Financing Techniques to Enhance Creditors' Protections in Retail Bankruptcy Cases

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It cannot really be debated that the Four Horsemen of the "retail apocalypse" have arrived and are comfortably hanging around the nation's shopping districts. Dozens of retailers filed for bankruptcy in recent memory, including Bon-Ton, Claire's, Gibson Brands, and Brookstone, with more on the bankruptcy watch list. With many recognized names liquidating through bankruptcy, perhaps no distressed industry has caused greater concerns for vendors, suppliers, landlords, and other operations-related creditors than retail.

Although not necessarily apparent at the outset of such cases, some of these liquidations may end up as potentially administratively insolvent cases. One only need to look at Toys R Us[1] for such an example. The company entered Chapter 11 with assurances of a 16-month runway to accomplish a successful reorganization; and yet, just six months after the bankruptcy filing and securing more than $3 billion in debtor-in-possession (DIP) financing, Toys announced the sudden and unprecedented liquidation of all of its U.S. operations. Citing disappointing fourth quarter results for 2017, an inability to obtain certain covenant waivers from its secured lenders, and the resulting lack of any viable sale or restructuring alternatives for domestic operations, the *Toys* case represents a large and rapid deterioration of an established operating retail company.

Despite the disappointing outcome of the case, *Toys* presents a useful case study on why it is essential, at the very outset of the case, to hope for the best but plan for the worst. This is particularly true in situations where retail operating creditors (vendors, suppliers, landlords, and others) continue to provide goods and services during the bankruptcy that inure to the benefit of the secured lender, especially when that secured lender either has a lien—or is granted a lien through adequate protection claims or a postpetition financing facility—on inventory, real estate, and other operating assets, leaving little, if any, unencumbered value in the estate.

The Basic Rules

In general, expenses related to administering the debtor's estate are not chargeable to the secured creditor's collateral, but are paid from the unencumbered assets of the estate. Section 506(c) of the U.S Bankruptcy Code provides an exception permitting the surcharge of collateral in certain circumstances, provided the expenses at issue (i) are "necessary" to preserve or dispose of the collateral, (ii) are "reasonable," and (iii) provide a "benefit" to the secured creditor.

Section 552(b) provides the general rule that postpetition property is *not* subject to a prepetition lien; however, like Section 506(c), Section 552(b) provides for certain exceptions, namely that a prepetition lien continues to be valid with respect to postpetition proceeds, products, offspring, or profits from the prepetition collateral. But, these exceptions are subject to a further exception: specifically, the validity of a security interest in postpetition proceeds, products, offspring, or profits of prepetition collateral under Section 552(b)(1) can be limited or eliminated by the court "based on the equities of the case."

The next concept is the common law right to marshalling that can be used to protect junior creditors by requiring a secured creditor with recourse to multiple pieces of collateral to recover first from one source, in an attempt to avoid harming junior creditors that have access to fewer sources of collateral. For example, if the working capital lender has a prepetition lien against inventory and obtains a postpetition lien against previously unencumbered real estate, marshalling would have the lender look to the inventory first to allow for the opportunity of junior (including unsecured) creditors to benefit from the value of the real estate if the lender is repaid from the inventory. In other words, the doctrine of marshalling seeks to satisfy the claims of both creditors in a more equitable manner.

These three rights—surcharges under Section 506(c) and Section 552(b) and marshalling—are typically raised in the negotiation of a DIP financing order, with such orders often providing that the debtor has waived its ability to assert such rights, leaving the negotiation to the committee and others to raise. Lenders typically seek to show that the budget for the DIP financing provides for the payment of operating and other expenses (per a budget), warranting the requested surcharge waivers. This leaves open, what happens if there is a subsequent liquidation event that gives rise to a right of the lender to cease DIP financing?

Toys R Us

When *Toys* filed as a reorganization case with a 16-month DIP financing, like many debtors, the *Toys* debtors made a number of concessions to their prepetition lenders in the initially proposed DIP orders, including waiving the rights to (i) surcharge collateral under Section 506(c), (ii) assert the "equities of the case" exception of Section 552(b), or (iii) compel marshalling. Despite these waivers, the official committee of unsecured creditors[2] negotiated certain meaningful (and prescient) improvements to the final DIP orders, including specific carveouts to the debtors' waivers of Section 506(c), 552(b), and marshalling rights.

Notably, although the original DIP orders contemplated complete waivers of estate rights under Section 506(c), 552(b) and the equitable doctrine of marshalling, the *Toys* committee obtained the right to assert certain Section 506(c) and 552(b) claims for unpaid administrative claims of trade vendors and landlords. Specifically, the final DIP order governing the *Toys* Delaware DIP facility preserved Section 506(c) and 552(b) surcharge rights to the extent of (i) the outstanding administrative expense claims of trade vendors and landlords, *less* (ii) the aggregate amount of postpetition payments the *Toys* debtors made on the prepetition unsecured claims of such trade vendors and landlords (including pursuant to the critical and foreign vendors orders).

In other words, Section 506(c) and 552(b) rights could be asserted to the extent that the aggregate net exposure of trade vendors and landlords was adversely impacted during the cases, as measured by the outstanding administrative exposure of such creditors after taking into account the benefit to such

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creditors from receiving critical vendor or foreign vendor payments for their prepetition claims. The authors refer to this as the "surcharge formula."

