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The Rest of the Story About the State of Brick-and-Mortar Retail



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It is a challenge to pick up a business periodical these days without confronting another article or commentary about the impending cataclysm facing retailers as a result of “online retailing.” This article performs a careful assessment of the facts surrounding the issue and offers a more in-depth analysis on the state of the retail industry. Somewhat surprisingly, given the amount of press already devoted to the topic, a significant number of very important facts have received little to no comment and may well be a considerable surprise to our readers. The big “surprises” generally fall into the following categories:

- The real magnitude of the problem.
- The collateral damage potential, some of which is almost completely invisible.
- The real causes of the problem beyond the inroads made by online retailing.

Let’s examine several facts.

Retailers in the U.S.: Bankruptcies Are Continuing to Increase

Retail bankruptcies are nearing a post-recession high. The conventional wisdom is that online retailing is the culprit, but this is only partly correct. Exploring the current state of retail, several observations can be made:

¹ Research assistance was provided by Jordan Johnson and Wen Tan. Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the views, opinions or positions of GlassRatner Advisory & Capital Group LLC.

- The number of retailers filing for chapter 11 protection is headed toward its highest annual tally since the Great Recession.²
- The rising number of retail bankruptcies comes as consumers are making more purchases online (approximately 10.1 percent in 2016³) and shifting their spending toward travel and other experiences.⁴
- Credit Suisse projects that 8,640 stores across the retail spectrum will close by the end of the year.⁵ Note: This is more than the number of annual store closures during the Great Recession.

As shown in Figure 1, a breakdown of annual units closing since 2000 and the chapter 11 filings for 2017 are quite revealing.

2017 Chapter 11 Filings

The number of retailers on Moody’s distressed list is at its highest since the Great Recession. The 19 retailers in Figure 2 were on Moody’s distressed retailers list⁶ (those companies with credit ratings

² Krystina Gustafson, “Retail Bankruptcies March Toward Post-Recession High,” CNBC (March 31, 2017), available at cnbc.com/2017/03/31/retail-bankruptcies-march-toward-post-recession-high.html (unless otherwise specified, all links in this article were last visited on Sept. 20, 2017).

³ “Monthly and Annual Retail Trade,” U.S. Census Bureau, available at census.gov/retail/index.html.

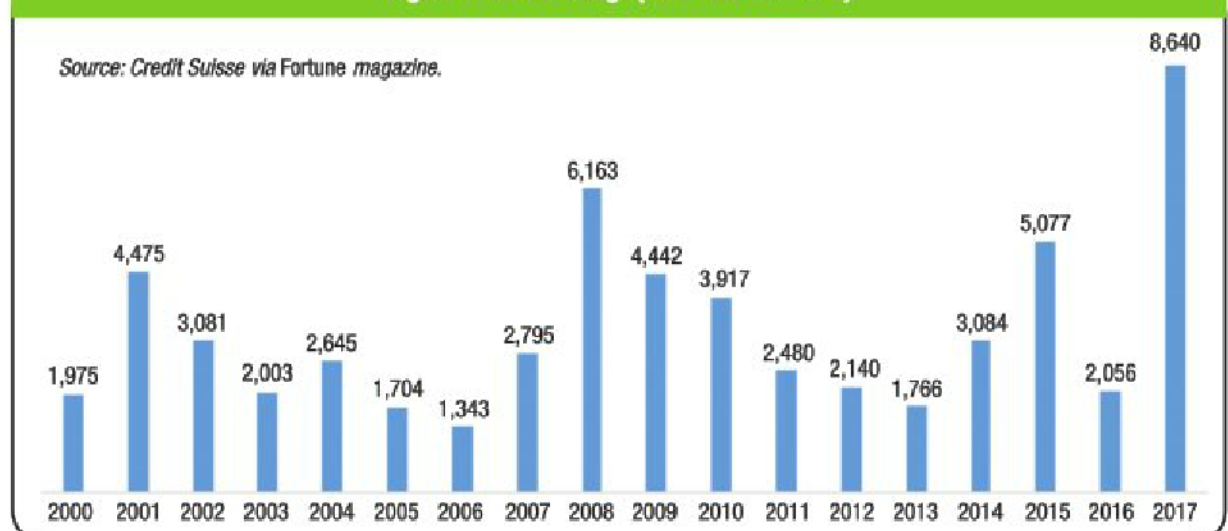
⁴ See Gustafson, *supra* n.2.

