Sears' Biggest Sale (Itself) Offers Valuable Lessons For Retail

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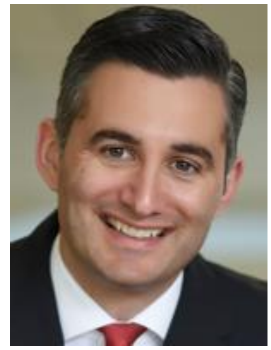

Robert Marticello

Philip Strok

Although a deal announced Wednesday could keep open more than half the department stores that retail dinosaur Sears Roebuck and Company had when it filed for bankruptcy protection last October, Sears remains, on many levels, a cautionary tale for the retail industry.

From its early operations as a mail-order catalog company and later expansion into retail locations, Sears cemented itself as a nationwide household name. Once America's largest retailer and employer, poor management and stiff competition from Amazon.com, Target Corp., Walmart Inc. and J.C. Penney Company Inc., as well as other brick-and-mortar and online retailers, left Sears struggling to stay in business.

Facing a $134 million debt payment and several billion dollars in outstanding obligations, on Oct. 15, Sears' parent company, Sears Holding Corp., **filed for Chapter 11 bankruptcy protection in New York**.

Sears hoped to avoid the liquidation fate of other well-known retailers such as Sports Authority Inc., RadioShack Corp., Toys "R" Us Inc. and Brookstone. Where others before it had not succeeded, Sears appeared confident it was "too big to fail" and would emerge from bankruptcy as a going concern. Sears believed that there remained a viable future for the business anchored to the sale of its core remaining stores.

Sears' going concern[1] sale approach met with immediate pushback from its own independent board members and creditors, who believed that more value could be realized through a short term going out of business sale rather than a time-consuming and expensive going concern sale process. If Sears was unable to turn itself around in the years leading up to bankruptcy, creditors had to ask, why would the outcome be any different in bankruptcy? The battle lines had been drawn and an aggressive going concern bid and liquidation auction timeline was instituted.

On the going-concern side, the only lifeline that emerged for this iconic retailer came from its billionaire chairman and former chief executive officer, Eddie Lampert, and his hedge fund, ESL Investments, who at first bid approximately $4.4 billion to salvage the core Sears stores and jobs for approximately 50,000 employees.

Sears initially declined the bid — and understandably so. The bid from ESL Investments, Sears' largest creditor, consisted of a "credit bid," meaning ESL Investments would acquire assets in exchange for debt owed by Sears (as opposed to cash). ESL Investments' offer also included a release of any claims that may exist related to pre-bankruptcy transactions against ESL Investments, Lampert and affiliates. The offer, which was the only bid submitted that did not involve the liquidation of Sears, did not leave much on the table for the repayment of creditor claims. Judges typically frown upon credit-bid offers that do not also infuse some cash for creditors.

However, bankruptcy is about negotiation and Sears and the bankruptcy court ultimately gave Lampert and his hedge fund a second chance to stave off liquidation, requiring a $120 million deposit in order to do so. Not only did Lampert pay the deposit, he sweetened the bid to over $5 billion and guaranteed a $35 million payment to unsecured creditors conditioned on the release of claims against Lampert, his hedge fund and affiliates.

On Wednesday, after several days of intense negotiation, the media reported that Lampert had prevailed[2] by upping his bid by another $150,000 million for a total bid of $5.3 billion that keeps open 400 stores — a little more than half of the 700 stores Sears had when it filed for protection last October (200 of those stores have since closed). The offer topped a bid by the Abacus Advisory Group to close all stores and sell their inventory.

Bankruptcy Judge Robert Drain still has to approve the rescue plan, which could happen at a sale hearing set for Feb. 1 in White Plains, New York, and creditors may still oppose the proposal.

While many see the last-minute deal as a “Hail Mary” win for Sears, its demise still has deep-seeded and far reaching implications and lessons for the retail industry and legal community. The bankruptcy serves as a haunting reminder that no company is too big to fail. With the benefit of hindsight, one could easily conclude that management should have recognized several decades ago that changes in the retail industry were imminent.

Practically speaking, by the time Sears figured out where things were headed and what changes were needed, it was simply too late. Large retailers such as Target and Walmart stand to gain from Sears' shortcomings, as they struggle to maintain market share against Amazon. Lack of innovation, stagnation and complacency eventually erode even the most successful businesses.

Sears is a further example of an all too familiar blueprint for retail bankruptcies. Bankruptcy has many benefits for a struggling company. Bankruptcy provides a company with the opportunity to shed unprofitable stores and move forward with a smaller, more profitable enterprise, restructure secured debt and potentially reduce debt service, and confirm a plan providing for the repayment of a portion of its unsecured debt overtime. However, bankrupt retailers have largely been unable to reorganize. Rather, retailer bankruptcies have followed a similar pattern — a short period of operation followed by a sale of the brand and/or a "going-out-of-business" liquidation.

Of course, a company's inability to reorganize can be caused by a number of factors. While bankruptcy is almost always a last resort, delaying a bankruptcy filing can limit options and make reorganization more difficult. Delay exacerbates already existing problems. Vendors will likely require payment prior to delivery, inventory can become stale, cash may be exhausted —preventing the purchase of fresh merchandise and significant payables (secured debt, rent and payroll) can mount. With dwindling cash, flagging revenues and mounting debt, a prospective debtor will have few options and little leverage or room to negotiate with creditors.

Importantly, notwithstanding all of the benefits bankruptcy can provide, it cannot create a viable business where one does not otherwise exist. Sears' bankruptcy may have less to do with the shift to e-commerce and direct-to-consumer competition and more to do with Sears' failure to change with consumer tastes. Put simply, if, at some level, consumers don’t want to buy what Sears is selling, there's not much the bankruptcy code can do to help.

We are at an inflection point in history. While brick-and-mortar retail is not dead, it is unquestionably transforming. Gone are the days of big-box department store retailers as anchor tenants in every mall across America. The foot traffic once driven by big-box retailers is being generated instead by restaurants, gyms, music venues and other entertainment-focused tenants. Companies are leasing smaller locations focused on specific products. Some brick-and-mortar are now "showrooms" rather than a place to actually take physical possession of the goods. Consumers can view, touch, feel or try-on the merchandise, but the orders are placed online and delivery is made later to the consumers at home.

Even if Lampert's latest bid is approved and 400 stores are saved, in order to maintain and sustain any level of long-term viability, Sears — the original Amazon — must now find new ways to compete with Amazon. It must weed out stale brands, replace them with the newest trends and somehow innovate new ways to lure back consumers.

In a marketplace where only the fittest survive, Sears’ future is anything but guaranteed.

Robert S. Marticello and Philip E. Strok are founding partners at the insolvency and bankruptcy law firm Smiley Wang-Ekvall LLP in Costa Mesa.

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[1] https://www.investopedia.com/terms/g/goingconcern.asp.

[2] https://www.wsj.com/articles/sears-to-stay-open-after-edward-lampert-prevails-in-bankruptcy-auction-11547636823.