

Things to Watch in Retail: Key Takeaways

June 23, 2017

On June 15, 2017, Cleary Gottlieb hosted a discussion on key issues affecting the retail industry so far this year and important considerations for businesses during the second half of 2017 and beyond.

Background

While the retail section is expected to continue to be under pressure for the rest of this year, companies in the retail space can act now to prepare for dealing with suppliers, customers, competitors and others who are experiencing distress, and to consider strategic opportunities in this market cycle. Restructuring partner Lisa Schweitzer opened the panel by discussing with co-panelists various warning signs that indicate signs of distress in counterparties and their causes, which can help in planning early to protect and maximize your interests.

What to Do if You Suspect a Counterparty Is in Distress

Restructuring partners Luke Barefoot and Jane VanLare discussed the importance of recognizing signs of distress in your business counterparties. Red flags may include unusual stretching out of trade payables, store closings, non-ordinary draws under revolver facilities and business line/brand divestitures, to name a few.

If you suspect your counterparties, including suppliers, customers and others, may be in distress, you can protect your interests through early planning, including reviewing contracts to confirm their effectiveness and terms, and be prepared to either react to or propose contract modifications that both account for changes in market demand and mitigate risk if the counterparty subsequently were to file for bankruptcy. The panelists also discussed potential opportunities in the current market climate, such as pursuing distressed asset sales and renegotiating trade terms.

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Specific Considerations in Real Estate

The Bankruptcy Code contains multiple limitations on claims arising from the rejection of real property leases in bankruptcy, but limits these risks with specific protections for landlords in shopping malls. Real estate partner Steven Horowitz described various contract considerations specific to leases and shopping mall tenants and landlords, including limitations on lease assignments intended to protect the tenant mix in malls.

In this volatile retail market, tenants should consider relocation and lease assumption opportunities if other distressed tenants are closing stores or liquidating their businesses in the same malls or nearby properties. Landlords should consider letters of credit for security deposits and good-guy guarantees, and should be aware of the compressed timing of most retail cases, in part driven by deadlines imposed on tenants to decide whether to keep or reject their various leases.

Specific Considerations in Intellectual Property

Intellectual property partner Daniel Ilan explained that different protective actions can be taken with regard to a distressed counterparty prior to a bankruptcy filing, depending on whether the distressed entity is providing or receiving IP.

If IP is provided to you by the distressed entity, you could risk losing certain important rights if the company were to later file for bankruptcy and reject the license. These include IP rights and services, such as trademark rights, software maintenance and support and access to improvements and new versions of the licensed technology. In cases where the distressed entity is receiving the IP, you should consider the risk that the license to the distressed entity would not be terminable after the bankruptcy filing (on grounds related to the bankruptcy) despite any termination provisions in the license; moreover, the bankrupt entity could even be able to assign its license to third parties, notwithstanding anti-assignment provisions in the license, particularly with respect to exclusive copyright licenses.

In either case, we recommend you review the various licenses now to consider potential vulnerabilities and opportunities to include protective terms that target the specific IP risks. When IP is provided by a distressed entity, these protections may include ensuring access to tangible embodiments of the IP that would enable you to operate software and technology without support from the distressed licensor. When IP is provided by you to the distressed entity, you may want to add contractual provisions concerning performance and termination that would be enforceable in bankruptcy.

Once a Filing Happens

The panel provided an overview of the bankruptcy process, particularly the milestones and provisions that are most important to retail bankruptcy filings, including:

- **Automatic Stay:** The automatic stay that goes into effect upon a bankruptcy filing enjoins substantially all creditor collection/enforcement actions against the debtor/property of the debtor's estate, and companies must continue to perform in the ordinary course under their contracts with the debtor entities. For contract counterparties, this includes not only ceasing to collect on pre-petition debts, but also potentially limits setoff and termination of the contract for pre-bankruptcy defaults. This is a major reason to consider and renegotiate contract terms before an entity files for bankruptcy.
- **Protections Given to Counterparties:** Both the relevant laws and common practice enable counterparties, particularly suppliers, to protect their interests if they act quickly at the start of a bankruptcy, including:
 - *Critical Vendor Status:* The debtor may obtain court permission to pay pre-bankruptcy claims of vendors it deems to be vital to the debtor's continuing operation.
 - *Reclamation Rights:* Suppliers who shipped goods received by the debtor within 45 days prior to a bankruptcy may have the right to

reclaim such goods if prompt notice is given. Unpaid invoices for goods received shortly prior to the bankruptcy filing also may be given priority over other creditor claims.

— **Assumption/Rejection of Contracts and Leases:**

The debtor may be subject to deadlines to keep (assume) or disavow (reject) its various outstanding contracts, where counterparties' rights in connection with the assignment of contracts and claims in the case of rejection may vary from the contract terms. Opportunities may exist to purchase these contracts from the debtor notwithstanding anti-assignment provisions.

— **Asset Sales:** Healthy counterparties can acquire brands, equipment, real estate and valuable IP from competitors in distress. In recent retail cases, there has been a particular focus on the ability to sell customer data, which has been successfully done but is subject to growing scrutiny and therefore to specific procedures and requirements. Intellectual property partner Daniel Ilan explained the value that can be derived from data sold by a bankrupt entity and the procedures and requirements associated with such sales.

— **Claims Bar Dates:** Panelists noted that an important consideration for creditors with respect to a counterparty's bankruptcy is the deadline to file claims against the debtor. Bankruptcy law requires creditors to file proofs of claim by a court-approved "bar date" to avoid being barred from distribution under a plan of reorganization. For this reason, it is important to consider any possible claims one might have in the bankrupt estate and to monitor the case from the beginning to know when this deadline is set, so as to not forfeit the right to bring legitimate claims.

Finally, the panel discussed avoidance actions and preferences, which entail the debtor clawing back pre-bankruptcy payments. The panelists explained that there are various defenses available in these instances, including safe harbors, new value provided to the debtor and the transactions being in the ordinary course of business.

The panel came to a close with a reminder that you do not need to wait until a counterparty files for bankruptcy to consider opportunities to protect or improve your interests and the terms of your relationship with that counterparty. In fact, early consideration of these issues can enable you to take steps that may not be available in the run up to a bankruptcy filing.

For further information on these issues, please feel free to reach out to any of the Cleary panelists or your other contacts at the firm.

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