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GUEST COMMENTARIES

Retailers Should Act Quickly to Survive the Financial Crisis

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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 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 (BAPCPA) 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. In fact, even before the troubles of Lehman Brothers and other financial institutions exacerbated the financial crisis in Sept. 2008, most retail Chapter 11 cases this year ended in liquidation. Many other retailers have announced significant store closings, and all companies are having trouble getting financing.

Legal problems faced by retailers:

Adding insult to injury, the 2005 amendments to the Bankruptcy Code 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, 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.

How Chapter 11 can still maximize value for distressed retailers:

Notwithstanding the constraints imposed by BAPCPA, Chapter 11 still provides advantages for 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 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.

Nevertheless, while the Grinch may be stealing Christmas, Chapter 11 still offers some solace to troubled retailers. 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, 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 GOB sales program.

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 avoid a fire sale.

The financial crisis may provide an opportunity to revolutionize 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), other retailers may want to switch to a showroom format. While this would not eliminate all 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 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.

Conclusion:

In short, while the retail industry faces many perils, and notwithstanding the adverse changes wrought by BAPCPA, distressed retailers can still use Chapter 11 to salvage value and enhance value, provided they address their problems early enough. 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.

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