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The Year Brick & Mortar Got a Bankruptcy Makeover

What Fashion and Luxury Goods Companies Need to Know About Restructuring and Bankruptcy

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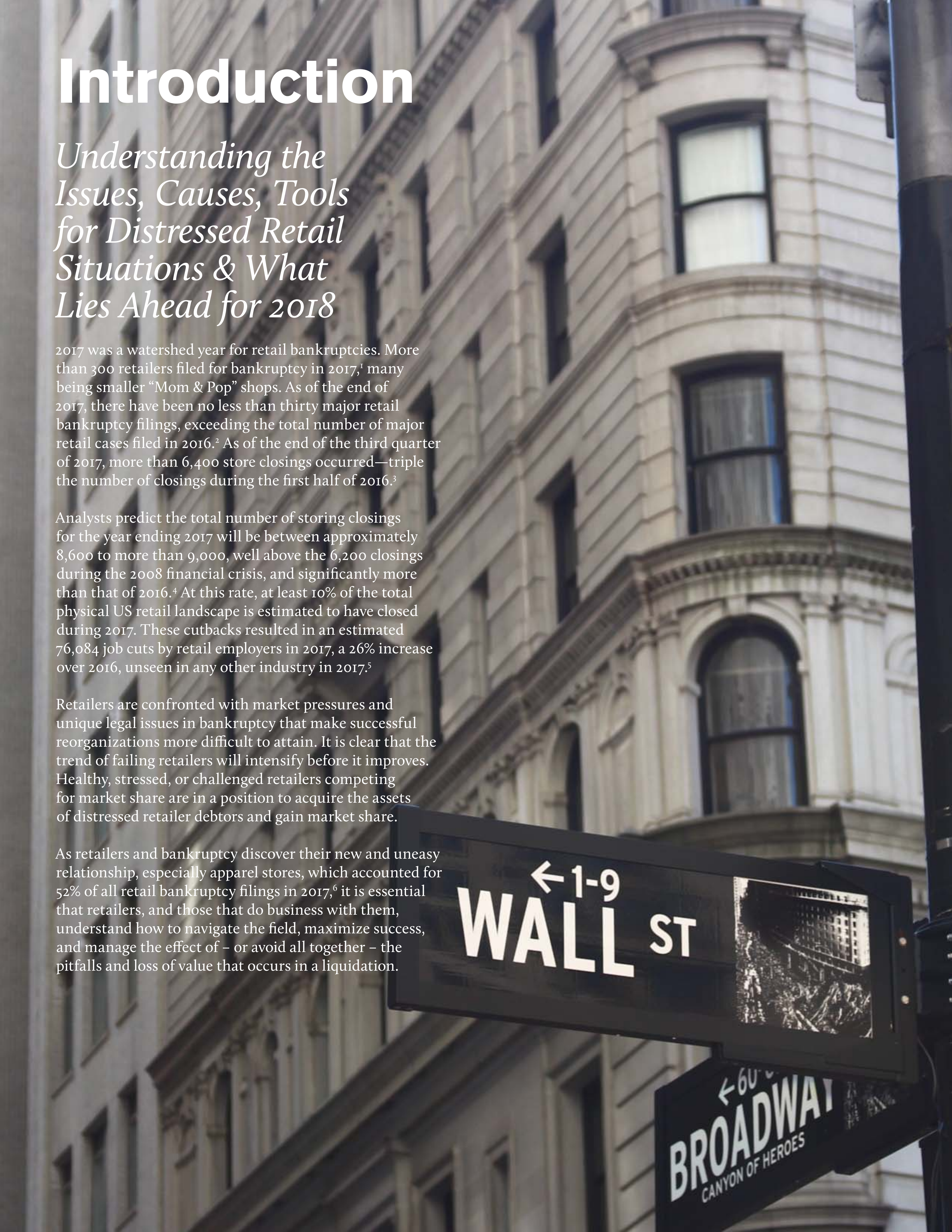


Introduction

Understanding the Issues, Causes, Tools for Distressed Retail Situations & What Lies Ahead for 2018

2017 was a watershed year for retail bankruptcies. More than 300 retailers filed for bankruptcy in 2017,[1] many being smaller "Mom & Pop" shops. As of the end of 2017, there have been no less than thirty major retail bankruptcy filings, exceeding the total number of major retail cases filed in 2016.[2] As of the end of the third quarter of 2017, more than 6,400 store closings occurred—triple the number of closings during the first half of 2016.[3]

Analysts predict the total number of storing closings for the year ending 2017 will be between approximately 8,600 to more than 9,000, well above the 6,200 closings during the 2008 financial crisis, and significantly more than that of 2016.[4] At this rate, at least 10% of the total physical US retail landscape is estimated to have closed during 2017. These cutbacks resulted in an estimated 76,084 job cuts by retail employers in 2017, a 26% increase over 2016, unseen in any other industry in 2017.[5]

Retailers are confronted with market pressures and unique legal issues in bankruptcy that make successful reorganizations more difficult to attain. It is clear that the trend of failing retailers will intensify before it improves. Healthy, stressed, or challenged retailers competing for market share are in a position to acquire the assets of distressed retailer debtors and gain market share.

As retailers and bankruptcy discover their new and uneasy relationship, especially apparel stores, which accounted for 52% of all retail bankruptcy filings in 2017,[6] it is essential that retailers, and those that do business with them, understand how to navigate the field, maximize success, and manage the effect of – or avoid all together – the pitfalls and loss of value that occurs in a liquidation.

