Reevaluating Retail REIT Restructurings

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On May 15th, JCPenney announced that the company was filing for chapter 11 relief. Another in a trend of major retailers filing for bankruptcy. JCPenney's announcement was expected, as forced closures in the pandemic exacerbated the company's pre-COVID financial problems.[1] However, what raised some eyebrows is the company's plan to spin its properties into a real estate investment trust (REIT) as a part of its proposal to emerge from bankruptcy.

A REIT is a company that owns, operates or finances income-generating real estate. Modeled after mutual funds, most REITs pool the capital of numerous investors, which the REIT uses to buy and operate real estate; the REIT then leases the properties, collects rent and distributes annually at least 90% of its taxable income (the rental proceeds) as dividends to its shareholders. There are a variety of commercial and residential properties that fall under the REIT umbrella, including apartment or condominium buildings, shopping centers, hotels, industrial warehouses and even hospitals. Generally, a REIT owns the property and leases it to a tenant that will operate the underlying business.

[1] Madeline Stone, "JCPenney's Bankruptcy Is the Latest Sign that Department Stores as We Know Them Are Dead," *Business Insider*, May 18, 2020, *available at* www.businessinsider.com/jcpenney-bankruptcy-latest-bad-news-department-stores-2020-5.

Published in ABI's October 2020 Real Estate Committtee Newsleeter
Available at: *https://www.abi.org/committee-post/reevaluating-retail-reit-restructurings*

JCPenney plans to close 242 stores, spin off roughly 160 of its company-owned stores and distribution centers into a REIT, and rent them through partial or full sale-leaseback[2] deals.[3] While not quite clear who will own the REIT because business plans are currently confidential, Court records indicate that a 35 percent share of the REIT could be sold to an third-party investor to generate cash or finance operations.[4]

Some financial observers are applauding JCPenney for tapping into what they tout as the retail giant's most valuable asset: its real estate.[5] The planned REIT is also attracting potential investments from major market players like Amazon as a way to increase its brick-and-mortar presence, and Simon Property Group, which wishes to take advantage of more favorable lease terms with JCPenney, a department store anchor in many of its malls.[6] But Sears's recent struggles with its own REIT spinoff and bankruptcy may suggest that some skepticism is appropriate with respect to JCPenney's plan.

In 2015, Sears, facing severe financial issues, spun off 266 properties into a newly created REIT, Seritage Growth Properties (Seritage). Seritage is primarily controlled by Sears's former CEO Eddie Lampert through his hedge fund ESL Investments Inc. (ESL). Under the transaction, Sears sold its interests in the properties to Seritage for approximately $2.58 billion and simultaneously agreed to lease those properties back from Seritage.[7]

On Oct. 15, 2018, Sears filed for bankruptcy protection under chapter 11 of the Bankruptcy Code. Sears's financial troubles accumulated from declining sales, mounting debt and generally bad business deals, but what pushed the company over the edge was a $134 million debt payment that was supposed to be due shortly after it filed for bankruptcy.[8] Several years before the chapter 11 filing, Sears engaged in a series of "financial engineering" moves, including stock buybacks, spinoffs of assets such as the "Land's End' brand, and the aforementioned REIT

[2] A full sale-leaseback occurs when a company sells its entire property and leases back the entire property. A partial sale-leaseback, however, is a more flexible option for investors and happens in a variety of forms. A partial sale-leaseback can occur when a company sells the entire property, but only leases back a portion of the property. *See* Samantha Goldberg, "Maximizing Value: Why Corporate Sale-Leasebacks Are a Win-Win for Investors, Occupiers," *Commercial Property Executive*, Nov. 9, 2017, *available at* www.cpexecutive.com/post/maximizing-value-why-corporate-sale-leasebacks-are-a-win-win-for-investors-occupiers/. Alternatively, a partial sale-leaseback could be where a company only sells and leases back a portion of its property and retains ownership of the remainder of the property. Interview by GlobeSt.com with Shan Gastineau, Senior Director, Stan Johnson Co. (Sept. 14, 2017), *available at* www.stanjohnsonco.com/sjc-in-news/sale-leaseback-back-dramatic-uptick-industrial. In other cases, the lease terms can be shorter than in a traditional sale-leaseback. *Id*.