⁵ Phil Wahba, “Major Wall Street Firm Expects 25% of U.S. Malls to Close by 2022,” *Fortune* (May 31, 2017), available at fortune.com/2017/05/31/malls-retail-stores-closing.

⁶ Krystina Gustafson, “Rising Rates Will Speed Up the Clock on Retail’s \$3.7 Billion Time Bomb,” CNBC (March 14, 2017), available at cnbc.com/2017/03/14/rising-rates-will-speed-up-the-clock-on-retails-37-billion-time-bomb.html.

Figure 1: Unit Closings (Full-Year Estimate)

Source: Credit Suisse via *Fortune* magazine.



of Caa or worse⁷) at the end of the first quarter of 2017. The five-year debt maturities total \$3.7 billion. Figure 3 shows the retailers on Moody's distressed list and a breakdown of the five-year debt maturities with credit ratings of Caa or worse totaling a staggering \$3.7 billion.

A number of these, including Payless, rue21 and True Religion, have filed for chapter 11 in recent months. As of June 7, 2017, the net number of retailers on Moody's distressed list has grown from 19 to 22. These 22 companies comprise approximately 15 percent of the 148 rated retail and apparel companies in the Moody's universe.⁸

One of the most recent retailers to file for chapter 11 is Toys "R" Us, another leveraged buyout (LBO) gone bad. The company was purchased in an LBO by private-equity firms Kohlberg Kravis Roberts and Bain Capital, along with real estate firm Vornado Realty Trust.⁹ Apparently, the deal was as much about the real estate Toys "R" Us owns as the retailing of toys. Since the buyout, the company has been struggling financially, with more than \$5 billion in total debt and with \$400 million of debt maturing in 2018.¹⁰ The company filed for chapter 11 on Sept. 18, 2017. The company asserts that increased competition from omnichannel retailers like Amazon and Walmart was partially to blame.¹¹ In reality, the bankruptcy is just a continuation of the trend of

failed highly leveraged LBOs in an industry in considerable flux and in need of a "reinvention."

Store Closings

Credit Suisse predicts that 20 to 25 percent of all U.S. malls will close by 2022, which translates to hundreds of shopping center closures in the next five years.¹² Mall-based retailers that have announced store shutterings this year alone include Michael Kors, J.C. Penney, Sears, Macy's and Abercrombie & Fitch. The department stores that are most exposed to weak malls' problems are J.C. Penney and Macy's.¹³ The retailers involved are shown in Figure 4.

The Decline of the Retailer Giants: Macy's, Sears, J.C. Penney

The situation facing Sears deserves scrutiny, as it indisputably illustrates many issues facing malls with a deteriorating anchor. It also illuminates the ripple effect on real estate.

It is evident that the demise of these retail giants is only a matter of "when" and certainly not "if." For example, Sears's credit rating by Moody's was downgraded to Caa2 from Caa1, sending the credit further into speculative or "junk" territory. It now shares the same rating as Greece's sovereign

7 Kate Taylor, "More Retailers Are in Danger of Bankruptcy Now Than During the Great Recession," *Business Insider* (June 8, 2017), available at businessinsider.com/retail-bankruptcy-concerns-reach-recession-levels-2017-6.

8 "Ranks of Distressed Retailers Set to Keep Growing Amid Industry Shift," Moody's Investors Service (June 7, 2017), available at moody.com/research/Moodys-Ranks-of-distressed-retailers-set-to-keep-growing-amid-PR_367907.

9 Tracie Razon and Andrew Ross Sorkin, "Three Firms Are Said to Buy Toys 'R' Us for \$6 Billion," *New York Times*, March 17, 2005, available at nytimes.com/2005/03/17/business/three-firms-are-said-to-buy-toys-r-us-for-6-billion.html.

10 Michael Corkery, "Toys 'R' Us Files for Bankruptcy, Crippled by Competition and Debt," *New York Times*, Sept. 19, 2017, available at nytimes.com/2017/09/19/business/dealbook/toys-r-us-bankruptcy.html.

