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Is Fashion Using Bankruptcy as a Lifeline?

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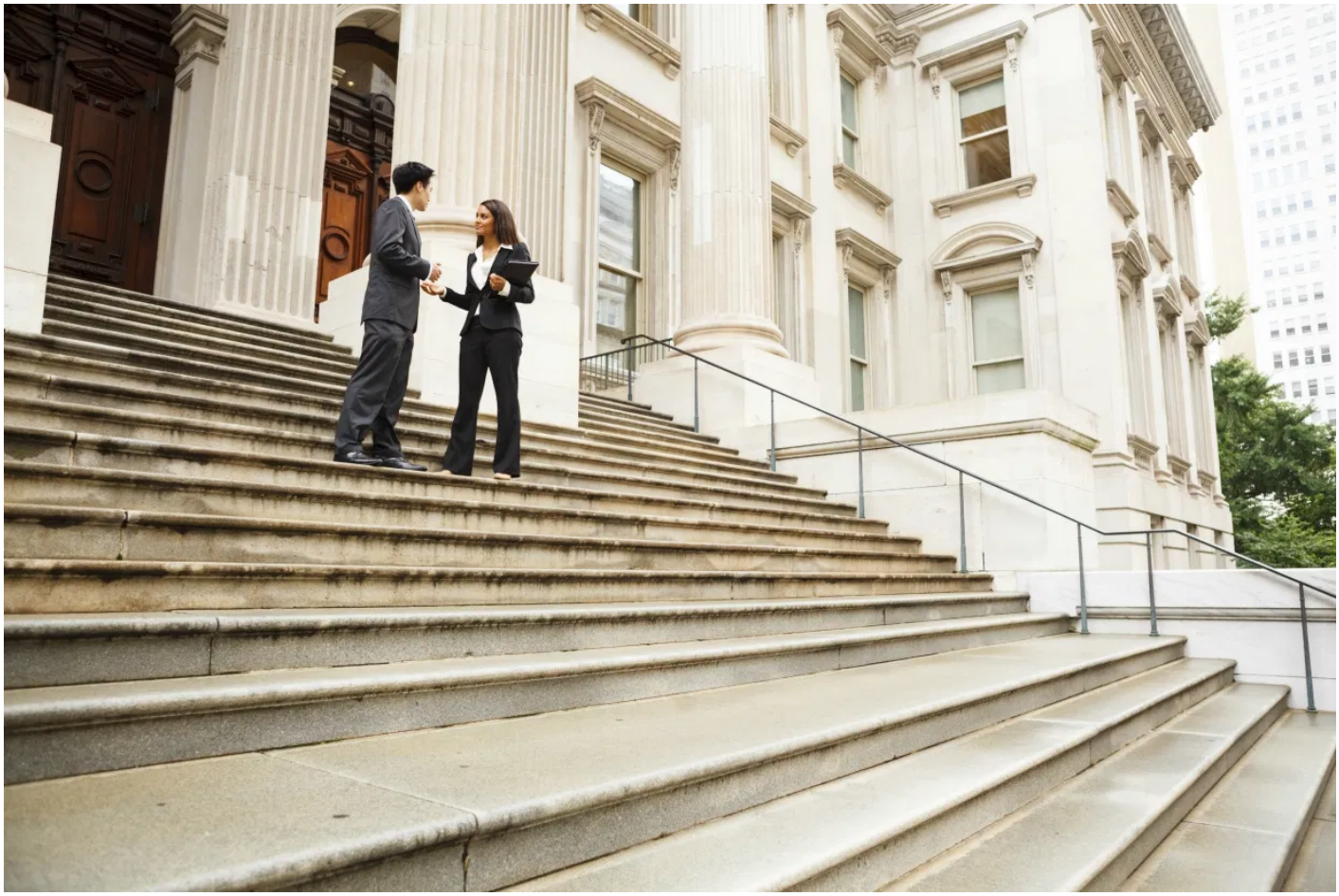

Bankruptcy could be a useful restructuring tool, but it also should be the last resort. CREDIT: Adobe Stock

The list of bankruptcy filings in the fashion and retail space continues to grow longer with each

passing day, so much so that some are beginning to wonder: are they banking on Chapter 11 filings as the way out of 2020's unending pressures?

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In some cases, maybe. In others, maybe not. But companies wondering whether they should file and take advantage of the process might want to think twice before taking the plunge.

Once a company files for bankruptcy, there's no going back. They'll be obliged to abide by certain rules that, in some cases, can be onerous. Bankruptcy is still the restructuring tool it always was—it should not be considered the new fashion strategy to evade the pandemic's impact.

Who's filing

More than anything, companies hard hit by COVID-19 want to minimize their obligations and monies owed to stay afloat.

