In the Business of Going Out of Business: What Unsecured Creditors Need to Know About Liquidation Agreements

By: David M. Posner, Esq. and
Kelly E. Moynihan, Esq.

As originally published in the Credit Research Foundation 3Q2018 Credit & Financial Management Review

Abstract

The "Retail Apocalypse" has arguably been upon us for the last decade and continues to be a force today. From January 2006 through September 2017, 46% of all retail bankruptcy filings with more than $50 million in liabilities resulted in liquidations.[1] This percentage excludes more recent high-profile liquidations such as Toys "R" Us and The Bon-Ton Stores, which filed for Chapter 11 and liquidated after September 2017. In situations where liquidation may be inevitable, unsecured creditors should be aware of the typical terms of a liquidator agency agreement and certain issues that may arise thereunder in order to ensure the highest possible recovery on an unsecured claim. This article examines "going out of business" sales generally, the most common terms of liquidator agency agreements, including fee structures, and steps unsecured creditors can take to protect themselves and their consigned goods in a challenging liquidation scenario.

---

[1] Source: AlixPartners, *Retail Bankruptcy Study: Why So Many Retailers Liquidate – and How to Improve the Odds*, October 2017.

Going Out of Business Sales Generally

In an effort to downsize operations and maintain more profitable stores, retailers may seek the protection of a Chapter 11 filing to conduct going out of business ("GOB") sales at their less profitable store locations. GOB sales tend to occur at a rapid pace due to certain time constraints imposed by the prepetition/postpetition ABL (Asset Based Lending), revolving loan or term loan lenders that are justified by a provision in the bankruptcy code requiring a debtor to assume or reject real property leases within 120 to 210 days of the bankruptcy filing. As a result, the secured lender typically demands that the GOB sales must be completed in less than the first 210 days of the Chapter 11 case, and often times, GOB sales are approved by the bankruptcy court and completed within 10-15 weeks of the Chapter 11 filing.

GOB sales arise in a Chapter 11 case in two ways: (1) the debtor seeks to assume a consulting agreement with a liquidator that was entered into prior to the Chapter 11 filing or (2) the debtor seeks approval from the bankruptcy court to sell substantially all of its assets pursuant to section 363 of the Bankruptcy Code ("363 Sale") either with or without a liquidator acting as the stalking horse bidder. Where a debtor seeks to assume a prepetition consulting agreement with a liquidator to facilitate the sale of inventory and furniture, fixtures and equipment ("FF&E") at underperforming locations, unsecured creditors should ensure that the debtor entered into the prepetition consulting agreement after a competitive prepetition process, which would include marketing and targeting various potential liquidators to ensure the best possible terms for the estate.

In a 363 Sale process, the debtor will seek court approval of bidding procedures and an auction process for the sale of its assets. Following the conclusion of the auction, the debtor will seek further approval of the sale terms. Where bids for a going concern sale are inadequate or in some cases, nonexistent, the successful bidder in a retail bankruptcy will typically be a liquidator or, as is more typical, a joint venture that is formed between several liquidators. For instance, in the Toys "R" Us case, the largest retail liquidation in bankruptcy history, an unprecedented joint venture comprised of liquidators (i) Gordon Brothers Retail Partners LLC, (ii) Hilco Merchant Resources LLC, (iii) Tiger Capital Group LLC and (iv) Great American Group LLC, liquidated the inventory and FF&E at over 700 Toys "R" Us retail locations. If multiple liquidators bid for the debtor's assets, the debtor will need to determine which liquidator is offering the highest and best price for the inventory, as it is not uncommon for the inventory to yield close to, or even more than, 100% of the company's costs for such inventory. After evaluating the various bids, and consulting with the debtor's various stakeholders, the debtor will enter into an agency agreement with the liquidator, allowing the liquidator to sell the inventory and FF&E at the debtor's GOB locations.

Liquidation Agreement

The liquidator's agency agreement governs the rights and obligations between the liquidator and the debtor. Such agreements will set forth, among other terms, (i) consideration the debtor will receive from the liquidator; (ii) list of the stores included in the GOB sale; (iii) detailed itemization of the inventory to be subject to the GOB sale and the price of such items; (iv) methodology for a physical inventory of the goods; (v) a budget reflecting responsibility for sale expenses such as rent, taxes and payroll; (vi) the extent of the liquidator's ability to use augmented goods; and (vii) a timeline for the completion of the GOB sale. The sale budget, including GOB sale expenses such as rent payments, payroll and other costs, will be negotiated between the debtor, its secured lender, and the liquidator. The timeline for a GOB sale is typically around 90 days start to finish, with extensions permitted depending upon the scope and scale of the liquidation.

