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Converting Trade Debt to a Controlling Stake

The Pragmatic Path to Jennifer Convertibles' Unique Reorganization

Written by:
Edward E. Neiger
Neiger LLP; New York
eneiger@neigerllp.com

Dina Gielchinsky
Neiger LLP; New York
dgielchinsky@neigerllp.com

About the Authors

Edward Neiger is a founding partner and Dina Gielchinsky is of counsel with Neiger LLP in New York.

A slow housing market and overall weak U.S. economy led furniture retailer Jennifer Convertibles Inc. and 11 of its affiliates (collectively, "Jennifer Convertibles") to file for bankruptcy on July 18, 2010, in the U.S. Bankruptcy Court for the Southern District of New York. The debtors had no secured creditors but owed almost $35 million in unsecured debt, not including taxes and past-due rent. Of that amount, the debtors owed more than $17 million to a Chinese furniture supplier, Haining Mengnu Group Co. Ltd. (Mengnu).

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Mengnu was the debtors' sole supplier of sofa beds, leather products and other furniture items, and custom-designed some of its equipment to special-produce merchandise for Jennifer Convertibles. Given Mengnu's integral role in the debtors' business, as well as its exceedingly large claim for unpaid goods, Mengnu played an active role in the debtors' reorganization. In fact, Mengnu signed a plan support agreement moments before the filing of the bankruptcy case, pursuant to which the debtors agreed to convert the Mengnu debt into a controlling stake in the reorganized Jennifer Convertibles.

The debtors hoped that its rendezvous in bankruptcy would be short. Indeed, the debtors confirmed a reorganization plan in just seven months. Under the plan, general unsecured creditors received a recovery of more than 22 percent on their claims, along with 9.9 percent of the reorganized debtors' new common stock. Mengnu received a recovery of more than 87 percent on its claims and 90.1 percent of the reorganized debtors' new common stock. This debt-for-equity swap was unique, as it is one of the few instances where trade debt was converted into a controlling stake in a debtor, and serves as an example of a possible solution for debtors with large amounts of trade debt. Although the reorganization was quick, several unique issues arose and may serve as a guide for practitioners facing similar circumstances.

Cover Feature

Ensuring Mengnu's Continued Shipments in the Absence of a Critical-Vendor Order

The debtors filed a critical-vendor motion as part of their first-day pleadings seeking to pay $400,000 to Mengnu on a weekly basis, which would pay down some of the debtors' pre-petition debt owed to Mengnu.[1] They were aware of bankruptcy courts' wariness of critical-vendor motions ever since the Seventh Circuit reversed an order authorizing more than $300 million in critical-vendor payments in the Kmart chapter 11 cases.[2] The debtors and Mengnu were also aware of presiding Judge **Allan L. Gropper**'s general skepticism of first-day critical-vendor motions. Judge Gropper declared in a previous bankruptcy case that "certain firms don't seem to understand that critical vendor orders are anathema to the bankruptcy process."[3] According to Judge Gropper, a first-day critical-vendor motion is a "chimera," reasoning that "[i]f a payment is not made, the customer understands the process and certainly can wait a week or two."[4] The debtors and Mengnu nevertheless requested the relief, knowing that Judge Gropper granted critical-vendor motions with respect to sole-source suppliers and foreign vendors in other cases.[5]

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The debtors argued that Mengnu was not only a foreign vendor, but it was also the debtors' primary supplier. Judge Gropper was still hesitant to grant the relief, pondering "[f]or what purpose are we alienating all the other unsecured creditors in the case and possibly unnecessarily?"[6] Judge Gropper stated that "I

1 Debtors' Motion Pursuant to §§ 105(a), 363, 364 and 503 of the Bankruptcy Code and Bankruptcy Rules 6003 and 6004 for Entry of an Order Authorizing, But Not Requiring, Payment of Certain Pre-petition Obligations to Critical and Foreign Vendor, Haining Mengnu Group Co. Ltd., dated July 19, 2010 [Docket #4].

2 *See In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004).

3 *In re Tronox Inc.*, Case No. 09-10156 (ALG), Tr. of Hearing on First-Day Motions, dated July 13, 2009, page 76, lines 3-5 [Docket # 59].

4 *Id.*, page 76, lines 9-11.

5 *See, e.g., In re Northwest Airlines Corp.*, Case No. 05-17930 (ALG), Tr. of Hearing on First-Day Motions, dated Sept. 15, 2009, page 47, lines 9-13 ("I think it should be understood that this is at least in my view a critical need for an entity such as an airline or a shipping company that is in the extraordinary position of shipping—of transferring its principal assets or some of them overseas. So I'll approve the order.") [Docket # 1843.]; *Tronox*, Tr. *supra* note, at 72, lines 6-9 ("I have more sympathy, much more sympathy, to the payment of foreign vendors. But you haven't told me in your papers that you have foreign operations that are subject to seizure or subject to attachment by foreign creditors.").