[3] John Egan, "A JCPenney REIT Is an 'Odd Value Proposition' in Today's Climate. But Its Stores Could Attract a Wealthy Buyer," *Nat'l Real Estate Investor*, May 26, 2020, *available at* www.nreionline.com/retail/jc-penney-reit-odd-value-proposition-today-s-climate-its-stores-could-attract-wealthy-buyer.

[4] Egan, *supra* n. 2; Lauren Hirsch & Lauren Thomas, "JCPenney Announces Plan to Cut 1,000 Jobs, Gets More Time from Lenders in Push for Survival," CNBC, July 15, 2020, *available at* www.cnbc.com/2020/07/15/jc-penney-gets-more-time-from-lenders-in-push-for-survival.html.

[5] Egan, *supra* n. 2.

[6] Eagan, *supra* n. 2; Sanford Stein, "The Outsized Role Simon Property Group May Play in the 'Retail Reset,'" *Forbes*, July 12, 2020, *available at* www.forbes.com/sites/sanfordstein/2020/07/12/the-outsized-role-simon-property-group-may-play-in-the-retail-reset/#667e0d236278.

[7] Complaint, 72, *Sears Holdings Corp., et al. v. Lampert, et al.* (*In re Sears Holdings Corp.*), No. 19-08250 (RDD) (Bankr. S.D.N.Y. April 17, 2019) (hereinafter the "Complaint").

[8] Chris Isidore, "Sears, the Store that Changed America, Declares Bankruptcy," CNN Business, Oct. 15, 2018, *available at* www.cnn.com/2018/10/15/business/sears-bankruptcy/index.html.

spinoff.[9] Throughout that period, Lampert and ESL extended secured credit to Sears, and when Sears finally filed its bankruptcy case, ESL held claims exceeding $6 billion.[10] Lampert stepped down as Sears's CEO after the company filed for bankruptcy, but remained its chairman and largest shareholder. In January 2019, the court approved ESL's $5.3 billion bid to take over the company.

The Sears chapter 11 sales process involved a complicated auction structure designed to sell several different types of assets, including stand-alone businesses and real estate.[11] Based on their secured claim, ESL made a $5.3 billion credit bid and the only "going concern" bid for the assets, offering to keep 425 stores open and prevent the loss of 50,000 jobs.[12] Unsurprisingly, no other bidder emerged, and Lampert succeeded with his bid in the bankruptcy auction.[13] However, Lampert failed to keep his promises, as Sears stores have continued closing since the January 2019 sale. As of September, there are only approximately 95 Sears (and Sears affiliate) locations worldwide.[14]

On April 18, 2019, Sears filed an adversary proceeding against Lampert alleging that he, along with other insiders, intended to hinder, delay and defraud creditors by transferring "billions of dollars of the [c]ompany's assets for grossly inadequate consideration or no consideration at all."[15] Sears alleges that these transfers occurred when the company was "insolvent and had insufficient capital to continue its operations and to repay its billions of dollars in debt," and the transfers constitute actual and constructive fraudulent transfers.[16] Sears also claims that Lampert and other company officials made billions off the failing retailer as it slid into a "death spiral" that ended in bankruptcy.[17] The suit alleges that the REIT spinoff, and other spinoff transactions that Lampert directed, "intended to transfer value to Sears'[s] shareholders and therefore divert that value from creditors."[18]