Trends in Retail Bankruptcies

Retailers grabbed headlines in 2016 as many filed for bankruptcy or underwent out-of-court restructurings. Significant bankruptcy filings of 2016 include:

- Aéropostale
- American Apparel
- Backwoods Retail
- DirectBuy
- Draw Another Circle (Hastings)
- El Piex Puertorriqueño (A la Orden Discount)
- Fairway Group Holdings
- Golfsmith International Holdings (Golfsmith and Golftown)
- Gracious Home
- Hancock Fabrics
- Joyce Leslie
- Komodidad Distributors (Gatsby)
- Nasty Gal
- Pacific Sunwear of California
- Sports Authority
- Southern Season
- Total Hockey
- Vestis Retail Group (operator of Eastern Mountain Sports, Bob's Stores, and Sport Chalet)
- Windsor Financial Group (operator of ASICS retail stores)
- Yogasmoga

2017 saw the continuation of this trend and no signs of letting up as major retailers continue to file for bankruptcy. Significant bankruptcy filings of 2017 include some of the most well-known retailers:

- AA Florida Bridal Retail Company (Alfred Angelo) (chapter 7)
- Aerogroup International (Aerosoles)
- BCBG Max Azria
- B. Lane Inc. (Fashion to Figure)
- Calypso St. Barth
- Charming Charlie
- Cornerstone Apparel, Inc. (Papaya Clothing)
- David Orgell
- Eastern Outfitters (Bob's Stores and Eastern Mountain Sports)
- Gander Mountain
- General Wireless Operations (Radioshack)
- Gordmans Stores
- Gymboree
- HHGregg
- I.O. Metro, LLC (Erdos at Home)
- Marbles: The Brain Store
- Michigan Sporting Goods Distributors (MC Sports)
- Model Reorg Acquisition (Perfumania)
- Payless ShoeSource
- rue21
- Shiekh Shoes
- The Sports Zone
- Styles For Less
- Tanner Companies (Doncaster)
- Toys "R" Us
- Vanity Shop of Grand Forks (Vanity)
- Velocity Holdings
- Vitamin World
- Wet Seal

The 2017 holiday season was one of the most profitable for retailers since the last recession with sales rising 5.5% to $691.9 billion during the last two months of 2017, but still trailing the growth of e-commerce, which saw a 11.5% jump in sales.[7] Even with the strong holiday season, many predict that 2018 will continue to be a busy year for restructuring of retailers, especially those that are highly leveraged.[8] The first few weeks of 2018 have already seen bankruptcy filings by fast-fashion retailer A'GACI, cosmetics brand KIKO, and in-store retail marketing firm Windsor Marketing Group, all blaming their filings on changes in the retail industry.

Retail debtors encounter unique obstacles when attempting to restructure. This trend is confirmed by studies that analyzed samples of recent retail bankruptcy cases.

In 2015, Fitch Ratings published the results of a study of 93 retail bankruptcy cases filed after the 2006 implementation of the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCA").[9] The study found that 47% of all resolved retail bankruptcy filings ended in liquidation.[10] Of the 93 retailers included in the study, only 49 emerged as a going concern, with 13 of those retailers subsequently re-entering bankruptcy.

In a more recent 2016 study by Fitch, 30 retail bankruptcies were analyzed.[11] That study found that, "[d]efaults resulted from shifts in consumer spending toward services and experiences, increased discounter and online penetration, and declining mall traffic, all of which have created a highly competitive retail environment. Retailers have also suffered from the ebb and flow of brand popularity. Negative comparable store sales (comps) and fixed-cost deleverage led to negative cash flow, tight liquidity and unsustainable capital structures."[12] The study established that the trend in retail bankruptcies (more likely than not) to end in liquidation continues (50% liquidating, compared to 17% for non-retail corporate bankruptcies), typically caused by competitors either offering the same merchandise at a better price or from brand degradation.

In a similar study, AlixPartners analyzed all resolved retail bankruptcy filings from January 1, 2016 to October 20, 2017 that had more $50 million in liabilities.[13] The study found that 45% of such bankruptcies ended in liquidation, 38% ended in bankruptcy sales (essentially equivalent to a liquidation), and only 17% resulted in reorganization.[14]

Based on this research, bankruptcy cases of retail debtors are more likely than not to end in liquidation or sale. Consider, for example, the recent bankruptcy of well-known retailer Sports Authority—although it filed for bankruptcy intending to reorganize, it ultimately liquidated.[15] Obviously, not all bankruptcy cases are the same and not every retail debtor will end up liquidating. Yet there is an undeniable trend that retailers are highly susceptible to financial distress, will enter chapter 11 bankruptcy, or even chapter 7,[16] and be steered toward liquidation.

At the outset, this report considers the pressures creating distress for retailers in the first place. Then we will consider the actors and applicable legal provisions in the Bankruptcy Code[17] that exacerbate or relieve their propensity for failure.

The Effect of Tax Reform on Retail Debtors

In December 2017, US Congress passed sweeping tax overhaul legislation, known as the Tax Cuts and Jobs Act, which will have serious ramifications for retail debtors, both good and bad. Benefitting retailers is the portion of the Act which replaces the prior-law graduated corporate tax rate, which taxed income over $10 million at 35%, with a flat rate of 21%.[18]

However, corporations which previously benefitted from unrestricted interest deductions now face a cap of 30% of their 12-month earnings before interest, taxes, depreciation, and amortization (EBITDA).[19] After 2021, the 30% cap will be limited to earnings before interest and tax.[20] The deductibility cap will cause distress to highly leveraged retailers and likely discourage leveraged buyouts, or require private equity to put more skin in the game by providing more cash as equity to fund acquisition.[21] "S&P Global Ratings estimates that nearly 70 percent of companies whose debt amounts to more than five times EBITDA would be negatively impacted by the interest deductibility cap."[22] An early 2017 study by Ernst & Young of 111 retailers and sellers of consumer products found that the average retail company had an EBITDA margin of 8.8%, well above the 5% S&P believes will be negatively impacted by the Tax Cuts and Jobs Act.[23]

As a result of these changes, profitable retailers with low debt should have greater free cash flow, potentially allowing them to dominate their competition. Unused interest deductions may be carried forward to future years indefinitely. But under the Tax Cuts and Jobs Act, net operating loss carryovers may only offset up to 80% of the taxpayer's income, thus limiting the value of the carryovers.[24]

Industry-Specific Pressures and Evolving Trends

Shifts in consumer preferences, changes in demographics, marketing demands, financial assumptions, and delicate supply chains are only a few of the many industry-specific market pressures faced by retail debtors. Understanding these pressures and employing strategies to overcome such pressures is key. Industry-specific pressures increase the probability of retail debtors entering bankruptcy and make it difficult for retail debtors to emerge from bankruptcy.

