

Happy (?) New Year: 2009, Retailers and Bankruptcy

By Andrew M. Troop and
Christopher R. Mirick

What should retailers expect for 2009? Little good, it appears. Reported opinions on retailers' prospects for this year range from difficult to disastrous, with very few predictions of any bright spots until 2010 or later. With dismal third-quarter results, and the year-end holiday shopping shaping up to be a mixed bag at best at press time, it seems likely that more companies are poised to follow Circuit City into Chapter 11 — and maybe follow Linens 'N Things, Mervyns, Tweeter Electronics and others in liquidating. This article discusses some of the challenges that face retailers who may file Chapter 11 in the coming year, and offers some suggestions for increasing the odds of successfully reorganizing.

FIRST, SOME PERSPECTIVE

During this past Thanksgiving week, the Commerce Department reported that third-quarter consumer spending suffered its biggest drop in 28 years. This set the mood for the start to the holiday shopping season on the Friday after Thanksgiving, so-called "Black Friday," when consumers historically hit the malls, and retailers begin to cover their losses and operate "in the black." Consumers stayed home in huge numbers, with retailers and mall operators generally reporting smaller crowds than in past years. And although so-called "Cyber Monday" — the first working day after Thanksgiving, when people have access

Andrew Troop is a partner and **Christopher Mirick** is a special counsel in the Financial Restructuring Department of Cadwalader, Wickersham & Taft, LLP. The authors gratefully acknowledge the assistance of **Jason Stratmoen**, an associate in that department, in the preparation of this article.

to their employers' high-speed Internet connections and go shopping on-line — posted increases of anywhere from 13% to 40% over last year, the boom in e-commerce seemed unlikely to offset the poor third quarter and drooping consumer confidence numbers. Analysts were forecasting weak holiday performance for retailers, as consumers held back from spending.

BACKGROUND

Consumers watched their wealth and access to credit vaporize in 2008. The housing market crashed and the stock market plummeted. The tightening corporate credit market was rippling through to constrict consumer credit as would-be buyers discovered that they could not get financing on cars; their credit card limits have been cut; and their home equity lines have been yanked. Retailers, naturally, were also feeling the pinch.

In addition to the retailers mentioned above, the current roster of businesses in Chapter 11 includes Boscov's, Home Interiors & Gifts, Sleep Innovations, Steve & Barry's, Whitehall Jewelers, Sharper Image, Harold's Stores, and Mrs. Fields Famous Brands. Retailers that have not filed for Chapter 11 were reporting drops in profits and cuts in operations, and are being punished for it in the stock market. For example, with an approximately 24% drop in profit in November, Target Corp. has curtailed new store openings through at least 2010, and has lost roughly 38% of its stock price. Macy's has announced a cut of approximately 50% in its capital spending for 2009, and its stock is trading at its lowest level since it emerged from bankruptcy in 1992. Similarly, Saks posted a third quarter loss of \$48.8 million compared to a \$21.6 million profit a year earlier, with its stock down 84% for the year through November.

Analysts predicted poor performance throughout the retail spectrum, from high-end to low-end and across broad categories of goods (clothing to home improvement

to electronics). Indeed, even sales of gift cards (which have become incredibly popular in recent years) were expected to be down anywhere from 5% to 15%, and consumer protection advocates were urging people to give actual cash instead, lest the gift cards become worthless when the retailers file for bankruptcy. About the only predicted winners in the retail sector were discounters and warehouse clubs, such as Wal-Mart and BJ's Wholesale Club, whose third-quarter profits rose 10% and 24%, respectively, over last year's numbers, and bars and liquor stores, whose sales actually increased in mid-2008 as the financial crisis gathered steam.

WELCOME TO CHAPTER 11

A year-end economic collapse represents the worst imaginable timing for most retailers. Historically, profits from December sales cover most retailers' basic operating costs for the rest of the year. Thus, for example, a pull-back in consumer spending in February is less of a crisis because retailers could attempt to scale back their operations before incurring most of a year's losses. Not only does a dismal December mean some retailers ended 2008 with a loss, but a continuing slump in consumer confidence and spending makes the argument to hold on a little longer for a turnaround less convincing. It seems inevitable that some retailers — perhaps many — will end up in Chapter 11 early in 2009.

We see three major issues facing retailers in bankruptcy: obtaining DIP financing, placating vendors, and dealing with leases. Each of these issues needs close attention before a company files, and careful handling during the bankruptcy.

DIP Financing

Left without cash or large inventories, the vast majority of retailers will need some sort of debtor-in-possession financing to operate. Remember, these companies are generally incurring losses for most of the year, so they're going to need a source of financing

to cover those losses while they figure out how to restructure. And if they want goods to sell, they'll likely need credit support to encourage vendors to agree to ship to them (more on that below).

The challenges to obtaining DIP financing, even with super-priority and senior liens, are daunting. First, there is the tightening of the credit markets that has limited the availability of new loans. Second, a retailer's assets — accounts receivables, inventory, real property to the extent it owns any — are probably not valued as highly as in the past. This combination makes it increasingly unlikely that new lenders will step in to fund a distressed retailer.

