

Legal Update from Flagler Law Group



Our Mission is to serve the legal needs of Christian publishing organizations by leveraging focused expertise into practical solutions.

Brian Flagler founded Flagler Law Group in the spring of 2006 to serve the legal needs of publishers, designers, producers, and distributors of Christian media. With a combined 20+ years in the industry, we know Christian publishing. We believe that our experience handling matters for a diverse variety of Christian publishers, ministries, and other organizations **from the publishing perspective** significantly contributes to the value that we offer our clients.

(541) 549-8401
brian@flaglerlawgroup.com

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Family Christian Stores Bankruptcy: What It Means for Publishers

By Craig Gipson and Brian Flagler

Family Christian LLC ("Family"), the entity operating Family Christian Stores, filed for Chapter 11 bankruptcy on February 11. The case affects many members of the Christian publishing industry and its outcome may have long-lasting implications. Below is a brief summary of the case and recommended actions publishers should consider while the court determines a fair resolution for Family's creditors.

General Background

Despite being one of the largest retailers of Christian products, Family's revenues fell significantly from 2008 to 2014. In 2012, an investment group led by the trio of Richard Jackson, Larry Powell, and Michael Kendrick purchased Family and sought to obtain stable financing. Their efforts resulted in Family staying afloat but on Wednesday, Family sought protection under Chapter 11 of the Bankruptcy Code. ¹

Bankruptcy Background: § 363 Sales

In court documents filed February 12, Family proposed a sale under Bankruptcy Code section 363. A so-called "§ 363 sale" essentially allows debtors in certain scenarios to opt-out of completing the Chapter 11 reorganization process. Instead, the debtor finds an interested buyer (referred to as a "stalking horse" in bankruptcy parlance) to make an offer for the debtor's assets. This offer establishes a minimum value for the assets that can be obtained and distributed to creditors. If there are multiple interested buyers, they may bid at auction against the stalking horse's original offer and the debtor's assets are sold through a more efficient process than traditional bankruptcy. ² If approved by the court, a § 363 sale allows the buyer to acquire the debtor's assets free and clear of any existing liens and, in theory, maximizes the value of the debtor's assets to the benefit of creditors. Selecting the winning bidder and dividing the sales proceeds among creditors is typically a negotiated process involving the debtor, the court, secured lenders, and a committee of unsecured creditors. Section 363 sales are also subject to abuse. Debtors may attempt to sell assets quickly without allowing all potentially interested buyers to bid, thus allowing the debtor to emerge from the sale debt-free at the expense of its creditors. Family indicated in court documents that it intends to hire an investment banking firm for the bidding process, which on its face is a positive sign for maximizing asset value and compensating creditors.

Creditors and Family's Proposed § 363 Sale

However, the status of Family's current debt and its proposed solution are troubling for unsecured creditors such as publishers and vendors.

In its filings, Family lists two secured debts, meaning those creditors are entitled to have their entire debts satisfied before any funds are allocated to pay debts to unsecured creditors. The first secured debt is a revolving line of credit originally from J.P. Morgan Chase Bank with an outstanding balance of approximately \$23 million. The second is a secured term loan from Credit Suisse with an outstanding balance of approximately \$34 million. After secured debts, Family claims to owe an additional \$40 million in unsecured trade accounts payable (most of this amount is made up of outstanding invoices payable to publishers and other vendors). It lists among its assets \$20 million in consigned inventory (this issue is discussed more below). The problem for publishers arises when examining the proposed “stalking horse” offer in the § 363 sale. The potential buyer is offering to pay \$28 million in cash, assume approximately \$43 million in real estate leases, and assume an additional \$2 million in miscellaneous debt for a total offer close to \$73 million. In that offer, **\$28 million in cash is available to satisfy \$57 million in secured debt and \$40 million in unsecured debt.** As mentioned above, secured creditors are paid in order first; therefore Family would pay the entire \$23 million revolving line of credit and, presumably, pay the remaining \$5 million in cash to Credit Suisse against the \$34 million balance on the term loan. If approved, this would leave Credit Suisse short many millions on its secured term loan with nothing remaining for the debts owed to unsecured creditors. And, as part of the proposed sale, \$20 million of consignment inventory would be converted to an asset transferred to the buyer, with no payment to the publishers which have placed this inventory on consignment.