"Bankruptcy has, in some situations, become a strategy to get out from under certain obligations," said Michael Appel, founder of restructuring consultancy Appel Associates LLC. "The COVID situation has exacerbated all of that, but it is more a reaction than a strategy. [A company that's] over-levered is a situation where bankruptcy is going to happen, COVID just accelerated that and now that liquidity has dried up, they are forced to deal with it."

Appel said there are three key profiles of distressed firms that end up filing for bankruptcy court protection: those that are overleveraged, those that aren't performing, and those with no money.

"The over-leveraged companies have survived because of low interest rates and the availability of capital. Now they are dried up and the day of reckoning is here, but it was already happening before COVID," Appel said. "Then you've got companies that were teetering, so they're not overleveraged, but also not performing and COVID dried up liquidity because now they don't have cash flow. So what choice do they have? There's no arrangement with banks to continue and so they have to file Chapter 11. Even if bankruptcy is an expensive process, that's the least of a company's problems when it's the only way out."

Some companies that were performing well have still seen the pandemic dry up their revenues, Appel noted.

"They may be in negotiations with lenders or other sources of capital. If they were doing well, they have a good chance of getting something done," he said. "But when banks go back to look at the chances for survival at each business, maybe they don't get the funding they need."

Who's at risk

Vendors, according to Appel, could be more at risk than some retailers, depending on who the suppliers are selling to.

"If they are selling to Walmart, Target and TJX, they're probably in good shape," he said. "But if they sell to the middle-market companies where a big portion of the business is centered, it could be difficult for some of them."

Continuing, he said, "If retailers can replace the vendor because other people are waiting in the wings, they will push to drive a hard bargain. Some vendors will look at the price cuts and say the retail account is not profitable and they won't take the order…I think it's going to be tough and there will be a bunch of retailers who aren't going to be around. That will be true for vendors too. As the number of retailers shrink, so will the number of vendors."

More retailers and their vendor counterparts are expected to file in the months ahead.

"The notion that companies stop paying rent, their employees, plus the amount of restructuring that's going on and even opting to choose which creditors to pay, that has happened because of COVID-19. How many retailers will be able to survive at the end of this will be critical to the sector," Simeon Siegel, senior retail and e-commerce analyst at BMO Capital Markets, said.

Siegel has been contemplating what the future might hold for the fashion apparel and retail sector five years out. Companies that were able to immediately strike new financing deals with their lenders in the past few months have, on average, until 2024 or 2025 to either pay back any borrowings or refinance the debt.

And it's the latter that's causing concern for Siegel.

"It's new debt and it was rapidly done. I've never seen levels of this kind of debt in retail. Debt is the only thing that kills retailers," Siegel said. "The big question will be what happens once we get to the other side of the pandemic.

> **Do they all pay back the protection money they borrowed simply to make it through or, rather, pay down in time? Basically, they've kicked the can down in time and they need to be watched to see if they can pay the loans back right away."**

Pros and cons for fashion firms

Smaller companies seeing some financial distress might be able to effect the same kind of restructuring that would be achieved in bankruptcy just by reaching out to creditors and effecting what are called out-of-court settlements.

Diane von Furstenberg was one fashion firm that did just that. While the U.K. business DVF Studio filed for administration (U.K. equivalent of a U.S. bankruptcy) in June, DVF's U.S. company was able to resolve some of its financial distress out of court.

"The company didn't have to file. It was able to replicate what one would have been able to do in court with settlements to get out of store leases and laying off employees by offering what it could without litigation. Settling out of court allowed it to be more private," Mary Ann Domuracki, a managing director at MMG Advisors, said, adding that "sometimes creditors are happier to get something rather than nothing at all."

Domuracki also worked with J. Hilburn in its Chapter 11 filing in May. The company had multiple investors from the venture capital community, as well as junior debt. Its largest creditor was Hong Kong-based TAL Group, whose affiliate agreed to acquire the company. That negotiation was completed out of court in advance of its filing, and the Chapter 11 was essentially required to restructure the debt and provide for new capital upon exit before the sale of the company could be accomplished. J. Hilburn exited bankruptcy last month and is now under new ownership.

"In fashion, any company with a lot of debt that's part of a complicated debt structure could be a good candidate," Domuracki said. "A complicated balance sheet often means many tiers of debt, and multiple creditor groups that could involve a securitization and both senior and junior levels. That means you need very high percentages of approval among the creditor groups, which can be almost impossible to get. What bankruptcy does is pull people in and force them to negotiate."

Other factors, such as ongoing litigation or warring creditor groups, she added, could be reasons a bankruptcy filing might be the preferred course of action.

Even Subchapter V isn't a cure for all ills

Bankruptcy is a useful tool to stay creditor enforcement actions and reorganize, while the new Subchapter V option permits streamlined procedures for small business, relieving them of certain, often onerous, obligations that larger businesses are subject to. The debt limit to qualify for relief under Subchapter V was increased from $2.7 million to $7.5 million, for a period of one year, after March 27, said Jeffrey Chubak, bankruptcy counsel at the law firm Amini LLC.

