THE ROLE OF

RESTRUCTURING ADVISORS IN REFINANCING TRANSACTIONS

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The oft-touted "retail apocalypse" has resulted in a large number of retailers seeking Chapter 11 protection. This wave of Chapter 11 filings has been attributed to a number of factors, including the rise of online and direct-to-consumer retail, a shift in retail preferences, and, of course, the COVID-19 pandemic.

However, Chapter 11 filings do not tell the entire story of the current retail restructuring market. Other retail companies have avoided Chapter 11 and successfully restructured out of court in an attempt to save jobs, minimize disruption to operations, and preserve value for equity holders.

One challenge facing retailers attempting to restructure out of court is that the traditional retail capital structures may provide limited flexibility for refinancing transactions. Often, a retailer has (1) an asset based loan (ABL) facility, which may be secured by, for example, a priority lien on the retailer's inventory, equipment, accounts receivable, and/or cash or some other combination of assets and a junior lien on other assets, and (2) a term loan, which is secured by a first-priority lien on the retailer's other assets and a second-priority lien on the ABL collateral.

As such, retailers may have few, if any, unencumbered assets to serve as collateral for a new capital raise, and lenders are reluctant to issue debt to a distressed retailer on a junior secured or unsecured basis. Such a debt structure leaves little room for additional first-priority secured debt and poses significant hurdles to an out-of-court restructuring.

In light of this, retail companies seeking to restructure out of court have turned to certain non-core asset classes to generate liquidity or as currency for new issuances or loans, whether such issuances or loans be for fresh capital or as part of an exchange. These transactions may involve the sale of an asset class to an affiliate or an "unrestricted subsidiary" under the company's credit documents.

Some retail companies have used a combination of unrestricted subsidiary baskets, investment baskets, restricted payments baskets, and asset sale baskets to move valuable assets to subsidiaries that are outside the scope of the credit parties and beyond the reach of existing lenders and noteholders. Such subsidiaries are not burdened by restrictive debt, lien, and restricted payment covenants. Once outside the existing credit group, these assets then can be used as collateral for new secured debt, sold to generate liquidity for operations and debt service, or remain unencumbered for the benefit of unsecured creditors and potentially some equity holders.

Recent examples of such transactions include the transfer of interests in intellectual property by J. Crew to an unrestricted subsidiary; the transfer by PetSmart of (1) 20% of its ownership interest in Chewy, an online pet supply retailer, to its shareholders and (2) 16.5% of its ownership interest in Chewy to an unrestricted subsidiary, which PetSmart argued caused an automatic release of Chewy's obligations on PetSmart's debt, including release of any related liens, because the online retailer was no longer a wholly owned subsidiary; and the designation of Anagram, a manufacturer of metallic balloons, as an unrestricted subsidiary of Party City.

These transactions each provided retail companies with an opportunity to address existing balance sheet issues without the immediate need for Chapter 11 protection. Predictably, however, such transactions are not well received by a company's existing secured creditors. These dynamics create a perfect storm for litigation by disgruntled secured debtholders, and the propriety of many similar transactions has been litigated either in state or federal courts, or even in subsequent bankruptcy cases.

Issues to Evaluate

Recently, issuers and borrowers, both inside and outside the retail sector, have seen success in defending these transactions from attack by disgruntled lenders (or settling resulting litigation). The success of retailers in finding opportunities to raise new priority debt without violating existing debt covenants is not surprising given that current debt market is very open and competitive (including for high-yield debt). This strong and competitive debt market has allowed borrowers to achieve increasing flexibility in debt covenant packages.

As legal victories in favor of issuers and borrowers build, and low interest rates continue to fuel the market for high-yield debt, a rise in out-of-court retail refinancings may follow. These transactions typically involve a holistic legal approach, including significant contributions by banking, capital markets, corporate, litigation,

