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When big retailers go bankrupt

Long Island landlords, vendors and others are impacted

By BERNADETTE STARZEE

The parade of retailers filing for bankruptcy marches on as consumer shopping habits continue to evolve and e-commerce keeps gaining market share.

Sears and Mattress Firm are the latest national retailers to file Chapter 11, following recent bankruptcy filings by Toys R Us and other well-known retailers, including Nine West, Bon-Ton and Claire's.

When national retailers enter bankruptcy, it impacts those Long Island landlords and vendors who do business with the retailer. And even though retailers often emerge from bankruptcy, the process typically involves the closure of stores in an attempt to right-size operations, which impacts jobs in the region as well.

"Retail bankruptcy filings are going to go on for the foreseeable future," said Patrick Collins, a partner at Uniondale-based Farrell Fritz who concentrates his practice on bankruptcy and restructuring and commercial litigation. "Even in a strong economy, the retail landscape is changing and the business models for some of these companies don't work any longer."

Part of the problem is that many of these stores – which have been struggling for years – have taken on incremental debt just to stay afloat.

"For a lot of bankruptcies, there was a prior restructuring that may have occurred, where a private equity firm may have been brought in to provide financing, but these are highly leveraged deals where the companies' assets are pledged as collateral for the whole transaction," Collins said. "In the case of Sears, the immediate impetus for the filing was that large debt service payments were coming due."

As retail sales gravitate to the web, some retailers simply have too large a brick-and-mortar presence and need to right-size the ship by closing underperforming stores. Mattress Firm, which acquired Long Island-based Sleepy's in 2015, is closing about 700 of nearly 3,300 stores, including stores in Plainview and Oceanside.

But it's not simply a matter of shedding some stores.

"When retailers file for bankruptcy, it gives them the opportunity to renegotiate all of their leases, even the ones that are retained," Collins said. "It's very commonplace for a retailer that files to demand concessions from all landlords."

If this happens, landlords must carefully weigh their options, Collins said.

"The landlord can say, 'I'm not required to agree to this; I have my rights under my written lease,'" he said. "But the flip side is that the bankrupt retailer can say, 'I'll reject that particular lease and focus my attention somewhere else.' And the landlord will have a claim for the rent under that lease, but that will be an unsecured claim against a bankrupt company, and those claims typically get paid at a fraction of their total value."

The bankruptcy code gives retailers the power to reject leases, "and that's a very powerful provision of the code that benefits the company in bankruptcy," Collins said.

How the landlord proceeds depends on many factors.

"In my experience, landlords are very savvy. They know their business and they know what their space is worth," Collins said. "It depends on how they feel the market is. Sometimes you get a landlord who is willing to keep the tenant in there, because it needs that tenant, especially in a shopping mall where there are synergies with the rest of the mix in the mall. Sometimes you have a landlord that will say 'I'm happy to get my space back because I think I can do better somewhere else.'"

Landlords and retailers often negotiate back and forth, through intermediaries. "Often the retailer will hire a real estate specialist who is an expert on doing just this – valuating the assets and leases and coming up with a rubric for how the retailer should get value out of its portfolio," Collins said. "Often it's the real estate adviser that is negotiating with the landlord or landlord's agent, and lawyers get involved to advise both sides as to the alternatives."

Often, Collins said, "the retailer will say to the landlord, 'Your store's not that profitable; we're inclined to close it unless we get concessions, as the income doesn't justify the rent we're paying.'"

Because of consolidation in the retail mattress industry, Mattress Firm has many stores in close proximity to each other.

"In the papers they filed, they pointed out that due to prior acquisitions, they're oversaturated in some areas," he said. "That factors into the decision about which leases to reject."

The goal of Mattress Firm is to exit from bankruptcy with as clean a balance sheet as possible. The company has to propose a plan that addresses how the claims to its creditors will be paid. "Of course the company's goal is to get rid of as many commitments as possible and reduce as much debt as possible to create a profitable venture going forward," Collins said. "It's a tug of war between creditors and the company as to how much trimming is enough. If the company tries to retain too much value for itself, the creditors will then argue that they are not getting enough, and that the company's plan should not be approved because it should pay off more to the creditors. In most cases in order to get out of bankruptcy, the company has to obtain an affirmative vote from a specified number of its unsecured creditors, so the retailer must get them in favor of that plan."

Photo courtesy of Farrell Fritz

PATRICK COLLINS: Sometimes a landlord will offer concessions to the retailer; in other cases, the landlord is happy to get its space back, because it can do better with a different tenant.

Photo courtesy of Rivkin Radler

MATTHEW SPERO: Letters of credit and guarantees will provide landlords with some protection if tenants declare bankruptcy.

Collins noted that it's quite commonplace for a company to emerge from bankruptcy only to stall a number of years later and wind up filing Chapter 11 again.

