

**AMERICAN BANKRUPTCY INSTITUTE  
MEDIA TELECONFERENCE TO EXAMINE THE FUTURE OF RETAIL  
SECTOR DISTRESS**

INTRODUCTION

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Calendar year 2008 was not a very good year as far as bankruptcies were concerned. In that year we witnessed about 1.1 million bankruptcy filings. Unfortunately, the numbers are not looking any better for CY 2009. At the ABI, we are projecting over 1.5 million bankruptcy filings with at least a 50% increase in business bankruptcy cases. In fact, as of Q1 2009, eight national retailers have sought relief under the Bankruptcy Code, thus following 27 national retailers that had filed in CY 2008. (Of those 27, 37% filed in Q4 of 2008). The CY 2008 total was the most since 32 retailers filed in CY 2001. Retailers who filed in the 4Q 2008/1Q 2009 included:

- Value City Department Stores LLC; 10/26/2008
- House of Taylor Jewelry, Inc.; 11/5/2008
- Harold's Stores, Inc.; 11/7/2008
- Circuit City Stores, Inc.; 11/10/2008
- National Wholesale Liquidators, Inc.; 11/10/2008
- Antioch Company, The; 11/13/2008
- BH S&B Holdings LLC; 11/19/2008
- Lenox Group, Inc.; 11/23/2008
- KB Toys, Inc.; 12/11/2008
- Theater Xtreme Entertainment Group, Inc.; 12/15/2008
- Recycled Paper Greetings, Inc.; 1/2/2009
- Retail Pro, Inc.; 1/10/2009
- Shane Co.; 1/12/2009
- Goody's, LLC; 1/13/2009
- Gottschalks Inc. Department & Specialty Store Chain; 1/14/2009
- Fortunoff Holdings, LLC; 2/5/2009
- S & K Famous Brands, Inc.; 2/9/2009
- Ritz Camera Centers, Inc.; 2/22/2009<sup>1</sup>

As our panelists will elaborate, present market conditions and the lending environment suggest that the retail sector will continue to suffer substantial losses and witness more and more companies liquidating or seeking other forms of relief under the Bankruptcy Code. For example, top line revenue numbers are down.

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<sup>1</sup> Bankruptcydata.com, <http://www.bankruptcydata.com> (last visited Apr. 13, 2009) (all numbers).

Profit Margins are down—businesses are reducing prices to draw customers. Consumer spending and credit are down with consumer savings increasing—good for consumers with debt, but not so good for a weak economy that is driven by consumer demand. Vendors are aggressively managing their credits, reducing credit terms, pulling back in volume shipments, etc. Vendors are no longer serving as short term banks. Banks are simply not lending beyond what it may take for a quick sale or to liquidate the business unless the business has good cash flows and a good brand. We are also seeing that we are way over built in retail space that the reduced consumer demand can no longer justify. In short, in retail, we have hit a liquidity wall. There are no financial buyers to speak of because of a scarcity in available capital. The present bankruptcy strategy is to find a strategic buyer quickly—because your creditors are giving you little time—or liquidate.

As capital returns to this sector, retailers will continue to face many challenges to rehabilitation—some of which are embedded in the law itself designed to help in rehabilitations of businesses. The 2005 Amendments to the Bankruptcy Code created a chapter 11 for good times, not a chapter 11 that is most effective for financially bad times. A major thrust of the drafters of chapter 11 of the Bankruptcy Reform Act of 1978 was to develop a flexible, adaptive, and transparent system that was business-plan agnostic. Our original chapter 11 design permitted a debtor a broad range of discretion, consistent with the exercise of sound business judgment and the best interests of the estate, to develop a business plan with the greatest chance of success. If anything, recent amendments to chapter 11 of the Bankruptcy Code have failed to serve the law's original purposes and policy goals.

In my opinion, Congress should consider at least three points in helping recalibrate bankruptcy law to provide a greater chance of success. First, Congress should consider removing the administrative priority for goods sold to the debtor within 20 days and returning that pre-petition claim back to the prior practice of establishing a reclamation claim or living with a general unsecured claim. Second, Congress should consider relaxing the deadline by which commercial real property leases must be either assumed or rejected. The 2005 Amendments place a cap of 210 days. By that time, a lease is deemed rejected if not assumed. In my opinion, Congress should consider removing this cap and restoring the discretion of the bankruptcy court to determine on a case-by-case basis whether cause has been shown to extend the deadline. Finally, Congress should consider relaxing the deadline for the period of exclusivity from 18 months to a time period determined by the bankruptcy court. The period of exclusivity is the period by which only a debtor may propose and obtain confirmation of a plan of reorganization. During this period, no other party may file a competing plan until that time period lapses. In my opinion, infusing more and not less judicial discretion is the appropriate way by which to provide a reasonable opportunity for debtor rehabilitation.

Below, we at the ABI introduce you to a stellar panel of experts on financial distress in the retail sector. The panelists will discuss some of the issues I have

raised in this introduction, along with providing key insights on the pressing problems in and challenging future of the retail sector. Enjoy.<sup>2</sup>

TRANSCRIPT

**John Hartgen (ABI):** Welcome everyone to today's conference looking at distress in the retail sector. The simultaneous trends of consumers cutting back on spending and credit markets tightening are intensifying the financial distress for many retailers. While seven large retail companies filed for bankruptcy throughout 2007,<sup>3</sup> 16 large retailers have already filed for bankruptcy since the beginning of 2008 with several months yet to play out.<sup>4</sup>

A panel of experts specializing in retail company bankruptcies will discuss the current problems in this sector, as well as the financial future of the retail industry. The program will consist of about 30 minutes of opening commentary by our experts, and then we will take your questions.

Our speakers include **Laura Davis Jones**, a managing partner of Pachulski, Stang, Ziehl, & Jones, **Scott Avila**, a managing partner with Corporate Revitalization Partners, and **Howard Brod Brownstein**, CTP, a principal of Nachman Hays Brownstein, Inc.

Our moderator for the program will be **Professor Jack Williams**, ABI's resident scholar. Professor Williams teaches an assortment of bankruptcy courses at Georgia State University College of Law. I'll now turn it over to our moderator for the program, Professor Jack Williams.

**Williams:** Thank you very much John As John mentioned, we have a wonderful panel to discuss a number of issues in the retail sector. We've got only about 30 minutes to do that. So what I'd like to do now is turn it over to Scott for an introduction of the topic, with a particular emphasis on the market, economic background, and current state of affairs in the retail sector. Scott . . .

