Managing Risks in Doing Business with Administratively Insolvent Retail Debtors

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When a retailer files a Chapter 11 bankruptcy case, its suppliers face the critical decision of whether to continue shipping goods to the retail debtor post-petition. Cutting off all further shipments would limit any further loss but would also guarantee that the supplier had little to no chance of getting paid for prior shipments. It would also mean a loss of future business with the retailer.

The alternative—continuing to do business with the retail debtor—may seem like the better business decision. In many cases, the retail debtor will pay for new shipments and may grant the supplier critical vendor status, giving it the potential to recoup partial or full payment of its prepetition claim.

However, the decision to continue shipments is fraught with peril. The retail industry has seen an increasing number of debtors complete asset sales, only to find themselves administratively insolvent and unable to even pay for *post-petition goods*, let alone make prepetition payments to critical vendors. This article discusses the increasing number of administratively insolvent retail bankruptcy estates and potential strategies suppliers can employ to minimize their exposure for post-petition shipments.

Disregarding Past Practices

For decades, retail suppliers relied on two fundamental principles in continuing to do business with retail debtors: (1) obtaining critical vendor status would ensure that the debtor would pay for the supplier's prepetition shipments; and (2) if the debtor ordered goods post-petition and its budget provided for payment, the supplier would be paid for its post-petition shipments. In reliance on these historical truths, a supplier would refuse to make further shipments until it received designation as a critical vendor.

The Toys R Us Inc. bankruptcy case, filed September 18, 2017, was the first large retail bankruptcy filing to highlight the problem with these practices. In the early months of its bankruptcy case, Toys R Us represented to its suppliers that the purpose of the bankruptcy filing was to restructure its business and emerge as a healthier company. But after a disastrous 2017 holiday season, the retailer missed milestones built into its debtor-in-possession financing, and its lenders refused to extend additional credit. Toys R Us was forced to liquidate its inventory and wind down.

The retailer then announced that its estate was administratively insolvent; Toy R Us would not be able to pay for the more than $300 million of goods it purchased and sold post-petition. After months of negotiating, Toys R Us and its lenders settled with the administrative expense claimants, resulting in a payment of only $180 million, approximately 60% of what it owed to holders of administrative claims. Suppliers that believed Toys R Us when it said it would be able to reorganize and had the budget to pay for goods suffered massive losses.

The incidence of administratively insolvent retail bankruptcy cases has only increased since the Toys R Us case. In *In re Sears Holdings Corporation,* Case No. 18-23538 (Bankr. S.D.N.Y. 2018), the Bankruptcy Court approved a plan of liquidation when the debtor did not have enough money to pay its administrative expenses. Rather, Sears intends to fund its plan by filing approximately 2,000 preference lawsuits to recover a portion of the estimated $1.3 billion the company paid to creditors during the 90 days prior to its bankruptcy filing.

After confirmation of its plan, Sears gave its suppliers a choice: take a 25% discount on payment of their administrative expense claim in exchange for expedited review of their claim and participation in an initial distribution, or reject the proposal and get paid in full once the amount of the claims was agreed upon by Sears, which could take months or years. *See also In re Specialty Retail Shops Holding Corp.* (Shopko), Case No. 19-80064 (Bankr. D. Neb. 2019) (creditors withdrew their motion to convert the case to Chapter 7 after reaching an agreement with the debtor on a discounted payment on their administrative expense claims); *In re Barneys New York, Inc.*, Case No. 19-36300 (Bankr. S.D.N.Y. 2019)

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(Bankruptcy Court approved Chapter 11 plan that will pay administrative expense claimants at discounted amount). In *In re Beauty Brands, LLC*, Case No. 19-10031 (Bankr. D. Del. 2019), the Bankruptcy Court converted the case to Chapter 7 after finding that the estate was administratively insolvent.

Minimizing Exposure

In this landscape of increasingly insolvent retail bankruptcy cases, suppliers need to step back and evaluate each customer on a case-by-case basis to determine whether the benefits of a continued relationship with a retail debtor outweigh the risk of nonpayment for post-petition shipments. There are ways that suppliers can minimize their exposure while continuing to provide goods to the debtor.

First, suppliers should rethink the traditional request to be treated as a critical vendor. Designation as a critical vendor has been the top priority for suppliers in traditional bankruptcy cases. In general, a critical vendor order provides that a supplier will be paid the prepetition amounts it is owed over time so long as the supplier agrees to continue to ship goods to the debtor on ordinary trade terms. This is generally defined as the terms that existed six to 12 months before the bankruptcy filing. Such agreements also require that the supplier continue to provide goods to the debtor throughout the bankruptcy case or risk having the debtor's prepetition debts converted to payments for the post-petition goods.

Until recently, holding critical vendor status was a great way to maximize recovery in a traditional bankruptcy case. However, suppliers may risk increasing their exposure by being designated as such in today's environment. If the debtor's estate is administratively insolvent, being forced to continue providing shipments on normal trade terms can result in a large, unpaid administrative expense claim, the amount of which exceeds that of the prepetition unsecured claim. To prevent this, suppliers should review critical vendor terms carefully and negotiate for the ability to terminate the relationship promptly if the debtor fails to make timely payments. Suppliers should also monitor post-petition relationships just as closely as they would those with struggling customers who have not yet filed bankruptcy.

Second, in situations where the supplier has not been designated as a critical vendor or has rejected critical vendor terms, suppliers should push for deposits, cash in advance, or other aggressive payment terms. Absent an ongoing executory contract between the supplier and the debtor, the Bankruptcy Code does not mandate that a supplier continue to sell goods to a debtor. If a supplier elects to do so, it should only maintain a post-petition relationship on its terms, which should be as aggressive as the supplier can negotiate.

Third, suppliers should look to plan confirmation as an inflection point where they can assert maximum leverage to exact the best possible payment terms from the debtor. Under Section 1129(b)(9) of the Bankruptcy Code, a plan must provide for the payment of all administrative expense claims in full on the effective date unless the holder of the claim agrees to different treatment. Debtors often get around this requirement by requiring a creditor to timely object to the plan or otherwise be deemed to accept different treatment. A debtor might also delay significantly the procedure and timing for determining the allowed amount of a creditor's claim by filing an objection to it.

A claim to which an objection is filed is deemed disallowed until the Bankruptcy Court determines the allowed amount of the claim.

Creditors can push back on these efforts by filing a motion for allowance of an administrative expense claim and requesting an expedited hearing on the motion, or if the debtor objects to the motion, seeking estimation of the creditor's claim under Section 502(c) of the Bankruptcy Code. Creditors should also object to Chapter 11 plans that do not provide for full payment of all administrative expense claims on the effective date. Once a creditor has filed such an objection, the debtor will be forced to resolve it in advance of plan confirmation, thus giving the creditor leverage to negotiate the best deal it can obtain.

Conclusion

Retail bankruptcies pose difficult quandaries for suppliers: continue shipping goods and risk administrative insolvency by the debtor or cut off future shipments and lose a potentially significant customer. Each supplier should evaluate its individual circumstances to determine the best path forward. With the strategies described in this article in mind, suppliers should be able to identify the risks associated with an administratively insolvent bankruptcy estate and implement these strategies to minimize the risk of nonpayment.

The number of retail bankruptcies will continue to increase as retail stores struggle to compete with their online counterparts. However, suppliers can now go into these bankruptcies aware of the risks and the steps to take to minimize them. ■

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