

# Bankruptcy Court Decisions

WEEKLY NEWS & COMMENT

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## TOP LEGAL CASES EXECUTORY CONTRACTS

Debtors have the power to decide whether to assume or reject executory contracts, and an unwanted postpetition tender of performance from the nondebtor contracting party cannot render an executory contract nonexecutory.

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## COURTWATCH

The 11th U.S. Circuit Court of Appeals unwillingly joins those Circuits holding that the Section 303(b) requirements for filing an involuntary bankruptcy petition are a matter of subject matter jurisdiction.

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## HOT CASE

Even professional employees need to watch what they take home once the employer files bankruptcy. Although both sides here engaged in "high drama," the plastic surgeon violated the automatic stay and will have to pay damages, including punitive damages.

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### Cases reported

Supreme Court Docket, page 10; New Judicial Decisions, pages 11-18.

## COVER STORY

### Retail filings reveal changing dynamics

When consumer spending drops, retailers suffer. It's as simple as that. It happened in 2000, and today, as consumer confidence plummets to its lowest level in five years, it's happening again.

While the cyclical nature of the retail environment may be a constant, it doesn't follow that retail bankruptcies from one wave to the next share similar characteristics.

Far from it.

Professionals entrenched in the latest spate of retail cases find themselves guiding parties through very different waters than those endured by retail debtors during the prior wave.

Not only are fewer debtors able to restructure today, but current lending and consumer spending climates are wreaking havoc on prior assumptions about the value and marketplace for retail debtors' assets. That's according to Michael A. O'Hara, president and managing member of Consensus Advisors LLC, and Adam C. Rogoff, partner in Cooley Godward Kronish LLP's bankruptcy and restructuring practice, who paneled an April 17 Turnaround Management Association Webinar. **Story, pages 4-5.**

## HIGHLIGHTS

### Home Interiors & Gifts files prepack

Home Interiors & Gifts takes its Mary Kay type business model to the U.S. Bankruptcy Court, Northern District of Texas in an effort to slim down and restructure. **Page 2**

### 30% of audits reveal material misstatements

The U.S. Trustee Program recently released the results of its FY 2007 consumer debtor audits. Are we closer to knowing the extent of abuse in the system? **Page 6**

### Financing fiasco grounds Eos Airlines

Eos Airlines had a term sheet in hand just days before ceasing operations and filing Chapter 11. **Page 8**

### Brian Gart joins Berger Singerman

Citing growing conflicts issues, 23-year Greenberg Traurig veteran Brian K. Gart recently joined the Fort Lauderdale office of Berger Singerman **Page 9**

## Welcome to the new wave of retail bankruptcies

While the last wave of retail filings, snagging retailers like Bradlees, Ames, Caldor, and Casual Male, may not have been that long ago, the current wave of retail bankruptcies, for many reasons, won't look very familiar.

For starters, restructurings in Chapter 11 among retailers seem to be the exception today.

"Five or 10 years ago, retailers could effectuate a restructuring because they could either get new credit coming in for exit loans or get the existing lenders to restructure debt," said Adam C. Rogoff, partner in Cooley Godward Kronish LLP's bankruptcy and restructuring practice in New York, a firm that is currently representing creditors' committees for retailers including The Sharper Image, CompUSA, Lillian Vernon, Harvey Electronics, The Domain Company, Wickes, Hancock Fabrics, Bombay Company, Princeton Ski Shops and Levitz Furniture. "Trade creditors were willing to take long-term debt, or even to take a significant haircut in a plan of reorganization in order to keep a future customer around. Those are the conditions that took Bradlees from *Bradlees I* to *Bradlees II*. Retailers aren't getting those opportunities this time around; a lot of them are truly DOA," Rogoff commented at a recent Turnaround Management Association Webinar. Deborah Piazza, a partner in the restructuring, bankruptcy, and commercial litigation group of Hodgson Russ LLP in New York moderated *Sale on Everything: The Changing Nature of Distressed Retail*, a discussion paneled by Rogoff and Michael A. O'Hara, president and managing member of Boston's Consensus Advisors LLC, an investment banking and financial advisory services firm exclusively serving the retail and consumer products industries.

With so few restructurings, all eyes are on the debtor's assets — its inventory, leases/real estate and intellectual property. And when it comes to wringing every last drop of value from those retailers, the panelists said, debtors are facing a myriad of changing dynamics. "Historically, inventory and leases/real estate were the primary drivers of value for creditors," O'Hara said. "What's happening today is less robust optioning for the inventory, which may or may not be enough to pay the working capital lender in full. Real estate is subject to its own market crisis now, so you're not seeing as much value coming out of those assets, either. What you are seeing are buyers with an appreciation for debtors' intellectual property."

### Inventory

With a few exceptions, most of the retail cases Cooley has been involved in have resulted in going out of business sales shortly after filing. And what they've seen is not encouraging for troubled retailers or their creditors.

Bidding for debtors' inventory has been far from aggressive.