**Avila:** Thanks, I appreciate the time today and thanks for everybody for joining.

I'm just going to go over a couple things here. It's really what happened prior to say 2008, what the current state looks like, and some of the impacts on sectors that are really being impacted by this.

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<sup>2</sup> The comments made in this roundtable discussion are those of the panelists and moderator, and do not necessarily reflect the views of their employers, organizations, the American Bankruptcy Institute, or St. John's University School of Law. This discussion took place on March 10, 2009.

<sup>3</sup> See TheDeal.com Staff, *Retailers and Bankruptcy*, THEDEAL MAG., Feb. 27, 2009, <http://www.thedeal.com/newsweekly/dealwatch/retailers-and-bankruptcy.php> (recapping major retailer bankruptcies from middle 2007 to 2009).

<sup>4</sup> See Anna Robaton, *The Fruits of Bankruptcy Reform*, SHOPPING CENTERS TODAY, Aug. 2008, available at [http://www.icsc.org/sct/sct\\_article.php?i=sct0808&s=1&d=1](http://www.icsc.org/sct/sct_article.php?i=sct0808&s=1&d=1) (listing several prominent retail chain bankruptcies in 2008).

And so prior to basically Q3 of '07 we saw three things going on. Number one, it was a very robust economy. Two, the financial markets were strong and three, there was—as part of that—low cost of capital.

On the economic side, you saw really low unemployment, strong housing—not only in construction and remodels, but also in general sale activity. With the financial markets there was abundant liquidity and low cost. The retailers were able to benefit two ways—one way was the consumers had access to cheap capital through several means, whether it was home equity loans or low interest rates.<sup>5</sup> And secondly, the retailers helped themselves to finance their goods and support their real estate and expansion growth.<sup>6</sup>

Again, the low cost of capital benefited everybody here. And that went up until about the Third Quarter (Q3). And subsequent to that, what you saw was a few things happening in Q3, 2007, which is really that whole process led to over-expansion due to unproceeded liquidity and strong consumer demand. Up until that time what you witnessed was a lot of new locations going up, new malls being built, new locations, and many new entrants to the retail market. If you'd walk around most of the malls, you would have seen, for example, many new jean stores and things of that nature you would not have seen before.

From the retailer standpoint, you also saw very highly leveraged balance sheets. Retailers would be able to put on a lot of debt, including a lot of creative debt such as second lien debt. Retailers were able to go much deeper into the debt streams then you were seeing in the past.

And today, if we fast-forward to where we look at it in 2008-2009, we realized what I call this trifecta approach to the retailers. You see three things that are really significantly impacting the retailers today. First, there is the general economic slowdown. Second, there is the distress in the housing industry. Third, there is really scarce capital. So it's really three issues that have hurt retailers—the economics, the housing, and the capital—and I'll touch on these for a moment.

Because of, in part, the economic slowdown, we are witnessing rising commodity prices that have really impacted the consumer and led to a lot less discretionary dollars than consumers had in the past. With consumers' real wages falling due to wages not increasing as fast as commodity prices, that's impacted consumer demand for retail goods and services. On top of that, you have higher unemployment, again negatively influencing consumer demand. And thirdly, you're really seeing consumer sentiment starting to impact retailers today.

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<sup>5</sup> See John Leland, *Couple Learn the High Price of Easy Credit*, N.Y. TIMES, May 19, 2007, available at <http://www.nytimes.com/2007/05/19/us/19debt.html?pagewanted=print> ("[A]s home values have increased and interest rates have dropped, home equity loans have enabled families to carry more debt—to buy more things—at lower cost.").

<sup>6</sup> See generally Terry Pristin, *Shopping Centers Begin to Feel Ripples of Housing's Ills*, N.Y. TIMES, Sept. 12, 2007, available at <http://www.nytimes.com/2007/09/12/realestate/commercial/12mall.html?n=Top/Reference/Times%20Topics/Subjects/F/Finances&pagewanted=all> (detailing lost allure of formerly booming retail real estate market due to housing crisis).

The distress in the housing industry and real estate in general, again impacted folks twice, because not only has the housing slowed down significantly, but also anybody who is buying a home generally has spent a lot in the retail environment. Additionally, the real estate values used to support the balance sheet and the expansion—retailers are not able to get that—to get that capital they had in the past.

The scarcity of capital, again has hurt consumers, which in turn, hurts retailers. For example, without being able to obtain those home equity loans that they had in the past, you'll really see a slowdown in any discretionary spending.<sup>7</sup> So if you see certain sectors like—I keep saying ATVs, big screen TVs, motorcycles—anything that someone would take out of their home equity loan and go buy—they've been dramatically negatively impacted.

We are witnessing that play out across many, many retailers. So the overall impact is, on the retailers, the number of poor performing stores has really increased. On top of that, you've seen a very leveraged balance sheet so that they don't have a lot of space from the financial standpoint to continue. Thus, we should expect more and more filings.

What you're seeing in some sectors is that the middle and lower demographics are really impacted much stronger, especially in the areas of casual dining, fashion, furniture, home goods—certain sectors are being impacted more than others.<sup>8</sup> You're seeing that purchases that can be delayed are going to be delayed. Destinations—if you have to travel to a retailer, those are impacted significantly because people, because of the gas prices, were not willing to spend the money to drive just to pick up one item. You're also seeing consumers go down market significantly, much more than they had in the past.

Lastly, the management teams of these retail organizations vary wildly, with very different skill sets, abilities and capabilities. So certainly retailers that are able to separate themselves from the herd are doing really well.

On the sector side, certain sectors that are really hurting include, obviously, specialty retail—it's been a significant growth sector in the past, but there is a lot of cannibalization going on. So they're impacted a lot.

Obviously, anything to do with home goods, so Lowe's and the Home Depots and anything that someone would go and buy are significantly impacted. Additionally, department stores are significantly impacted.<sup>9</sup>

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<sup>7</sup> See Liz Benston, *The State of Our Engine*, CASINO CITY TIMES, Mar. 2, 2009, available at <http://www.casinocitytimes.com/news/article.cfm?contentID=177246> (discussing how Las Vegas is city reliant on discretionary spending, and is suffering as result of lack of consumer acquisition of home equity loans).

