



Bankruptcy's 20 Questions

Credit managers everywhere groan when they think about bankruptcy. It's a long and expensive process, and fraught with unexpected twists and turns. For larger creditors, it makes sense to be on the creditors' committee and have direct input into the process. In the following interview, one of the country's leading legal advisors to creditors committees, especially in retail cases, Lawrence C. Gottlieb of Kronish Lieb Weiner & Hellman LLP in New York, offers helpful insight for creditors on the trends in retail bankruptcies.

Bankruptcy Trends

Q: *Do you feel the trend is toward or away from creditors' rights in bankruptcies?*

A: I'm not sure there is a "trend" per se. Each case is different. The circumstances of the case itself and whether the trade is "in the money" may determine the extent of creditor influence in the case. Likewise, the jurisdiction you're in and the bankruptcy judge assigned in the case may make the difference. Some judges, depending upon their experience practicing law and/or on the bench, may have their own "inclination" as it relates to the influence exercised by creditors in the case. There may also be a difference depending upon the size of the case. In smaller cases, creditors may have more influence on subsidiary issues.

However, larger cases tend to confirm [debtor] plans more often. Therefore, we often see large debtors with more success on key issues in those cases.

Q: *Has the phenomenon of "forum shopping" by debtors changed?*

A: Debtors continue to consider a host of factors when deciding where to file. Some call this forum shopping; others call it practicing law in the real world.

Q: *Do you feel certain forums are still more advantageous for creditors' committees?*

A: Yes. However, the nature of the case is MOST important. The larger the case, the more one can expect the court to favor the debtor if it helps to confirm the plan. There are some jurisdictions with greater experience in dealing with large Chapter 11 cases. As such, creditor representatives may be better able to predict how the court in those jurisdictions is going to handle certain issues unique to the case.

Q: *Where does the "critical vendor" doctrine stand after the Kmart bankruptcy case? Do you think other courts will follow this decision? What can a creditor do to improve its chances?*

A: Although the "critical vendor" doctrine is not dead, it will not be nearly as prevalent. First, many

creditors realize that their companies are generally unlikely to be "critical vendors" and have turned against the concept. The court, if willing to consider a critical vendor motion, generally will be much more stringent, and will require proof that the debtor cannot survive without the product and that there is no other vendor to supply it. If the doctrine continues, a creditor will only be considered if it shuts off the debtor upon the bankruptcy filing and steadfastly continues thereafter to refuse to ship – a strategy that is a bit risky.

Q: *Montgomery Ward was a "Chapter 22" – a serial bankruptcy. Are we likely to see other reorganized companies slip back into bankruptcy? Do any prominent examples come to mind?*

A: Because companies often emerge from Chapter 11 undercapitalized, many reorganized companies will slip back into bankruptcy. Once a company slips back in, it almost always is liquidated. Because companies know a Chapter 22 means liquidation, many may liquidate outside of bankruptcy rather than file again.

Q: *Are we likely to see another wave of retail bankruptcies in the foreseeable future?*

A: Yes. The economy is cyclical and retail bankruptcies are cyclical as well. However, there is substantially

less competition in retail because of consolidation over the last few years. Therefore, I would expect that there will be fewer retail bankruptcies, but those that occur will generally likely be larger.

Q: *What have retail landlords done to strengthen their position vis-à-vis trade creditors?*

A: Retail landlords have become much more active in Chapter 11 cases. They work hard to get on creditor committees and they appear in court much more often to push their positions.

Q: *What should trade credit managers watch out for when extending credit to mall-based retail customers?*

A: Generally, the issues are the same whether or not the debtor is based in a mall. However, it is probably fair to say that mall-based retail customers have landlords who are much better organized and more aggressive. On the other hand, leases in malls are generally more valuable than other leases, enabling a debtor potentially to raise funds by selling leases, or, in the event of liquidation, provide more funds available for creditors.

Q: *The Office of the U.S. Trustee claims it looks out for creditors' interests. What changes, if any, would you like to see?*

A: I'd like to see more uniformity in the UST's program for selecting committee members. As things stand now, the composition of each committee is largely within the discretion of a local UST office. The approaches can be as diverse as there are jurisdictions in this country. By and large, I believe USTs do their level best to appoint committees that fairly represent creditor interests. It would be beneficial, however, if guidelines were established so that representations were more predictable. Generally, if there is an active creditors' committee, the UST need not be

as active as in cases where there is no active committee.

