

BANKRUPTCY UPDATE

Expert Analysis

Dewey's Bankruptcy Case, Developments In Madoff, Sbarro, Ritz Camera

This column discusses the recent bankruptcy filings of Ritz Camera and Image and Dewey & LeBoeuf, two of the more recent high-profile entities to file for bankruptcy. The column discusses why Ritz and Dewey filed, and how they hope to use the bankruptcy process to achieve their respective goals—restructure in the case of Ritz, and liquidate in the case of Dewey. The column also updates readers on Sbarro's successful emergence from bankruptcy and how it used the bankruptcy process to reorganize its business and restructure its balance sheet. Finally, the column discusses the latest events in the Bernard L. Madoff Investment Securities LLC bankruptcy, including the slew of new lawsuits brought by the trustee in that case against investors in Madoff feeder funds.

Ritz Camera & Image

Ritz Camera & Image LLC filed for Chapter 11 bankruptcy protection for the second time in three years on June 22, 2012, in the Delaware bankruptcy court. RCI, the largest specialty camera retailer in the United States, cited liquidity problems and the need to close unprofitable stores as the primary reasons for seeking relief under the Bankruptcy Code. RCI's bankruptcy petition listed assets and liabilities ranging between \$50 million and \$100 million.

The photography-product retailer emerged from its first bankruptcy in 2009 after closing more than 400 stores and selling the remainder of its business for \$33 million to a group headed by RCI president David Ritz.

As part of its restructuring, the company intends to "reject" above-market leases, close

By
**Edward E.
Neiger**



128 stores and consolidate its inventory. Bankruptcy Code §365 allows a bankrupt debtor to reject a lease or executory contract that it deems burdensome. In order to reject a lease or executory contract, the debtor must demonstrate to the bankruptcy court that, in its business judgment,

The stated goal of the Dewey & LeBoeuf bankruptcy filing was an orderly liquidation rather than a restructuring.

rejection will benefit the estate. Once the bankruptcy court approves rejecting a lease or executory contract, "rejection damages" (damages arising from the breach of the agreement) is paid in "bankruptcy dollars," which is typically cents on the dollar.

Since seeking bankruptcy protection, RCI obtained interim approval of "debtor-in-possession financing" in the amount of \$20 million, providing the bankrupt retailer the working capital it needs during the bankruptcy. Debtor-in-possession financing, often referred to as "DIP financing," is typically new financing provided to a Chapter 11 debtor to fund its operations in bankruptcy.

Subject to bankruptcy court approval under Bankruptcy Code §364, DIP loans often have high interest rates, superpriority

repayment status and may even prime existing liens, provided that the debtor demonstrates, among other things, that current liens are "adequately protected" and that it could not obtain financing under more favorable terms. RCI's DIP financing terms provide for an aggressive bankruptcy schedule and require that the debtor auction its remaining business on or before Sept. 6, 2012.

Ritz Camera & Image (Bankr. D. Del. Case No. 12-11686)

Dewey & LeBoeuf

International law firm Dewey & LeBoeuf filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code on May 29, 2012, in the bankruptcy court for the Southern District of New York after more than half of its partners defected. Dewey's bankruptcy petition listed debts of \$245 million and assets of \$193 million. The stated goal of the bankruptcy filing was an orderly liquidation rather than a restructuring. While the primary purpose of Chapter 11 is to reorganize, with Chapter 7 reserved for liquidations, courts often allow companies to use the provisions of Chapter 11 to run an orderly liquidation process.

Following the bankruptcy filing, the firm and its bankruptcy advisers focused on achieving a global settlement with the firm's former partners that would release the partners from potential "clawback" claims brought by the firm's creditors. Typical clawback claims are preference actions commenced under Bankruptcy Code §547 and fraudulent transfer actions commenced under Bankruptcy Code §§544 and 548.

Bankruptcy Code §547 allows a trustee to avoid certain transfers made to creditors during the 90-day period (one year if the transferee was an insider) preceding the commencement of a bankruptcy case. The theory behind such actions is that the

debtor was presumptively insolvent at the time the payments were made, providing “preferential” treatment to the creditors who received them over other creditors who did not.

