DIP FINANCING IN RETAIL BANKRUPTCY CASES

Looking to Precedent to Reduce Litigation, Save More Retailers

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With the surge in retailers filing for Chapter 11 over the last several years, precedents abound for the debtor-in-possession (DIP) packages put together to finance the bankruptcy cases of retail debtors. Certain patterns and common practices have begun to emerge.

A review of large retail Chapter 11 cases suggests there are several key constituencies that most often become actively involved in the DIP financing court approval process. Understanding who those players are, the key issues and arguments they typically make, and the consensual agreements that have been reached in the past might be used by restructuring professionals to help chart a successful—and less expensive and litigious—path through future retail Chapter 11 cases, for companies and their creditor constituencies alike.

ABL Lenders

Given the seasonality and inventory build common to a retail business, substantially all of the large retail companies that filed for bankruptcy over the last several years had in place a senior secured asset-based lending (ABL) facility. ABL facilities typically are provided by large, traditional banking institutions and secured by a first-priority lien on the company's most liquid assets — cash, inventory, and related receivables. The maximum amount of borrowing availability under ABL facilities is governed by a borrowing base formula; in essence, the amount the company can borrow is capped at a percentage of the estimated value of the company's inventory and receivables.

Because of the first-priority lien it provides on assets vital to the day-to-day operation of the business, it should come as no surprise that ABL DIP financing is extremely common in retail bankruptcy cases. At a bare minimum, the consent of the ABL lenders is sought and obtained to allow the debtor to continue to use the ABL lenders' cash collateral. More commonly, the prepetition ABL facility is transformed into a post-petition ABL DIP financing facility, usually with the same lenders and on similar terms to the prepetition facility.

However, the DIP facility also often includes: (i) a roll-up of the ABL lenders' prepetition liens into post-petition liens and super-priority administrative claims, (ii) adjustments to the borrowing base and more flexibility to put in place reserves to guard against downside risk, and (iii) numerous terms and conditions related to the Chapter 11 process, typically including things like case milestones, consent rights over material transactions, control over the selection of a liquidator, and the acceptable terms of a Chapter 11 plan.

In short, ABL lenders are a key constituency whose active participation and support are almost always necessary for a retailer to have any hope of a successful reorganization. That's borne out by the fact that nearly every large retail case over the last few years has included an ABL DIP facility. That said, while ABL lenders often may be the most protected and viewed as one of the more powerful constituencies, certain other constituencies frequently raise issues that need to be addressed when negotiating the terms of an ABL DIP facility.

Other Funded Debtholders

Large retailers also commonly have complex capital structures that may include multiple secured and unsecured classes of debt. Often, other secured financings take valuable intellectual property and/or real estate as collateral. Moreover, in complex capital structures, private equity sponsors, alternative asset managers, and distressed investment funds may have a seat at the negotiating table through their investments in these various classes of debt. Their motivations may diverge substantially from those of the more traditional banks acting as ABL lenders.

It is relatively common for ABL lenders and other secured lenders to share "swapping" liens on each other's collateral. That is, the ABL lenders have a first-priority lien on traditional ABL collateral, such as cash, inventory, receivables, etc., and a second-priority lien on intellectual property (IP), real estate, or other assets, while other secured lenders have a first priority on the IP, real estate, or other assets and a second lien on the traditional ABL collateral.

The respective rights and priorities of the various secured lender groups are set forth in an intercreditor agreement. That intercreditor agreement, in turn, contains provisions that govern, and often restrict, what each secured lender can do in the event of a Chapter 11 filing of the borrower, including whether the different lenders can provide DIP financing, and sometimes how much.

Careful attention must be paid to ensure that any DIP financing arrangements not only are on terms acceptable to the debtor but also are in compliance with the relevant intercreditor agreements. Further, any proposed modifications or amendments to intercreditor agreements prior to a Chapter 11 filing should be carefully scrutinized for the potential impact on DIP financing alternatives.