<sup>8</sup> See Malcolm M. Knapp, *Mortgage Woes Suppress Traffic at Casual-Dining Restaurants*, NATION'S RESTAURANT NEWS, Sept. 17, 2007, available at [http://www.nrn.com/article.aspx?keyword=&menu\\_id=1426&id=345308](http://www.nrn.com/article.aspx?keyword=&menu_id=1426&id=345308) (noting reduced spending by consumers on casual dining and goods).

<sup>9</sup> See AP Online, *S&P Places 6 Department Stores on CreditWatch*, ASSOCIATED PRESS, Feb. 5, 2009, available at [http://money.aol.com/news/articles/qp/ap/\\_a/sandp-places-6-department-stores-on-rfid182562661](http://money.aol.com/news/articles/qp/ap/_a/sandp-places-6-department-stores-on-rfid182562661) (discussing six department store companies placed on negative CreditWatch list by Standard & Poor's Ratings Services due to "pessimism over the impact of the U.S. recession on the troubled sector").

The higher end locations seem to be doing very well in the market, but as you see people shift down market due to the economic change, the discount stores are performing much better—so the Costcos, the Sam's Clubs, and the Wal-Marts are doing really well.<sup>10</sup>

In summary, the significant growth and liquidity in the retail industry were up until '07, and an over-expansion due to the abundant liquidity, the strong economy, has turned to where we are now witnessing a slow down in the economy, production, and consumer spending, coupled with the higher leverage of balance sheets. There are much more distressed retailers than we've seen in the past.

**Williams:** That was fantastic. And if I could elaborate on what you just said—it looks like a primary driver to a number of the financial distresses in the retail sector isn't necessarily bankruptcy or the 2005 amendments *per se*, but just the market and the economic conditions in which the retail sector is operating.<sup>11</sup>

Laura and Howard, do you have any comments on the economic frame of reference here before we move to the Bankruptcy Code and its potential influence and impact on retail sector distress?

**Jones:** Really only to agree, Jack, I'm going to let Howard jump in, and then I might be able to move ahead and talk about some of these market changes, how it's affected actual restructuring cases that we're seeing. But I definitely agree with Scott that the stress that the market has now put on these retailers has caused a lot of variance in restructurings now, versus even two years ago.

And Howard, I don't know if you have any general comments on that before I kind of jump into some specifics on both how the market has changed what we see in the restructurings, but then I also do have some thoughts on how the Bankruptcy Code has changed, some of what we see in the retail restructurings as well.

**Brownstein:** Let me make a few comments about just the business environment before we get into the cases.

I read a report today called *The American Shopperscape 2008 Report*, which is put out by a publication called *TNS Retail Forward*. And this was a survey of people's shopping patterns. Basically shoppers are trading down, shopping at fewer stores and closer to home. The survey reported that 75% are planning their errands more to minimize the amount they have to drive.<sup>12</sup> And more are going to one-stop-

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<sup>10</sup> See Leslie Earnest, *Retail Sales Beat Low Expectations*, L.A. TIMES, May 9, 2008, available at 2008 WLNR 8671698 (noting "better-than-expected" increase).

<sup>11</sup> E.g., Matt Kiefer, *Linens 'n Things Closing in Schaumburg, Palatine*, SCHAUMBURG REV., May 8, 2008, available at 2008 WLNR 9171463 (noting "significant deterioration" in housing and credit markets impacts retail).

<sup>12</sup> See Kathy Clarke, *Americans are Staying in and Driving Less to Save Money*, TNS Retail Forward (Sept. 19, 2008), <http://www.retailforward.com/pressroom/pressreleases/090208.asp>.

shopping stores. More are going to stores that are closer to home or work.<sup>13</sup> And more are doing stuff around the house anyway.

But one of the most interesting statistics was that a fourth of the people surveyed are doing more online shopping.<sup>14</sup> And so to me, the current climate, gasoline, etc., could be the catalyst that really shifts more people from bricks to clicks. And it will be very interesting to see even if overall spending is down, if the mix within what spending there is, shifts more to online spending. This could be what it takes, i.e., the "tipping point." That was the only general comment about the consumer part of the market I wanted to comment on.

The other comment I would make is that everybody knows the retail industry is a very seasonal industry.<sup>15</sup> If it weren't for back to school and Santa Claus, there might not be a retail industry. So that's to say from a turnaround professional's point-of-view, which is what I am, retail businesses are "lumpy"—their sales are not spread evenly throughout the year. They have big peaks and valleys—not only with respect to their sales—but also regarding their need for capital, especially working capital. And so they need a way to bridge the gap between when they have to put out money to order the goods and get the goods on the shelves, because you can't sell what you don't have on the shelf, and when they turn that inventory into cash. And that's typically a several month gap, and that gap is a nervous time for everybody, especially the providers of capital like vendors, lenders and factors.

So those are my comments about the general economic climate.

**Jones:** And just to pick up on something that Scott and Howard both said in terms of what's happening in the market itself demographically. I was contacted maybe a month ago from a large retailer who works, or provides products in the way of soaps and lotions and things like that. And something I hadn't really even thought of—their average price point of someone coming in—they spend about \$25. And the average income of someone coming into that store—a total family—encompasses somewhere between \$50,000 and \$75,000.<sup>16</sup>

They said that their sales, now it isn't that they're just trending down, they have stopped. And they said that the \$25 that folks would have come in and spent on bath and beauty products, is now just the \$25 they're putting in their SUV for gas. And/or that they're starting to store away for their winter heating bills. And it's one of those—and Howard and Scott can have a lot of thought on this—it's very difficult to now start thinking about a business plan or a restructuring plan when

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<sup>13</sup> See *id.* (reporting 55% of people go to stores close to home or work).

<sup>14</sup> See *id.* (reporting 26% of people are doing more online shopping).

<sup>15</sup> E.g., Erin Ailworth, *Retailers Banking on Post-Holiday Rush to Salvage Season, More Bargains Than Bargain Hunters*, BOSTON GLOBE, Dec. 27, 2008, at 1 available at 2008 WLNR 24792752 (discussing retail industry's reliance on holiday season).

<sup>16</sup> Cf. WILLIAM F. LEWIS, MARKET SEGMENTATION AND TARGET MARKET SELECTION FOR CONSUMER BEHAVIOR 10–39 (2006), available at <http://www.dbmorgan1.com/634Documents/Market%20Segmentation%20Project%20Outline%20MASTER%206-12-06.pdf> (reporting Bath & Body Works' breakdown of demographics' income).

you have an entity whose revenues haven't just started to shrink, they're just stopping, and it's very difficult.

