# Weathering the Storm

## Retailers need to act quickly to survive the financial crisis

By Nicholas F. Kajon and Lee E. Buchwald

In the wake of one of the worst Christmas shopping seasons in years, and an economic crisis that transcends retailing, many industry observers predict a rash of Chapter 11 bankruptcy filings under rules that are far less hospitable to debtors than in past years.

Nevertheless, financially distressed retailers can still use Chapter 11 to maximize value, provided they address their problems early enough to be able to navigate the tight time frames 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.

The 2005 amendments to the Bankruptcy Code (BAPCPA) made Chapter 11 reorganizations more difficult and more expensive, especially for retailers. The most troubling change for retailers is the new limit of 210 days on the debtor's deadline to assume or reject leases. If the lease is assumed within that time frame and then subsequently rejected by the retailer, landlords will have an administrative claim for damages up to two-year's rent.

These new provisions serve to decrease debtor liquidity, thereby jeopardizing reorganization prospects and undermining creditor support. 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 leases. This shortened deadline also undermines the debtor's ability to monetize leases for non-essential stores.

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 merger and acquisitions transactions. Before BAPCPA, Chapter 11 provided ample time to implement all of these solutions. In fact, it was not uncommon for a retailer in Chapter 11 to test-drive its modified business plan through at least one, if not two, Christmas seasons. BAPCPA no longer provides present-day retailers with the luxury of time enjoyed by their counterparts during the last downturn.

**All is not lost:** Notwithstanding the constraints imposed by BAPCPA, Chapter 11 still provides opportunities to restructure balance sheets and business operations, 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 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 going-out-of-business sales program.

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 avoid a fire sale.

**Business models:** The carnage in retailing may portend new retailing models with more resilient cost structures. For example, we may 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), others may want to switch to a showroom format. Though this tactic would not eliminate all bricks-and-mortar, it would cut operating, working capital, transportation and shipping costs significantly.

The increasingly pervasive Internet shopping is likely to continue to change the traditional retail model as the industry adjusts to the new landscape.

For the 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 and thus depressed pricing for the foreseeable future. Those retailers that are able to take advantage of this will be better prepared to weather the next storm. ■

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