6 *See In re Jennifer Convertibles Inc.*, Case No. 10-13779 (ALG), Tr. of Hearing on First-Day Motions, dated July 21, 2010, page 22, lines 4-7 [Docket # 79].

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have never, never, entered a critical vendor order on day one of the case without notice and without formation of a creditors' committee. And I've had a lot of lawyers tell me 'Well, that's the end of the case,' and it's never happened, never."[7] The debtors withdrew the critical-vendor motion.

In order to reassure Mengnu that it would be paid for continued shipments crucial to the debtors' survival, the debtors and Mengnu requested a court order authorizing the debtors to pay Mengnu cash in advance. The debtors and Mengnu argued that cash in advance, as opposed to cash on delivery, was necessary because of the 13-week lag between the debtors' placement of an order and the arrival of the goods to the U.S. from China. Judge Gropper entered an order authorizing the cash in advance terms: 75 percent payment upon placement of the order and 25 percent payment upon receipt of the goods.[8] Providing cash in advance to foreign vendors and cash on delivery to domestic vendors may be one way to provide comfort to important vendors in a bankruptcy in the absence of a critical-vendor order.

Assumption of the Licensing Agreements

Ashley Homestore Ltd. and Ashley Furniture Industries Inc. (collectively, "Ashley") objected to various aspects of the debtors' reorganization. Prior to the debtors' bankruptcy filing, Ashley authorized one of the debtors, Hartsdale Convertibles Inc.,[9] to use Ashley's trademark in specific store locations owned by the debtors called "the HomeStores." The Hartsdale debtor was actually profitable, and Ashley was concerned that the value of its trademark would decline as a result of the inclusion of Hartsdale in the debtors' bankruptcy. Ashley objected to, among other things, the debtors' motion to assume the six separate trademark usage agreements (TUAs) governing Hartsdale's use of the Ashley trademark in the HomeStores. The debtors stressed that the TUAs were vital to their reorganization, as the revenue generated by the HomeStores was a key component of their going-forward business.

Ashley insisted that the debtors could not assume the TUAs, citing § 365(c)(1) of the Bankruptcy Code, which requires the consent of a counterparty to the assumption or assignment of an executory contract when an assignment would otherwise be prohibited by applicable law.[10] Ashley argued that the express language of the TUAs prohibited their assignment, as did applicable law, including the Lanham Act, which prohibits a party from using "in commerce any...false designation of origin...which is likely to cause confusion...as to the affiliation, connection or association of such person with another person, or as to the origin, sponsorship or approval of his or her goods, services, or commercial activities by another person."[11] Courts prohibiting assignments of license agreements under the Lanham Act have found that such assignments confuse consumers as to the actual origin of the goods.[12]

Ashley insisted that the court should adopt the "hypothetical test" when examining whether a license agreement that cannot be assigned may be assumed, as opposed to the "actual test," also known as the "*Footstar* Approach." Under the hypothetical test, if applicable nonbankruptcy law bars assignment of an agreement to a third party, the debtor may not assume the agreement, even if the debtor has no intention of assigning it.[13] Under the actual test, the debtor may assume the agreement without the consent of the counterparty, but may not assign it.[14] Ashley also argued that the proposed substantive consolidation of the debtors under the proposed reorganization plan would effect, for all intents and purposes, a prohibited assignment of the TUAs from Hartsdale to all of the debtors.

The debtors argued that although the Second Circuit has not ruled on the issue, courts in the Southern District of New York that have faced the issue have adopted the actual, not the hypothetical, test, and therefore, they could assume the TUAs as long as they did not assign them.[15] To illustrate, the court in *Adelphia Communications Corp.* stated as follows:

> [Applying the actual test] is the clear holding of the decisions of Judge Hardin of this Court in the *Footstar* cases, which this Court believes it should follow. The *Footstar* decisions also are consistent in outcome with the decisions of the First Circuit and the Fifth Circuit, and the great majority of the lower courts, which in this Court's view reach the proper result. Cases to the contrary, including some Circuit Court decisions that apply a species of "plain meaning" analysis to section 365(c)(1), are in this Court's view incorrectly decided.[16]

The debtors also explained that although the motion was made by all of the debtors, Hartsdale was the only entity assuming the TUAs. Since Hartsdale was not going to assign the TUAs, the assumption was not prohibited by § 365(c)(1).