But Jack, if you want I can pick up a few points on how these market changes have affected the bankruptcy routine.

**Williams:** That would be a great idea.

**Jones:** Scott was talking about what I would refer to as saturation in the market of leased space. I mean there's just so much space available. And one of the primary areas that it's impacting our ability to be able to restructure retailers is often times you put a company into bankruptcy saying that you are going to rid yourself of the different premises and locations that are losing money. You try to cut deals and better your terms with your landlord, but if you can't, you get rid of those leases. And you also hear people say that they get rid of the locations that are on the bubble. They're not quite losing a lot of money, but they're not making any money and so you get rid of those as well.

What's difficult now is there's no interest in the lease space. And I don't know the precise numbers, but I can tell you, for example, in Linens-N-Things, which just had an auction in 2008 for some of its lease space—they had 85 leases that they wanted to sell, and they had interest in only five of them.<sup>17</sup> You take two years ago, even, two and a half years ago, there would have been interest in all 85 of the spaces, and there would have been some serious bidding on a good number of the spaces.

The same is true; it's affecting what we refer to as "designation rights." And I think most people are familiar with the concept that parties come in and buy the option, if you will, buy the time to decide whether to have a debtor assume and assign a lease to them. And if they decide not to at the end of the day, they just direct the debtor to reject the lease.

But what I am finding in a lot of our retail cases is there's just no interest in buying the designation rights, because there's so much other space that's out there that's available, you don't need to spend money to preserve the option to be able to try to get some space.<sup>18</sup>

I can give a real-life example. I represented G&G Retail in the Southern District of New York in January of 2006 going forward, and they were the owners of the Rave Apparel Stores; we had approximately 500 stores in total. We had a potential buyer in Wet Seal to take the space. We put it out for bid, let other parties

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<sup>17</sup> See Sandra M. Jones, *Final Sale: More Retailers Liquidating*, CHI. TRIB., Oct. 22, 2008, available at <http://archives.chicagotribune.com/2008/oct/22/business/chi-wed-retailers-liquidators-oct22> (detailing Ms. Jones' comment from ABI teleconference and identifying her as managing partner of firm that represented secured noteholders in bankruptcy).

<sup>18</sup> Cf. Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603, 624 (2005) (positing BAPCPA "is likely to have a chilling effect on the sale of [certain] designation rights because the time period for finding an assignee is shortened").



be interested in it, and a number of parties came in, and Max Azria came in and said, "I want all of the stores—I'll take 350 of them right away, and I want designation rights with respect to another 150."

And then there were other parties that tried to bid against Max Azria, so, and Max probably in the end of the day looking back probably over-paid for the rights and also for the space, but it was a footprint he wanted; they were located in malls throughout the country, and it was typical of retailers who would try to glom on to space that the other competing retailers had that they now have an interest in.

In representing the retailers we have now there's just not that level of interest and it makes it very difficult to do a retail restructuring.

Another market-based influence on the restructurings that's become a problem is—and Scott spoke to this, and I am sure could speak more to it, is the real tightening on capital or being able to get any financing. The asset based lending is drying up for retailers.<sup>19</sup> And what there is—is extremely expensive. I think I saw an article the other day that it's now LIBOR plus 2.25% to 2.75%; it's very expensive borrowing. And also what is considered an eligible receivable or eligible inventory to borrow against is also diminishing.

And so because there is that lack of money, there's lack of money to do capital expenditures at these various locations. And one of the things I think most people are aware of is Bennigan's, for example, a casual retail dining chain, decided not to even do a chapter 11, but went straight to chapter 7—didn't even "pass Go."<sup>20</sup> And one of the key elements in that decision was that so many of their properties needed capital expenditures for improvements and there just wasn't the money to do it.

So those are two examples of things you're seeing where the market is really impacting in a restructuring.

And then the last point I'll make on what the market affect is having is when you can get lending, and there is somebody that either wants to buy the retail or otherwise restructure it, the speed at which it needs to be done now is so much faster. The lenders are putting very, very tight controls on how quickly they want a bankruptcy to happen, and whether it's a sale under 363 or an internal restructuring. And there are very tight time lines and very tight milestones put into place to keep total governance on the process where it used to be much looser, even a year and a half ago.

Howard, I don't know if you have any other market-type impacts that you're seeing on the restructurings.

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<sup>19</sup> See John Keilman, *Commercial Jungle's White Elephants; Large, Vacant Properties in Suburbs Remain a Financial and Aesthetic Burden*, CHI. TRIB., Feb. 18, 2009, available at <http://www.chicagotribune.com/news/local/chi-vacant-north-zone-18-feb18,0,2852773.story> (asserting that because of credit crisis, loans are "more expensive and less available," causing "many would-be [commercial] tenants [to] decide it's not worth the hassle").

<sup>20</sup> See Jeffrey McCracken & Janet Adamy, *Dining Chains Shut Doors*, WALL ST. J., July 30, 2008, at B1 (noting that filing being discussed was "one of the largest Chapter 7 bankruptcies of a restaurant chain in recent history").

**Brownstein:** What we're seeing is that lenders are—no big surprise—moving the goal posts. What was an OK credit a year ago, or even several months ago, is not an OK credit today.

Drilling down, how that manifests itself is how they value collateral. In the retail industry, lending takes primarily two forms.<sup>21</sup> First, it's the credit that the retailers get from their suppliers. It's open account credit from their suppliers, but what's behind that is something called "factoring," and I am going to assume the folks on the call know what that is, but if you don't, ask during the Q&A. And so really, the retailers' financial well-being is heavily impacted by the willingness of factors to provide credit to the suppliers to those retailers. If the retailers can't get trade credit, they're dead. And the factors have all been pulling back their horns because they don't want to get stuck when a retailer files bankruptcy and can't pay the supplier.

