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Luxury Brand

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Practical Guidance for Luxury Brands Navigating Retailer Insolvency

The ongoing financial distress of luxury brand retailers has raised urgent questions for sellers of luxury brands. For independent brands and institutional luxury houses alike, each distressed situation creates unique challenges that can directly impact financial results, as open orders, receivables, existing contracts, and long-standing relationships are put at risk. Being armed with advanced knowledge of the "best practices" to employ in the face of customer financial distress will allow sellers of luxury goods to obtain better outcomes by enabling them to react thoughtfully, without haste, and with purpose when being forced to address such customer financial distress.

IDENTIFYING RISK

Luxury brands will be well served to proactively monitor the financial health of their retail partners, particularly given the high value of inventory at stake, seasonal ordering cycles, and the potential for brand dilution in a distressed sale. Early warning signs of retailer financial distress that warrant heightened attention include:

- An attempt to obtain better credit terms to aid the retailer with liquidity issues;
- An unexpected lump sum payment, as an indicator of an impending bankruptcy filing;
- Bounced checks;
- Layoffs;
- Frozen bank accounts;
- Increased payment delays;
- Industry rumors;
- Negative disclosures regarding the finances of a parent or affiliate;
- Public filings concerning adverse financial results or a "going concern opinion" in a 10-K or 10-Q, etc.;
- Receipt of "lock box" payment instructions;
- Reduced communication in response to inquiries;
- The sale of a profitable division or business to generate cash;
- Sudden attempt to resolve open issues, perhaps in preparation for a refinancing, forced sales, or bankruptcy filing;
- Suits by other parties against the customer;
- The hiring of a chief restructuring officer and other advisory professionals; and
- Upper management turnover.

ACTION ITEMS

When a retail partner appears on a brand's financial distress radar for the first time, a seller of a luxury brand would be well advised to take immediate action to address the situation, rather than waiting for the occurrence of a payment or other significant default. The seller should consider assembling a cross-functional response team (including commercial, finance, and supply chain leadership) and engage legal counsel experienced in creditors' rights and retail insolvency matters impacting luxury brands. By doing so, the seller can identify and evaluate the rights,

remedies, and obligations of the parties under any governing agreements and the applicable laws. Such laws may include the Uniform Commercial Code (the "UCC"), as the statute governing virtually all domestic commercial sale and financing transactions involving goods, the Bankruptcy Code, and relevant state and federal regulations.

By addressing the relevant action items thoughtfully and with due deliberate speed, luxury brands should be able to better position their business vis a vis increased risk. Some of the action items requiring immediate attention may include:

- Revising purchase order protocols;
- Evaluating credit risk;
- Identifying potential preference and fraudulent transfer exposure, and adopting a strategy to minimize such risk;
- Identifying the documents that constitute the contract between the parties, including supply agreements, correspondence, amendments, purchase orders, invoices, shipping documents, and the like;
- Reviewing such documents and focusing on provisions setting forth the rights and remedies available to the parties in case of a counterparty default or other credit event;
- Revising and renegotiating contract provisions, including affiliate offset rights, where appropriate;
- Obtaining guaranties, a security interest, deposit or other additional credit support; and
- Pursue litigation remedies, if warranted.
- Luxury brands with international retail relationships or cross-border supply chains (for example, in Canada, Mexico, or Brazil) will have additional issues to consider, including:
- Determine the legal title to assets, with a focus on assets subject to special customs arrangements (such as bonded maquila operations);
- Prepare documents for authentication so they can be timely produced; and
- Review agreements and understand the rights and remedies of the parties under applicable foreign law.

REMEDIES AND WORKOUT STRATEGIES

The best practice will be to be proactive, rather than waiting to react to a payment, volume purchase, or other default. Luxury brands that get ahead of the "default curve" and work with legal counsel may be able to obtain an agreement between the parties or avail themselves of contractual and legal remedies in a thoughtful and deliberate fashion, rather than having to react to a critical event, such as a payment default or bankruptcy filing. The statutory remedies generally available to brands concerned about a retailer's financial condition, before or after an event of default, include:

- An action for the price of the goods;
- "Adequate assurance" (UCC § 2-609) remedies;
- Anticipatory repudiation (UCC § 2-610) remedies;
- Damages for non-acceptance of goods or repudiation of the contract, including loss of profit;
- Identification and salvage of goods;
- Cancellation of the contract;
- Reclamation;
- Resale of goods;
- Stoppage of goods in transit; and
- Termination or modification of credit terms.