11 *Id.*

12 See Wahba, *supra* n.5.

13 *Id.*

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Figure 2: Companies and Their Next Maturity Dates

Company	Next Maturity Date
99 Cents Only Stores	Jan. 13, 2019
Bon-Ton Stores	Dec. 1, 2018
Charming Charlie	Dec. 1, 2019
Chinos Intermediate Holdings (J.Crew)	May 1, 2019
Claire's Stores	June 1, 2017
David's Bridal	July 13, 2019
Evergreen AcqCo (Saver's)	April 9, 2019
Fairway Group Holdings	Jan. 1, 2020
Gymboree	Dec. 1, 2017
Indra Holdings Corp. (Totes)	Dec. 1, 2021
Nine West Holdings	March 15, 2019
NYDJ Apparel	Jan. 6, 2019
Payless	March 1, 2021
rue21	Oct. 1, 2018
Sears Holdings	July 1, 2017
Toms Shoes	Oct. 1, 2019
Tops Holding II	June 15, 2018
True Religion	July 30, 2019
Velocity Pooling Vehicle	May 1, 2019

Figure 3: Ca/Caa Retail and Apparel Issuers Have \$3.7 Billion in Public Debt over the Next Five Years



Excludes private maturities; 2019 includes \$1 billion in HoldCo PIK Notes for J.Crew; 2020 includes only private data and is therefore not shown.

Sources: Moody's Investors Service, Company Filings/Moody's via MarketWatch Inc.

Figure 4: The Decline of the Retailer Giants

	Macy's	Sears Holdings*	J.C. Penney
Number of Stores	829	1,430	1,013
Square Footage (estimate)	130,158,000	163,045,000	103,000,000
Credit Rating	BBB-	CCC+	B+
Sales Per Square Foot	\$198	\$129 (estimate)	\$121

*Includes Sears Domestic and Kmart.

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debt, which is hopelessly insolvent. In addition, Sears has a worse rating outlook.¹⁴ The potential impact of these retail chains going bankrupt would have catastrophic consequences far beyond what industry experts have analyzed to date.

There are a combined 400 million square feet of retail space that are currently owned by these three retail giants (Sears Holdings includes both Sears Domestic and Kmart). If one assumes the cost of reconfiguring and re-letting the space (including tenant improvements, leasing commissions, free rent and other costs) is \$50 per square foot, the resulting dollar amount is around \$20 billion.

To further magnify the problem, *Sears or Seritage (a related REIT) owns most of their store real estate.*¹⁵ The significance of this is that when they go dark, the owner of the shopping center cannot unilaterally redevelop a Sears Holdings store. Doing anything with that space would require the landlord to make some sort of deal with Sears, Seritage or another third-party owner. Absent such an agreement, a Sears location could sit dark for years, as some have.¹⁶ A dark anchor has a profound impact on a shopping center's traffic, and one can expect that sales per square foot for the other tenants will decline as a result.

An even more obscure fact is that *many other tenants in these shopping centers have co-tenancy clauses in their leases.* The effect of these clauses is generally that if/when one of the anchors disappears, the leases of at least some of the other tenants have contractual clauses that mandate an automatic step-down in their lease rates, causing an immediate additional reduction in NOI for the center. Ultimately, the tenants choosing to stay may demand to pay percentage rent only.

Finally, shopping center developers spend time and money to achieve the best configuration of tenant mix and relative proximity in order to maximize the overall sales per square foot of the shopping center. Imagine that a large-footprint retailer disappears and the space is redeveloped. Many alternative uses will not achieve the same synergy on behalf of the other tenants. An example is the re-tenanting of the closed Mervyn's locations, many of which were converted into health clubs. The health club alternative may not be as stimulative to the shopping centers' other tenants as a successful department store.

What Is Happening in the Retail Sector?

The "conventional wisdom" is that online retail is killing the brick-and-mortar retailers. While that may eventually become true as online retail continues to grow, the current numbers suggest otherwise.

Online retail currently only accounts for approximately 10.1 percent of total retail sales. A migration of 10.1 percent of store sales to the online channel does not adequately explain the wholesale carnage in the sector. Keep in mind that a significant portion of online sales are from existing brick-and-mortar retailers. Therefore, the net loss to existing retailers from online sales is actually less than the 10.1 percent figure. The more successful operators are demonstrating some fluency with omnichannel retailing. Best Buy's transformation is perhaps one of the more striking examples of this evolution.

How is the 10.1 percent figure explained, then? It is increasingly apparent that the stores in the worst financial shape are also the stores that have done the *worst job of merchandising*. People forget that merchandising is both an art and a science, and is fickle to boot. Merchandising is one of the hardest things to do well in business, and there are only a handful of really good merchants in the business at any given time. The management teams at the failing big box retailers simply have not created reasons for customers to come into their stores. In fact, they have managed to create *negative brand equity* for their stores. Perhaps the worst offender in this area is Sears, as previously noted.