The asset-based lenders who lend to the retailers have been pulling back in a number of ways. First of all, there had been a trend towards lending on the retailer's brand name—that the brand name had intellectual property value, and the thought was that, if this retailer got into problems, the brand name of the store—not the brand name on the goods—would be worth something.<sup>22</sup>

I think that has proved to be somewhat of an illusory concept, and so lenders are less willing than they previously were to ascribe a lot of value to that.<sup>23</sup>

Retailers really don't have any accounts receivable. All they have are credit card receivables, and not many retailers run their own charge accounts to consumers any more. A lot of store charge cards are really someone like GE Capital in disguise. So really, the retailer's collateral is its inventory. And so, from a lender's viewpoint, what's the inventory worth, and what can the lender get for it if the lender has to liquidate it? Lenders view of that value, and in particular their former expansiveness, has declined, and they're much tougher in terms of what value they'll attribute to the retailer's inventory. And to the extent the retailer owns any of its real estate, needless to say in this real estate climate; lenders are unwilling to attribute much value to the retailer's real estate.<sup>24</sup>

So the lending climate has gotten very tough for retailers, and for the suppliers of retailers, which then impacts the retailers themselves.

**Avila:** Howard, just to add to that, you're seeing the factors really clamp down on the suppliers. I'm involved in three or four of them and you're seeing that the

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<sup>21</sup> See Chaim J. Fortgang & Thomas Moers Mayer, *Developments in Trading Claims: Participations and Disputed Claims*, 15 CARDOZO L. REV. 733, 757 (1993) ("Retailers buy goods on credit from their suppliers. Their suppliers 'factor,' or assign, their receivables to financial institutions . . .").

<sup>22</sup> But see Stuart Whitwell, *Lending Against Intangible Assets*, FIN. WKLY., Oct. 14, 2008, available at <http://www.intangiblebusiness.com/Brand-services/Banking-services/News/Lending-against-intangible-assets~1171.html> (discussing brand name value).

<sup>23</sup> See *id.* (noting "[r]efinancing including intangible assets as collateral" can be risky).

<sup>24</sup> See John Golden, *A Debt Calamity*, 47 FAIRFIELD COUNTY BUS. J., Apr. 7, 2008, available at 1008 WLN 7995998 (discussing how commercial office real estate values in Westchester-Fairfield area could drop anywhere "from 5 percent to as much as 25 percent" before credit crisis is over).

factors are driving the liquidity markets, because they don't have faith and there's a lot of reservation about the holiday season coming up—and there's a lot of people looking and waiting to see how those orders are to flow through and the sell through.

And they're supporting manufacturers into the retailers that have the systems and the process to—and the management teams that have been successful in these kinds of downturns. But I agree with everything everybody said that it's the price it's going from—used to be, you know, a fairness closing the loan, it used to a point and then LIBOR plus two. Now it's two points and LIBOR plus three—and that's just the pricing adjustment—but then the actual participants in the number of lenders—the sheer number of lenders lending to the retail environment has dramatically decreased over the last two years. There are just not many parties in the game.

**Jones:** I think—assuming you could get past the market issues on a restructuring, there are a couple of bankruptcy issues that have impacted the restructurings, but frankly I think they're the tail wagging the dog because you really need to get past these market issues, which I know we've all painted a kind of a doom and gloom scenario here, but there are a number of retailers that are going to make it, and mainly they're going to make it through sales to other healthier entities.

But there are a couple of the bankruptcy impacts that you all may have heard about through BAPCPA, the 2005 amendments to the Bankruptcy Code that have made the retailer restructurings a little more difficult. First, there is section 503(b)(9), which gives any supplier, or anybody who delivers goods within 20 days of a bankruptcy filing—they get an administrative claim—they get a right to a hundred cents on a dollar.<sup>25</sup> This makes it a very different ballgame when you're trying to emerge from chapter 11 and do a plan of restructuring or a plan of liquidation, because you have to pay those folks a hundred cents.

Well we all know in the retail industry, especially whether it's casual dining or some of the other faster turning retailers that Scott spoke about—there's going to be a lot delivered in the 20 days before a bankruptcy filing. Food or what have you. And to know that you have to pay all of those vendors a hundred cents on the dollar that delivered during the 20 days before the filing could be a huge nut that has to be thought through when you're trying to emerge from chapter 11.

The other bankruptcy change that came in the 2005 amendments that people talk about a lot, but frankly, my practical experience has been that it has not made too much difference, is that the Bankruptcy Code now limits the amount of time that a retailer or debtor has to decide to assume or reject a lease. It's now 120 days plus 90 days, so a total of 210 days, unless you have consent from a landlord to extend it further.<sup>26</sup>

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<sup>25</sup> 11 U.S.C. § 503(b)(9) (2006).

<sup>26</sup> 11 U.S.C. § 365(d)(4)(B)(i) (2006).

Frankly, as a practical matter, because the capital restraints are so tight, most retailers filing have to figure out what they're doing within 210 days in any event. If we ran a market where there was a lot more available capital, I think that would be more of an issue, but the ones that I've been representing since the amendments have come out, things are moving so quickly, and have to move so quickly because of their capital constraints, that we've been able to work with that 210 days. And where we were not able to—we were able to get consent of the landlord because like Howard and Scott were saying, people want stores open through the holiday or what have you.

So those are two big bankruptcy issues that I think get involved in these retailer restructurings, among some others. But I think the market driven factors are much more dispositive of what you're going to see happening in the retail industry.

**Brownstein:** Let me just make a quick comment. There's no doubt that the change in the Bankruptcy Code affects how these cases proceed and are managed. But it really doesn't change the underlying facts. The underlying facts are that everybody—the creditors, the landlords, the banks, the factors—are all looking at the same thing, which is what is the success or chance for success of the underlying business. Without a good chance of success, there's not a whole lot to talk about, and all these changes in the rules affect is who's got the power to do what and when. But it doesn't change the underlying reality.

And so in a case where a restructuring is possible, all that these changes and deadlines do is force the parties to plan a little better, get out in front of the problem more, perhaps have turnaround professionals like me begin talking to landlords ahead of a filing, because the landlord doesn't want the empty space either.<sup>27</sup> And it's not like they have a lot of other stores lined up to take the space. So in this climate, landlords may be more inclined to be flexible, both as to deadlines and as to terms.

The real question is—is there a "pony under the pile?" Is there a business that can make it and what will it take?