Generally, the most important term of a liquidation agreement for unsecured creditors to review is the consideration to be received by the debtor, and therefore, the amount of consideration that *may* make its way to unsecured creditors. The form of the agreement, which is often dictated by the fee and cost structure, is typically one of two forms: (i) agency or equity; or (ii) fee. In an agency or equity-based agreement, the liquidator purchases the existing inventory for a guaranteed, agreed upon price and sells the inventory out of the debtor's stores. The liquidator agrees to reimburse the debtor for all store carrying costs, e.g., rent, real estate taxes and employee salaries, for the duration of the GOB sale. The guaranteed amount is often a percentage of the cost of the inventory to be sold. A portion of the guaranteed amount may be paid up front to the debtor. At an auction with competing bids from liquidators, the consideration typically being "bid up" through each round of bidding is the guaranteed amount. Some agency agreements will contain a sharing mechanism pursuant to which the debtor will share in a percentage of the sale proceeds in excess of a stated amount. If the guaranteed amount is relatively high, which may occur as a result of active bidding at the auction, the upside sharing may be eliminated.

In a fee-based agreement, the liquidator will oversee the GOB sale process for an agreed-upon fee. The fee is most often based upon a formula of the results of the sale. The liquidator under a fee-based agreement may provide staff and advertising for an agreed upon fee paid by the debtor and generally based on a formula of the sale results. In this scenario, the liquidator essentially acts as a consultant to the debtor. In a fee-based agreement, the inventory is not sold to the liquidator, but remains property of the debtor until sold directly to consumers. Further, the debtor bears the risks and costs of the GOB sale under a fee-based agreement, including rent and employee salaries. In Toys "R" Us, the consulting agreements provided for a sliding scale fee based upon the gross recovery (i.e., the gross sale proceeds divided by the aggregate retail value of the inventory). The liquidators' fee ranged from 1.8% of gross sale proceeds for a gross recovery below 57%, and 3.5% of gross sale proceeds for a gross recovery 60% or above. In RadioShack's 2015 Chapter 11 filing, the liquidator received a flat fee of $500 per store closing plus a 1.5% fee of the gross sales at each location. The liquidator would receive an additional 0.5% of the gross sale proceeds if the GOB sales were completed at 90% of the closing stores by a certain date. The liquidator was additionally entitled to 17.5% of the gross proceeds from the sale of FF&E.

An agency or equity-based agreement has been seen more often in recent retail bankruptcy cases. The following are examples of guaranteed amounts provided in agency agreements in recent Chapter 11 cases involving GOB sales: (i) Sports Authority – 101% of inventory cost plus $1.8 million for an augment guarantee; (ii) Coldwater Creek – 98% of inventory cost; (iii) Borders – 72% of inventory cost plus a 50/50 sharing of proceeds above a certain threshold level; (iv) The Bombay Company – 109.5% of inventory cost; (v) Filene's Basement – 90% of inventory cost; and (vi) Loehmann's Holdings Inc. (2013) – 29.8% of retail value plus other consideration.

While an agency or equity-based agreement requires the liquidator to purchase the debtor's inventory for a "guaranteed" purchase price, the term "guaranteed" can be misleading as it is based upon a percentage of the retail value or the debtor's cost of the inventory to be sold. Moreover, the "guaranteed" amount is typically contingent upon the debtor's estimates of the value of its inventory. When a company files for Chapter 11, however, it may be impossible to provide an accurate assessment of the debtor's assets, which in turn, could affect the "guaranteed" amount calculation. Additionally, a liquidator may take a security interest to protect itself in the event that the debtor is obligated to repay the advance payment of the guaranteed amount that the liquidator provides up front. Unsecured creditors should critically analyze the "guaranteed" amount set forth in the liquidation agreement and the methods used by the debtor to estimate the value of its inventory in order to avoid a liquidator from foreclosing on its security interest in assets of the debtor in order to retrieve any overpayment of the "guaranteed" amount.

Consignment Issues

Any creditor with a consignment, scan-based trading, or similar agreement must ensure that the agency agreement does not conflict with the creditor's rights under the consignment agreement and does not propose to sell the creditor's consigned goods. Under a consignment agreement, a seller, or consignor, delivers goods to the purchaser, or consignee. The consignor generally retains title to the goods, and payment is deferred until the consignee sells the goods to, in a retail case, the consumer. Importantly, a consignor must properly perfect its security interest in the consigned goods, pursuant to the requirements of Article 9 of the Uniform Commercial Code, prior to the consignee's filing of a Chapter 11 petition. Failure to do so may result in the consignor's treatment as an unsecured creditor in the Chapter 11 case, as opposed to a secured creditor with a properly perfected security interest in the consigned goods.

GOB agency agreements may allow for the sale of all merchandise and FF&E without any distinction for consigned goods. Owners of consigned goods that are in the possession of the debtor should file objections to any sale and agency agreement that does not provide for the separate treatment of consigned goods. The agency agreement itself, or the court order approving a GOB sale, should allow for the retrieval of the consigned goods by their owner and, to the extent that the goods are sold, the liquidator's fees should not dilute the monies owed to the owner of the consigned goods under the consignment agreement.

