Ch. 11 Rules Stacked Against PacSun's Reorg Attempt

By **Matt Chiappardi**

Law360, Wilmington (April 7, 2016, 8:47 PM ET) -- PacSun has become the latest retailer to file for Chapter 11 seeking to pull off the herculean task of a quick reorganization, but changes to the Bankruptcy Code have made the prospect more challenging than ever as the retailer and others in the industry continue to reel from structural shifts in the economy, experts say.

Although amendments to the code in 2005, chiefly those that bolstered vendor rights and set stricter timelines on dealing with landlords and leases, are not new, they were enacted during a time when business was relatively good for the retail sector.

Fast-forward 10 years and the retail industry is on the ropes, scrambling to deal with an unrelenting migration of consumers to online shopping as well as stubborn weakness in the general economy.

Some retailers like Quiksilver have been able to **successfully confirm** Chapter 11 plans that center on a reorganization, but the vast majority of such cases under the new rules have been going-out-of-business liquidations such as Coldwater Creek, Deb Shops, Delia and Wet Seal — all businesses operating in roughly the same sector as PacSun.

While Pacific Sunware of California Inc. appears to be making the proper preparations to deal with retail bankruptcy's changed landscape, the code amendments mean that the details of any retail restructuring have to be decided on such a quick timeline that they can often turn into chaotic scrums, swelling professional fee bills in the process, practitioners say.

“Those changes are the things that killed retail reorganization forever and ever,” said Edward T. Gavin IV of corporate restructuring firm Gavin/Solmonese. “With the time frame and other constraints there is simply less time for herding cats and getting everyone organized.”

In PacSun's case, the company is **entering Chapter 11** with a plan proposal for a debt-for-equity swap with lenders in hand, essentially creating a take-it-or-leave-it situation that would have been unheard of under the old regime, which fostered long-term proceedings that gave businesses a shot at trying on new business plans, practitioners say.

When the code was amended in 2005, one of the key changes eliminated what, in practice, had been debtors’ ability to extend the time they have to decide whether to assume or reject a lease without a landlord’s consent.

The new rules gave the debtor only 120 days to make that decision, with one 90-day extension available before it requires a landlord’s written agreement, severely compressing the time a national retailer has to make complex, multipolar decisions on how to deal with various locations across the country.

While the changes were in part made to address legitimate concerns from the real estate industry about the balance of interests in bankruptcy cases, they have since had unintended consequences that have changed the landscape drastically, said Jay Indyke, chair of Cooley LLP's corporate restructuring and bankruptcy group.

“We saw this coming with the amendments, and a lot of what we saw came to pass,” Indyke said. “Almost every case ends up being a liquidation or a sale on a relatively short-term basis.”

Retailers are forced to make crucial decisions under the pressure of a short window, which can grow even shorter if issues and delays crop up in central issues like debtor-in-possession loans and bid procedures, and secured lenders are even timing their financing deadlines to fit with the squeezed schedule.

Under the old rules, retail bankruptcies could last more than a year, with the debtor proposing things like altered business plans and changes in management — and being able to test the ideas through typically telling periods like the holiday season.

“Debtors would approach a case saying, 'We’re not under the gun,'” Indyke said. “They could go through the holiday season and see how a business plan works. They may have gone a couple of years, and that didn’t necessarily hurt the cases or hurt value. Returns were arguably higher than they are now.”

One avenue no longer really available to the parties is a process called designation, in which a tenant had time to put together a strategy identifying which lease it would like to assume, which it would like to reject, and which it needs to further evaluate.

“There’s no timeline to do that anymore,” said Brian L. Davidoff, chair of Greenberg Glusker LLP’s bankruptcy and financial restructuring group. “You effectively have to make a decision in the first 90 days of the case, and that makes it very difficult for any major retail bankruptcy.”

Another change that has been a challenge for retailers are so-called 503(b)(9) claims, which give vendors a priority claim on goods sold to a debtor up to 20 days before a bankruptcy case is filed.

Debtors now need to ensure they have a sufficient amount of money to satisfy these claims before they can even think about reorganizing, according to Gavin.

“It used to be a debtor could build a war chest prepetition,” Gavin said. “A debtor can now find itself in bankruptcy without sufficient resources to ever get to reorganization. 503(b)(9) will destroy the cash they have.”

Both rules have made retail bankruptcies more aggressive and chaotic than ever, creating new tensions among trade creditors, landlords, secured lenders and other constituencies and making the landscape more unpredictable and harder to manage, practitioners say.

“You always had pressure from banks, but now there’s an extreme amount of pressure,” said Joseph Lemkin of Stark & Stark. “It’s almost like if you land in bankruptcy, you have to prepare for a liquidation.”

Lemkin did say that the changing marketplace itself could ease some tensions. As retail Chapter 11 filings accelerate, there may be more opening for landlords to make compromises, not wanting to all of sudden be inundated with storefront vacancies, he said.

As for PacSun, the company seems to be moving forward adjusting to the shift. It has already filed a Chapter 11 plan, born out of a restructuring support agreement with affiliates of Golden Gate Capital that aims to convert its term loan debt into equity in the reorganized company. And it appears to have spent considerable time prepetition putting together a game plan for dealing with both vendors and landlords, all points experts say have to be paramount in contemporary retail filings.

But bankruptcy in the retail space has become a mercurial proposition, with unforeseen issues popping up that have the potential derail the best laid plans, as exemplified by Sports Authority's recent, and ongoing, **row with consignment vendors**, practitioners say.

“Large retailers like Pacific Sunwear need a lot of pre-bankruptcy planning,” said Aaron M. Kaufman of Dykema Cox Smith.

Kaufman said that large retail debtors must go to their landlords and vendors beforehand to develop a strategy that could limit their exposure and perhaps give them much more negotiating leverage.

“A decade out [from the amended code] you can’t just throw a retailer into bankruptcy and hope for the best,” Kaufman said. “If they’re a big retailer and they’re going into bankruptcy, they’re going to require a lot of preparation.”

The lead case is Pacific Sunwear of California Inc., case number 1:16-bk-10882, in the U.S. Bankruptcy Court for the District of Delaware.

--Editing by Jeremy Barker and Emily Kokoll.