**Avila:** I think, Howard, I think what you just said is really the key—what you're seeing now in the restructuring is if you don't bring to the table sooner, what I'll call a consensual understanding of the underlying economics—is this business really here? Is it going to survive in the current economic conditions? I've seen situations where they're trading down on the com store basis, you know, double digits. And the question everybody is asking themselves is—for how long is this going to trade down—is this location? And they think, as you said earlier Laura, these bubble locations in the past might have been good, but you're seeing them cut deeper stores

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<sup>27</sup> See *Slump Allows Occupiers to Trump Landlords: CoreNet Global Predicts More Favourable Terms for Tenants in Leases*, 74 PROP. WKLY. 445, Jan. 23, 2009, § 4, at 445, available at 2009 WLNR 3099538 [hereinafter *Slump Allows Occupiers*] (noting corporate tenants' ability to negotiate with landlords).

sooner and situations I've been in with Movie Gallery and others, you just had to cut a lot deeper and sooner.

And then secondly, is there really a business, as you say, around some core group of stores that can weather the storm? And then B is, you better have gone out beforehand with your senior lenders, with your subordinated lenders, if you have any, as well as with your landlord. But it's all based on a strong business model that's defensible and it's going to survive in the current economic conditions.

**Williams:** Howard, I've got a question for you—we're slowly starting to, unfortunately, run out of time, but what do you think, from your perspective, the future of this sector is going to look like? If I ask you to pull out your crystal ball, are we going to be talking about the retail sector a year from now? What are some of the problems that may percolate between now and then and what do you see as the future for this particular sector?

**Brownstein:** I think things are going to change fundamentally. A pebble has been dropped in a well to hear how deep it is, and we haven't heard it hit bottom yet. I think we haven't really seen the impact in our economy of it costing \$50 and \$60 to fill up your tank with gas. And it's going to ripple through the economy in so many ways. I mean, look at all the industries that depend on retailing—shipping companies and delivery companies and people that do all the cleaning at the malls and everything.<sup>28</sup> I think that this is going to have a huge effect, and I don't think even with the recovering economy, which we all hope and pray there will be, I don't think it will ever get the genie back in the bottle. I think memories will stick. So I think we're going to see a fundamental shift in the retailing industry, and I think there will have to be some fundamental structural changes in how space gets used.

In our belief, the retailing industry is really just real estate in disguise. You're just selling real estate by the shelf foot. And so you've got to have something that makes that shelf foot valuable or it becomes less valuable.

Almost 200 years ago, David Ricardo said that corn wasn't expensive because land is expensive, it was the other way around.<sup>29</sup>

**Avila:** Two takes. Number one is I agree with Howard, there is a fundamental change. And I agree with the real estate concepts. Everybody talks about the Internet, and I think you're going to see a shift to—there are products that work well

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<sup>28</sup> See *Impact of Economic Crisis on Postal Service*, Statement of Postmaster General/CEO John E. Potter, Before the Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Services, and International Security of the Committee on Homeland Security and Governmental Affairs United States Senate, available at 2009 WL 205384 (Jan. 28, 2009) (stating factors affecting retail industry's economy also affect Postal Service's economy).

<sup>29</sup> See Fred E. Foldvary, *The Corn is as High as the Subsidy's Aye*, FREE LIBERAL, Dec. 19, 2006, available at <http://www.freelibrary.com/archives/002493.html> (noting David Ricardo explained "price of corn [was] not high because land values [were] high; rather, farm land [was] high because corn [was] high").

on the Internet, and others that don't, and that's going to really be affected by the touch and feel the products and the ability to continue to do that touch and feel.

There's—you're just still seeing, and you haven't seen the huge slowdown people expected, even though retail has grown. You're seeing the destination issue, as we had mentioned earlier about the \$60 gas. If I need to buy a gadget and I look at myself and need to drive 25 miles, or 30 miles round trip to buy it and I can easily just get online and buy it, and the touch and feel doesn't matter—those are the types of products, and you're going to see that through the retails and how they floor plan, how they plan their locations, how they plan their season aspects—you're going to see more and more of that change to where consumers are going to shift their buying patterns and the retailers that are on top of the ball are going to see that.<sup>30</sup>

I think you're going to see changes in the sales tax because the sales tax issues for malls and retailers are starting to impact your local states and governments and counties. But they're not getting that sales tax revenue from online—and I think you're going to see a change in legislation for that because there's a lot of pressure from malls and retailers in their lobbying efforts to drive that change, and because they want to compete on a fair basis and you're going to see the local government standing up for that.

I think the last thing is the customer experience. The customer experience needs to get better.<sup>31</sup> I mean I know I went to a Home Depot the other day, and you could walk in and out and not talk to a soul except the guy at the store who hands you your receipt to make sure you've got the right stuff in the bag. And you can easily confuse him for the valet.

So I think those three issues the Internet, the touch and feel, and actually service concept are going to have an impact.

**Williams:** And Laura, last but not least, from your perspective, what do you see developing in the future in the retail sector?

**Jones:** I think from a bankruptcy lawyer's restructuring perspective, and maybe I'm just taking it just a step further down the road from what Howard and Scott say. I think you're going to see a lot more in the near future of companies doing what Bennigan's did—decide not to "pass Go," just go directly to chapter 7 because of the costs involved and the liquidity restraints and the practical realities of whether

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<sup>30</sup> See Jayne O' Donnell, Sharon Silke Carty & Erin Kutz, *Borders Opens Bookshelves to Digital Services; Customers Can Download Books, Music, Burn CDs, Print Pictures*, USA TODAY, Feb. 14, 2008, at 1B, available at 2008 WLNR 2880253 (describing Borders' strategy to attract online shoppers by providing digital center allowing music downloads, book downloads, picture printing and burning music onto CDs).

<sup>31</sup> See Michael Ashison, *Talking Shop—Get Back to Where You Once Belonged*, DRAPERS, Oct. 11, 2008, available at 2008 WLNR 19479463 (highlighting one store's effort to overcome economic downturn by focusing attention on importance of sales from shop floor and "reconnect[ing] with . . . customers").

they're really going to be able to restructure, because is there going to be anybody interested in their leases that they need to get rid of and so forth.<sup>32</sup>

I think a lot will be telling on what happens after this coming holiday season. I think this holiday is going to be very important for the retailers. And my guess is what you'll see on the other side is more consolidation. Only the bigger, stronger ones will survive. And in some of the more regional chains I think we'll see them—it's more filings after the beginning of the year and then hopefully it settles out by summertime. But I think the settling out will end up in being fewer choices for the consumer, frankly fewer choices of bigger entities and you know, just the stronger ones that, as Howard would say, were able to weather the storm will be standing around and be available for the next holiday season. But I think this holiday season is going to weed out quite a bit of the less strong entities.