Bankruptcy Code §548 allows for the recovery of fraudulent transfers made within two years of a bankruptcy filing, and Bankruptcy Code §544 allows a trustee to use the look-back period of the applicable state law, which in New York is six years prior to a bankruptcy filing. A “fraudulent transfer” is any transfer or obligation made within the aforementioned look-back periods with the “actual intent” to hinder, delay or defraud a present or future creditor. In the absence of actual fraudulent intent, a transfer that was made within the aforementioned look-back periods may still be avoidable as “constructively fraudulent” if such transfer was made in exchange for less than reasonably equivalent value and: (i) the debtor was insolvent at the time of the transfer, (ii) the debtor was rendered insolvent as a result of the transfer, or (iii) the transfer was made to an insider of the debtor.

Dewey’s bankruptcy advisers hope Dewey’s former partners will agree to pay specified amounts (determined based on certain objective criteria) into the bankruptcy estate in exchange for mutual releases. Many of Dewey’s former partners may also assert claims against the firm’s former leadership, including chairman Steven Davis, who will likely be excluded from the potential settlement’s release provisions.

Dewey & LeBoeuf (Bankr. S.D.N.Y. Case No. 12-12321)

Sbarro

Sbarro Inc. filed a “prepackaged” Chapter 11 bankruptcy petition in April 2011 in the bankruptcy court for the Southern District of New York. The bankruptcy filing was precipitated by, among other things, rising cheese and flour prices and reduced mall attendance during the recent economic downturn. Unlike an ordinary Chapter 11, in a prepackaged bankruptcy the debtor negotiates and agrees upon a plan of reorganization with its creditors and parties in interest prior to the bankruptcy filing.

In October 2011, Sbarro obtained bankruptcy court approval to “assume” more than 400 unexpired leases. Assumption of a lease allows a debtor to continue the contract by “curing” any past defaults, typically by paying what is owed under the lease. If a debtor does not assume a contract within 120 days after filing for

bankruptcy (or seek an extension of this time period from the bankruptcy court), it is deemed to “reject” the contract, in which case it will likely pay “rejection damages” at significantly reduced amounts. The ability to reject a contract or lease and pay reduced damages provides debtors with significant leverage to renegotiate contracts and leases, which Sbarro effectively used to reduce its annual rent by approximately \$4 million.

In November 2011, Sbarro confirmed its Chapter 11 plan of reorganization. The lender-sponsored plan reduced the company’s debt from approximately \$400 million to approximately \$130 million and gave the prepetition lenders ownership of the company. The Chapter 11 plan went “effective” on Nov. 28, 2011. A plan of reorganization goes effective when a debtor meets the conditions set forth in the plan as prerequisites to emerging from bankruptcy, for example, consummating exit financing or completing a sale of the business.

On June 21, 2012, the bankruptcy court granted Sbarro’s application for a “final decree,” which, when entered, officially closes a Chapter 11 case. At the hearing on the application for a final decree, Sbarro’s counsel stated that the company’s business was doing well and that its restructuring efforts enabled it to invest in improvements.

Sbarro (Bankr. S.D.N.Y. Case No. 11-11527)

Madoff

Irving Picard, the trustee charged with the liquidation of Bernard Madoff Investment Securities LLC for the benefit of its victims, commenced more than 1,000 lawsuits since 2008 seeking to recoup tens of billions of dollars in profits and principal withdrawn by investors before Madoff’s scheme collapsed in 2008. On June 6, 2012, Picard commenced new clawback suits seeking the return of more than \$800 million from parties that received payments from Madoff “feeder funds,” which are funds that invested other people’s money with Madoff, and who repaid their investors from Madoff distributions. The defendants were primarily large Swiss banks.

Bankruptcy Code §550 allows a trustee to recover monies from “subsequent transferees” of property that was first fraudulently conveyed to “initial transferees.” The new clawback lawsuits assert that the banks were subsequent transferees of the fraudulent transfers received by the feeder funds, which were the initial transferees.

Separately, on June 20, 2012, the trustee announced that he will appeal to the U.S.

Court of Appeals for the Second Circuit a series of rulings by a district court judge that slashed the trustee’s potential clawback recoveries by billions of dollars.

One of the most important areas of the appeal will focus on U.S. District Court Judge Jed Rakoff’s September 2011 ruling in the trustee’s case against the owners of the New York Mets. In that case, Rakoff limited the time for which the trustee could clawback fake profits from Madoff investors to two years prior to the bankruptcy filing instead of six years.

The owners of the Mets settled with the trustee and agreed to pay the estate \$162 million to avoid the potential trial and appeal. Nevertheless, the trustee is still appealing the decision because Rakoff applied the two-year limit imposed in the Mets decision to numerous other cases filed by the trustee in the months following that decision.

Bernard L. Madoff Investment Securities (Bankr. S.D.N.Y. Case No. 08-01789)