Rather, the more likely sources of DIP financing are those parties already involved with the retailer. The existing bank group is the logical first choice. They know the business and its assets, and are already invested (so to speak) in the company. We have seen a rise in "defensive DIPs" as existing lenders advance new money to their troubled borrowers. We also have seen a rise in roll-ups as those lenders use their leverage to turn outstanding prepetition loans into administrative expense claims. The prospect of giving this advantage to current lenders may be unpleasant for a would-be debtor, but if a retailer enters Chapter 11 without committed DIP financing, in our view its odds of survival are limited.

The other party with an investment to protect is equity. The willingness of private equity shops or other institutional owners to provide DIP financing should not be dismissed. If there is a possibility of retaining some equity in the reorganized company — or exiting a company's capital structure cleanly — current equity holders may well be willing to provide DIP financing to facilitate a Chapter 11.

Vendors

A retailer with nothing to sell is not going to continue in business for long. As the recent re-filing of Steve & Barry's illustrates, a disruption in your supply chain can mean swift death, even if the company has adequate capital.

In our experience, vendors hate surprises. To the extent practicable, we would encourage retailers to avoid springing a Chapter 11 on their key suppliers. Rather, condition them in advance that there might be some bumps ahead but you are committed to working with them. And, when you do file, reach out to them quickly to let them know what the game plan is. The message should be simple: "We've obtained

DIP financing. This financing, and any letter of credit facility, provides sufficient liquidity to pay you for new goods you ship."

Of course, most large vendors know all about the "critical vendor" orders that used to be *de rigueur* in certain courts, and may demand to be paid on their outstanding prepetition invoices before agreeing to ship postpetition goods. If the vendors will agree to extend credit postpetition to avoid tapping availability under the DIP facility, this may be a worthwhile exchange. However, as a practical matter, we expect DIP lenders may be less willing to fund these exactions, and courts may be more willing to require vendors to rely on their new priority under § 503(b)(9) of the Bankruptcy Code rather than approving full payment early in the case. Again, working with vendors up front may help manage expectations, and prevent supply chain disruptions that could imperil a reorganization effort.

Leases

The 2005 amendments to the Bankruptcy Code introduced strict limitations to the time period within which a debtor must decide whether to assume or reject a lease of nonresidential real property. Where previously courts often extended this deadline through plan confirmation, Bankruptcy Code § 365(d)(4) now deems the lease rejected and requires immediate surrender of the premises if the lease is not assumed within the first 120 days of the case. This deadline may be extended "for cause" by up to 90 days, but any extension after that requires the prior written consent of the lessor.

For retailers, this creates a 120- to 210-day clock to decide what to do with each leased premises. Negotiations with landlords need to start quickly, probably even before filing for Chapter 11. You're not going to emerge from Chapter 11 without stores, and you have a limited amount of time to figure out what to do with your leases.

Do the landlords really have the upper hand? Although the statutory language is clear that any extension after the first 90-day extension must be with the "prior written consent of the lessor in each instance," what is the practical consequence of this mandate? Put simply, if a debtor retailer is able to continue paying something on account of the lease, some landlords may prefer that stream of income over having a store go dark and sit empty. With even healthy retailers announcing cut backs on capital expenditures and delayed store openings, competition to take over empty spaces will be limited. We note that General

Growth Properties, the second largest mall operator in the U.S., has reportedly retained bankruptcy counsel. Clearly, there is pain to be had on the landlord side of the lease, too.

We expect to see a rise in consensual extensions of the § 365(d)(4) deadline to assume or reject nonresidential real property leases, with the debtors paying some amount of rent in exchange for remaining in the premises and retaining an option on the lease. The parameters of these deals are limited only by the imaginations of the parties (and the willingness of committees and courts to go along). Certainly, the payment of past-due rent, adjustments in current rent, and terminations of future options to renew, are all elements that will be bargained over in exchange for an extension of time. To the extent these negotiations can be conducted before the retailer files, and then put in place swiftly after the petition, the odds of a smooth reorganization are increased.

CONCLUSION

It is going to be an interesting 2009 in the retail sector. With the dour expectations for the 2008 holiday season apparently true, and the continued credit crisis setting the stage for a potentially slow recovery in consumer spending, we expect a rapid rise in retail bankruptcies.

Every case of course presents its own unique facts and problems, and calls for equally unique solutions. However, the introduction in the recent Bankruptcy Code amendments of the new strict timetable for addressing nonresidential real property leases puts a premium on negotiating with landlords quickly. Similarly, the interplay of DIP financing and critical vendor demands suggests that would-be debtors face a difficult task in balancing the demands for cash and credit during the case. All these factors will benefit from advanced planning before the bankruptcy is filed, and attentive managing during the case. With skill and a fair bit of luck, we may see more retailers emerge from Chapter 11 rather than liquidate.