**Williams:** That's very interesting. Scott, Laura, and Howard, I want to thank you on behalf of the ABI for your comments. It's been fascinating today. Would any of the panelists like to add anything else to the conversation?

**Brownstein:** That's awfully dangerous telling me that there's time for me to talk. But let me just add a quick comment or two that one thing we're seeing is landlords are being flexible. For example, as to the use restrictions that they might have in their leases, and being more willing to let either a new tenant come in, or an existing tenant try to restructure, vary from some of the rules that restricted the use of the property in the past. And again, it's recognition that the economic realities trump what's in a contract.<sup>33</sup> That while the contract may say one thing and the Bankruptcy Code may have stiffened up an ability of the landlord to get such restrictions, and keep them in place even in a bankruptcy, the fact remains that if the landlord wants to rent the space, they're going to have to meet the market. And if the market is that this is the tenant who's available and this is how he wants to use the space—the landlord is going to have accept that or have empty space. So I think that's important.

A big question in people's minds has to do with luxury goods and branded goods. You know, in past softenings of the consumer economy, luxury goods have held up and have been a safe bet—there's been a kind of a flight to quality. People with money would still buy the high-priced spread. We're seeing some real cracks in that façade. We're seeing luxury goods not nearly as lustrous as they were and even people with money to spend not being as quick or willing to spend it on luxury goods.

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<sup>32</sup> See Pallavi Gogoi, *Bankrupt Retailers: Pushed to the Brink*, BUS. WK. ONLINE, Aug. 12, 2008, available at 2008 WLNR 15065202 (describing new bankruptcy law enacted in 2005 places cap on time period for reorganization and its effect on several stores including Sharper Image).

<sup>33</sup> See *Slump Allows Occupiers*, supra note 27 (describing how economic downturn may give corporate tenants more power to negotiate with landlords).

I think we've seen some kind of over branding. Everybody has a brand—everybody wants a brand. Brands are merged and married together in the marketing of a product. I think we're going to see eventually some pulling back on that. I think that brand recognition is a good thing, but it's not an infinite thing. And I think we're going to see some pulling back on that, because people are just going to have stretch their dollars and they're going to become less concerned with whose name is on the product.<sup>34</sup>

So it's going to be quite a ride and we don't see a lot of relief from this through, I would say, back to school season next year. And it's a question on everybody's mind what Christmas '09 will be like. Christmas '08 is not going to be a happy time, I think, regardless of the outcome of the election, by the way.

**Williams:** Are there any questions from our audience in the queue?

**Question:** Your comments have been very helpful today, and it seems from my observations, even the typical distress debt players are much less involved today than they have been in the last few years.

I wonder if you could just spend a minute talking about how many of these 11's will likely convert. And how many of them you see will be good candidates to emerge, given the context of the current environment?

**Jones:** I think of the bankruptcy cases that are already queued up, the ones that are already in the bankruptcy court and other bankruptcy protection—just from what I know and who's involved out there, I think you're talking about 60% to 70% of them will successfully emerge because they're far enough down the road with lenders that are committed and I think they will make their emergence. Now remember, for most of them these are liquidating 11's. They are not internal restructurings. So they're either being sold in bits and pieces or sold to another entity.

But having said that, unlike where we would have been two, three years ago, there's still, I think, the potential of the 30% to 40% that are in the queue that are already in bankruptcy that won't make it despite them being liquidating cases, because there's just not enough interest in what it is that they're liquidating and the lenders are just not willing to stand by and wait for it.

In terms of ones that we know that are in the channel, that have not yet filed, or ones that we think will file come February after the end of next year—I think the chance of them being chapter 7 versus 11 even in the first instance is much higher. And I think there will be some that will try it as an 11, but that will convert to a 7.<sup>35</sup>

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<sup>34</sup> See Elaine Sciolino, *In the Lap of Luxury, Paris Squirms*, N.Y. TIMES, Jan. 15, 2009, at E1, available at 2009 WLNR 773478 ("As high-end consumers everywhere have suddenly suppressed their appetite for luxury goods, what was once considered a recession-proof industry has been hit hard.").

<sup>35</sup> See John Blakeley, *HomeBanc Seeks Ch. 7 Conversion*, DAILY DEAL, Feb. 9, 2009, available at 2009 WLNR 2437710 (detailing how HomeBanc originally sought protection under chapter 11, but planned to request conversion to chapter 7).



**Brownstein:** I think I'd agree with the comments. I think they'll certainly be pushed to convert these. I think it's the U.S. Trustee's inclination, anytime that the weather in the room goes up or down a degree, to move for conversion, although I think sometimes that's just a cudgel that gets people moving and gets solutions created. But it's the rare business of any real magnitude that benefits from a chapter 7 conversion with a panel trustee at the helm, rather than an orderly liquidation run either by management or by corporate renewal professionals. There's always something worth saving as a going concern, or there's intellectual property that might be realized upon.<sup>36</sup> There's a way to bring in special purchase goods to run orderly going out of business sales. And a lot of that is hard to do in a chapter 7.

**Question:** Is it fair to say that given the amount of leverage that's been out there over the last few years that the secureds in these cases will be taking pretty good big hits in these liquidations?

**Brownstein:** When you say secured, I assume you're meaning not to senior debt, but people who have a secured position behind what I'll call traditional banks, is that correct?

**Felkner:** Yes. I mean first and second tier basically, right?

**Brownstein:** Say that again.

**Felkner:** Basically first and second tier debt.

**Brownstein:** You will see them either being prepared or converting down to own it on a restructured basis.

**Jones:** And I think, and consistent with our comments we made earlier, I think you're going to see a lot less likelihood to be a new lender into the situation. It's going to be much more difficult to find DIP financing or other ways of lending into the situation.

So I think you are correct that the old lenders, or the old secured players, will be taking severe haircuts. But the more troubling aspect is going to be that it's going to be difficult to get new money into the situation.

**Question:** And if I heard you correctly, earlier you were saying pretty much that the level of patience to wait this out is going to be much less than what it's been.

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<sup>36</sup> Ben Branch, *Streamlining the Bankruptcy Process*, 27 FIN. MGMT. 57, 60 (1998) available at <http://www.jstor.org/stable/3666293> ("[T]he vast majority of nonfungible assets are sold in a process that allows the market substantial time to discover . . . the underlying values.").