Advising Creditors' Committees

Q: *What do you tell creditors' committee members about their fiduciary duties and about confidentiality?*

A: We tell them that their duty extends to the entire general unsecured creditor class, and not only to the company by which they are employed. We explain that the duty to maximize value to the creditor body as a whole may sometimes be to the detriment of a particular creditor, including their employer. For this and other reasons, confidentiality is crucial to the successful functioning of the committee. Accordingly, committees are asked to abide by a strict code of confidentiality as it relates to discussions and decisions made by the committee.

Q: *How does the presence of distressed debt/claims buyers on a creditors' committee affect the dynamic?*

A: To the extent that claims are purchased, the committee may be comprised of members whose view of value to the creditors is different than the view of creditors who are in the "trade." Trade creditors see value in both the return of dollars on their claims, as well as the prospect of business with a reorganized debtor going forward. Claims traders do not always appreciate that perspective, and may more readily consider selling the company or taking equity in the reorganized company. Trade creditors more often prefer cash and/or a note.

Q: *What do you look for when recommending a financial advisor to a creditors' committee?*

A: We almost always let the committee make its own choice of financial advisor. We believe that creditors' committees on the whole are comprised of sophisticated business people

capable of judging for themselves which professionals are best suited to meet the needs of the committee.

If asked for an opinion, we recommend the advisors whom we think have the best experience in the industry in question, and the professionals with the qualifications best suited to do what's needed in a particular engagement. Like legal professionals, we believe there are a number of financial advisory firms with highly qualified people who each come to the party with varied skill sets. When picking a professional firm, we believe it is important to pick the professional who will work on the case – as well as the firm.

Q: *When should a creditors' committee consider formulating its own plan of reorganization? Does it help to have a financial advisor that is prepared to implement the creditors' plan?*

A: A creditors' committee must understand that it is not easy to terminate plan exclusivity. However, if the debtor is not doing well, and has not formulated an acceptable plan, or if the debtor is recalcitrant and not working well with the committee, then the committee should start thinking about taking steps to enable it to file its own plan.

In my view, it is literally impossible for a committee to prepare or implement its own plan of reorganization without the assistance of a financial advisor. The committee has no choice, if it wishes to confirm its plan, but to propose a plan that is workable, feasible and clearly in the interests of creditors and the estate. Creditors should not leave financial issues to lawyers.

Lessons Learned

Q: *What are some case examples where Kronish Lieb was able to obtain great value for the creditors? How did you do it?*

A: Some of our more interesting and successful cases have been: Allied Stores (Federated) – 100% plus interest; Today’s Man I – equity worth over 100%; Elder-Beerman – equity worth over 100%; Bob’s Stores – over 70% in cash; Bedford Fair – 100% plus interest; Casual Male – 95%+; Stage Stores – equity in excess of 100%.

Our results were obtained through careful diligence. Our goal is to understand the business and deal with the business issues as well as the legal issues. We try to reach agreement on a plan and to be creative, but if necessary aggressively represent our client. We have the resources and the will, if necessary, to take strong actions such as motions to terminate exclusivity and file a committee plan, to contest confirmation of the debtor’s plan or to generally litigate. For Bob’s Stores, we did not take for granted the debtor’s assertion that there were no bidders for the stores. We found bidders and the distribution to creditors more than doubled. In Bedford Fair, we confirmed a creditors’ plan, over the objection of the debtor, which paid creditors in full.

Q: *In the Montgomery Ward II case, in which Kronish Lieb represented the creditors’ committee, please describe the result you obtained in litigating against the secured lender. Was the litigation helpful?*

A: It was. We were successful in turning what would have been a 3% to 4% return to creditors into what will likely be a 30% return. We did so by challenging GE Capital’s secured position after an extensive investigation, followed by litigation and competing plans of reorganization. The committee deserves great credit for the success of the litigation. All members persevered despite great pressure and a genuinely difficult litigation atmosphere.

Q: *Do you see creditors being successful in other cases by challenging the secured lender?*

A: Rarely. However, once again, every case stands or falls on its own merits. We have little doubt, however, that the mistakes and wrongdoing of others in the past will repeat themselves. Examining, investigating, and litigating, if necessary, will always be a part of what creditors’ committees may need to do to achieve a fair result for their constituency.