The foregoing forms of relief may be available consensually. A luxury brand with concerns about a customer's financial stability may be well advised to have such retailer agree to one or more of the following forms of credit enhancement:

- A purchase money security interest in the goods being sold by the brand to the retailer;
- Guaranties and other credit support;
- Payment of legal fees;
- Price increases and accelerated payment terms; and
- Additional reporting requirements.

An agreement between parties is always preferable. Yet, it is important for sellers of luxury brands to properly understand and assess the risks engendered by a consensual pre- or post-default workout, as benefits obtained by a brand/creditor through a workout are likely to be subjected to creditor and/or judicial scrutiny or challenge. Courts and competing creditors may focus on issues including:

- Whether the transaction constitutes a voidable transfer/fraudulent conveyance in favor of the seller;
- Whether the transaction constitutes a preferential transfer to the seller; and
- Whether the transaction constitutes some sort of overreaching or fraud by the seller.

To avoid a subsequent unwinding of a consensual workout transaction, sellers should consult with legal counsel when negotiating with a financially distressed retailer. Simply structuring a transaction in a certain way may result in a better outcome, should the transaction be subjected to scrutiny by the courts or competing creditors.

If a retail partner is unable or unwilling to make concessions, and the exercise of remedies is not a good option, third-party credit support for the retailer's obligation may be the only answer.

The concept of third-party credit support refers to guaranties and similar legal arrangements where a third party agrees to be financially responsible for the obligations of the retailer. Forms of third-party credit support include:

- Credit insurance;
- Guaranties (which may be secured or unsecured);
- Performance bonds;
- Standby and commercial letters of credit; and
- Suretyship obligations.

Guaranties may be provided by well-financed affiliates (such as a parent or a shareholder) or non-affiliates (such as a bank). Brands must take care to carefully document any agreement for third-party credit support to avoid losing its benefits by virtue of a legal misstep. Legal issues that could impair third-party credit support include:

- Altering the debt or collateral;
- Failure of consideration, fraud, or duress;
- Failure to notify the guarantor of the sale of personal property collateral, as required by the UCC or as otherwise required by the governing documents;
- Failure to satisfy conditions precedent to enforcement;
- Voidable/fraudulent transfers—did the guarantor receive "fair value" or "reasonable equivalent value" in exchange for a guaranty;
- The Statute of Frauds—any guaranty must be in writing and signed by the guarantor; and
- Ultra vires—does the entity providing the credit support have the authority to do so under its governance documents.
- Bankruptcy

In the event of a bankruptcy filing by a retail partner, luxury brands will confront a range of bankruptcy-specific issues and must act quickly to protect their interests. Priority action items include:

- Assessing any plan of reorganization or liquidation proposed by or on behalf of the debtor/retailer;
- Asserting critical brand status;
- Asserting Section 503(b)(9) claims;
- Asserting reclamation rights;
- Asserting the right to stop goods in transit;
- Considering appropriate objections to a motion for debtor-in-possession ("DIP") financing or use of cash collateral by the retailer crafted to prevent a loss of any rights the luxury may have against the retailer or in the luxury brand's that may be in the retailer's possession;
- Considering creditor committee participation;
- Considering the possibility that a financially distressed customer may seek cross-border protection by invoking a reorganization statute in more than a single country and the impact of such cross-border process on the brand;
- Defending preferential transfer claims;
- Defending voidable transfer/preferential transfer claims;
- Effecting setoff rights if appropriate;
- Focusing on financing and operational issues;
- Monitoring the bankruptcy case;
- Preparing and timely filing a proof of claim;
- Prosecuting administrative, priority, and secured claims where such status is available under applicable law; and
- Responding to claims objections, if any.

