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A Not So Merry Christmas for Retailers

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As the worst Christmas shopping season in years continues to unfold, retailers are faced with a host of business, financial and legal threats, including a version of chapter 11 that is far less hospitable to debtors than in past years. Nevertheless, financially distressed retailers can still utilize chapter 11 to maximize stakeholder recoveries, provided they can navigate the tight timeframes and overcome the additional burdens imposed when the Bankruptcy Code was amended three years ago. Astute retailers may also use this crisis as an opportunity to revolutionize their business models.

Business and Financial Problems Faced By Retailers

Many retailers took on excessive debt to fund expansion or acquisitions when credit terms were easy. During the last 12 to 18 months, as the financial crisis has gathered steam and the economy has gone into recession, retailers' financial results and business prospects have deteriorated. Now, retailers appear to be facing their worst Christmas season in many years due to ongoing effects of the financial crisis, and the resulting recession, layoffs, foreclosures and cutbacks in consumer spending. Luxury goods, home furnishings and apparel have been particularly hard hit.

Unfortunately, retailers can no longer turn to the credit markets to fund their liquidity needs during this business downturn, because debt has been downgraded, defaults have risen, yields have soared and credit has dried up. In fact, even before the troubles of Lehman Brothers and other financial institutions exacerbated the financial crisis in September 2008, most retail chapter 11 cases this year ended in liquidation, including Mervyn's, Linens 'n Things, Steve & Barry's, Whitehall Jewelers and Friedman's.[1] Many other retailers have announced significant store closings.

In years past, if they survived this far into the year, retailers were usually able to obtain sufficient credit to get them through the Christmas shopping season. If chapter 11 was still necessary, retailers generally waited to file until after the lucrative Christmas season, when they would be flush with cash. However, some retailers such as Circuit City have been unable to await Santa's bounty and filed for chapter 11 protection on November 10, 2008. In light of the financial crisis, all companies are having trouble getting financing, including DIP financing. Retailers will soon be entering their slowest season and may not be able to obtain continued credit support to restock their shelves and continue operating.

Almost all of the big retail chains that filed chapter 11 this year were owned by private equity (PE) firms. In many cases, PE firms layered debt on the retail operations to effectuate the LBO and generate cash to pay dividends and fees to the PE sponsors. In the case of Mervyn's, PE firms stripped out the real estate into a separate entity depriving the retail operations of valuable assets that could have been used to stay afloat. This financial engineering did nothing to strengthen the businesses and left the retailers with little margin for error, compounded their operational problems and thereby hindered efforts to obtain new money.

Distress in the retail industry has many harmful spillover effects especially for mall operators, suppliers, lenders and consumers. Moreover, reduced sales tax collections and retail layoffs will further strain budgets of municipalities.

Legal Problems Faced By Retailers

Adding insult to injury, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), most of whose provisions took effect in October 2005, has

made chapter 11 reorganizations more difficult and more expensive, especially for retailers. Provisions contributing to increased costs include (1) a new administrative expense claim for the value of any goods received by the debtor within 20 days before the commencement of the case; (2) the expansion of the right to reclaim goods shipped while the buyer was insolvent, including increasing the reach-back period from 10 to 45 days and eliminating the ability to deny reclamation by granting an administrative expense or lien; (3) the bolstering of the rights of utilities, including the requirement that adequate assurance of payment be a cash deposit, a letter of credit, a certificate of deposit, a surety bond, a prepayment of utility consumption or another form of agreed security, rather than merely granting an administrative expense under prior practice; (4) administrative expense status for *ad valorem* taxes; and (5) an increase in the priority portion of employee wage and benefit claims.

Even more critical for retailers is BAPCPA's new limit of 210 days on the debtor's deadline to assume or reject leases. If the lease is assumed within that timeframe and then subsequently rejected, landlords will have a damage claim capped at two-year's rent, but such damage claim will be entitled to administrative expense status.

These new provisions serve to decrease debtor liquidity, thereby jeopardizing reorganization prospects. Administrative expenses must be cashed out on confirmation of a plan, whereas holders of secured debt can be stretched-out, and so will continue to bear the risk that the reorganized debtor fails. Under a 363 sale, however, liens attach to the proceeds of sale and lenders are likely to be paid at the closing. As a result, BAPCPA provides an incentive for secured creditors to pressure debtors to engage in 363 sales to mitigate the value that would otherwise have to be shared with other constituencies.

Recognizing that the best place to liquidate their collateral is in the borrower's existing stores, BAPCPA encourages senior lenders to push for liquidation if a deal cannot be struck in the first few months of the case, so that going out of business (GOB) sales can be completed within the 210-day deadline to assume or reject leases. This shortened deadline also undermines creditor support and recoveries by inhibiting the debtor's ability to monetize leases for non-essential stores.

How Chapter 11 Can Still Maximize the Value of Distressed Retailers

Notwithstanding the constraints imposed by BAPCPA, chapter 11 still provides advantages for distressed retailers, their creditors and parties interested in acquiring assets from distressed retailers. Distressed retailers need access to capital, and an opportunity to de-leverage their balance sheets, cut costs, effect operational changes, shed underperforming assets and explore M&A transactions. Before BAPCPA, chapter 11 provided ample time to implement all of these solutions. In fact, it was not uncommon for a retailer to file chapter 11 soon after Christmas, take some time to implement a new business plan, and then test drive its modified business plan through at least one if not two Christmas seasons to ensure that the reorganized company would emerge from chapter 11 strong enough to face reasonably anticipated business risks. Unless the Bankruptcy Code is amended next year, which is a distinct possibility, BAPCPA no longer provides present day retailers with the luxury of time enjoyed by their counterparts during the last downturn.