Shifts in consumer preferences are no more apparent than in the increasing market share of online retailers such as Amazon and Zappos. Online apparel sales increased 12% in the 12 months ending November 2016, with Amazon "the biggest online seller of apparel in the US," outpacing its brick and mortar competition.[25] In the second half of 2017, retail sales rose from 1.5% in the first half of the year to 2.5%, paling in comparison to e-commerce's expected 14% gain.[26] "Competition from newer, on-line retailers – E-commerce's share of US retail sales has increased from 5% in 2010 to almost 12% in 2016, and is projected to reach 15-17% by 2020."[27]

Even traditional brick and mortar retailers are being forced to grow their e-commerce sales. The CEO of GAP Inc. has stated the importance of partnering with and selling its products on Amazon's platform.[28] In 2017, Nike announced that it is testing a partnership with Amazon as, "part of an effort to revamp its sales tactics as brick-and-mortar retail continues to suffer."[29]

In fact, many retail debtors that filed for bankruptcy now operate *exclusively* online.[30] Recognizing this trend, BEBE recently closed its physical stores and set forth plans to pivot its business on e-commerce.[31] Similarly, The Limited announced in early 2017 that it would no longer operate stores, closing all 250 of its physical retail locations in 42 states, along with its website, filing for bankruptcy shortly thereafter.[32] As part of the bankruptcy proceedings, Sycamore Partners announced it had purchased The Limited's brand and website, relaunching the brand's website in late 2017 – sans stores – promising to communicate with The Limited's loyal customers about how to obtain the merchandise "they know and love."[33] Sycamore continued this approach with Coldwater Creek, acquiring the brand and re-launched the retailer as an online catalogue store.[34]

The head of retail research at Cushman & Wakefield believes that, "[m]ost of the retailers that are struggling still have loyal core consumers, they just don't have enough of them. [I]f a brand is a household name, or if it has a positive reputation or brand cachet, it will be a candidate for . . . [digital focus]. Someone will eventually buy the intellectual rights for many of these brands and eventually they will start popping up online."[35]

While the market push is for e-commerce, storefronts remain vitally important, and "[i]n 2016, apparel stores became a destination for *experiences* rather than simply for buying clothes."[36] "There is a set of customers that wants to touch the product."[37] Even "[p]ure e-commerce players are opening stores, understanding the synergy of being on all distribution platforms."[38] By way of example, as of the end of 2017, Amazon had 13 brick and mortar book stores, with no less than three more expected to be opened in the near future.[39] During 2017, Amazon also completed an acquisition of Whole Foods, immediately decreasing the price of some items by 40%, increasing competition and platform to sell its products, possibly leading to disruption in the grocery retail segment.[40]

This trend can also be seen by e-commerce startups which have expanded to brick and mortar. Bonobos began as an online-only men's retailer in 2007, but has since opened over 30 "guideshops" where employees are available to assist customers.[41] Bonobos has also integrated an in-store technology platform that manages the entire shopping process, allowing employees to use mobile devices to provide style and fit guidance, and quickly find products, inventory, and customer information.[42] Bonobos's Chief Experience Officer has stated, "Our goal is to extend the relationship between guide and customer beyond four walls . . . allowing an even easier process to follow up with customers, as well as increase in-store and at home conversion."[43] Similarly, Warby Parker, which was founded online and opened its first physical store in 2013, expected to open 25 physical stores in 2017, in additional to its approximately 50 stores at the start of 2017.[44] As of the end of 2017, Warby Parker has no less than 65 brick and mortar stores. Warby Parker's co-founder stated, "I don't think retail is dead. Mediocre retail experiences are dead."[45]

Another shift is the declining appeal of department stores.[46] Consumer demand for specialty stores—or standalone brand stores—has replaced demand for department stores that carry standalone brands as well as other brands. As an example, the trend is for the *standalone* Burberry store, as opposed to a department store that carries Burberry as well as other brands. "In an effort to both break away from the sea of sameness found in so many department stores, and to better control their own brand identity, brands intensified their own direct-to-consumer efforts across all channels."[47] Department stores struggling to face this changing industry include Sears Holdings, Bon-Ton Stores and Neiman Marcus Group, all of which are on the S&P list of highest-risk companies with negative outlooks.[48]

Changing demographics is another force behind the shift. The impact of millennials—the only demographic with growing wealth and disposable income—requires retailers to employ "omni-channel marketing" through the use of new technology, such as interactive touchscreen kiosks, virtual fashion mirrors, bar-scanned videos, interactive dressing rooms, real-time in-store coupons, and personalized recommendations.[49] They are looking for "frictionless and entertaining shopping experiences."[50] Even the up-and-coming "Generation Z," known as "the optimization generation, rel[y] on technology to bring efficiencies to everyday lives."[51] To meet the challenge, retailers need not look further than Apple, which provides shopping experiences that meet these new needs and expectations.[52] An Apple store alone has been credited with leading to a 13% increase in a mall's sales per square foot.[53] Retailers failing to adjust are more susceptible to failure.

Marketing demands are changing as well. Rather than "try[ing] to please all of the people all of the time," retailers must "reflect an individual point of view."[54] Take, for example, the ability to allow customers to "scan[] a barcode of a dress in a Burberry store that triggers a video of the designer narrating the story of what inspired him and how and where the dress was made[.]"[55] Retail has also utilized influencers on social media as part of their marketing strategy.[56] "The concept of using influencers as a way to reach customers is no longer up for debate . . . . It has become the norm within retail. In fact, the trend has become so elevated that the top-tier influencer is no longer just acting as the face of the brand but also collaborating on designs."[57] Retailers have also tailored their stores for "experiences" beyond just shopping. For example, active wear retailer Lululemon turned certain of its stores into studios, where shoppers can take yoga classes taught by an instructor.[58]

Another recent trends includes the "increase in retailers . . . putting their brands on other [retailers'] platforms, like J. Crew placing its brand on Nordstrom's platform."[59] However, as discussed above, retailers are also placing their goods on e-commerce sites, such as Amazon, thereby fueling their competition to survive, potentially leading to their ultimate demise.

