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Navigating Preference Actions in Retail Industry Restructurings

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Within Chapter 11 cases, navigating preferences can be a complex and arduous process that requires strategic foresight and hands-on experience. In charting one's course through bankruptcy proceedings, there are specific pitfalls and considerations that debtors, creditors, and their legal and financial advisors should be aware of and approach carefully when preference actions are involved.

While there are many potential issues surrounding preference actions that could play out in a Chapter 11 case within any industry, retail restructurings can bring certain considerations. In the current economic environment, a retailer filing for bankruptcy will likely either sell substantially all of its assets or use the Chapter 11 process to reorganize its business and continue on as a going-concern. In either situation, there are numerous factors that financial advisors and other involved professionals must understand and evaluate before determining the best approach when it comes to addressing preference claims.

A Brief Overview of Preference Claims

Under the tenets of the U.S. Bankruptcy Code, unsecured creditors in the same class are to be treated equally. When certain unsecured creditors are paid in the period prior to the debtor's bankruptcy filing, and others are paid a lesser amount, or not at all, a disparity in treatment can arise.

Therefore, §547 of the Bankruptcy Code empowers representatives of the bankruptcy estate, whether it be the trustee, the official committee of unsecured creditors or their designee, with the opportunity to avoid or recover preferential transfers—payments made to creditors by a debtor within the 90-day period prior to filing bankruptcy on account of

antecedent debt. By allowing the bankruptcy estate to pursue and recover preferential transfers, the Bankruptcy Code seeks to uphold equitable treatment of all unsecured creditors in a bankruptcy.

Section 547 Amendments

With the enactment of the Small Business Reorganization Act (SBRA) of 2019, amendments were made to the Bankruptcy Code's preferential transfer statute in §547. Section 547(b) was amended to require that "*the trustee may, based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c), avoid any transfer of an interest*

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of the debtor in property." This change created ambiguity for trustees and other professionals to determine what "reasonable due diligence" entails as it is not clearly defined by the Bankruptcy Code or in existing case law.

Furthermore, under the Consolidated Appropriations Act (CAA) enacted in December 2020, temporary amendments to §547 were made to offer protections to accommodate debtors whose businesses were impacted by the COVID-19 pandemic. These provide protection to lessors from the repayment of rental arrearages entered into on or after March 13, 2020 as part of a non-residential contract or lease, as well as goods and services.

In light of these amendments, it is essential that debtors, trustees and their advisors run a defense analysis, using reasonably available information, on potential new value and ordinary course defense. By enlisting professionals who are knowledgeable about these and other potential issues, one can benefit from a more streamlined and effective approach to preference claims.

Landlords and Lease Assumption/Rejection

When considering whether preference claims should be pursued in a retail case, the lease assumption and rejection process and the involvement of landlords as creditors are important to consider. In retail bankruptcies, landlords are typically one of the larger creditor constituencies, particularly for nationwide, brick-and-mortar retailers. In general, landlords tend to have good defenses against preference claims either because their leases are assumed pursuant to §365 of the Bankruptcy Code or they provided subsequent new value, and therefore are not viable preference targets.

A debtor seeking to assume a real property lease is required to cure all existing defaults under the lease, and this obligation eliminates any preference exposure for the landlord related to prepetition payments made pursuant to the lease. This makes sense from a practical standpoint since the debtor would be required to pay any amounts recovered from the landlord on account of a preference (dollar for dollar) right back to the landlord as a cure payment.

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The other defense commonly available to landlords in retail cases is that they can demonstrate under §547(c)(4) of the Bankruptcy Code that they provided subsequent new value to the debtors in the form of the use of the leased location or premises. Accordingly, in situations where the debtor was in possession of the applicable premises (pursuant to an unexpired lease) in the period leading up to the bankruptcy filing, the landlord is not likely to have preference exposure for monthly rent payments made during the preference period. A situation where a debtor had fallen behind on rent and made a large "catch up" payment on a lease that would be rejected in the bankruptcy case would be vulnerable as a preference.

Understanding the Value of the Preference Claim Portfolio

In weighing the decision as to whether preference actions should be pursued, one must also consider the value of preference claims in the context of the unsecured creditor recovery. In many retail cases, the proceeds of a sale of substantially all of a debtors' assets, or a reorganization plan that distributes equity to secured creditors, may not provide a meaningful recovery to unsecured creditors. In these cases, multiple tranches of secured debt and administrative claims, which take priority over unsecured creditor claims, may have already eaten away at the value in the estate.

When assessing a value of a preference claim, it's necessary to take into account how much more the creditor received by getting the preference than they would have received had they not been paid and been left with a claim in the bankruptcy case. Accordingly, the lower the amount of the distributions to unsecured creditors, the greater the value in pursuing the preference. In other words, for every one cent of distribution on unsecured claims, the value recoverable on a preference goes down by one cent.

There is also a mechanism under §502(h) of the Bankruptcy Code that allows a creditor or other party that pays back money on account of a preference claim to file a proof of claim or assert a claim for the amount returned. For example, if creditors pay back $50,000 for a preference claim, they are entitled to assert a claim for $50,000. Following this through, as distributions go up, the less value there is in preferences because if a creditor gives back $50,000 and receives a claim that is going to pay a 50% recovery, they will get back $25,000 for a net gain of $25,000. Trustees and other advisors for the estate must conduct a full analysis with consideration to these factors to determine whether it is worth the time and resources to pursue preference claims in instances where unsecured creditors are receiving a meaningful recovery.

Cost and Other Considerations in Pursuing Preferences

Unlike many other claims in the bankruptcy process, preference claims can be pursued on a contingency basis so there are generally no out-of-pocket costs involved in prosecuting actions for preference recoveries.

Aside from financial costs, another factor to consider is whether pursuing preference claims may distract professionals and management from focusing on other issues that are central to the bankruptcy proceedings or divert resources away from them. For debtors and buyers of assets seeking to continue the business as a going concern, there also is a potential non-economic cost of upsetting parties that they do business with; however, this can be mitigated if handled appropriately.

Timing is also an important consideration as it may be beneficial to pursue preference claims at a later stage in the bankruptcy administration process. In some instances, preference claims can be a negotiating tool within the claims resolution process when preference exposure can be used as a basis to object to or reduce the value of asserted claims.

Even when preferences are not ultimately pursued, it is still very valuable for the estate and their professionals to understand their value, strengths, and weaknesses. In any negotiation with creditors, it is important for the estate and the creditor to evaluate the full package of rights, claims and interests between the parties. In this way, a fulsome understanding of preferences can lead to appropriate reductions in claim and cure amounts or form the basis for legitimate estate objections to claims under §502(d), which provides a basis for the estate to object to the claim of a creditor that received an avoidable transfer that has not been paid back. Preference claims can represent a valuable asset within a retail restructuring, yet their complexity should not be underestimated. It is essential to gain a comprehensive understanding of the preference portfolio and the implications of pursuing them or not within the context of each unique case. By enlisting knowledge professionals and proceeding cautiously yet strategically, preference actions can serve as a lucrative and beneficial endeavor for the bankruptcy estate and its stakeholders.