Nevertheless, while the Grinch may be stealing Christmas, chapter 11 still offers some solace to troubled retailers and their creditors. If the business is viable, retailers in financial distress can use chapter 11 to restructure not just their balance sheets but also their business operations (assuming the retailer is strong enough to obtain financing), or alternatively to pursue M&A transactions. Operational changes could run the gamut from rejecting leases of underperforming stores to closing all stores and becoming an online retailer. M&A transactions can be of either whole businesses or non-core assets and can also include engaging in sale-leaseback transactions to enhance liquidity. Of course, in light of the 210-day deadline to assume or reject leases, distressed retailers will have to act quickly to analyze their leases and negotiate an M&A transaction before the impending lease assumption deadline causes lenders to insist on implementation of a GOB sales program. If the business operations can be restructured, then debt can be swapped for equity under a plan of reorganization to de-leverage the balance sheet.

If some stores are viable, retailers can use chapter 11 to do a quick section 363 sale of viable stores on a going concern basis to a stronger competitor or private equity firm interested in rolling up the industry. Thereafter, any remaining assets can be liquidated. If the business cannot be saved, retailers can still use chapter 11 to perform an orderly liquidation to maximize recoveries and avoid a fire sale.

Notwithstanding adverse changes under BAPCPA, retailers in financial distress can still use the framework of chapter 11 to negotiate settlements with secured

lenders, bond holders, suppliers, landlords and other constituencies. Chapter 11 also opens other avenues to enhance creditor recoveries including the ability to avoid unperfected liens, recover preferences and fraudulent transfers and pursue other litigation claims. Section 502(b)(6) of the Bankruptcy Code limits landlord rejection damage claims to the greater of (a) one year's rent or (b) 15% of the remaining term not to exceed 3 years, thereby enhancing recoveries for other constituencies.

As over-leveraged retailers liquidate or close stores, their better capitalized competitors will have opportunities to strengthen their positions through internal growth and acquisitions, and well-capitalized investors may be able to shop for retail assets at bargain prices. Holders of the senior debt may also be interested in acquiring the assets, as they have the advantage of being able to "credit bid" the face amount of the their secured debt in a bankruptcy sale, provided that such debt is "in the money." A prospective buyer who wants to minimize its exposure to competing bidders may want to consider purchasing the senior secured debt at a discount from an institutional lender looking to protect its downside, and then credit bid at auction using the face amount of the secured debt, even though purchased at a discount. The right of secured creditors or their assignees to credit bid may, however, chill the bidding because other bidders will have to pay cash. Parties interested in acquiring assets from distressed retailers may well want to consider consummating the transaction under section 363 of the Bankruptcy Code or a chapter 11 plan to obtain the benefits of a "free and clear" order and insulate the transaction from challenge as a fraudulent transfer.[2]

The Financial Crisis May Provide An Opportunity To Revolutionize Business Methods

The carnage in retailing may portend new retailing models with more resilient cost structures. For example, The Sharper Image liquidated all of its stores. However, the brand will still live on as the company's new owners (Hilco Consumer Capital, Gordon Brothers and Bluestar Alliance) pursue licensing arrangements for the brand and develop a website for internet-only marketing.

We may also see a shift away from traditional bricks and mortar retailing. While there will continue to be certain retailers that need to have a physical presence with goods on hand (e.g., supermarkets), other retailers, such as clothing and house wares, may want to switch to a showroom format. In the showroom, goods can be displayed and tried on. However, instead of walking out with the purchase, the item would be ordered online (either in the store or at home) and be shipped directly to the customer. While this would not eliminate the bricks and mortar, it would cut operating, working capital, transportation and shipping costs significantly. The increasingly pervasive internet shopping by consumers is likely to continue to change the traditional retail model as the industry adjusts to the new landscape.

For those retailers that survive this cycle, and for new retailers that may emerge, the dark clouds may have a silver lining. There is likely to be excess retail property available for a long time. This means that pricing will be depressed for the foreseeable future. Those retailers that are able to take advantage of this will be better prepared to weather the next storm.

Conclusion

In short, while the retail industry faces many perils, and notwithstanding the adverse changes wrought by BAPCPA, distressed retailers and their creditors can still use chapter 11 to salvage value and enhance recoveries. Parties interested in acquiring assets from distressed retailers may use chapter 11 to go bargain shopping but still be assured of obtaining clean title free of creditor claims. The current problems faced by the retail industry may force drastic but ultimately beneficial changes to business models and provide opportunities for entrepreneurial retailers and investors.

About the Authors

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[1] Mr. Kajon is lead counsel to Friedman's Inc. and its subsidiary Crescent Jewelers in their chapter 11 case pending in Delaware. Mr. Buchwald is sole director of Friedman's Inc. and its subsidiary Crescent Jewelers.
[2] For a discussion of the advantages and disadvantages of utilizing bankruptcy for distressed M&A transactions, see generally Kajon, Credit Crisis Limits Options for Troubled Companies: The Coming Rise in Distressed M&A, May 8, 2008, available at http://www.stevenslee.com/news/bankruptcy/Distressed_M&A_0508.pdf