Shifts in consumer spending and cyclical trends require adjustments to assumption-laden business models of retailers. As an initial matter, the fixed costs for physical space, inventory, and personnel, in conjunction with the evolving demands of fickle consumers, create inherent vulnerabilities within the retail business model. Indeed, retail debtors depend on significant cash flow generated during the holiday season to support the slower months of the cycle. Precipitating this fragile model is the combination of high leverage and the cyclical nature of retail.[60] Accounting for such cycles requires reliance on many financial assumptions, and one misplaced assumption, such as a pick-up in sales that never materializes, is enough to cause a liquidity crisis.[61] Almost all bankruptcy cases of retail debtors are attributable, at least in part, to misplaced assumptions and projections.[62]

In the competitive retail market, retailers are susceptible to "price wars" that ignite a "race to the bottom."[63] In a competitive market full of price-sensitive consumers, retail debtors are tempted to provide "value" through lower prices, which comes with shrinking profit margins. From the retailer's perspective, the strategy is "temporary" and the resulting increase in sales volume will offset the shrinking profit margins. But these retailers fail to recognize that this strategy provides fertile grounds to ignite a "race to the bottom" as competitors follow with lower prices. As even healthy retailers are compelled to lower prices, the strategy presents a "zero-sum game" with all competing retailers struggling to survive. "As they struggle to survive, distressed retailers can take more desperate measures, including highly promotional pricing that can border on irrational."[64] As an example of this irrational behavior, is a push for a "loss-leader" strategy—in effect, selling products at a loss to stimulate the sales of profitable products. "This leaves stronger firms with the choice of either competing in a race to the bottom, or giving up sales in order to preserve margin."[65] In the end, all retailers feel the pressure.

Despite the rocky terrain, some landlords are managing to hold their own. Simon Property Group's Q4 2017 results beat analysts' expectations. Although tenant occupancy was slightly down at the end of 2017, Simon saw its revenue rise by 0.1%, lowered its borrowing costs, and showed a profit of $571.1 million, or $1.84 a share, compared with $394.4 million, or $1.26 a share, in the same quarter a year earlier.

Nonetheless, the much vaunted "death" of retail poses a potential systemic risk to landlords depending on the portfolio of properties held by such landlords, and the ratings of their holdings. Malls are graded from A++ to D, and are based on sales per square foot per retailer, and other significant factors.[66] One study of Atlanta malls found that an A++ rated mall can bring in sales of $1,000 or more per square foot, while a C rated mall may be closer to $240 per square foot.[67] Additionally, A++ rated mall tends to see close to 100% occupancy, while a C rated mall may be closer to 80%.[68] Based on the holdings in a real estate portfolio, landlords and REITs, which own about half of America's malls, hold more lower rated holdings are susceptible to systemic risk from ongoing retail bankruptcies.[69]

These shifts have caused the value of certain shopping malls to decrease.[70] Some landlords have handed over ownership to lenders, rather than attempt to restructure debts on properties with darkening outlooks.[71] A sign of an impending "correction," "[r]etail square feet per capita in the United States is more than *six* times that of Europe or Japan."[72] The retail industry, "not unlike the housing industry, saw too much square footage capacity added in the 1990s and early 2000s."[73] "The top-rated shopping meccas in the country have flourished, while hundreds of others closed or turned into "zombie malls," after a downsizing of national retail chains left certain malls vacant or desperate to fill space with local chains and non-retail tenants. This has created an unwillingness to open new malls—only six [as of 2015,] have opened since 2006[.]"[74]

Landlords have not been sitting idly, instead adapting to reinvent the mall experience. A++ rated malls have diversified its anchors away from department stores to include restaurants and tech-heavy stores, such as Microsoft, Apple and Tesla.[75] The shift away from department stores has antiquated traditional mall developments premised on providing rent subsidies to department stores or "anchor stores" that were relied upon by their "non-anchor" counterparts to attract consumers. Confirming such shift are studies revealing that specialty stores are replacing 54% of "anchor" space, and that from 2005 to 2015 department store sales dropped 10% and specialty store sales increased 33%.[76] Since 2013, big-name department stores, including Macy's, Sears, J.C. Penney and Dillard's, well known "anchor stores" have collectively closed a total of 700 stores.[77] Sears announced it will be closing over 100 more stores in 2018; Macy's stated that it plans to close at least 11 more stores in the upcoming year (nearing its plan to close 100 locations since the start of 2017); and Bon-Ton announced 47 store closures slated for early 2018.[78] One commercial real estate firm has estimated that 310 of the nation's 1,300 shopping malls are at high risk of losing an anchor tenant in 2018.[79] The loss of an anchor tenant can trigger co-tenancy clauses with other mall tenants that allow the non-anchor tenants to reduce their rent or terminate their leases in the event an anchor tenant goes dark.

Landlords have also begun to accept new businesses as traffic drivers such as Whole Foods, movie theaters, and high-end services, such as hair salons.[80] The CEO of GGP, a real estate investment trust, has stated that it plans to integrate fitness centers into half of its 115 malls in the next decade.[81] The reason being that "fitness centers have boomed and diversified, and a proliferation of smaller, boutique gyms that draw higher-end customers have created more attractive tenants that are easier to accommodate."[82]

Landlords and their retailer tenants should take steps to discuss their respective priorities, needs, and strategic plans – beyond standard rental terms. Doing so will not only improve communication and build a collaborative approach, but it will also ensure that key issues are addressed before there is a crisis. Our experience shows us that at times, there is a disconnect between landlord and tenant, which can lead to polarization and impediments to compromise. Finding common ground and developing a plan together will more likely drive a successful outcome.

The confluence of these factors makes the retail sector inherently challenging. It should come as no surprise that lenders approach even "healthy" retail debtors with heightened scrutiny.[83] The challenging nature of the retail industry, both online and offline, makes retailers more susceptible to failure. "The king or queen of retail will master both online and offline—online is the efficiency, offline is building the experience[.]"[84]

Key Constituents in Bankruptcy Cases of Retail Debtors

Once in bankruptcy, retail debtors must work with many constituents, including asset-based and traditional lenders, factoring companies, landlords, trade vendors, consumers, and purchasers of assets. Understanding the incentives and rights of key constituents will increase the probability of success in bankruptcy cases of retail debtors.

Landlords/REITS

To understand the importance of, and clout possessed by, landlords, it is important to start with the Bankruptcy Code itself. In 2005, Congress overhauled the Bankruptcy Code by enacting BAPCPA. Among other things, BAPCPA shortened the time within which retail debtors must "assume" or "reject" their leases under section 365(d)(4). In bankruptcy, debtors are authorized to "assume" beneficial unexpired leases and "reject" burdensome unexpired leases. "Assumption" is a debtor's declaration to perform under the lease and, therefore, treat the lease as if it was never breached by requiring the debtor to promptly cure any defaults. "Rejection" is a debtor's declaration that it will not perform under the lease, resulting in a hypothetical breach as of prior to the bankruptcy filing, leaving the landlord with an unsecured damage claim against the estate, which is subject to certain caps.

