BCLP. Client Intelligent

RetailLawBCLP

RESTAURANTS VS. APPAREL: A DIFFERENT RECIPE FOR RESTRUCTURING A RETAIL FOOTPRINT

Nov 28, 2017

With the holiday season now upon us, analysts are closely watching the restaurant industry, particularly the casual dining segment. Reminiscent of the conditions in 2008-2009, many are speculating whether the increase in online consumer shopping that served as a catalyst for the current "Retail Apocalypse" will reduce crucial holiday shopper foot traffic and push some teetering dining chains over the edge.

In the first half of Q4 2017 alone, there were at least three Chapter 11 filings by national and regional casual dining chains, including Romano's Macaroni Grill and Vasari LLC, the second largest franchisee of Dairy Queen franchises. In Q2 2017, Ignite Restaurant Group commenced its Chapter 11 cases to conduct a 363 sale process for Joe's Crab Shack and Brick House. Meanwhile, industry commentators are keeping a close watch on some household name chains and other mid-market brands such as Bravo Brio and Bertucci's.

Following in the footsteps of apparel retailers, over the last eighteen months, a number of national and retail restaurant chains have announced significant store closures in an effort to right size operations. By now, many restaurants are likely evaluating these same strategies to weather the expected storm. However, executive teams should be cautious and not assume that the out-of-court recipe for restructuring an apparel footprint will be effective for a restaurant chain.

Larger Landlord Pool = Greater Holdout Risk

In many cases, a restaurant chain and apparel chain with similarly sized footprints will have disparate negotiating leverage due to the make-up of their landlord pool. Consequently, it is vital that restaurant executive teams evaluate landlord concentration vis-à-vis the dollar value of the real estate portfolio.

For apparel retail chains, there is a higher tendency to have a concentrated pool of commercial landlords limited to two to three of the behemoth owners of shopping malls across the U.S., such as Simon Property Group. In the scenario where an apparel retailer is seeking to shutter 50 percent of the leases it maintains with a single mall owner, the commercial trade for the mall owner is much different. In the current environment, these large mall owners are weighing the cost of waiving early termination penalties and future earnings on 50 percent of the stores, and on the other hand, lost earnings on 100 percent of the stores if the retailer is forced to liquidate, plus indirect impact to other tenants.

In comparison, restaurant chains can be expected to have a larger diversified pool of commercial landlords comprised of sophisticated management companies, REITS, family trusts, and individual property owners. A restaurant chain with 20 or 200 locations may not have a single landlord with greater than 5 percent of the total rental exposure. For those landlords, the impact store closures will have for the other 95 percent is irrelevant. Likewise, restaurant chains have no incentive to agree to a landlord-friendly settlement in order to preserve business relations with a family trust or local property owner that owns a handful of properties. With this recipe for an impasse, restaurant executive teams should anticipate hold-out problems for some percentage of their landlord pool.

Hold-Out Neutralizer

The events leading to the Chapter 11 filing of Romano's Macaroni Grill are illustrative. According to its pleadings, between January and July 2017, Romano's achieved consensual deals for 70 percent of the 37 closed locations. After the hold-out landlords filed lawsuits, Romano's was forced to abandon its out-of-court restructuring and seek relief under Chapter 11.

Yes, hindsight is 50/50. While Chapter 11 is an expensive process and should be a tool of last resort, Chapter 11 is also the ultimate hold-out neutralizer. Whereas landlords can demand 100 cents on the dollar for early termination outside of bankruptcy, Chapter 11 caps lease rejection claims at an amount equal to the rent for the greater of one year or 15 percent, not to exceed three years, of the remaining term of the lease. Whether that amount turns out to be $500,000 or $5 million, it typically yields cents on the dollar. Thus, in some scenarios, the expense of Chapter 11 may be mitigated by the cash savings from amounts that would have otherwise been paid to landlords for early termination settlements outside of bankruptcy.

By no means does this imply that a company with a market cap of $800 million should quickly pivot to Chapter 11 to shed 40 non-performing stores. For companies with tight liquidity and thin margins that are quickly eroding, however, time is not on their side. Against that backdrop, executives should carefully evaluate whether they have the runway and the balance sheet to pursue an out-of-court turnaround for a 6 or 7 month period only to find themselves at an impasse with unbending landlords.

For questions or additional information, contact the author, Andrew Schoulder, at (212) 541-1192 or Andrew.Schoulder@bryancave.com.

MEET THE TEAM

Merrit M. Jones

San Francisco

merrit.jones@bclplaw.com
+1 415 675 3435