**Jones:** That's correct, sir. I mean it's—there's just many more controls being put on when lending is being made.<sup>37</sup> The timelines are being made much tighter and there's just new conditions being put into the financing. One of the most recent popular things that's happening now—it's this concept of lease reserves that is being put into DIP financing.<sup>38</sup> I've seen it probably in three cases now. I don't know, Howard and Scott, if you have been negotiating these yet or not. But basically this is where the lender now demands that as part of the DIP financing there's going to be a reserve put out there, or money set aside, if you will, to be able to pay the rent at the various locations should the lender be put in the situation where it has to go into the space and run GOB sales or what have you. So now just another new—well, one it's in addition of the tightening up and getting more protection so that two, it's a new tool do it—it's this concept of lease reserves.

**Question:** And last follow up on this—will we see a reduction in the number of 363s coming out of this because of the economy there's just not enough bidders out there to be interested?

**Brownstein:** Well, 363s are sales to bidders, so I'm not sure what the question means.

**Question:** I'm sorry. Will there be fewer of them posed?

**Brownstein:** Well, there certainly will be fewer people showing up at the auctions.<sup>39</sup> And ultimately these things—if there's anything to sell, it will sell. The question is—what's the value and how popular will it be? The values are definitely down.

**Jones:** I think the other thing, Howard, in connection with that is like the Bennigan's situation; I think you will see more 7s without trying to do a 363 in the chapter 11 cases.

**Avila:** What you also could see though, I think is, speaking to the questioner's first point is that these second lien lenders are below the first liens. If they have money in the deal they may need to put up funds to support the business, in effect, to credit bid it to get it out—so it's a 363, but it's not really because there's no real

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<sup>37</sup> Swaminathan S. Anklesaria Aiyar, *Capitalism is Reinventing Itself*, *ECON. TIMES*, Feb. 16, 2009, available at 2009 WLNR 2985187 ("Everybody agrees that financial markets need more regulation. We will doubtless see more controls on financial derivatives and stricter lending norms.").

<sup>38</sup> *Kelly Leaves Epicor*, *ACCT. TECH.*, Mar. 1, 2009, at 8, available at 2009 WLNR 3992253 (noting software vendor Retail Pro has utilized DIP financing in its chapter 11 reorganization).

<sup>39</sup> George Rush & Joanna Molloy, *'On the Lam' Not a Cipriani Dish*, *N.Y. DAILY NEWS*, Jan. 18, 2009, at 23, available at 2009 WLNR 1060564 (noting "[m]usic business insiders were stunned by the meager \$18 million the Death Row Records catalogue fetched" at bankruptcy auction, despite unreleased tracks by popular music artists).

bidders—it's kind of a one bid show.<sup>40</sup> And if [they] goes to a credit bid to preserve their investment, [it will] have to come out-of-pocket assuming the fund has liquidity. If it doesn't, then obviously that's off the table.

So when you say it's a 363—it's just all—it's the emotion, but back to what Howard and Laura both said is there's really no other bidders. It's they're just going to convert their debt down because it's that or they take a big haircut. I think you're going to see that cycle continue, and we saw it last year and but candidly a lot of cases you're going to see more and more of that whether it's retail—retail is a great example, if they over leverage and people come in in the second lien basis and then convert down to equity the 363 is just credit bidding. I mean Laura, what do you think?

**Jones:** I agree with that.

**Felkner:** Thank you.

**Williams:** Do we have any more questions?

**Question:** What are "factors?"

**Brownstein:** OK. Well, the actual financing called factoring goes back, I think, to the days of the Venetian merchants in the Renaissance.<sup>41</sup> And factoring was an invention whereby if you're a supplier to a retailer, you can get financing for yourself by, in effect, selling that account receivable owed by the retailer, to a lender. And at that point, the money is collected from the retailer by that lender. And there are all sorts of variations on that theme. The major one is whether there is any recourse by that lender back to you as the supplier if the retailer doesn't pay.

And there are other variations whereby all a factor will really provides is credit insurance, whereby you invoice the retailer; you collect the money when the retailer pays. And if the retailer doesn't pay for certain reasons, then the factor would pay you, less a deductible.

It's a big industry. There is an organization called the Commercial Finance Association out there that includes all the asset based lenders and the factors.<sup>42</sup>

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<sup>40</sup> See, e.g., Matt Miller, *Bennigan's, Steak & Ale Auction Set*, DAILY DEAL, Sept. 15, 2008, available at 2008 WLNR 17398020 (referring to "unusual agreement between . . . the Chapter 7 trustee . . . and creditor").

<sup>41</sup> G.A. Holmes, *Florentine Merchants in England, 1346–1436*, 13 ECON. HIST. REV. 193, 206–07 (1960) available at <http://www.jstor.org/stable/2591178> (last visited Mar. 5, 2009) ("Like the Genoese and Venetian communities, they made small loans . . . . The growing English trade in the marts of the Netherlands must have created a need for exchange facilities which the Italian houses based on Bruges would be best able to meet.").

<sup>42</sup> See Commercial Finance Association, *Commercial Finance Association Releases 4th Quarter Asset-Based Lending Index*, SCI. LETTER, Mar. 3, 2009, at 4178 available at 2009 WLNR 3787289 ("[G]iven the current economic climate, a virtually neutral change in loan volume confirms the unique stability of asset-

There are other factoring associations that mostly deal with smaller factoring companies. But it's a huge industry and it's the way people who sell to retailers principally finance themselves.

**Avila:** The reason why it's so important to add a little comment to that is—is that you will see in situations that a factor may represent multiple suppliers to a retailer or vice versa—a retailer may be into a factoring on the other side to the supplier, so you will see that if you're restructuring a retailer and if there's concerns about that retailer, he'll go through a large swath of his supply chain overnight and his credit and liquidity will dry up instantaneously.

So if he buys—pick the number—\$100-million goods a year, you could see 50-million liquidity because instead of 60-day terms go to 10-day terms overnight.

**Williams:** Any more questions? All right. Well, thank you again to the panelists and all those who were in attendance today. On behalf of the ABI we, again, thank you so much. It was a wonderful session and very informative. You all have a great day.

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based lending . . . . Despite the stability shown by asset-based lenders in the fourth quarter, the CFA continues to pay close attention to the current state of the credit markets . . .").