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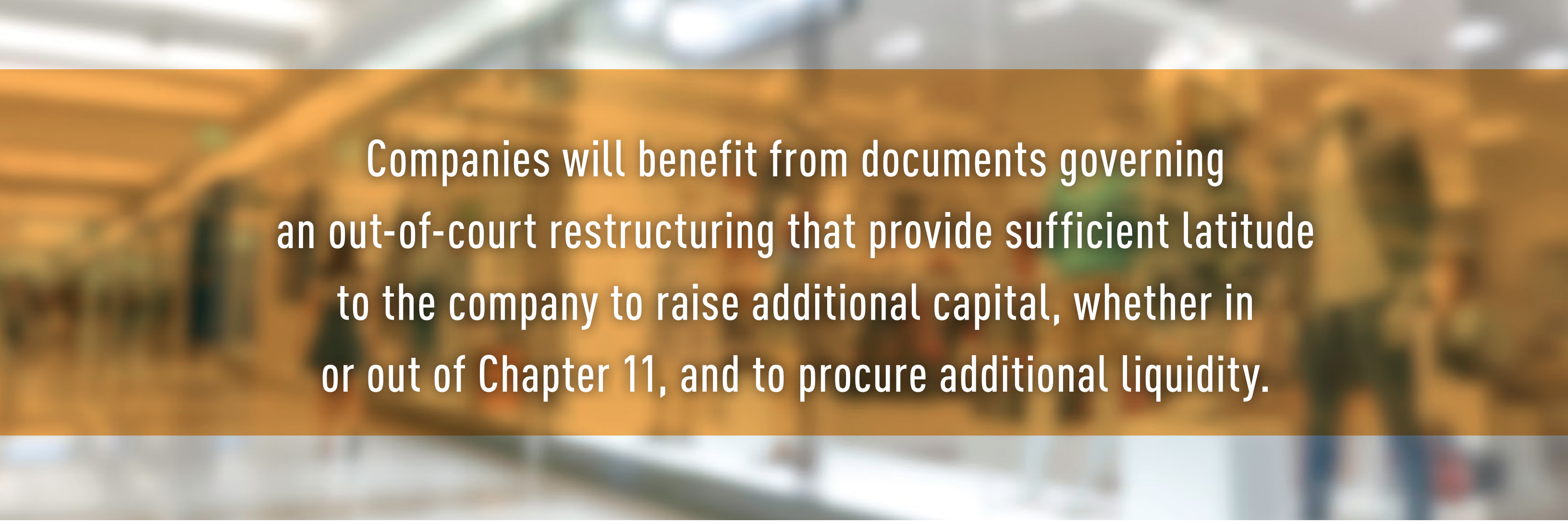

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and tax professionals. The role of restructuring advisors is critical in these scenarios, particularly in evaluating and addressing the following issues.

Avoidance Issues. With the transfer or disposition of substantial assets comes the potential for avoidance litigation, whether such claims are based on theories of fraudulent transfer or preferential transfer. Restructuring counsel should consider and evaluate any such potential claims, the parties likely to bring such claims, and the strengths and weaknesses underlying such litigation.

In addition, financial advisors and bankers should be involved to evaluate the pre- and post-transaction solvency of the company and the sufficiency of consideration received as part of the transaction. Restructuring advisors should present retail clients with a full picture of the potential risks associated with any litigation, enabling their clients to make informed decisions and avoid unwanted surprises post-closing.

Support Agreement Drafting. Some out-of-court transactions, particularly those involving consent or exchange solicitations, are undertaken pursuant to restructuring support agreements or transaction support agreements. Restructuring counsel can aid in the process by drafting restructuring and transaction support agreements to be durable in case the company needs to implement a recapitalization through a prepackaged Chapter 11 filing.

Additionally, the applicable support agreement ought to provide for amendment provisions that enable a core group of supporting constituents to consent to amendments, such as lowering minimum participation thresholds or extending milestones, to accommodate changes in circumstances that may occur post-execution and preclosing. The company and its advisor team will be well-served to understand these amendment provisions and be prepared to utilize them to address post-signing developments to preserve key debtholder support.

Preparing for Subsequent Financings. The volatility of the retail sector requires that retailers preserve flexibility to raise additional capital. Companies will benefit from documents governing an out-of-court restructuring that provide sufficient latitude to the company to raise additional capital, whether in or out of Chapter 11, and to procure additional liquidity.

Transaction modelling should take into account the potential need for post-refinancing capital raises. Moreover, maintaining flexibility in its balance sheet may enable a company to issue additional debt or to raise incremental refinancing capital as part of any resolution of litigation (or threat thereof) with nonconsenting debtholders. Restructuring advisors should take an active role in negotiating documents to ensure that, post-transaction closing, the company's supporting debtholders continue to have sufficient decision-making authority to consent to incremental financing or DIP financing, if necessary.

Avoiding the 'Bridge to Nowhere' Problem. Out-of-court refinancings are often attractive options for distressed retailers because they provide companies with opportunities to restructure their balance sheets without the need for Chapter 11 protection. However, an out-of-court transaction is not a panacea, and a one-size-fits-all approach will not be appropriate for many retailers.

Restructuring professionals should work closely with retailers and their co-advisors to evaluate the company's business plan and go-forward business needs. Simply put, some retailers will need to utilize the tools available to companies in Chapter 11 to execute their business plan and survive.

Some companies will need to sell non-core assets free and clear of liabilities, or reject uneconomic leases. In other cases, equity holders of some retailers may be out of the money, and a more thorough balance sheet restructuring may be necessary. In these cases, a fulsome review of Chapter 11 tools, combined with realistic and reasonable business plan modeling, will prevent retail refinancings from becoming a bridge to nowhere.

Conclusion

Out-of-court refinancings provide unique opportunities for stressed and distressed retailers. By focusing on the issues summarized in this article, restructuring advisors can serve three important roles in these transactions. First, they can help their clients anticipate and evaluate potential litigation around liability management transactions. Second, they can "weatherproof" support arrangements and enable retailers to respond in real time to changes in circumstances that arise prior to closing. Third, they can position their clients for success, growth, and stability post-closing.

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