Specifically, regarding the REIT spinoff, Sears alleges that the property's purchase price was not negotiated but was established unilaterally by Lampert and other insiders, and undervalued the transferred real estate by at least $649 million.[19] Sears further alleges that the terms of the Seritage leases were not negotiated at arms' length but were imposed unilaterally by Lampert and other insiders, which resulted in blatantly unfair terms, including permitting Seritage at any time and at its sole discretion to (1) recapture up to half of the square footage of each store, and (2) retake the entirety of 21 specified stores upon the payment of a fee to Sears.[20] Another allegedly unfair term required Sears to pay a hefty fee to Seritage if it voluntarily terminated a

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[9] Adam L. Rosen, "Take-Aways from the Sears Sale Process," *Law Journal Newsletters*, April 2019, *available at* www.lawjournalnewsletters.com/2019/04/01/take-aways-from-the-sears-sale-process/.
[10] *Id.*
[11] *Id*.
[12] *Id*.
[13] *Id*.
[14] Warren Shoulberg, "Total Sears and Kmart Store Count Going Down to Just 95," *Forbes*, July 12, 2020, *available at* www.forbes.com/sites/warrenshoulberg/2020/07/12/total-sears-and-kmart-store-count-going-down-to-just-95/#67e8e64260eb.
[15] *Complaint* at 1-2.
[16] *Id*. at 2, 107.
[17] *Id.* at 8.
[18] *Id*. at 6.
[19] *Id*. at 7.
[20] *Id*.

lease.[21] Sears alleges that the transaction saddled it with hundreds of millions of dollars of rent and termination fees ultimately paid to Seritage, and it resulted in Sears losing many of its most profitable locations.[22]

The adversary proceeding initially was stayed while Sears pursued plan confirmation, and the case remains in its initial stages. Answers and responses to the Complaint were filed on Feb. 21, 2020. Lampert and ESL filed their Motion to Dismiss on that day,[23] in which they contend that Sears's allegations mentioned above are factual disputes and are not seeking the dismissal of those claims at the pleading stage, but did move to dismiss the "kitchen sink of other claims relating to the Seritage Transaction," such as claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, unjust enrichment and illegal dividend.[24] Sears filed its Brief in Opposition to the Motion to Dismiss on April 3, 2020. The court has not yet ruled on the Motion to Dismiss. On July 9, 2020, the court entered a further scheduling order that provides for discovery to conclude by October.

Recently, Seritage has begun to face financial troubles. With the number of Sears locations dwindling, Seritage has had to reevaluate its sale-leaseback strategy. Their current strategies still rely primarily on retail tenants paying rent, and many are struggling these days. So, while Seritage may have thrived in the beginning, the long-term feasibility of a REIT that largely relies on payments from a company that was driven into chapter 11 based on a lack of demand for brick-and-mortar retail and increasing competition from online retailers — effectively putting it into a "death spiral" — is a questionable restructuring strategy.

JCPenney's stakeholders should look to Sears's bankruptcy as a cautionary tale and might not want to be so quick to mimic its REIT strategy. The transactions among Sears, Lampert and other insiders have led Sears to a lengthy, complicated and expensive bankruptcy lasting almost two years, with a complicated adversary proceeding only beginning. The chances that the company will emerge from bankruptcy appear doubtful. JCPenney's stakeholders should look with skepticism as the REIT plan's details come out in the coming months. Particularly, they should pay attention to possible conflicts of interest, as demonstrated in the *Sears* case, and whether a REIT spinoff is profitable in the long run if it plans to do sale-leaseback transactions with an already failing business.

It is important to note, however, that unlike Sears's REIT, JCPenney's REIT strategy will be undertaken in bankruptcy with court and creditor supervision. This supervision should lessen the risk of any fraudulent activity and the prospect of future litigation over whether it was a fair transaction.

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[21] *Id*.
[22] *Id*.
[23] Memorandum of Law Related to Motion to Dismiss Adversary Proceeding, 11, Dkt. 105, *Sears Holdings Corp, et al. v. Lampert, et al.* (*In re Sears Holdings Corp.*), No. 19-08250 (RDD) (Bankr. S.D.N.Y. April 17, 2019) (hereinafter the "Motion to Dismiss").
[24] *Id*.