The Risky Business of Extending Credit to Ch. 11 Debtors

Once a thriving toy retailer, Toys R Us is no more. Debt struggles repeatedly struck the popular chain store in 2016 and led the company to hire a law firm for corporate restructuring the following year. In September 2017, the century-old New Jersey-based company filed for Chapter 11 bankruptcy, only to decide to liquidate in March 2018.

Despite the impending downfall, suppliers stayed supportive of Toys R Us by extending hundreds of millions of dollars in trade credit and lengthening invoice payment periods, hoping the retailer would turn around—an objective Toys R Us vocally expressed to its suppliers. Instead, Toys R Us left suppliers high and dry after announcing plans to liquidate its assets, close hundreds of stores across the U.S, and effectively leave suppliers unpaid. It's not unusual for suppliers to lend a hand to a Ch. 11 debtor, or in this case, lend credit, but when murmurs of bankruptcy arise, broken promises of payment can strain or even sever a business-to-business relationship.

Just because a debtor is in Ch. 11 doesn't necessarily mean credit managers should avoid their business. Due diligence must be a priority, said Bruce Nathan, Esq., partner with Lowenstein Sandler LLP of New York. What happened with Toys R Us doesn't happen in every Ch. 11 case. Sometimes, Nathan said, debtors file for Ch. 11 reorganization and restructuring, continue paying administrative costs and then exit fairly unscathed. Then, there's the liquidation process seen with Toys R Us.

"If the case liquidates and if there isn't enough to pay the secured lender [at all] or in full and have funds for all of the administrative expenses in Ch. 11, like unpaid post-petition rent, professional fees and all other post-petition payables, then everybody takes a haircut on their post-petition credit extension," Nathan said. "Anybody who is considering extending credit has to do a lot of homework and be able to figure out what happens when the music stops. What are the chances of their post-petition credit extension getting paid in full? There's a risk of delayed payment. There's a risk that it will not be paid in full."

In the case of Toys R Us, vendors were told that the existence of Ch. 11 financing provided assurance of post-petition trade claims. The company expected to come out on top in 2018 or 2019 after the holiday shopping season; however, Toys R Us never had the chance due to an underperforming budget.

According to a Retail Dive article in August, a settlement agreement was reached between the retailer and vendors in July that "provides a baseline recovery of $180 million on some $800 million owed to vendors, with the potential for more." To their dismay, vendors can't sue the retailer or pursue claims in full to fully recover, but they can file a proof of claim.

Critical vendors were "burned" by Toys R Us because they agreed to have their pre-petition claim paid over time and continued to extend post-petition credit, Nathan said. Then, payments stopped when the company failed.

"If I were a critical vendor, I wouldn't extend credit in excess of whatever payment I got on my critical vendor claim because, otherwise, you'd be extending yourself more than you got paid," Nathan said. "I'm not saying you shouldn't do business with a Ch. 11 debtor; I'm saying there's a risk that if you do business on credit, you don't get paid in full or there's likely a delay in payment. The answer may be that you do business on cash-in-advance terms." Bloomberg reported in June that nearly 40% of the company's vendors shipped product without cash in advance, cash on delivery or payments outstanding.

Nathan said paying attention to the company's wellbeing is the best way to deal with a Ch. 11 debtor.

—Andrew Michaels, NACM editorial associate