With so many auctions taking place, there's less competition among liquidators, who now have the luxury of picking and choosing where they want to invest. Going out of business sales are everywhere. O'Hara relayed a story in which an associate spied no less than four sign walkers near a New York mall arguing over which one of them had the right to advertise their going out of business sale on a particular corner.

While the flood of options available to liquidators works to cool bidding, so too does liquidators' keen awareness of waning consumer spending. Not only are consumers spending less, but if they do decide to shop at a going out of business sale, choices abound. Today's consumers are also savvy. Rather than snatching up goods at 30 percent off, they may wait until the merchandise is 70 percent off.

Liquidators, therefore, expect merchandise to linger longer, and bid accordingly. Surely, the winning bidder at auction is happy to pay 30 cents on the dollar when they thought they'd have to bid 70 cents on the dollar, but sleepless nights might be ahead when no one shows up at the first Saturday sale.

"Unlike several years ago, you can't count on a good return coming in on the inventory sale, enough to take out the working capital lender and then usually provide for some additional unencumbered funds in the estate," said Rogoff. "You're just not seeing that as much these days ... and you have to look to the debtor's other assets."

### Real estate

So, creditors, particularly unsecured creditors, turn a hopeful eye to the debtor's real estate.

In the last wave, lease values became a significant unencumbered asset for unsecured creditors, since, to the extent that the working capital lender purported to have a lien on the lease, they frequently failed to perfect it.

Today, due to the flood of retail space on the market, and the drought of retailers seeking new real estate, fewer proceeds are available for unsecureds.

During the last wave of retail filings, Bradlees found it had significant value in the sale of their leases, but by and large those leases were sold to Kohls, which was expanding to the Northeast. Other bulk buyers like Home Depot and Target present in the last wave, aren't doing debtors much good, likely because the retail space occupied by today's retail debtors is a far smaller footprint than that required by big box companies most likely to seek bulk leases.

While this may be bad news for liquidating debtors, or retailers looking to slim down, it's likely good news for those retailers able to restructure.

When the BAPCPA was passed, much was said about the new limits on the debtor's ability to assume or reject leases, and the impact that would have on struggling retailers. These days, it doesn't seem to matter, however, as many retailers are closing operations well before the seven-month time limit. But to the extent that certain retailers are surviving, they're met with a welcome surprise. While the BAPCPA shifted the balance of power to the landlord, the reality of the marketplace is that for those retailers that stay around long enough, landlord consent may not be difficult to get. The International Council of Shopping Centers' estimate that there will be 5,770 store closings in 2008 likely helps to put landlords in a negotiating mindset.

Hancock Fabrics, for instance, a company that is currently going through its plan process, found that its landlords were quite willing to work with them. For Hancock, the 210-day period to assume or reject was set to expire in October 2007, and the last thing the owner of the property wanted was another store going dark as they headed into the holiday season. Deals were struck to keep the stores open.

On the upside for liquidating debtors, the panelists have found that parties are continuing to buy designation rights to leases. In addition, opportunistic foreign-based retailers, lured by the U.S. dollar, might think it's a good time to expand into the U.S. market space, and in doing so, pick up some of the slack. While a less than favorable consumer environment awaits them, five years from now, they'll be glad they entered their leases when they did. For that reason, retailers trying to unload leases should look both East and West, the panelists said.

### Intellectual property

All eyes, then, turn to IP value, which, this time around, may provide the kind of value creditors have been waiting for. IP is becoming the new

value frontier for distressed retailers. For example, it was the sale of Bombay's IP, not its inventory, that delivered the greatest value to the estate, the panel said.

Lillian Vernon, an exception to the rule on many fronts, held a *competitive* auction that fetched enough to pay first position secured lender Wachovia in full, with \$6 million left over. A large part of that success can be attributed to the value of the Lillian Vernon brand name.

The trend reflects a change in thinking in the marketplace. Remember former Pillowtex brand name Fieldcrest towels? Official Pillowtex LLC, a joint venture led by the Schottenstein liquidation business purchased the brand, among other assets, out of Pillowtex's bankruptcy. Official Pillowtex went on to effect a completely different marketing scheme for the brand, selling it through stores like Kohls and Target.

Around the same time, Iconix Brand Group began scooping up brand names it knew customers valued, like London Fog, Mudd, Mossimo, Ocean Pacific and Danskin. In October 2007, the company paid \$231 million in cash for the same brands Official Pillowtex LLC bought for \$128 million only four years earlier.

At the time of the purchase, Iconix said it expected the former Pillowtex brands to generate between \$35 and \$37 million in 2008. Total aggregate guaranteed royalty revenue for the brands equaled approximately \$160 million or approximately 65 percent of the purchase price.

With no overhead, it's not surprising that the business model has been picked up by others. Collective Brands, for instance, scooped up brands like Keds, Sperry Top-Sider and Saucony. Perry Ellis saw it fit to scoop up Penguin and Munsingwear.

Two or three years from now, you just may see Bombay products or Sharper Image products being sold at Sears, Wal-Mart or Target. Today's liquidators recognize the value of the goodwill associated with a brand, and lucky for creditors, liquidators are quick, nimble, and ready to bite. ■

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