Q: *What can a creditor do to protect itself against having to disgorge pre-petition payments as preferences? Are there policies and procedures management can implement in its credit management? Is there anything a creditor can do once the bankruptcy is filed?*

A: First, remember that cash in advance and COD are never preferential. Payments made pursuant to a letter of credit are likewise not preferential. However, a credit manager doing his job will suffer losses if his goal is reasonably to assist the company in its sales. The only way to avoid preferences is to be too conservative.

That having been said, the credit manager needs to be on top of the situation and to try to know when a debtor is in distress. The tough decision is when does a credit manager cease authorizing shipments without obtaining a letter of credit, cash in advance, or COD.

Most important, if a creditor is requested to return a payment because the debtor or trustee claims it is preferential, the credit manager needs to analyze the account carefully and should probably seek legal advice as to whether or not there are defenses available to the creditor. It generally pays to fight and not to settle early, except if a favorable offer of compromise is received from the debtor or trustee.

Q: *Reclamation rights are often cited as being under utilized. How do these work, and how should a creditor stay prepared to exercise them?*

A: Often creditors fail to recognize that reclamation rights exist under state law, and not just bankruptcy law. Creditors have indicated that, although aware that the customer was not paying its debts on time and was at or near insolvency, they have not filed reclamation demands because a formal bankruptcy had not been filed.

But creditors should send in their written reclamation demands immediately upon receiving information that the customer is in financial difficulty and not paying its debts in the ordinary course. The sending of a proper reclamation demand (which must be made within 10 days of the customer’s receipt of the goods subject to the demand) will preserve a creditor’s priority position in a bankruptcy case, even if a formal bankruptcy is not filed until weeks afterwards.

Although in bankruptcy creditors will not be able to receive a return of the product subject to the reclamation demand, they most likely will receive an administrative priority claim for their valid reclamation claims, and accordingly, priority in payment before all other unsecured creditors are paid.

Q: *What can a creditor do once a customer is on its “credit radar screen?” Do actions like seeking a security interest (subordinate to the bank) really help?*

A: If a customer starts becoming a problem credit, then there are certain actions that a creditor can take to prepare and be in a better position to recover on old debt and not sustain losses.

First, on any new orders, the creditor may look to shift to prepayments for new goods. Prepayments are not preferences even if a bankruptcy is filed, because they are not payments on old debt. Alternatively, a creditor may consider entering into a consignment arrangement with a customer

that would allow for new product to be shipped in and not be subject to pre-existing creditor's security interests. (Legal counsel should be sought in setting up a proper consignment arrangement to withstand challenges by secured creditors and other creditors.)

Creditors may seek to obtain liens on the customer's assets to secure both old debt and new debt as a condition to providing merchandise going forward. However, they should be aware that a lien to secure old debt could be avoided as preferential if obtained within the 90-day preference period prior to a bankruptcy filing. Also, an inter-creditor agreement may be required with a secured lender that has a lien in most or all of the assets. Most secured lenders will not subordinate their priority positions, so creditors may have to accept secondary security interests in assets that may not provide full value in the event of liquidation.

Creditors should be aware of rights that exist under the Uniform Commercial Code, such as reclamation and the right to stop goods in transit, in the event that the creditor believes that the customer may be insolvent.

Q: *When should a supplier consider forming a pre-bankruptcy "unofficial creditors committee"?*

A: This is probably the best piece of preventative medicine a creditor can take. We encourage creditors to band together early when the warning signs of a potential filing appear.

Q: *How does an unofficial committee work, and what are the do's and don'ts?*

A: At the risk of sounding self-serving, the first thing creditors should do is to call a firm that specializes in these cases. We have experience in helping creditors organize pre-petition and can help them map out a work-out strategy both within and without the bankruptcy context. The goal initially is to try to work out the debt without a bankruptcy filing.

The out-of-court committee should work with the debtor to get financial information and to see if the debtor and committee can reach an accommodation. There are no antitrust issues with creditors forming an out-of-court committee.

Remember, out-of-court deals are difficult because dissenting creditors cannot be compelled to go along as they can in Chapter 11. An out-of-court committee must be realistic and not let the debtor delay an inevitable bankruptcy filing. The committee also needs to be aware that, with the passage of time, potentially avoidable preferences may disappear.

Q: *If you could give one piece of advice to credit managers around the country, what would it be?*

A: When you smell smoke, assume it's a fire. Catch on to the case and don't let grass grow under your feet.

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