At the hearing, Judge Gropper did not decide the issue, stating that it would be more appropriate to address it at the plan confirmation hearing, since the assumption of the TUAs was an integral part of the debtors' plan and reorganization. Nevertheless, Ashley's concerns were distilled during the hearing, and it stated that if Hartsdale alone were assuming the TUAs, and if Hartsdale were not jointly liable for the debts of all of the other debtors, it would not object to the assumption of the TUAs on the basis that the assumption violated § 365(c)(1). Accordingly, the debtors resolved a significant portion of Ashley's objection by filing an amended plan in which Hartsdale was divested of the bulk of the other debtors' liabilities.

Consolidation Issues

Ashley then objected to plan confirmation, citing concerns with the debtors' proposed substantive consolidation of their estates for purposes of voting, confirmation and making distributions under the plan. Ashley argued that the plan did not satisfy the best-interest-of-the-creditors test of § 1129(a)(7) with respect to the Hartsdale creditors. Section 1129(a)(7) of the Code provides that a plan may only be confirmed if, "[w]ith respect to each impaired class of claims or interests[,] each holder of a claim or interest of such class has accepted the

7 *Id.*, page 26, line 25; page 27, lines 1-4.

8 Order Authorizing the Debtors to Enter into a Stipulation with Haining Mengnu Group Co. Ltd., dated Aug. 31, 2010 [Docket # 202].

9 The debtors operated under various trade names, including Hartsdale Convertibles Inc.

10 Section 365(c)(1) provides, in pertinent part:

> The trustee may not assume or assign any executory contract...whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if
>
> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment.

11 U.S.C. § 365(c)(1)(A) and (B).

11 15 U.S.C. § 1125(a)(1)(A).

12 *See, e.g., Tap Publs. v. Chinese Yellow Pages*, 925 F.Supp. 212, 221 (S.D.N.Y. 1996).

13 *See N.C.P. Mktg. Group v. Blanks (In re N.C.P. Mktg. Group)*, 337 B.R. 230, 234 (D. Nev. 2005).

14 *See Institute Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. Mass. 1997).

15 Debtors' Reply to the Objection of Ashley Homestores Ltd. to Debtors' Motion Pursuant to 11 U.S.C. § 365 for Approval of the Assumption of Executory Contracts with Licensor, Effective as of the Effective Date of a Plan of Reorganization, dated Jan. 11, 2011 [Docket # 425].

16 *In re Adelphia Communs. Corp.*, 359 B.R. 65, 72 (Bankr. S.D.N.Y. 2007) (citations omitted).

plan; or will receive or retain under the plan...property of a value...that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title."[17] Hartsdale was a profitable and healthy debtor, and Ashley maintained that the debtors' consolidated liquidation analysis did not establish that Hartsdale creditors would receive at least what they would receive in a hypothetical liquidation of Hartsdale under chapter 7.

The bankruptcy court found that the debtors did not prove that Hartsdale's creditors did not rely on Hartsdale's separate identity in extending credit (an important factor in determining whether substantive consolidation is appropriate), and that the debtors should have provided a separate liquidation analysis for Hartsdale, and perhaps a greater distribution to its creditors. However, Judge Gropper provided a roadmap to confirmation without requiring the debtors to perform a complete do-over at the eleventh hour. Judge Gropper noted that Ashley was not affected by the substantive consolidation because the debtors were going to cure any defaults under the TUAs. The next-largest creditors, Hartsdale's landlords, were also not affected by the substantive consolidation, as they renegotiated their lease agreements with the debtors. Thus, the only creditors arguably adversely affected by the substantive consolidation were a relatively small number of vendors that extended credit to Hartsdale, whose claims collectively equaled less than $100,000.[18]

Accordingly, Judge Gropper suggested that the debtors could cure their plan defects with respect to substantive consolidation in one of two ways: (1) pay Hartsdale's smaller creditors in full and immediately confirm the plan, or (2) supplement the record on the issue of substantive consolidation and submit a separate liquidation analysis for Hartsdale.[19] The debtors chose the first proposed resolution, which paved the way for the debtors to confirm their plan four days later.

Conclusion

Practitioners are well-advised to employ creative solutions when dealing with parties who are indispensable to a debtor's reorganization. The trade debt-for-equity swap offered by the debtors in these cases provided them with a viable alternative to liquidation, while affording creditors an opportunity to own interests in a reorganized debtor with a positive financial outlook. Judge Gropper's practical solution to a potentially fatal confirmation problem also helped Jennifer Convertibles exit bankruptcy in a timely manner. ■

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17 11 U.S.C. § 1129(a)(7)(A).
18 *Id.* at pages 13-16.
19 *Id.* at pages 18-19.