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Distressed Deals Update: The Erosion of Brick and Mortar Retailers

By Raymond L. Fink

March 9, 2017 | **CORPORATE**

The general contention is that the U.S. economy is strengthening. In support of this observation the pundits rely upon sustained low unemployment reports, improving consumer confidence, a robust stock market and the expectancy of one or more increases in the overnight federal interest rate. Nevertheless, 2017 still portends trouble, particularly in the brick and mortar retail industry. As the energy industry (which most recently experienced severe stress) emerges and stabilizes, the retail sector has and will continue to suffer losses and confront insolvency issues.

The list of brick and mortar retailers who recently have entered into chapter 11 continues to expand. Some of the notables are: RadioShack, BCBG Max Azria, Wet Seal, Sports Authority, Aéropostale, Pacific Sunwear of California, American Apparel, Quicksilver, The Fairway Group, hhgregg, Marbles: The Brain Store, Eastern Mountain Sports, Bob's Stores and The Limited Stores. It is rumored and anticipated that Gordman's Stores and Gander Mountain will imminently seek refuge in chapter 11.   Others, such as Sears and JC Penney are currentlyclosing retail stores across the country.

The significant decline of customer traffic and in-store retail sales is widely attributed to the geometric growth in internet sales. No doubt e-commerce is changing the old line retail business format. However, there are usually additional factors that contribute to financial decline. Inadequate management, excessive leverage and disproportionate operating and overhead expenses are among the contributing causes that generate adverse financial results.

As the retail industry moves from brick and mortar to cyberspace, there will be collateral implications and resulting financial challenges downstream. Owners of retail shopping centers now have to address the realities and prospects of retailers "going dark". In the long run, the retail shopping center property owners need to implement new strategies and alternate uses for their properties. Traditional retail stores will need to be reconfigured, along with intelligent changes in use and tenant mixes. One could readily assume that the closure of retail stores will precipitate chapter 11 filings by shopping center property owners, particularly when faced with defaults under extant mortgage loan facilities.

The implications for equity funds are considerable. Many of the retailers who have entered into chapter 11 include equity funds within the ownership structure. The parent company of Eastern Mountain Sports and Bob's Stores is owned by a private equity fund. It barely acquired these retails stores 12 months ago out of its predecessor's chapter11 proceeding. The Limited also is a case in point where ownership is vested in private equity funds. Interestingly, in addition to shuttering all 250 retail stores, The Limited also took its internet site offline. The same is equally true with the composition of the ownership of the retail shopping centers. Many of these properties are owned by REITs and/or equity funds. Aside from the immediate adverse impact of declining revenues and sustained operating losses there are oftentimes more subtle concerns that may arise.

The Aéropostale chapter 11 case is instructive and highlights an area of potential concern. Aéropostale was partially owned by a private equity investment fund. A closely related party to the equity fund also was the predominant secured lender of Aéropostale. This duality of structure is not uncommon, but can be a very dangerous alignment, particularly in the context of the chapter 11 proceeding. The close connectedness between the private equity fund and the secured lender exposed the latter to litigation where Aéropostale and its constituents sought to entirely subordinate the secured loan facility and further to prevent the secured lender from exercising its statutory right to credit bid in connection with the anticipated sale of Aéropostale's assets and business. This is the type of litigation that causes nightmares. The United States Bankruptcy Court for the Southern District of New York ultimately refused to subordinate the secured loan facility or deprive the lender of its right to exercise its credit bid. The factual allegations apparently were insufficient to justify the relief sought. Other courts, however, have equitably subordinated secured creditor claims and/or deprived them of the right to credit bid based upon compelling facts and circumstances. Where the capital structure of an insolvent company consists of a closely connected and interlocking relationship between the equity ownership and the secured lender, the risks can be considerable. The structure coupled with bad facts can have dire consequences.

2017 will prove to be an interesting year in many respects. Even as the first quarter comes to a close, the volume of brick and mortar retailers who exit the traditional retail store model will continue with collateral damage upon the retail shopping center property owners and their lenders.

This post was co-authored by Raymond L. Fink and John A. Mueller who have joined Lippes Mathias Wexler Friedman LLP to co-lead the firm's Financial Restructuring, Reorganization and Insolvency Practice Team. This practice allows us to offer current and new corporate clients substantial assistance on distressed M&A deals, 363 transactions, and advising companies and investors on bankruptcy and insolvency matters. Mr. Fink and Mr. Mueller are highly recognized bankruptcy attorneys who work with clients across New York state and the north-east.

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