Problems with the Proposed Plan

Courts may refuse to approve a § 363 sale if the debtor does not demonstrate a “substantial business reason” for conducting a sale rather than completing a restructuring or liquidating plan under Chapter 11. Factors in a court’s determination may include: (1) the necessity for a speedy resolution; (2) whether there is a business justification for the stand-alone sale; (3) the likelihood of competitive bids; (4) the type of protections the buyer is seeking; and (5) who benefits from the sale. ³ Family’s justification for the sale is to offer the retailer a way forward without a debt burden that would cripple the organization as a whole. But further complicating matters is the identity of the proposed buyer, and the actual recipient of the cash in the proposed sale.

An organization called FC Special Funding, LLC purchased the secured revolving line of credit originally issued to Family by J.P. Morgan Chase. Therefore FC Special Funding, LLC is now the first secured creditor and stands to receive \$23 million if the court approves the § 363 sale. The “stalking horse” entity proposing to buy Family is an entity called FCS Acquisition LLC. Richard Jackson (and potentially other investors) is involved with the ownership of **all three entities**: Family, FC Special Funding LLC, and FCS Acquisition LLC. As Office of the United States Trustee ⁴ attorney Michael Maggio pointed out, “This man is wearing three hats . . . [i]n essence, at the moment, it would appear we’re only moving this case for the benefit of Mr. Jackson.” ⁵ Credit Suisse attorney Jennifer Hagle noted “[t]here is a significant issue of transparency in this case. The company would like to buy back the company and get rid of over \$75 million in debt. This is not an acceptable use of Chapter 11.” ⁶

Being a Proactive Publisher

The bankruptcy court will determine whether Family’s proposed § 363

sale is reasonable. In conducting its analysis, the court will consider objections which are likely to be raised by Credit Suisse, the Unsecured Creditors Committee currently being formed (see below), and other creditors such as publishers. Each publisher which has inventory on consignment with Family and/or has open trade accounts receivable with Family should evaluate how to pursue their interests, including whether to engage counsel to assist in this matter.

The 20 largest creditors as listed in Family's court filings were given the opportunity to apply to serve on the Unsecured Creditors Committee. The United States Trustee will select the members from those who apply. The Committee is entitled to engage legal counsel and financial advisors to represent the interests of unsecured creditors at the expense of the bankruptcy estate. The Committee's counsel will negotiate with Family's counsel and provide input to the bankruptcy court on behalf of unsecured creditors.

Family's agreements with some publishers are on a consignment basis. **As noted above, Family's court documents claim consignment inventory is an asset of Family.** If your organization is party to a consignment agreement with Family, we recommend retaining counsel to discuss protecting the inventory to which your organization still owns title. A group of such consignment publishers last week engaged experienced bankruptcy counsel to represent their unique interests in the case. This group welcomes additional consignment publishers to join. If your house has a consignment arrangement with Family and would like to join this consortium, please contact Allison R. Bach with Dickinson Wright at 313-223-3604 or ABach@dickinson-wright.com. We understand certain other consignment publishers have engaged their own counsel, who may be willing to add publishers to their representation as well.

If your organization is not selected to serve on the Committee, it is worth assessing whether your interests are being adequately represented by others and whether you would benefit from ready access to bankruptcy counsel who is tracking the case, is available to address questions as they arise, and can arrange for an attorney to appear on your behalf if needed. Further, each publisher creditor will complete a notice of claim and should be prepared to respond to potential preference claims ⁷, activities which often benefit from guidance from bankruptcy counsel. We have been advised some ECPA members may not have yet engaged bankruptcy counsel in this matter and would desire to do so in a cost-sharing arrangement. If your house is interested to explore such an arrangement, please contact Brian at 541-549-8401 or brian@flaglerlawgroup.com. We have identified experienced bankruptcy counsel available to assist non-consignment publishers on a cost-sharing basis if desired.

