Attention Kmart Shoppers, Bankruptcy in Aisle 11

Without stigma of past, Chapter 11 becomes convenient business strategy.

BY HOWARD BROD BROWNSTEIN • CTP

Several months before becoming the largest US. retailer ever to file for bankruptcy, Kmart was the object of speculation in financial markets that it would have to seek protection from its creditors.

The convulsions of yet another troubled company had become all too familiar: anemic sales in the fourth quarter, followed by a 'just get through the holidays" mentality to turn inventory into cash, suppliers tightening up on shipments and credit terms, post-holiday markdowns and doldrums and, finally, the cast of bankruptcy lawyers, lenders and insolvency specialists playing their roles in a passion play whose ending is still far from clear.

Having rallied back before from the brink of bankruptcy, Kmart had grown to over $37 billion in sales and over 2,100 stores. Initially, the company claimed all stores would remain open. But a main reason that distressed retailers utilize bankruptcy as a reorganization tool is that they can eliminate unprofitable stores without having to honor their lease obligations. This is because the federal bankruptcy code allows the bankrupt company to pick and choose among "executory" contracts those which have substantial performance due from both parties. The most common type of executory contract is a real estate lease, and Kmart leased nearly all of it's stores. This ability to "walk away" from lease obligations will give Kmart strong leverage in negotiating with local landlords that want Kmart to stay. But while Kmart may be able to renegotiate its lease terms sufficiently to keep some of its marginal stores open, we can expect to hear about store closings in the near future. Kmart has since acknowledged it will close stores, with many analysts predicting that up to 500 units will be closed.

The aftershocks of the Kmart earthquake are likely to be felt far and wide. Kmart stores are "big boxes," often the "anchor" stores of the shopping centers where they are located. It will be difficult in this economy for many of these neighborhood shopping centers to find replacements for Kmart. And whenever the shopper traffic is reduced because the anchor store has gone dark, all of the stores in the shopping center suffer. Other Kmart stores are stand-alone locations, providing their communities with a key place for families to buy general merchandise and groceries. If any of these stores close, many families will have to go elsewhere, possibly having to travel farther or pay higher prices. Jobs will also be lost in large numbers at Kmart and their shopping center neighbors. For example, workers living in these neighborhoods with only modest training have the most difficulty finding new jobs in a recession. Neighborhood lenders that provided financing for shopping centers could be hit as the landlords, lacking rental income, could have trouble meeting their mortgage payments.

And what about the suppliers? At the time of its bankruptcy filing, Kmart owed billions to its suppliers, called unsecured creditors" in a bankruptcy. Perhaps, there are some suppliers which are smaller companies that had probably rejoiced when they landed their first sale to a large national retailer like Kmart. The larger suppliers typically employed "national account" sales reps whose job it was to turn their company inside out in order to satisfy Kmart. They made dutiful pilgrimages to Kmart's Michigan headquarters in hope of another percentage point of market share, only to see their profit margins squeezed time and again in order to avoid losing precious shelf space. All of these creditors will get "crammed down," the money owed to them delayed months if not years, and even then they will be paid a fraction of what they are owed, and without interest. Such is the Darwinian reality of a performance economy, and a domino effect which will severely hurt if not sink some suppliers can be expected.

Why *bankruptcy?* Because it's the *national pastime!* In a simpler bygone age, bankruptcy carried a stigma; today, it's a red badge of courage. Time was when bankruptcy was considered immoral, an affront to a propertarian society's most cherished value: that debts should be paid, on time and in full. Why, our legal forbears in England even *imprisoned* debtors in Fleet Street Prison. Today, unless a senior executive has been through a large corporate bankruptcy, he or she may not be considered to have the requisite skills to manage a company's future, which could require him or her to utilize bankruptcy as a strategy tool. Just a few decades ago, most large law firms did not even have bankruptcy attorneys, shunning that area of the Jaw along with divorce and personal injury. Today, bankruptcy is for many leading law firms among their most profitable and fastest growing areas of practice.

The story is told of the beleaguered owner of a failing business who sought the counsel of his clergyman. Not knowing anything about business, the clergyman used his time honored fallback-advising his congregant to open the scriptures to a page at random, and his hand would be divinely guided to a solution. A few weeks later the clergyman saw this congregant looking 100% better, and was surprised when he was told that it was the clergyman's advice that had done the trick. "I solemnly opened the bible to a random page, and there was the answer: 'Chapter Eleven'!"

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Reprinted from Retail Merchandiser April, 2002