BANKRUPTCY LAW ALERT

December 5, 2022

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The Sears Saga Continues: The Second Circuit Affirms Bankruptcy Court's Use of Orderly Liquidation Value

In the continuing saga of the failed retailer, the Second Circuit affirmed the Bankruptcy Court's utilization of Net Orderly Liquidation Value ("NOLV") to value certain collateral as of the filing date in the Sears bankruptcy proceedings.

On October 15, 2018 ("Petition Date"), Sears Holding Corporation and its affiliates ("Debtors") filed for bankruptcy, commencing a well-documented bankruptcy proceeding. As of the Petition Date, the Debtors had approximately $2.68 billion of debt. The Debtors' first and second lienholders were secured principally by the Debtors' inventory and related assets. The second lienholders were provided with "adequate protection" under the Bankruptcy Code in the form of additional liens and "super priority" rights to payment ahead of all other creditors, other than the first lienholders. The protections afforded to the second lienholders would preserve the value of their collateral, and, in the event that the value of the collateral diminished over the course of the bankruptcy proceeding, grant the second lienholders priority of payment of the value lost.

The Debtors entered into a transaction to sell substantially all of their assets for approximately $5.2 billion. The purchase price consisted of non-cash consideration, including a $433.5 million "credit bid" resulting in a dollar-for-dollar reduction in the purchase price. The first lienholders' claims were discharged after the sale. Notwithstanding that the second lienholders did not participate in the purchase of the assets, they were required to participate in the credit bid resulting in a substantial reduction in their rights to payment.

As a result, the second lienholders asserted super-priority claims, arguing that the amount of the credit bid was less than the value of their collateral. If the value of the collateral depreciated beyond the $433.5 million credit bid, the second lienholders would prevail and could recover the deficiency based on their super priority claims. As such, the second lienholders' claims were contingent on the value of the collateral as of the Petition Date.

The Bankruptcy Court heard testimony from multiple expert witnesses, including valuation experts for the Debtors and each of the second lienholders, and held that the bulk of the Debtors' collateral would be valued at NOLV, which was greater than liquidation value, but less than their full retail price. Judge Robert D. Drain held, *inter alia*, that NOLV valuation was appropriate because as of the Petition Date, a complete liquidation of the Debtors' assets was a genuine possibility. Ultimately, Judge Drain concluded that the value of the collateral on the Petition Date was approximately 87.4% of book value or $2.147 billion. This was reduced by $1.96 billion owed to creditors senior to the second lienholders, leaving only $187 million available for the second lienholders. As the second lienholders already had realized more than that amount from the $433.5 million credit bid, Judge Drain held that they were not entitled to any further recovery based upon their super-priority claims.

The second lienholders appealed Judge Drain's decision. The District Court affirmed and the case went to the Second Circuit Court of Appeals. The Second Circuit affirmed, lauding the fact-finding and analyses of Judge Drain in the process.

The decision hinged upon the Court's interpretation of the terms "retained" and "used" with respect to the collateral. The Bankruptcy Court was required to determine whether the sale of the collateral was properly characterized as a "disposition" of the collateral or a "use" of the collateral under § 506(a) of the Bankruptcy Code. Judge Drain interpreted the words using their plain language and determined that the sale property was a "disposition of the collateral." The Second Circuit agreed with Judge Drain's determination that there were two realistic scenarios: (a) a going concern sale or (b) a forced liquidation of the collateral. Further, the Court agreed that the collateral would be valued based upon what the Debtors would likely be able to recoup from the collateral at NOLV.

The Second Circuit rejected the second lienholders argument that it should value the collateral at retail value on the Petition Date because the collateral ultimately was used in the attempted reorganization of the Debtor and was first used as inventory in the stores during the pendency of the bankruptcy cases.

This most recent Sears decision has the Second Circuit recognizing, and affirming, Judge Drain's herculean effort in both determining the appropriate valuation method, and then accurately valuing the inventory under the facts and circumstances of this case. While it appears that a reasonable outcome was reached, it is too soon to tell if this approach will be used in subsequent retail insolvency cases.

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