The money that could have refreshed the Sears stores was instead expended on share buybacks (more than \$5.8 billion to date¹⁷) as part of their "corporate strategy." Clearly, the same customer perception and lack of brand equity also attaches to Kmart and, perhaps to a lesser extent, J.C. Penney. Many other retailers have failed or will fail as a result of mediocre merchandising. This relegates them to the status of commodity resellers with no brand equity or reason to exist. Also consider the following:

The unemployment rate is 4.7% and the economy has improved to the point that the Federal Reserve expects to quicken its pace of rate increases. If stores can't do well in this environment, what happens when the economy, as it always does, slows down?¹⁸

Note that the most optimistic forecast for sustainable GDP growth is about 2 percent. Clearly, salvation for troubled retailers is not going to come from a robust U.S. economic expansion.

Even the surviving retailers are downsizing their stores to more efficient retail models. While this will usually result in higher rents to the landlord, it also requires considerable expenditures for reconfiguring and re-letting the vacated portion of the space.

There is another common thread in many of these failures. Retailers were acquired by PE firms. These transactions were highly leveraged and generally had the real estate spun off, and the store rents increased sharply. The result was a reduction in store "free cash flow," and there was no margin for error when the business then hit bumps in the road.

14 "Moody's Downgrades Sears Holding Corporate Family Rating to Caa2," Moody's Investors Service (Jan. 20, 2017), available at moodys.com/research/Moodys-downgrades-Sears-Holdings-Corporate-Family-Rating-to-Caa2--PR_380948.

15 Andriy Blokhin, "The Logic Behind Sears' REIT," Investopedia (Aug. 4, 2015), available at investopedia.com/articles/markets/080415/logic-behind-sears-reit.asp.

16 Hayley Peterson, "Haunting Photos of Dead and Deserted Sears Stores as Experts Warn the End Is 'Very Near,'" *Business Insider* (Dec. 11, 2015), available at businessinsider.com/photos-of-deserted-sears-stores-2015-12; see also Rocco Pendola, "16 Pathetic Pictures from an Iconic L.A. Sears Store That's Now a Dump," *The Street* (May 6, 2014), available at thestreet.com/story/12896012/16-pathetic-pictures-from-an-iconic-la-sears-store-thats-now-a-dump.html.

17 Sears Holdings Corporation (Form 10-K), available at sec.gov/Archives/edgar/data/1310067/000131006716000099/shid201510k.htm.

18 Justin Lahart, "Consumers Confident but Not Enough to Spend," *Wall Street Journal* (Jan. 13, 2017), available at wsj.com/articles/consumers-confident-but-not-enough-to-spend-1484335510 (log-in required to read article).

The U.S. is *severely over-retailed* and has been for years. The supply of new retail space being developed in the last 10 years has been a *fraction* of historical levels. Developers and lenders recognized that there is already too much space. *The amount of retail square footage per capita in the U.S. is about 1.5 times the next-highest country (Canada).* Canada generates more retail sales per capita than the U.S. with considerably less retail space per capita. *The U.S. also has more than four times the retail square feet per capita compared to other developed countries like France, the U.K. and Japan.* Based on the comparisons below, one can conclude that the U.S. is, by far, *the least-efficient developed nation when it comes to the utilization of retail space.* This creates a retail environment that is profoundly Darwinian. The strong survive and prosper (Amazon and Lowe's), and the weak (Sears and Kmart) fail and are figuratively eaten by predators (the competition).