Supply agreements generally will have the legal status of an "executory contract" under the Bankruptcy Code, as it is the very nature of such agreements to provide for the sale of goods by the brand and payment for such goods by the retailer/debtor on an ongoing basis. (11 U.S.C. § 365). As an "executory contract," the agreement between the brand and its retailer/debtor may be assumed or rejected by the retailer/debtor during the administration of such retailer's bankruptcy case. "Assumption," subject to carve-outs, generally means that (a) the contract in question continues in place, (b) pre-bankruptcy defaults, including payment defaults, must be "cured," and (c) the parties are left to their own devices almost as if there was no bankruptcy case. Rejection means the retailer/debtor will no longer perform under the contract and that the retailer/debtor has incurably breached the contract. The foregoing is only a summary of this complex area of bankruptcy law and does not address many issues, including the claims created by a rejection. Any brand involved with a retailer in bankruptcy will be well advised to consult with legal counsel having the appropriate experience in bankruptcy law and creditors' rights matters when addressing contracts in a bankruptcy milieu.

Most bankruptcy courts agree that after the filing of a bankruptcy case, but prior to assumption or rejection of a contract, such contract continues in effect, is binding on the non-debtor party, and the non-debtor party is required to continue providing performance, even though the contract cannot be enforced against the debtor entity during this so called "limbo" period. For example, when a retailer under a supply contract has filed for

Chapter 11 relief, its suppliers have been obligated to continue supplying goods to the debtor/retailer, notwithstanding pre-bankruptcy payment defaults and contract provisions drafted to preclude such an outcome.

Thus, a retailer/debtor in Chapter 11 may be able to compel a brand to continue selling goods, notwithstanding the existence of a pre-bankruptcy payment default. In response to an attempt to compel performance.

Luxury brands often rely on a contract provision purporting to permit them to terminate contracts or modify terms upon the insolvency or bankruptcy of a customer. However, such reliance is misplaced, because such clauses, referred to as ipso facto bankruptcy default provisions, are not enforceable against a retailer/debtor in a Chapter 11 case (11 U.S.C. § 365(e)(1)).

ADDITIONAL CHALLENGES FOR LUXURY BRANDS

The automatic stay found in Section 362 of the Bankruptcy Code serves to prohibit the exercise of creditor remedies upon the filing of a bankruptcy petition by a debtor entity. Thus, a

Chapter 11 filing legally enjoins a brand from protecting itself by pursuing its rights and remedies. Unfortunately, brands can be left in a position where they may have to continue to supply a retailer/debtor and the retailer/debtor may have to pay for current shipments, but the brand will be stayed from trying to collect for pre-bankruptcy sales or exercising other remedies normally available to a seller of goods, absent relief from the automatic stay pursuant to a court order. What can a brand do to protect its interests in a Chapter 11 situation where it is the non-debtor party to an executory contract? A “to-do list” after bankruptcy filing may include the following items:

- Force an early assumption or rejection;
- Demand adequate assurance;
- Renegotiate;
- Assert administrative priority status where appropriate;
- Assert secured claim status where appropriate;
- Monitor for assumption, which can occur by motion or through a Chapter 11 plan of reorganization or liquidation;
- Watch out for estoppel notices; and
- Watch out for sales of the brand’s contract to a third party under Section 363 of the Bankruptcy Code.
- Key Takeaways for Risk Mitigation

The unease of a luxury brand with the uncertain future of a major retailer is a reminder that brands must be vigilant to mitigate risk and avoid losses. Best practices will include:

- Monitor early warning signs of retailer distress and promptly revisit key contract terms.
- Understand how bankruptcy will affect receivables, reclamation rights, and supply agreement.
- Engage experienced bankruptcy counsel early in a restructuring to preserve leverage and optionality.

The team of professionals that comprise Blank Rome’s Luxury Brands and Bankruptcy and Restructuring practices can help such brands protect themselves at every stage of the process. Drawing on deep industry knowledge and multidisciplinary service offerings, our team can assess exposure, strengthen agreements, and navigate retailer insolvency to protect cash flow, brand equity, minimize losses, and reduce disruption.

For more information or assistance, please contact Clara Feldman, Ira L. Herman, or another member of Blank Rome’s Luxury Brands or Bankruptcy & Restructuring practice groups.

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