Even with a robust intercreditor agreement in place, there can be extensive negotiations and even disputes between different lender groups over their respective rights. As a result, negotiations between the major secured lender groups can become a key focus in the lead-up to, and during the early stages of, a retailer's Chapter 11 case, and it is not uncommon to see multiple DIP financing facilities in a large retail Chapter 11 case — one from the ABL lenders and another from lenders holding another class of debt.

Key Unsecured Creditor Groups

There are three key categories of other creditors that, to protect their specific interests, often try to influence the ultimate terms of the DIP financing arrangements for retail debtors: large vendors/suppliers, consignment vendors, and landlords.[1] Some or all of these constituencies typically are members of the official creditors' committee, but it is becoming increasingly common for these types of creditors to retain their own individual counsel, sometimes coordinate with each other, and agitate for their own interests, thereby increasing the leverage and influence they might wield.

Large Vendors/Suppliers. Large vendors and suppliers of a retailer entering Chapter 11 often face a difficult series

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Analyzing who the major consignment vendors are, what steps they may have taken to perfect their security interests, and how much value is at stake can be key to minimizing objections and reaching a consensual resolution.

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of choices. When the retailer is a major platform for distribution, vendors and suppliers usually have an incentive to support the retailer's effort to reorganize and continue in operation. That said, many retail bankruptcies ultimately result in complete liquidation, and increasingly there appears to be a real risk of administrative insolvency in some cases.

As a result, vendors and suppliers may be forced to find ways to support the debtor while also making sure to protect themselves. This dynamic also can cause the interests of large vendors and suppliers that need the retailer as a major distribution outlet to diverge from the interests of smaller vendors and suppliers, which may be more concerned about the risk of liquidation and administrative insolvency.

More often than not, vendors and suppliers, both large and small, are a key constituency that the official creditors' committee seeks to protect. In the context of the approval of DIP financing, key points of negotiation have included: (i) fighting to keep as much collateral as possible unencumbered; (ii) preserving avoidance actions and maximizing the time available to investigate and potentially challenge the liens of secured lenders; (iii) minimizing the size of the carve-out for professional fees; and (iv) increasingly trying to include new and creative protections as part of the DIP financing orders to guard against potential administrative insolvency.

In addition to the efforts of the official creditors' committee, large and sophisticated vendors and suppliers may obtain their own counsel to protect their interests. More often than not, concerns by individual vendors or suppliers are raised informally and usually can be resolved by agreement on specific language in a DIP financing order protecting or preserving certain rights, such as potential rights related to set-off and recoupment.

Consignment Vendors. A constituency that has become increasingly vocal and organized in retailer Chapter 11 cases is consignment vendors, which purport to retain ownership of the inventory they give to a retailer to sell. In doing so, and assuming they take all of the proper steps under the Uniform Commercial Code (UCC), they may have a superior security interest in both the inventory and the proceeds of that inventory, and therefore come ahead of the first-priority liens that typically secure the debtor's ABL facility.

That said, teasing out who truly has a first-priority lien on consignment inventory, and more specifically the proceeds from the sale of such inventory, is a little like how people used to be able to describe their relationship status on Facebook—it's complicated. Suffice it to say, it involves the interpretation and interplay among UCC Article 2, UCC Article 9, and the Bankruptcy Code.

In cases where the ABL lenders believe they are sufficiently oversecured, issues with consignment vendors may be resolved by including language in a DIP order to make consignment vendors comfortable that their rights are preserved. However, in cases where there is sufficient value at stake and the secured lenders may not be as comfortable with their collateral coverage, these complicated issues can lead to significant, time-consuming, and expensive litigation. One relatively recent example of this was the Chapter 11 proceeding of Sports Authority, where a dispute between the secured lenders and an organized group of consignment vendors devolved into a full-on battle royal.

