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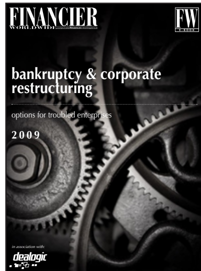

Herrick, Feinstein LLP

2009 Bankruptcy & Corporate Restructuring
options for troubled enterprises

Ultra Stores success in the Chapter 11 fast lane

BY JOSHUA J. ANGEL

A wise old attorney once said that any fool lawyer with a form book and a fountain pen can file a Chapter 11 petition for a client, but emerging from Chapter 11 with the client's skin intact is another matter entirely. This is the story of how one company found its way in and out of bankruptcy with its skin intact, when others in the same industry had failed.

Ultra Stores Inc. was incorporated and opened its first retail jewellery store in 1991. By December 2008, its footprint consisted of 105 outlet stores, 57 jewellery departments in three department store chains, three airport stores, and 16 other stores in various locations. Revenues for the three most recent fiscal years were in the $150m range, and EBITDA went from $17m in 2007 to $12.5m in 2008 and $8m in 2009. Ultra's capital structure included a $35m asset-based revolving credit agreement provided by Bank of America (BoA), and a junior secured term loan of $15m provided by Crystal Capital Fund.

By the end of 2008, borrowing under the revolving credit facility had reached about $16m, with the loan – then current – secured by a first lien on substantially all of Ultra's assets. The amount Ultra could borrow from BoA was determined by a formula that multiplied Ultra's inventory and accounts receivable by a fixed factor of their respective net values minus certain reserves as BoA reasonably mandated. Over the previous year, BoA had severely limited the amount Ultra could borrow, plunging the company into a full-fledged liquidity crisis.

When it made the pre-petition term loan, Crystal entered into an intercreditor agreement with BoA that required that Crystal provide BoA with 45 days' notice before invoking a default. In December 2008, the BoA loan was current, meaning that Crystal's loan could not be called into default until 45 days after the expected covenant-busting date of 31 January 2009. That gave Ultra a window of less than three months to organise its team, evaluate its options, and negotiate and put into effect a plan for the company's rehabilitation.

Ultra's business model

Ultra obtained its merchandise in two ways: vendor credit purchases and consignment or 'memo' purchases. Generally speaking, with credit purchases, goods are acquired from vendors on open account, with title passing on receipt and payment due at some later date. Title to consigned merchandise typically remains with the consigner, pending its sale by the consignee, and consignments must be perfected in accordance with the Uniform Commercial Code to receive full faith and credit in bankruptcy proceedings. Ultra's consignment arrangements generally required that Ultra report periodically the sale of consigned jewellery to the consigner and pay for the sold jewellery within two weeks of a reported sale. The arrangements gave Ultra the right to return jewellery that didn't sell, and allowed Ultra to delay payments until after merchandise sold. Because the consigned merchandise was not owned by Ultra, it could not be used as collateral for loans from its secured lenders. Ultra's major vendors supplied goods on both credit and consignment terms, and the continued trust and support of those vendors would ultimately prove critical for its reorganisation.

On 31 December 2008, Ultra owed its merchandise vendors $11m for open account credit purchases, and the value of its owned inventory was $50m. At that time, the company inventory, together with substantially all of Ultra's other owned assets, served as collateral for Ultra's $31m secured debt obligations to its institutional lenders, with the value of consigned merchandise at about $50m. In formulating a plan

for Ultra's reorganisation, insolvency counsel – after assuring itself that nearly all Ultra's consignment vendors had perfected their liens – advised Ultra to continue its consigned merchandise program and immediately communicate that decision to the consignment vendors to enlist them as reorganisation allies.

The plan

Counsel determined that Ultra would best be served by employing a pre-arranged bankruptcy plan in which it would seek to resolve consensually its major issues, by informal agreement with the creditors, before seeking Chapter 11 relief. Counsel then instructed Ultra to revisit its business plan and generate a series of new business plan projections employing a variety of assumptions for fiscal 2010. The plan would include debt forgiveness, flat sales, declining sales, no credit on open account, and various permutations of store closings. The new projections led to several conclusions being drafted.