Prior to the passage of BAPCPA, a debtor tenant could routinely seek multiple extensions of the deadline to assume or reject a non-residential real property lease. This left landlords in a state of limbo while retail debtors evaluated their options—including, for example, assuming and assigning below market leases to the detriment of landlords. "Some commentators and landlords believed that courts were granting debtors in possession very lengthy extensions of the section 365(d)(4) deadline on a routine basis. They believed that these open-ended extensions significantly impaired the landlords' rights under the leases and non-bankruptcy law, as well as their ability to identify substitute lessees and negotiate substitute leases in a timely manner."[85]

In response, landlords lobbied Congress and achieved amended section 365(d)(4) in order to impose a deadline on the time within which retail debtors must assume or reject leases. The rationale was that the open ended extension was a perceived abuse by debtors. As amended, section 365(d)(4) now provides debtors with an initial 120 day period to assume or reject leases, with the ability to seek an additional 90 days by motion. Any subsequent extension requires the consent of the landlord in each instance. Armed with section 365(d)(4), landlords now hold significant leverage in retail cases.

Due to the BAPCPA changes, debtors now have to address their lease issues very early in a case, often making speculative, premature decisions as to which leases to assume or reject. This often means making decisions on leases well before the debtor may have an idea of how it intends to reorganize, in many cases discouraging reorganization.[86]

As discussed above, section 365(d)(4) requires landlord consent for extensions past the 210 days within which to assume or reject leases. It is not uncommon for landlords to demand "consent fees," or other favorable treatment, for such extensions. A consent fee program was approved by the Bankruptcy Court in the Toys "R" Us case.

However, even after the changes in the Bankruptcy Code which provided leverage to landlords, the landscape has changed and power is tilting towards retailers, at least in Manhattan.[87] After seeing retail occupancy plummet, in part due to unsustainable rent increases and competition from online retailers, landlords are providing concessions, such as paying retailers for moving expenses and interior redesigns to keep storefronts from going dark.[88] In one instance, Nike, which signed the largest lease in Manhattan in 2016, was able to negotiate the landlord's payment of Nike's remaining term of its existing store lease, while in the case of Tom Ford, the landlord provided a $12 million allowance for improvements.[89]

Retailers looking to reduce or eliminate their physical footprint can also engage landlords to negotiate settlements, as an alternative to bankruptcy filings. In the case of BEBE Stores Inc., the company negotiated terms with its landlords to close its 180 stores so that it could move its business completely online.[90] BEBE offered the landlords better deals than they would have received in bankruptcy, and in return, BEBE avoided the substantial costs associated with a bankruptcy filing.[91]

New Breed of Lenders

Leveraged buyouts over the last decade have significantly fueled the number of retail bankruptcies seen in recent years. Nearly 40% of leveraged buyouts of retail companies by private equity companies occurred during the height of the financial crisis, in 2007 and 2008. Since 2011, the retail sector has accounted for 17% of chapter 11 filings by private equity-owned companies, while only accounting for 9% of large leveraged buyouts by private-equity companies over the last decade.[92] Private equity owners, on average, paid 10 times EBITDA for retail buyouts, approximately five times more than the funded debt carried by the average publically owned retail company.[93] Combined with the "highly cyclical, low-growth, low-margin business" of the retail industry, as well as the failure to fully appreciate the growing impact of e-commerce and fickle nature of consumers, in hindsight, it is easy to see why leveraged buyouts of retailers failed and it is unclear whether capital markets will continue to support leveraged buyouts of retail companies going forward.[94]

Over the last 10 years, the increased presence of alternative lenders, such as hedge funds and private equity firms, has changed the landscape of retail of bankruptcies.[95] This new breed of lenders may benefit debtors through increased financing, but it may come at the risk of increased pressure for a debtor to liquidate when a reorganization does not appear feasible.[96] Hedge funds and private equity also commonly manage retail debtors after they invest, unlike traditional lenders which avoided operating retail debtors and, instead, preferred to defer to management.

It was less common for retail debtors to be indebted to alternative lenders, such as private equity firms and hedge funds. The landscape changed after enactment of the Dodd–Frank Act, which, among other things, prohibits traditional lenders from holding certain types of investments under the Volcker Rule.[97] Under the new landscape, traditional lenders are selling debt of distressed retail debtors to these less-regulated, alternative lenders, such as private equity firms and hedge funds at substantial discounts.

As a recent example, retail debtor Aéropostale accused its main lender of forcing it into bankruptcy as part of a "loan-to-own" strategy.[98] These alternative lenders, which often hold equity interests as well, may push retail debtors to finance dividends by incurring additional debt—in common parlance, "dividend recapitalizations." Payless ShoeSource's decline into bankruptcy, according to creditors, was hastened by dividend recapitalizations.[99] The involvement of self-interested parties create an incentive for failure by making it difficult for retail debtors to avoid, and emerge from, bankruptcy.

As retail debtors reach the brink of insolvency, many lenders refuse to provide financing without the retailer first filing a bankruptcy petition. Post-petition debtor-in-possession loans have grown in popularity due to the priority given to such loans under the Bankruptcy Code. These loans usually fund a company through a reorganization or sale, and in 2017, more than $15.5 billion in such loans were issued, fueled by retail bankruptcies.[100] DIP lenders are typically a debtor's pre-petition lender, increasingly hedge funds and private equity firms, that lend additional cash on a post-petition basis, generally secured by liens on all assets. As discussed below, pre-petition lenders, usually the only parties in a position to serve as DIP lenders, seek to quickly monetize their collateral—*ie*, inventory—through going-out-of-business sales, and impose tougher milestones than those imposed on non-bankrupt debtors.

The increased pressure by DIP lenders can be traced back to the amendments in BAPCPA. BAPCPA imposed a 210 day cap on the assumption or rejection of non-residential leases, a major change from the pre-BAPCPA practice of liberal extensions of time.[101]

Lenders of retail debtors usually hold claims secured by liens on cash and inventory, which are the main assets of most retail debtors. For this reason, lenders generally have no incentive but to liquidate their collateral—*ie*, inventory—as soon as possible.[102] Such incentive is especially important considering the diminishing value of the inventory by which their liens are secured. It is not surprising that lenders usually fund liquidations only to preserve their liens and quickly realize on their collateral.

