Retail Failures Give Rise to Reclamation Claims: "Get The Goods or Get Paid" From Your Insolvent Customer!

By: James Andrew Hinds, Jr., Esq. © 2017

HERE IS THE UNDERLYING ISSUE

Here is a dismal statistic: last year, in the United States alone, on average, one retailer failed every 12 minutes; five failures per hour, 24 hours per day, 365 days per year. Remember these retail giants from not too long ago?: American Eagle Outfitters; Aéropostale; The Limited; Shoes.com; BCBG Maz Azria Group; Sports Authority; American Apparel; Radio Shack; and Sports Chalet. Walk through a regional mall and count the number of empty spaces. This is not likely to change over 2017.

Here are five primary reasons that retail businesses fail:

1. Poor cash management is the Number One Killer of retail businesses today. Producing profits may be the sign of a good business, but profits matter little if a business runs out of cash. What keeps retail businesses running is enough cash coming in so that purchases can be made and obligations met at all times.

2. Unsold overstocked inventory is the Number Two Killer of retail businsses. All retail businesses that carry inventory have special problems. Inventory is the "engine" of the business: Inventory generates all of the Gross Margin dollars and it is responsible for customer satisfaction (or the lack of it.) But inventory also soaks up cash, often lots of it. Unsold inventory whether due to changes in market conditions or just poor planning, seals the death of more and more retail businesses.

3. The Number 3 Killer of retail business is inadequate gross margin management. What good does it do to ask: "How are my sales?" The more important question is: "How are my Gross Margin dollars contributing to Operating Profit?" As a retailer, you must not ignore the message of your Gross Margin Management.

4. Expense management is the Number Four Killer of retail businesses. Expense management may sound like an old idea, but today, it's more important than ever.

5. E-Commerce competition is driving a lot of Brick and Mortar retailers out of business. This impacts not only customers and suppliers, but also commercial landlords.

With this back drop, if the customer is insolvent, or files bankruptcy, the vendor may be stuck with an unpaid account. To make matters worse, some retail customers (especially those with limited prospects for financing in their chapter 11 case known as Debtor in Possession, or DIP Financing) may even "load up" on inventory and then file bankruptcy without paying. Regardless of why it happens, no one wants to ship goods and not get paid.

When a retail customer faces potential bankruptcy, trade creditors may want to stop doing business with the retailer. However, if the retailer is still paying for goods, then having the account is usually preferable to foregoing the business. Revenues received through sales to a troubled counter-party are better than no sales. Even so, trade creditors must be cautious and plan properly in case the retailer does file for bankruptcy.

WHAT TO DO BEFORE THE "STUFF" HITS THE FAN

There is good news, but it requires diligence on your part. The most basic thing that a Seller can do pre-petition to avoid having to seek reclamation of its goods later is to be aware of Buyer's financial condition: Has the Buyer recently started to pay late? Has the Buyer started to increase its orders over historical amounts? Has the Buyer experienced recent layoffs? Has there been a general downturn in the Buyer's industry (which may also be Seller's industry)? If there is any evidence of the foregoing, Sellers should try to: (1) tighten terms by allowing for no more than 20-days open shipping, thus ensuring that all (or most) of the money owed will be treated as an administrative expense; (2) eliminate all open terms and go to pre-payments or COD; (3) obtain advance payment in full for all orders; or (3) a combination of foregoing to reduce exposure for a large unpaid AR.

Trade creditors can seek to negotiate security interests with retailers and secure collateral to protect their credit. The sooner the security interest is perfected by a proper Security Agreement and a UCC-1 Filing with the Secretary of State (requirements vary State to State) the better because in a chapter 11, or chapter 7 bankruptcy filing, that security interest can be set aside as a Preferential Transfer, if perfected 90 days, or less prior to the bankruptcy filing. A security interest may also be established in conjunction with a Letter of Credit Agreement and a UCC-1 Filing with the Secretary of State (depending on applicable State Law requirements). Those, too, provide may provide security and can help protect trade creditors from liability for Preferential Transfers, if in place 90 days or more before a bankruptcy filing.
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