Publishers have an additional legal protection which, to be effective, **requires very prompt action.** Bankruptcy law includes a reclamation provision potentially allowing publishers to recover inventory recently shipped to Family. If Family received any inventory from your organization in the 45 days preceding February 11 (the date Family filed its bankruptcy petition), you may provide written notice of your intent to reclaim such inventory. In order to be effective, Family must receive your notice no later than March 3, 2015 (20 days from the date Family filed its petition). ⁸ A secured creditor (such as Credit Suisse in this case) may have the right to block your reclamation of inventory. However, even if your organization is unable to reclaim its inventory, you may still submit a claim for the invoice value of the inventory received by Family within 20 days before the petition date. ⁹ This claim

places your organization ahead of secured creditors for the value of that inventory. Consignment publishers especially should promptly consult with counsel regarding filing a reclamation claim for inventory.

Ongoing Sales to Family

Under these circumstances, publishers naturally evaluate whether to continue to sell product to a bankrupt retailer on credit. This is a decision which each publisher must make independently and which ECPA will not, as a policy, provide any recommendations. The proposed § 363 purchase agreement currently includes a provision by which the buyer agrees to pay for any trade accounts payable incurred between the bankruptcy filing date and the date of the sale. We interpret this provision as intending to encourage publishers to continue to sell to Family on credit, expecting to be paid by the buyer. We simply note that this provision, and the sale as a whole, may or may not be approved and/or become effective. As such, each publisher is advised to consider how it will do business with Family going forward, and to discuss this decision with your counsel as you deem appropriate.

This update is not intended to serve as legal advice and therefore does not replace the need for each organization to discuss these matters with counsel.

1 Chapter 11 allows for organizations to restructure debt as opposed to liquidating under Chapter 7.

2 You may be familiar with § 363 sales from the 2008 recession in which finance giant Lehman Brothers Holdings Inc. became the largest debtor to escape bankruptcy under the provision. To illustrate the potential efficiency of the process, Lehman, with its pre-petition assets of \$639 billion, sold its brokerage division to Barclays five days after filing its bankruptcy petition.

3 *In re Gulf Coast Oil Corp.*, 404 B.R. 407 (Bankr. S.D. Tex. 2009) (the court rejected a § 363 sale because the debtors sought a release and the elimination of successor liability; creditors would be better served by a Chapter 11 process).

4 The Office of the United States Trustee is responsible for overseeing Chapter 11 cases to ensure compliance with the Bankruptcy Code. The Trustee's Office does not have prosecutorial authority but is required by law to report "reasonable grounds for believing that a violation" of the Bankruptcy Code has occurred. 18 U.S.C. § 3057.

5 Jim Harger, *With \$75 million on the line, creditors question rescue plan for Family Christian Stores*, MLIVE, February 17, 2015, http://www.mlive.com/business/west-michigan/index.ssf/2015/02/with_75_million_on_the_line_cr.html

6 *Id.*

7 Preference claims are made by the bankruptcy estate against vendors, claiming a vendor received payments or returns of inventory during the 90 day period leading up to the bankruptcy which exceeded, on a pro rata basis, the amount received by other similarly situated creditors.

8 11 U.S.C. § 546(c)(1) (2015)

9 11 U.S.C. § 503(b)(9) (2015)



www.ecpa.org
info@ecpa.org

This update is provided as an informational service of ECPA to its members and does not serve as, and should not be understood to provide, legal advice. Please contact [Brian Flagler](#) or your attorney if you would like to discuss application of this update to the specific circumstances of your publishing organization.

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