Due to the 210-day limit on assuming or rejecting non-residential leases, a decision to reorganize or liquidate must be made very early on in a bankruptcy case to either facilitate "going-out-of-business" sales or for consummation of a sale to a third party, either as a going concern or as an asset sale.

Liquidation usually encompasses a "going-out-of-business" sale and lenders generally enforce strict timelines, in the form of milestones, on such sales out of concern that retail debtors will not have stores in which to sell inventory after the lease assumption period lapses. A going-out-of-business sale typically takes around 90 days or more to complete, and based on the 210-day deadline within which to assume or reject leases under section 365(d)(4) of the Bankruptcy Code, leaves retail debtors with only 120 days or less to decide whether to assume leases, and attempt to reorganize or conduct a sale as a going concern, or reject leases, and pursue liquidation.[103] Going-out-of-business sales are conducted by liquidation firms retained by the debtor, and take a percentage of the sale proceeds. Liquidation firms offer competitive prices for assets of retail debtors—for example, liquidators paid 111% of Anna's Linens' cost of inventory and 97% of Coldwater Creek's cost of inventory.[104] The shortened timeline to conduct such sales before store leases are deemed rejected contributes to the high rate at which retail debtors in bankruptcy end in liquidation.

Going concern and asset sales to third-parties also face expedited timelines, such as in the Ritz Camera bankruptcy case, where the DIP lender required a stalking-horse bid within 55 days, an auction within 76 days, and entry of a sale order within 84 days.[105] It is only under the most uncommon circumstances, such as where there is confidence in the ability to reorganize without diminishing collateral value, that DIP lenders provide financing for purposes other than liquidation.

Accordingly, retail debtors should negotiate with lenders in advance of bankruptcy and determine which stores are profitable and unprofitable, and whether a reorganization is feasible.

Trade Vendors

Retail debtors should keep trade vendors informed of a potential bankruptcy in order to avoid surprises. In other words, retail debtors should approach trade vendors on the "offensive," rather than responding on the "defensive." Obtaining support from trade vendors depends upon the outcome of negotiations with individual vendors or a group of vendors, "but the likelihood of receiving support is much higher if the retailer and its vendors have maintained good relationships, despite the financial stress on both sides, and if the vendors believe that they benefit more from the retailer continuing as a going concern than if it liquidates."[106]

However, when relationships sour, trade vendors are armed with various methods to assert leverage and recover their goods. Prior to a bankruptcy filing, vendors, especially those that are critical to a debtor's operations, may demand payment of all outstanding balances, require cash on delivery, change delivery terms, or require third party guarantees. Although, if these changes occur within 90 days of bankruptcy filing, they may be subject to claw-back by the bankruptcy estate as a preferential transfer.[107] In 2017, after news of Toys "R" Us' potential bankruptcy became public, vendors began tightening creditor terms, which is arguably a significant cause of its bankruptcy.[108]

Post-bankruptcy, trade vendors generally hold claims on goods delivered to retail debtors immediately before bankruptcy. Section 503(b)(9) provides, among other things, administrative priority for goods delivered within 20 days of the petition date.[109] While 20 days appears insignificant, retail debtors with high inventory turnover will likely face significant section 503(b)(9) claims. This additional layer of payment makes it more difficult to confirm a reorganization plan because retail debtors must pay administrative claims, such as those under section 503(b)(9), before paying other claims. As an alternative to asserting an administrative claim, trade vendors may assert rights of reclamation. Section 546(c) allows trade vendors to reclaim certain goods sold to debtors that file for bankruptcy relief within 45 days of receipt of such goods.[110] The assertion of reclamation rights against goods received by the retail debtor often spawns litigation with other lenders who hold a lien on all assets. Nevertheless, rights of trade vendors to assert administrative priority and reclamation rights may influence reorganization strategies.

Furthermore, trade vendors may assert consignment claims purporting to retain ownership of delivered goods until sold, notwithstanding the retail debtors' physical possession of such goods. Retail debtors, on the other hand, may argue that such goods and their proceeds are property of the estate. For example, central to Sports Authority's bankruptcy case was litigation over $80 million consignment claims for goods received pre-petition—the focus was on the relative priority between secured lenders and "consigning vendors" to the proceeds derived from goods received pre-petition.

Consumers

The rights of consumers are generally represented by attorneys generals, the Federal Trade Commission, and the United States Trustee. Retail debtors typically address rights of consumers through first day motions to maintain reward programs and other customer-loyalty programs.[111]

The claims of consumers are generally afforded priority status and can be significant—*eg*, the gift card claims in the Toys "R" Us bankruptcy case amounts to over $200 million.[112] Debtors typically have attempted three methods to deal with gift card claims: (i) continuing to honor the gift cards; (ii) honoring the gift cards until a fixed date; or (iii) dishonoring gift cards and seeking to have gift card holders deemed unsecured creditors. Courts have disagreed regarding whether gift card holders are entitled to priority status under section 507(a)(7) of the Bankruptcy Code, but have generally found that they are unknown creditors and are only entitled to notice by publication.[113]

The sale of personally identifiable information has also become a growing trend in retail bankruptcies. Section 363(b)(1) of the Bankruptcy Code provides that if the debtor has a privacy policy in effect at the time of the bankruptcy filing, which prohibits the transfer of personally identifiable information, as defined under section 101(41A) of the Bankruptcy Code, the information cannot be sold in bankruptcy unless additional requirements are satisfied.[114] If triggered, section 363(b)(1) prohibits the sale of personally identifiable information unless the bankruptcy court finds that the sale is consistent with the debtor's privacy policy or unless the court approves the sale at a hearing after, (a) appointing a consumer privacy ombudsman to assist the court in reviewing the facts and circumstances of the sale, and (b) finding that the sale of the information would not violate applicable non-bankruptcy law.[115]

Intellectual Property

"As the value of brick-and-mortar 'hard' assets stores becomes tapped out, a retailer's brands, licenses, and associated IP rights may present reliable sources of value."[116] IP assets will play a key role in the future of retail bankruptcies and restructurings. Bankruptcy cases of retail debtors present opportunities to acquire trademarks, customer lists, trade names, patents, copyrights, and domain names in order to re-launch such retail debtor through lower-cost platforms, such as online and magazine platforms that do not require expensive store leases. A recent example, retail debtor Sports Authority sold its brand name to rival Dick's Sporting Goods for $15 million.[117] In addition to selling its brand name, Sports Authority sold its naming rights to the Sports Authority Field.[118]

Retailers are also turning to the sale of their IP to avoid bankruptcy, as was the case with J.Crew. Faced with over $2 billion of debt and diminishing sales, J. Crew transferred its IP to a Cayman subsidiary in exchange for $250 million, allowing it to restructure upcoming debt maturities,[119] while also entering into a royalty agreement allowing J. Crew to use its IP, essentially the IP version of a sale-leaseback transaction.[120] This transaction has led to pending litigation by certain term loan holders, alleging that the transfer violated the terms of the loan agreement.[121]

As retailers try to maximize value from their IP, they must assess the risk of litigation when transferring encumbered IP assets and analyze the best way to maximize returns, whether through sale, licensing, or other alternatives.