Firstly, Ultra had to obtain immediate, significant rent concessions from nearly all its landlords, or immediately reduce its store count by liquidating the stores where concessions could not be obtained. Secondly, the value of Ultra's business had deteriorated so badly that Ultra's common stock was worthless, wiping out unsecured creditors in liquidation. Also, Crystal's pre-petition term loan was deeply under-collateralised, while BoA remained fully collateralised on its loan and would likely come out whole in an Ultra liquidation. It was suggested that Ultra could survive for at least three months beyond Christmas 2008 without receiving significant new merchandise, provided it made minimal cash purchases and redeployed inventory from underperforming, to-be-closed stores to the remaining viable stores. By freezing payments to its landlords and vendors and putting the Crystal term loan on payment in kind (PIK) status effective 1 January 2009, Ultra would have sufficient cash to remain viable for several months, allowing it to make timely payments of interest to its senior secured BoA loan. Ultra also would be able to continue to pay consignment vendors as consigned merchandise was sold.

Having forged an early alliance with consignment vendors, Ultra knew that those vendors who also supplied merchandise on open account would be intent on protecting the $50m of consignment merchandise held by Ultra, and would not be overly militant in negotiating terms for the settlement of their unsecured claims. Because liquidation would undoubtedly result in no distribution to unsecured creditors, it was not difficult for Ultra to convince vendor creditors to agree to settle their unsecured claims of approximately $11m for a pro-rata distribution of 18 percent of Ultra's post-reorganisation common stock and a $3m unsecured 7.5 percent payment in kind note maturing in 2013.

Ultra first met with its senior secured lender BoA in early January 2009. At that meeting, Ultra apprised BoA of its decisions to PIK pay the Crystal debt effective 1 January 2009 and freeze unsecured vendor and landlord cash payments. BoA agreed to Ultra's request that it adopt a short-term neutral stance while Ultra sought agreements for debt relief from its junior secured lender, Crystal, and its unsecured vendor and lease creditors.

Immediately following the BoA meeting, insolvency counsel – together with Ultra's senior management – stressed to Crystal that its term loan was under-collateralised. They opined that Crystal would be best served by converting a portion of the loan to equity and restructuring the payment terms on the remaining portion of the loan rather than force liquidation. Crystal's fear of loss in a forced liquidation was not the determining factor in convincing it to convert its junior secured loan into a combination of equity and a financial covenant-free PIK replacement note. It was the compelling case for future profit that Ultra and counsel put forth that ultimately convinced Crystal to think reorganisation rather than liquidation. The argument for future profitability was based on the premise that at recession's end, a leaner Ultra – featuring trimmed overhead, trade support, a manageable debt load, and a superior management team – provided an attractive investment case far more compelling than a liquidated estate.

Crystal recognised that its interests would be best served by a switch from junior secured lender to vulture investor, as sanity, commitment and the prospect of outsized future profit triumphed over fear. Crystal became Ultra's most vocal and ardent reorganisation ally, allowing for agreement regarding Crystal's debt, albeit after complicated and contentious negotiations. In general terms, the Crystal/Ultra agreement provided for the $15m pre-petition loan to be split in two, with half being a financial-covenant-free secured PIK note maturing in 2013, and the other half a debt-for-equity swap that gave Crystal 56 percent ownership interest in reorganised Ultra.

Simultaneously, Ultra successfully negotiated with virtually all its landlords rent-relief agreements conditioned upon Ultra successfully confirming the pre-arranged bankruptcy, with landlords preferring diminished rent from viable tenants to empty stores. The bankruptcy plan also provided for Ultra's post-petition management to receive 26 percent of Ultra's common stock as sweat equity, vesting over four years. The logic behind the equity grant was Ultra's need to secure the ongoing commitment of senior management as the final, indispensable ingredient for financial redemption.

With those agreements in place, BoA agreed to provide Ultra with a debtor-in-possession loan that would replace the revolving credit facility once Ultra filed its bankruptcy petition. In addition, BoA agreed that it would provide exit financing for the reorganised company, provided Ultra confirmed the bankruptcy plan before 30 July 2009.

Ultra formally filed for Chapter 11 bankruptcy relief on 9 April 2009. On July 28, Ultra confirmed its bankruptcy plan. Against a landscape of failed reorganisation attempts by Fortunoff, Friedman's, Whitehall and Christian Bernard, why was Ultra able to reorganise? Ultra built consensus and convinced its lenders, landlords and vendors to analyse, plan and execute a reorganisation before Ultra formally dove into the bankruptcy pool.

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