These complexities have at least three major implications when thinking about DIP financing for a retail bankruptcy case. First, consignment vendors are now more likely than ever to appear and seek to protect their rights by filing objections to proposed DIP financing. Analyzing who the major consignment vendors are, what steps they may have taken to perfect their security interests, and how much value is at stake can be key to minimizing objections and reaching a consensual resolution.

Second, secured lenders must be wary of the potential rights and security interests of consignment vendors and ensure that they are not lending against collateral over which they might not have priority liens and/or that they are putting in place appropriate reserves to protect against this risk. Third, from the debtor's perspective, getting a handle on these issues well in advance of a bankruptcy filing and developing a strategy to minimize potential litigation could turn out to be the difference between keeping the business in operation and succumbing to liquidation.

Landlords. Last, but certainly not "leased" (pun intended), large retailers in bankruptcy seem to almost always face a litany of landlord objections and reservations of rights in connection with their proposed DIP financings. The central legal issues usually in dispute are the ability of the DIP lenders to (i) take liens on the landlords' leases as part of their collateral package and (ii) enter into leased premises to conduct going-out-of-business sales.

After a number of skirmishes over the first issue, a tentative truce appears to have taken hold, at least when it comes to the relevant concepts. This tentative truce allows lenders to take a lien directly on a lease when such a lien is not prohibited by the terms of the relevant lease document, and, where such a lien is prohibited by the lease, the lender can have a lien on the proceeds of the lease only. Notwithstanding this conceptual truce, large retail debtors still often have to review and address dozens of objections and reservations of rights filed by landlords, and substantial time and effort might need to be dedicated to agreeing on precise language with a diverse group of landlords, each with its own counsel.

Likewise, numerous landlords almost always object to any language in a DIP order or related credit agreement that purports to give lenders the right to enter into leased premises to conduct going-out-of-business sales. This is an important issue for ABL lenders in particular, since a substantial amount of their collateral is inventory that sits in leased retail locations around the country. This dispute also can spill over from the DIP financing process into a retail debtor's relatively common request for the approval of procedures to conduct going-out-of-business sales.

As with the liens-on-leases issue, a relatively standard set of procedures and language is appearing in increasing numbers of retail Chapter 11 cases. However, each side continues to press the fight and look for advantages in each new retail Chapter 11 case.

Given this past experience, and the proliferation of consensual agreements reached in numerous cases, large retail debtors can look for ways to minimize, if not completely avoid, disputes with landlords when it comes to the terms of their DIP financing. That said, each situation is unique, and there may be cases in the future where the debtor, the lenders, or the landlords believe it's important enough to litigate these issues in court. Moreover, regardless of the plethora of precedent, debtors and lenders should be prepared and have a game plan in place to actively engage with the company's landlords on these issues.

Conclusion

It's sobering to read that almost half of all retail and grocery bankruptcy cases over the last 15 years have ended in liquidations.[2] The potential reasons are often debated—cultural shifts, the "Amazon effect" and other competition, changes to the Bankruptcy Code, bad management, etc. But, regardless of the cause of retail distress and failure, it seems beyond dispute that restructuring professionals need to continue to look for ways to reduce the failure rate and improve, streamline, and reduce the cost of Chapter 11 for retailers to give viable businesses a fighting chance to survive.

To that end, the continued accumulation of precedent reflecting the consensual resolution of concerns raised time and again with retail DIP financing arrangements can help all constituencies understand some of the major dynamics at play and might be used to facilitate a smoother, less litigious, and less expensive start to the Chapter 11 process for retail debtors.

This article represents the opinions of the author only and not those of Skadden, Arps, Slate, Meagher & Flom LLP or its affiliates, and is not intended and should not be construed as legal advice.

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[1] While unsecured bondholders are another constituency that can play an important role in the DIP financing approval process, they are not addressed in this article because the issues they present usually are not unique to the retail industry.

[2] See Al-Muslim, Aisha, "After Bankruptcy, Nearly Half of Retailers Close All Stores," *The Wall Street Journal*, January 23, 2020.