Planning Retail Bankruptcies

Planning is critical for increasing the likelihood of successfully restructuring retailers in bankruptcy. Many retailers are accustomed to planning on a monthly or quarterly basis, but signs of distress must be addressed early on.[122] Regular "dashboard metrics" may reveal early signs of stress or distress, such as a slowdown in vendor payments, and reduced foot traffic.[123] Early on, retail debtors must be aware of available capital market options by starting a dialogue with distressed investors, securing stalking-horse bidders, and pre-arranging plans.[124] As discussed above, communication is critical—retail debtors should *approach* constituents on the "offensive," rather than responding on the "defensive," especially landlords and vendors. If bankruptcy appears unavoidable, retailers' first focus "should be to create as much 'runway' as possible to effectuate either an out-of-court turn around or a well-planned bankruptcy."[125] This is achieved by creating a detailed understanding of a company's liquidity position and should also include a thorough review of debt covenants and other triggers that lenders may have to accelerate a filing. By understanding such position, retail debtors can focus on activities to generate additional liquidity, such as vendor management, capital expenditure curtailment, expense reductions, and borrowing-base optimization.[126]

Recent bankruptcy filings indicate that retail debtors recognize the importance of planning. Consider, for example, the bankruptcy case of The Limited which entered bankruptcy having already sold "substantially all of [its] brick and mortar inventory, and had ceased operations at and vacated the premises of all of [its] approximately 250 stores and delivered possession of each store to the respective landlord."[127] By entering bankruptcy with a "done deal" that was already fully vetted and competitively tested, the retail debtor maneuvered around the competing objections of constituents that would occur if the deal was vetted and tested during the bankruptcy case—in effect, avoiding the litigation concomitant with the "collective" decision-making process of "real-time" marketing efforts in bankruptcy. The trend of entering bankruptcy with liquidation and marketing efforts already exhausted pre-petition is an increasingly common strategy employed by retail debtors.

The speed of recent bankruptcy cases underscores the importance of planning. Sophisticated legal strategies have accelerated the speed at which debtors move through bankruptcy—one debtor emerged from bankruptcy in only four days.[128] In addition to sophisticated legal strategies, hedge funds, which "increasingly have replaced banks as senior creditors," drive the "faster Chapter 11 proceedings." Focused on maximizing returns, hedge funds often take aggressive positions—such as supporting a "hastily arranged auctions"—to the detriment of other constituents.[129] Long gone are days in which debtors hibernated in bankruptcy for several years.[130]

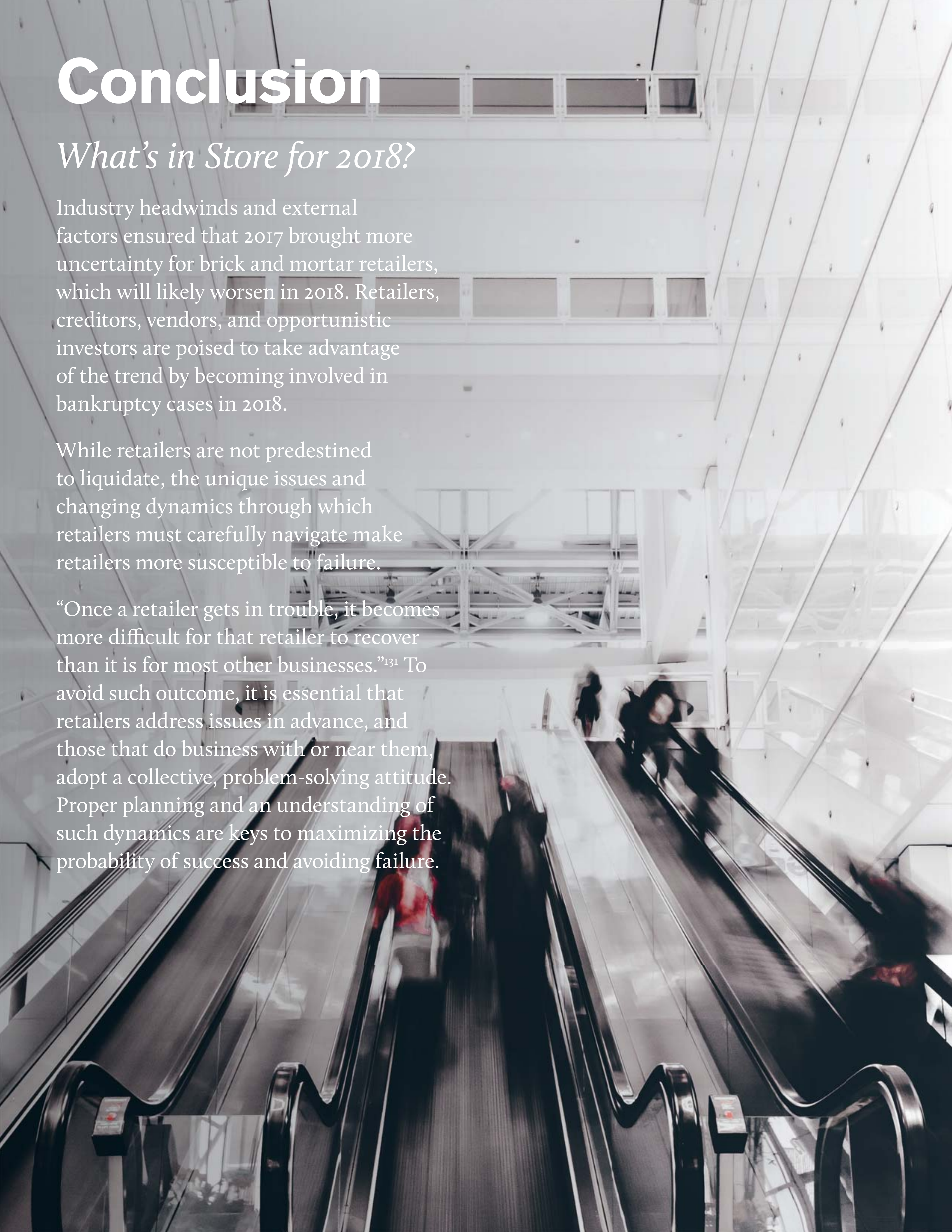
Conclusion

What's in Store for 2018?