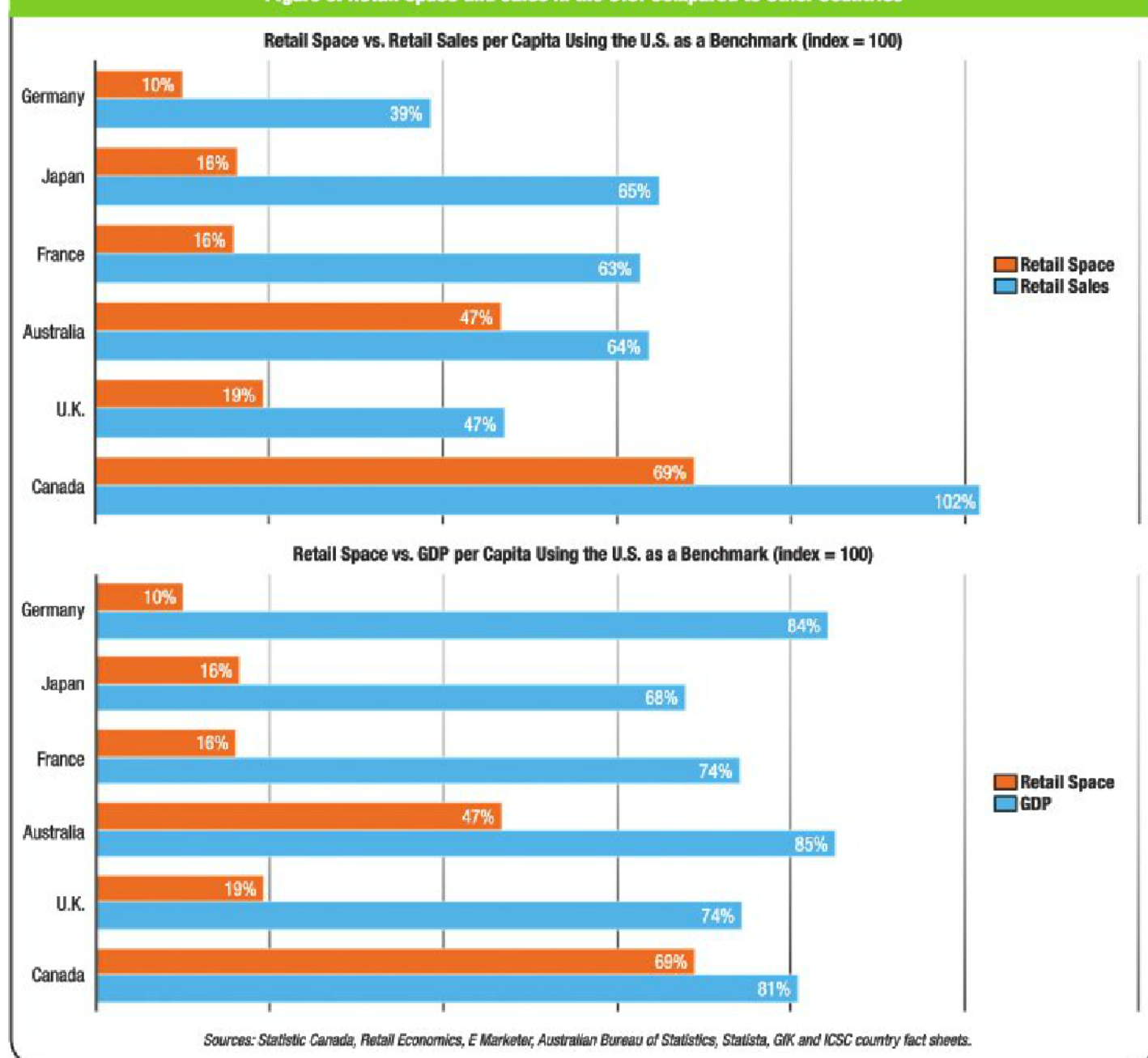
Figure 5 illustrates that *every country* has significantly less retail space compared with retail sales and overall GDP when benchmarked against the U.S. on a per capita basis. The question then becomes: What should brands do with the failing big box model? Brands are responding to the current evolution in the retail space, but not without struggle.

Challenges of Converting Failing Big-Box Spaces to Alternative Uses

There are many who view the disappearance of the big-box stores as an opportunity to redevelop some of these sites. However, this does not come without some major obstacles.

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Figure 5: Retail Space and Sales in the U.S. Compared to Other Countries



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The cost for redevelopment is very high, especially in urban areas. Additional costs, including environmental costs and encumbrances, can deter potential developers.¹⁹

Regulatory and institutional barriers, including outdated zoning practices and surviving reciprocal easement agreements, often prohibit the redevelopment of commercial areas into residential use. In addition, redevelopment often requires interaction with many different municipal departments and agencies. The lack of communication among these agencies can dramatically increase the waiting process — sometimes to as long as five years.²⁰

Physical barriers, including the shape of the mall (especially in urban areas), create a difficult challenge to developers. Another area of concern is the age of the infrastructure; older malls have aging water and sewer systems that often need major upgrades.²¹

City governments also have insatiable appetites for sales tax revenues. Any redevelopment of retail space that does not feed that appetite will be difficult to get approved in a timely manner.