As an example, in the Toys "R" Us case, Readerlink Distribution Services, LLC ("Readerlink"), among certain other creditors, objected to the debtors' store closing motion based upon the treatment of consigned goods. Under its consignment agreement, Readerlink was to deliver books on consignment to Toys "R" Us. The books remained property of Readerlink for which Readerlink previously filed a UCC-1 financing statement to perfect its security interest in the books and proceeds. Under the consignment agreement, Toys "R" Us was to reimburse Readerlink with the MSRP for each unit of products sold. Readerlink also provided FF&E for display of its products. Readerlink did not object to the sale of its products so long as the terms of the consignment agreement were complied with, i.e., that the debtors remitted the applicable portion of the sale proceeds derived from Readerlink's products to Readerlink on a timely basis. Absent compliance with the consignment agreement, Readerlink objected to the sale of its products, arguing that Readerlink retained title to the products, which were not property of the debtors' estates. Readerlink further objected to the assessment of a fee payable to the liquidators if such fees diluted the sums due and owing to Readerlink from the sale of Readerlink's products in accordance with the consignment agreement. Ultimately, the Bankruptcy Court sustained Readerlink's objection and included the following language in its order approving the GOB sales:

> In connection with any consignment, scan-based trading, or other similar agreement . . . any such party shall be entitled to, at its own cost and expense and in coordination with the Debtors and the [liquidators], remove any validly-owned property from the Debtors' stores. Upon the sale or transfer of any goods covered by such Consignment Agreement to any non-Debtor entity or individual, the Debtors shall compensate the [consignor] to such agreement in the amount and on the terms set forth in the applicable Consignment Agreement.[2]

[2] *Order (i) Authorizing the Debtors to Wind-Down U.S. Operations, (ii) Authorizing the Debtors to Conduct U.S. Store Closings, (iii) Establishing Administrative Claims Procedures, and (iv) Granting Related Relief*, *In re Toys "R" Us, Inc., et al,* No. 17-34665(KLP) (Bankr. E.D. Va. Mar. 22, 2018).

Parties to consignment agreements with a debtor should ensure that similar language is contained in the agency agreement between the debtor and the liquidator or in the court's order approving the GOB sale. While it is unlikely that a bankruptcy court would require that the debtor pay for the removal of a consignor's goods from the debtor's stores, a consignor should still attempt to request such relief.

Augment

To supplement a debtor's inventory, and therefore the GOB sale proceeds, a liquidator may seek authority to augment the debtor's inventory with outside inventory in the possession of the liquidator. Liquidation agreements that permit augment with a liquidator's goods have prompted objections from state Attorney Generals who raise consumer fraud, deceptive practices and false advertising concerns, *i.e.*, the consumer purchases products from a debtor expecting a certain quality but is unaware that they have received goods of the liquidator, which may be of a lesser quality and were never produced or sold by the debtor. Generally, augmented goods must be of the same type and quality as the debtor's existing inventory to allay the concerns of the state Attorney Generals. While state Attorney Generals may voice concerns or scrutinize augment provisions, allowing a liquidator to bring augmented goods into a debtor's store during a GOB sale can inure to the benefit of creditors because such goods often can result, through negotiations with the debtor and liquidator, in a higher guaranteed amount under the agency agreement. For instance, in Toys "R" Us, the liquidators agreed to pay the debtors 5% of the gross proceeds from the sale of any augment goods. As the percentage guaranteed or recovered on augment can be a critical part of recoveries for the estate, unsecured creditors should be hyper-focused on augment negotiations with liquidators. In addition, bringing in augment or moving inventory from the debtor's closed stores to other stores enables the debtor to keep the debtor's stores more fully stocked, which may entice more consumers into the store to purchase.

Takeaway

With nearly half of all retail bankruptcy cases resulting in liquidations, unsecured creditors should keep apprised of the debtor's GOB sale efforts in order to maximize recovery for themselves. If a debtor entered into a consulting agency agreement prior to the bankruptcy filing, unsecured creditors should review the debtor's efforts to obtain offers from multiple liquidators to determine which agency agreement is the best. Where the debtor seeks to sell its assets in a 363 Sale, creditors should carefully analyze the proposed bidding procedures to ensure that such procedures allow for a robust bidding and auction process, encouraging the highest or best bid for the debtor's assets from competing liquidators. Where a creditor is a party to a consignment agreement with the debtor, the creditor should ensure proper perfection of its interest in the consigned goods and object to any GOB sale or agency agreement that proposes to dilute payments to the creditor as provided under the applicable consignment agreement. Lastly, permitting a liquidator to provide augmented goods to the debtor's stores during a GOB sale can result in the debtor's receipt of increased percentages of the sale proceeds, which may enhance recoveries for unsecured creditors.

David M. Posner is a bankruptcy and financial restructuring partner in the New York office of Kilpatrick Townsend & Stockton LLP. He represents companies, creditors' committees, Chapter 11 trustees, acquirers, financial institutions, and other significant parties-in-interest in complex reorganizations and financially distressed situations. In addition, he has substantial litigation experience representing both plaintiffs and defendants in complex commercial litigation inside the context of complex reorganization cases, and in state and federal courts across the country.

Kelly E. Moynihan is a bankruptcy and financial restructuring associate in the New York office of Kilpatrick Townsend & Stockton LLP. She specializes in the representation of debtors, creditors' committees, indenture trustees, and other significant parties-in-interest in complex Chapter 11 reorganizations.