Industry headwinds and external factors ensured that 2017 brought more uncertainty for brick and mortar retailers, which will likely worsen in 2018. Retailers, creditors, vendors, and opportunistic investors are poised to take advantage of the trend by becoming involved in bankruptcy cases in 2018.

While retailers are not predestined to liquidate, the unique issues and changing dynamics through which retailers must carefully navigate make retailers more susceptible to failure.

"Once a retailer gets in trouble, it becomes more difficult for that retailer to recover than it is for most other businesses."[131] To avoid such outcome, it is essential that retailers address issues in advance, and those that do business with or near them, adopt a collective, problem-solving attitude. Proper planning and an understanding of such dynamics are keys to maximizing the probability of success and avoiding failure.



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112. Richard Vanderford, Borders Gift Card Holders Push to Revive Refund Claims, Law360 (Apr. 30, 2013, 7:46 PM), http://www.law360.com/articles/437293/borders-gift-card-holders-push-to-revive-refund-claims.

113. See, *In re WW Warehouse, Inc.*, 313 B.R. 588 (Bankr. D. Del. 2004) (determining that gift cards are entitled to priority treatment based on the legislative history of section 507(a)(7); *but see*, *In re City Sports Inc.*, 554 B.R. 329 (Bankr. D. Del. 2016) (finding that gift cards are not "deposits" within the scope of scope of section 507 (a)(7), as "'deposit" under that section connotes a temporal relationship between the timing of the consideration given and the time the right to use or possess is vested in the individual giving the consideration, that gift cards allow the consumer to immediately receive the benefit of his/her bargain in the form of a freely transferable instrument). *In re BGI, Inc.*, 476 B.R. 812, (Bankr. S.D. N.Y. 2012), *stay pending appeal denied*, 2012 WL 5392208 (Bankr. S.D. N.Y. 2012) *and appeal considered moot*, 2013 WL 10822966 (S.D. N.Y. 2013) *and subsequently aff'd*, 772 F.3d 102 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 155, 193 L. Ed. 2d 44 (2015) (finding that gift card holders are unknown creditors and that publication notice is sufficient notice for a claims bar deadline).

114. 11 U.S.C. § 363(b)(1).

115. *Id.*

116. http://www.lawjournalnewsletters.com/sites/lawjournalnewsletters/2017/11/01/retail-restructuring/?slreturn=20171125184717.

117. Lillian Rizzo, *Dick's Sporting Goods Wins Sports Authority Brand Name in Bankruptcy Auction*, *Wall St. J.*, June 30, 2016, http://www.wsj.com/articles/dicks-sporting-goods-wins-sports-authority-brand-name-in-bankruptcy-auction-1467299379.

118. *See* Corrected Order Authorizing the Debtors to Assume and Assign Stadium Naming Rights Contract to the Denver Broncos Pursuant to Section 365 of the Bankruptcy Code, *In re Sports Authority Holdings*, No. 16-10527 (MFW) (Bankr. D. Del. Aug. 23, 2016) [Docket No. 2810].

119. https://www.courthousenews.com/j-crew-lenders-balk-intellectual-property-transfer.

120. http://www.lawjournalnewsletters.com/sites/lawjournalnewsletters/2017/11/01/retail-restructuring/?slreturn=20171125184717.

121. Id.

122. Gregory L. Segall, *Retail Survival in a Weak Consumer Environment*, Versa Capital Management, Inc., at 9, http://www.versa.com/news/Retail_Survival.pdf (last accessed Feb. 12, 2017).

123. Id.

124. Recently, retail debtor Eastern Outfitters' prepetition efforts culminated in Sportsdirect's letter of intent to serve as a stalking-horse bidder in a section 363 sale, provide debtor-in-possession financing, and refinance debt. *See Declaration of Mark. T. Walsh in Support of First Day Motions*, *In re Eastern Outfitters, LLC*, Case No. 17-10243 (LSS) (Bankr. D. Del. Feb. 7, 2017) [Docket No. 26].

125. J. Hogarth & H. Etlin, *Results of Retail Bankruptcy Study: Plan or Perish*, *AIRA Journal*, Vol. 29, No. 4 (2015).

126. Id.

127. See Declaration of Timothy D. Boates of Limited Stores Company, LLC, in Support of Debtors' Chapter 11 Petitions and First Day Motions, *In re Limited Stores Company, LLC*, No. 17-10124 (Bankr. D. Del. Jan. 17, 2017) [Docket No. 12].

128. See Tom Hals, Ever-shorter U.S. bankruptcies have creditors scrambling, *Reuters*, (Feb. 1, 2017), http://mobile.reuters.com/article/idUSKBN15G5FO ("For example, it took just four business days for vodka maker Roust Corp, which owns the Russian Standard brand, to get a plan approved last month in one of the shortest cases ever.").

129. Tom Hals, Ever-shorter U.S. bankruptcies have creditors scrambling, *Reuters*, (Feb. 1, 2017), http://mobile.reuters.com/article/idUSKBN15G5FO

130. Tom Hals, Ever-shorter U.S. bankruptcies have creditors scrambling, *Reuters*, (Feb. 1, 2017), http://mobile.reuters.com/article/idUSKBN15G5FO ("Legal strategies, such as prepackaged bankruptcies and quick auctions, and the increased role of hedge funds have transformed Chapter 11 from the 1990s, when companies such as discount retailer Bradlees spent years protected from creditors.").

131. Wolf Richter, Debt restructuring and bankruptcy could be the biggest growth industry of 2017, *Bus. Insider*, Feb. 7, 2017, http://www.businessinsider.com/debt-restructuring-and-bankruptcy-may-be-biggest-growth-industry-2017-2017-2.

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