Finally, neighborhoods sometimes have increase-of-traffic and parking issues. An example would be the community rejection of a new gym in a downtown area amid parking concerns for residents.²²

Conclusion

The challenges facing the retail space are ominous, but there is room for optimism. Retail has changed, but it is not dead. The statement that “online retailing is killing brick-

and-mortar shopping” is overstated and not entirely true. Many retailers, brands and malls are adapting. However, several key facts remain.

Retail bankruptcies to date have largely been the result of the changes in the retail industry and evolution of customer preferences, high-risk LBO structures and terrible store merchandising. These companies that failed to adapt to the changing retail landscape are getting pushed out by more agile competition. *Total retail sales are still growing.* However, the growth rates for the past three years were 3.9 percent in 2014, 1.9 percent in 2015 and 2.7 percent in 2016.²³ There are now more buying options for customers, and retailers have started to diversify their channels.

The U.S. has more retail space per capita than *all* other developed countries — and this will continue to be a headwind for landlords, retailers and lenders. The excess space, generally in the lower-tier malls, will eventually be redeveloped — at considerable cost — to alternative uses.

Retail is changing. It is not now — nor has it ever been — a stagnant industry. Current trends are toward “lifestyle retailing experiences.” The Grove in Southern California is one of the best examples. People now want retail to be fun and offer a variety of experiences beyond just shopping. This means that clever and insightful merchants can still survive and prosper, while the staid retailers stuck in the past, poorly merchandised and incapable of evolving, will disappear — likely at an accelerating rate.

Substantial collateral damage will also be inflicted on the institutional lenders to the industry. A major dislocation is underway, and most of the weaker players will not survive. The cost of redeveloping that space, and the attendant debt write-downs over the next decade, will be tremendous as the industry literally reinvents itself in order to thrive. **abi**

19 James Goldstein, Michael Jensen and Edward Reisking, “Urban Vacant Land Redevelopment: Challenges and Progress,” Lincoln Institute of Land Policy (2001), available at citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.591.5812&rep=rep1&type=pdf.

20 *Id.*

21 *Id.*

22 Tamara Duncan, “Wentzville Planning and Zoning Says No to Downtown Gym, Cites Parking Issues,” *70 West Sentinel* (Feb. 14, 2017), available at 70westsentinel.com/wentzville-planning-zoning-says-no-to-downtown-gym-cites-parking-issues.

23 “Quarterly Retail E-Commerce Sales 1st Quarter 2017,” *U.S. Census Bureau News*, available at census.gov/retail/mrts/www/data/pdf/ec_current.pdf.

Building Blocks: Getting Your Priorities Straight

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that water, natural gas and electricity are goods,¹¹ while others have held that claims related to the provision of electricity are claims arising out of a service, which are not entitled to § 503(b)(9) treatment.¹²

Incidental Charges Are Not Goods

Once you have determined that a creditor has provided goods to the debtor, be aware that charges for freight, shipping, taxes, penalties, interest and late fees will not likely be recognized as part of the value of the goods.¹³ Instead, like

services, these charges will be treated as other pre-petition claims with general unsecured priority.

Were the Goods Actually Received by the Debtor Within 20 Days before the Commencement of the Case?

Section 503(b)(9) grants administrative priority to creditors that furnished debtors with goods that are “received” by a debtor within 20 days before the commencement of a bankruptcy case. Recent case law focuses on the meaning of the term “receipt.” Earlier this year, in *In re World Imps. Ltd.*, the Third Circuit Court of Appeals decided that “receipt” turns on the debtor’s physical possession of goods.¹⁴ Where goods were shipped “free on board”

11 See, e.g., *in re Escalera Res. Co.*, 563 B.R. 336 (Bankr. D. Colo. 2017) (electrical energy is a good); *in re Pilgrim's Pride Corp.*, 421 B.R. 231 (Bankr. N.D. Tex. 2009) (natural gas and water are goods since they are included in U.C.C. § 2-107, but electricity is not).

12 See, e.g., *Hudson Energy Servs. LLC v. Great Atl. & Pac. Tea Co.* (*in re Great Atl. & Pac. Tea Co. Inc.*), 538 B.R. 666 (S.D.N.Y. 2015); *in re NE Opco Inc.*, 501 B.R. 233; *in re Pilgrim's Pride Corp.*, 421 B.R. at 238-40.

13 *In re Pilgrim's Pride Corp.*, 421 B.R. 231 (disallowing freight charges); *In re Plastech Engineered Prods.*, 397 B.R. at 839 (disallowing charges for labor).