claims. Recently, however, one court ruled that a recipient of a payment under Section 503(b)(9) cannot also apply "the value of those same goods as a basis for a new value defense under §547(c)(4)." *Siegel v. Sony Elecs., Inc. (In re Circuit City Stores, Inc.),* No. 08-35653, 2014 Bankr. LEXIS 3859, at *25 (Sept. 8, 2014 Bankr. E.D. Va.) (citing *Circuit City Stores, Inc. v. Mitsubishi Digital Elecs. Am., Inc. (In re Circuit City Stores, Inc.)*, 08-35653, 2010 Bankr. LEXIS 4398 (Dec. 1, 2010 Bankr. E.D. Va.)).

Being Prepared

Trade creditors face many challenges when dealing with retailers that might or do file for bankruptcy. Pre-bankruptcy, it's imperative that trade creditors monitor and manage the credit risks and consider alternative business terms.

If a retailer does file, then trade creditors must immediately consider possible remedies related to goods they delivered before the filing; protect and pursue recovery on their prepetition claims; review filings in the case to determine if critical vendor status is an option and whether service on a creditors' committee makes sense; determine if their contracts are executory and, if feasible, pursue assumption; and, assert administrative expense claims when applicable. Finally, trade creditors must be aware that the bankruptcy estate might have claims to assert against them for amounts they received prepetition and plan accordingly. J

Daniel A. Lowenthal is a partner in the Business Reorganization and Creditors' Rights Group at Patterson Belknap Webb & Tyler LLP in New York. He can be reached at dalowenthal@pbwt.com.