But corporate bankruptcy filings can include traps for the unwary.

“Retail businesses are among the hardest hit by the COVID-19 pandemic, due to the accrual of rent obligations even while government stay-at-home orders prevent businesses from operating, and generating the revenue needed to pay rent,” Chubak said. “Many landlords have responded by abating rent for the applicable period; some tenants have simply elected not to pay rent,” he said, noting that bankruptcy law has specific requirements for the assumption and rejection of leases.

Rejecting leases requires occupants to immediately surrender the premises, while an assumption requires payment of back rent, in full, which could be unrealistic for cash-strapped businesses. “Failure to comply with these requirements could result in the bankruptcy judge ‘converting’ the case to one under Chapter 7, which would result in the appointment of a trustee—displacement of management—charged with liquidating the business and distributing the proceeds to creditors,” Chubak said.

In his opinion, bankruptcy is a useful tool for reorganizing as a general matter, but might not be so helpful to the many businesses whose financial predicament has been cause by coronavirus-driven rent issues. These companies, Chubak said, “may be better off working with landlords to get current on rent over time, or failing that defending an eviction action brought by the landlord in state court, where the backlog of cases is tremendous and where the judge is not bound by the [requirements of federal bankruptcy law].”

Most companies are trying to avoid a turn in bankruptcy court and those that file have no other choice, according to Loeb & Associates consultant Walter Loeb.

“So much of the debt is due to rent obligations on all their leases and they don’t know how to get out of them,” he added.

Loeb isn’t so sure yet that landlords are willing to provide rent relief. “Most malls do not want to give them any relief. I think that’s a major problem for them. Simon Property is not giving any relief, and it has sued some retailers, like Gap Inc., for back rent. Usually, when one mall operator is that serious about getting what’s owed, the other real estate investment trusts will fall in line,” he said.

But lest anyone think the mall REITS are the bad guys, Loeb was quick to note that many of them are pressured too, and have few options. They grow by redeveloping existing locations or building experiential new centers. And that means they’ve taken out loans to fund those development projects.

“They themselves have debts that they have to pay. Everything falls together and they can’t afford to let retail tenants go without paying any rent,” Loeb said. “Besides, there are too many stores. If they do it for one tenant, does that mean they need to do it for all their tenants? That’s a big question.”

Howard Bader, managing partner at the law firm of Ballon Stoll Bader & Nadler P.C., says fashion clients have been talking to him about Subchapter V and overdue rent obligations owed to landlords.

“Some leases have force majeure clauses that allow tenants to leave due to some unexpected event, but not every lease has the clause. Creative lawyers are trying to have their clients stay in the locations at reduced rents,” Bader said. “I’m involved in a case now negotiating a lease that’s a lot of

money, about $90,000 a month. I'm trying to get to a place where my client can afford to make the payments. We're looking at maybe reducing the rent for a period of six months to a year, but the key will be the profit margins. If there's a shortfall, maybe we can put it on the back end of the lease.

> **"Landlords need to think about who will come in to take over the space, and in most cases, there's nobody in the back of the line waiting for that space," he added.**

For Bader, companies should think hard about filing for bankruptcy, and should always try to resolve financial disputes with their landlords, lenders and whoever else is owed money.

"To me, it's always better to work it out than file," Bader said. If companies are of a decent size and can't take advantage of a filing under Subchapter V, legal fees can cost around $300,000 to start, he said, which could wipe out the entire debtor's estate.

At many fashion firms, and even some of the smaller retailers, the owners have signed personal guarantees on the leases, letters of credit and personal bank accounts. The key is to try to limit their use to what is considered reasonable.

"Maybe you put in a 'good guy' clause in the lease, which allows companies to exit their leases, and cap any personal guarantees to three or four months. Some people, as their companies grow, don't think about them and then the company gets very large and the owners give very large personal guarantees," he said. The problem comes up when the businesses hit a major speed bump on the road. "If these companies fail, the owners are stuck paying the factor, the banks and the landlords out of their own personal funds. You have to be very, very careful. Try to do a workout first. If you don't, you can end up wiping out both the business and the family's financial assets."

What to consider

"Companies can't really file unless their assets are fewer than their liabilities. That's the rule," said Alan Behr, a corporate business attorney at Phillips Nizer and chairman of its fashion practice. But even if they could, filing should be the last resort, in large part because of the stigma attached to bankruptcy.

"Don't do it unless you have to, when you really can't pay your debts," Behr cautioned.

While there are any number of reasons a bankruptcy filing might make sense, he said companies in the fashion industry also have to think about their brand image.

“All fashion firms sell things based on the brand….People buy based on a story that brands tell to capture the consumer’s imagination, who wants to experience its story,” Behr said. “For Ralph Lauren, it’s about the affluent world of the cowboy. For Armani, minimalism is the whole image. What you don’t want to call to mind is the fact that the company went bankrupt.”

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