In addition to the surcharge formula, although the originally proposed DIP orders called for complete waivers of marshalling, the secured lenders also agreed to carve this back through negotiations with the committee. Notably, with respect to avoidance actions, the revised DIP orders reflected the agreement of the DIP lenders and prepetition secured lenders (to the extent they were entitled to adequate protection) to proceed first against certain collateral—namely DIP collateral and prepetition collateral—to satisfy their claims, and only then to look to the proceeds of avoidance actions.

Further, with respect to the *Toys* Delaware DIP facility, the term DIP lenders agreed to first seek recoveries from any excess ABL collateral (*e.g.,* inventory) before seeking recoveries from any other collateral. While the orders contain more exacting language, the overall point is that such concessions had the potential to free up unencumbered assets for the benefit of creditors.

Ultimately, how did these protections factor into the subsequent events in *Toys*? Following the announcement of the winddown of Toys' domestic operations, there was understandable concern from many creditors, with some suggesting the cases be converted to Chapter 7 or dismissed. Numerous factors had to be considered in the most practical path forward, including seeking to maximize the opportunity for payment to creditors, among them postpetition creditors that supported the pre-winddown operations and were now at risk of nonpayment.

While the administrative claims reconciliation process remains ongoing, the *Toys* debtors have estimated the potential unpaid claims for administrative creditors may exceed $800 million. Because the term DIP facility provided the DIP lenders with liens on *all* of the company's assets, and provided the secured lenders (entities that largely overlapped with the DIP lenders) with those same liens to secure adequate protection claims that they asserted amounted to hundreds of millions of dollars, upon the announcement of the winddown the secured lenders asserted that *no* value was available for distribution to pre-winddown non-secured creditors.

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Based upon, among other factors, the negotiated surcharge-related reservations and exceptions in the DIP financing (together with its reservations of rights to challenge various liens and claims), the *Toys* committee was in a favorable position to participate in a monthslong negotiation among many parties, including the *Toys* Delaware debtor, the secured lenders, and an ad hoc group of trade vendors. Ultimately, the secured lenders agreed to a settlement that provided a carveout—consisting of a guaranteed baseline cash component of $180 million, plus additional contingent recoveries based on recoveries at certain debtors and preserved litigation claims—to fund payments to various trade and other pre-winddown administrative creditors. The settlement was approved by the Bankruptcy Court on August 7, 2018.

One of the key negotiating elements included the rights negotiated by the *Toys* committee to seek to enforce the surcharge formula and/or seek marshalling based upon the express reservations in the DIP financing orders, as it was on this basis that the creditors could argue that notwithstanding the DIP and adequate protection liens granted in the DIP order, there remained unencumbered value that should be available for non-secured creditors. As expected, the secured lenders contested the surcharge formula calculation, as well as the implications of the marshalling agreement, but agreed to resolve these disputes consensually through the cash and other carveouts provided in the settlement agreement.

Take-Aways

Waivers of the rights to surcharge collateral and seek marshalling frequently occur in postpetition financing arrangements. Creditors' committees and other creditors often work to reclaim some leverage caused by the debtors' waivers. Retail trade creditors and landlords are in the unique position of providing postpetition financing, often on an unsecured basis, in the form of goods or services that enable the retailer to operate in bankruptcy. Where the operating assets (inventory, real estate, etc.) are fully encumbered, however, the benefit of those services inure to the secured creditor, absent negotiated budgets and carveouts.

These rights are particularly appropriate to seek to preserve in retail cases where postpetition trade vendors provide the inventory (upon which the lender asserts its lien) or landlords enable the inventory to be sold in their leased stores (and thereby generate the proceeds subject to the lien). In each instance, a correlation can be drawn between the collateral preservation or enhancement and the goods or services provided.

For cases that are prearranged or prepackaged (whether pursuant to restructuring support agreements or 363 sales), as some retail cases have been, the risk should be more minimal for trade and landlords because the adequacy of the DIP budget can be assessed in the context of the stated case outcome. Likewise, for cases that start off as orderly liquidations, the focus will be on the adequacy of the liquidation financing budget. This, in turn, can often be addressed by the budget supporting the going-out-of-business (GOB) sales, which should provide for the payment of GOB period rent, any merchandise delivered during the liquidation sales, and other winddown-related services.

This leaves the risk resulting from "free fall" retail cases not supported by either a prearranged sale or other restructuring outcome, or immediate liquidation. In these cases, preserving rights to surcharge collateral or assert

marshalling rights to reduce the loss of potential value in previously unencumbered assets becomes key. It is safe to assume that, as sure as there will be more retail filings, postpetition financings will waive surcharge rights under Sections 506(c) and 552.

Postpetition creditors in retail cases will carefully assess whether to extend credit—even with the lure of critical vendor dollars. The outcome may simply be fewer free fall retail cases as lenders and merchants decide, before filing, whether to reorganize swiftly or sell assets immediately through going concern or GOB sales.

Should a free fall retail case occur, however, surcharge and marshalling rights will likely undergo enhanced scrutiny, with carveout exceptions, pursuant to a surcharge formula as used in *Toys* or otherwise, taking on a greater role in negotiations.

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[1] *In re: Toys "R" Us, Inc., et al.*, No. 17-34665 (KLP) (Bankr. E.D.Va.).

[2] Kramer Levin is counsel to the official committee of unsecured creditors in the *Toys* cases for all debtors other than the "PropCo I" debtors, whose cases (which were filed six months after the main *Toys* debtors filed their cases) are being separately administered.