"There are too many of these cases. We call them Chapter 22s – companies that file Chapter 11 twice," he said. "The first time they stand the best chance of emerging from bankruptcy with the prior owner still owning the company. Often the second time (and sometimes the first time) the lenders to the company wind up becoming the owners."

Toys R Us surprised many people when it moved to liquidate its assets.

"The retailer had a fair bit of confidence when it filed that it would emerge out of bankruptcy looking very similar to the public as it had before," Collins said. But for various reasons, including a less-than-stellar holiday season in 2017, it couldn't right the ship.

The bankruptcy filing by Sears was unsurprising to many.

"The rumors have been going on for a couple of years," Collins said. "Sears has a lot of debt and continues to suffer losses year after year. It pulled off a number of transactions over the last few years to stay out of bankruptcy, such as selling off its Craftsman tool brand and selling off real estate. It's not yet clear what Sears' exit plan is." However, the retailer's store closings mount, with the New Hyde Park and Garden City locations to be among the casualties.

As retail bankruptcies are sure to continue, landlords can mitigate the risk by trying to get as much security as possible. But much depends on their bargaining power.

"It's easier to negotiate when you have more leverage," said Matthew Spero, a partner in the bankruptcy and commercial litigation practice groups at Rivkin Radler in Uniondale. "When you are dealing with these mega retailers, and the landlord has an interest in obtaining an anchor tenant for a shopping center, it can make it more difficult."

Landlords can ask for larger security deposits, as well as letters of credit and guarantees from the principals.

When tenants declare bankruptcy, it is generally safer for the landlord to have a letter of credit instead of a cash security deposit, because under bankruptcy law, the cash security deposit is considered part of the debtor's bankruptcy estate, while letters of credit are not and can be drawn down on relatively easily.

When a landlord gets a "good guy guarantee" from the retailer's principals, "the principals agree that if the company is in default and has to vacate the premises, that they will cooperate and not force the landlord to evict them," Spero said. "The principals guarantee, 'We'll be good guys in that situation; we will peacefully surrender the premises. If not, we'll be on the hook for some money to you.' That's fairly common. You can also request a guarantee of payment from the principals. If the lease is in default, you have a second source that you can look to if the tenant can't pay."

Another way for a landlord to protect itself amid the changing retail landscape is to diversify its portfolio.

"There's a lot of talk about putting some retail space to a different use," Collins said. "If there are too many vacancies in a shopping mall, maybe it would be better to put that piece to a better use, such as residential or office space."

Besides landlords, many vendors stand to lose when a large retailer goes under. Before a vendor enters into an agreement to sell goods to a retailer, "the vendor can do a judgment search to see if the buyer has judgments against it," Spero said. "If the buyer has been sued multiple times and there are judgments out there, the buyer might be facing some financial difficulty."

It's always best to sell COD (cash on delivery), but "in reality, that is very difficult to negotiate," Spero said. "If the vendor can't get COD, it can request a guarantee from the principal of the company, which can help to incentivize the company to make sure the seller is paid what it is owed. The personal guarantee is only as good as the person who stands behind it, and the seller can also consider requesting some additional collateral, such as a second mortgage on the home of the principal." Again, this depends on the vendor's bargaining power.

The vendor can also look into credit insurance. "There are insurance policies out there that offer protection in case the vendor sells goods to a buyer and the buyer goes out of business," Spero said.

Once things start to go south and the buyer has filed for bankruptcy, there are a couple of tools available to sellers, Spero said.

"There's the right of reclamation under the New York Uniform Commercial Code, which allows the seller to make a demand on the buyer that the seller can reclaim goods," Spero said. "But the buyer might ignore the demand, and perhaps the goods have been comingled with other goods and it's impossible to put the genie back in the bottle."

The first thing the vendor should do if the buyer files for bankruptcy is file a proof of claim in the bankruptcy case, so it goes on record that the vendor is owed a specified amount, Spero said. Under section 503(b)9 of the bankruptcy code, sellers of goods that were received by the buyer 20 days before the buyer filed for bankruptcy have an elevated claim in the event of bankruptcy – it gets paid before most other claims.

"That's a powerful tool to have," Spero said. "The seller of goods needs to be aware and go on record and assert that claim."

When a retailer declares bankruptcy, a vendor may breathe easier knowing that it received payments from the retailer before the filing. But not so fast: "Any payments received by the vendor within 90 days of the buyer filing for bankruptcy are subject to claw-back claims," Spero said. "The thinking is, the debtor is presumed by law to be insolvent during that time and paying some creditors but not others. It's not really fair that some got paid and others didn't. Maybe some creditors exerted undue pressure. The fairest thing to do is to claw back the money to the bankrupt estate to redistribute it to all creditors."

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