Sears, SRG, and the Economics of Fraudulent Conveyance

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In 2015, Sears sold a portion of its real estate holdings to Seritage (SRG), a newly formed real estate investment trust (REIT) owned by existing Sears shareholders, in a $2.7 billion sale-leaseback transaction. The real estate holdings consisted of existing Sears retail locations, and as part of the transaction, Sears continued to operate these stores under a lease agreement with SRG. Given the continued deterioration of the retail sector and Sears's increasingly precarious financial position, investors and observers have shown a great deal of interest regarding how this transaction would fare if Sears were to declare bankruptcy.

Because the applicable state fraudulent transfer law could extend to transactions by Sears as much as six years prior to a bankruptcy filing, a bankruptcy trustee (or, perhaps, Sears's creditors) might attempt to unwind the deal or seek additional money from SRG. This article details considerations concerning the value Sears received, which are frequently lost in discussions of Sears's and SRG's potential exposure to fraudulent conveyance claims, including the complex economics of the transaction and the import of potentially applicable state law. Given that many distressed retailers use asset sales to increase liquidity in the current environment, these considerations are broadly applicable and relevant to other transactions as well.

Deal Background

Sears sold 235 real estate properties and its stake in 31 joint-venture properties in the deal with SRG, a publicly traded REIT created solely to purchase and manage those real estate properties. SRG financed the purchase, in part, through a rights offering to existing Sears shareholders that gave them a transferable right to purchase SRG common stock at $29.58 per share; 97 percent of those rights were exercised. SRG financed the remaining portion of its purchase through a debt issuance (**Figure 1**, page 30).

In connection with its sale of properties, Sears also entered into a master lease agreement (MLA) with SRG, pursuant to which the retailer leased those same properties from SRG at below-market rents. Under the lease, SRG retained the right to evict Sears from certain properties and to lease them to other tenants. Arguably, the transaction benefited Sears by providing an injection of capital, a continued ability to monetize the real estate holdings while maintaining store operations, and an avenue to reduce overhead costs by terminating leases of less profitable stores. For its part, SRG would pursue a distinct corporate strategy, focusing on real estate management, and would benefit from tax advantages unique to REITs.

Should Sears file a bankruptcy petition in the future, there is little doubt that its deal with SRG, and the value it received, will be scrutinized. This is particularly true given that key Sears stakeholders stood on both sides of the transaction, including Sears's CEO Eddie Lampert, who also serves as chairman of SRG, and Sears's largest shareholders, Lampert's ESL fund and Fairholme Capital, which also own a portion of SRG.

A bankruptcy trustee appointed to maximize value for Sears's creditors might attempt to avoid the SRG deal by alleging that it was a fraudulent conveyance. A trustee can pursue such claims under both federal and state law. While a trustee might allege that the deal was an intentional fraudulent conveyance—*i.e.*, that Sears intended to shield its assets by putting them beyond the reach of creditors—proving intent is exceedingly difficult.

Thus, it is more likely that if a trustee were to challenge the transaction, it would do so on grounds that the transaction was a constructive fraudulent conveyance. That claim would require the trustee to prove

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FIGURE 1: SRG CAPITALIZATION (000s)

SOURCES OF FUNDS		USES OF FUNDS	
Proceeds from equity issuance	$1,643,840	Purchase of Sears Properties	$2,677,274
Proceeds from debt issuance	$1,161,196	Redevelopment & capital expenditures	$96,459
		Cash	$31,303
Total	**$2,805,036**	**Total**	**$2,805,036**

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that Sears transferred the properties for less than "reasonably equivalent value" or "fair consideration," and that the company was either insolvent at the time of the transaction or became insolvent as a result of the deal.

Under federal law, a trustee can generally only seek to avoid transfers of a debtor's property that occurred in the two years before the bankruptcy filing. Because the Sears-SRG transaction closed more than 25 months ago, absent some reason to toll that two-year limit, a claim under federal law seems unlikely.

State law, however, is frequently more generous to a trustee and, depending on which state's law applies, a trustee might attempt to avoid transfers that occurred as much as six years before a bankruptcy filing. Thus, should Sears file for bankruptcy, the Sears-SRG transaction may still be vulnerable.

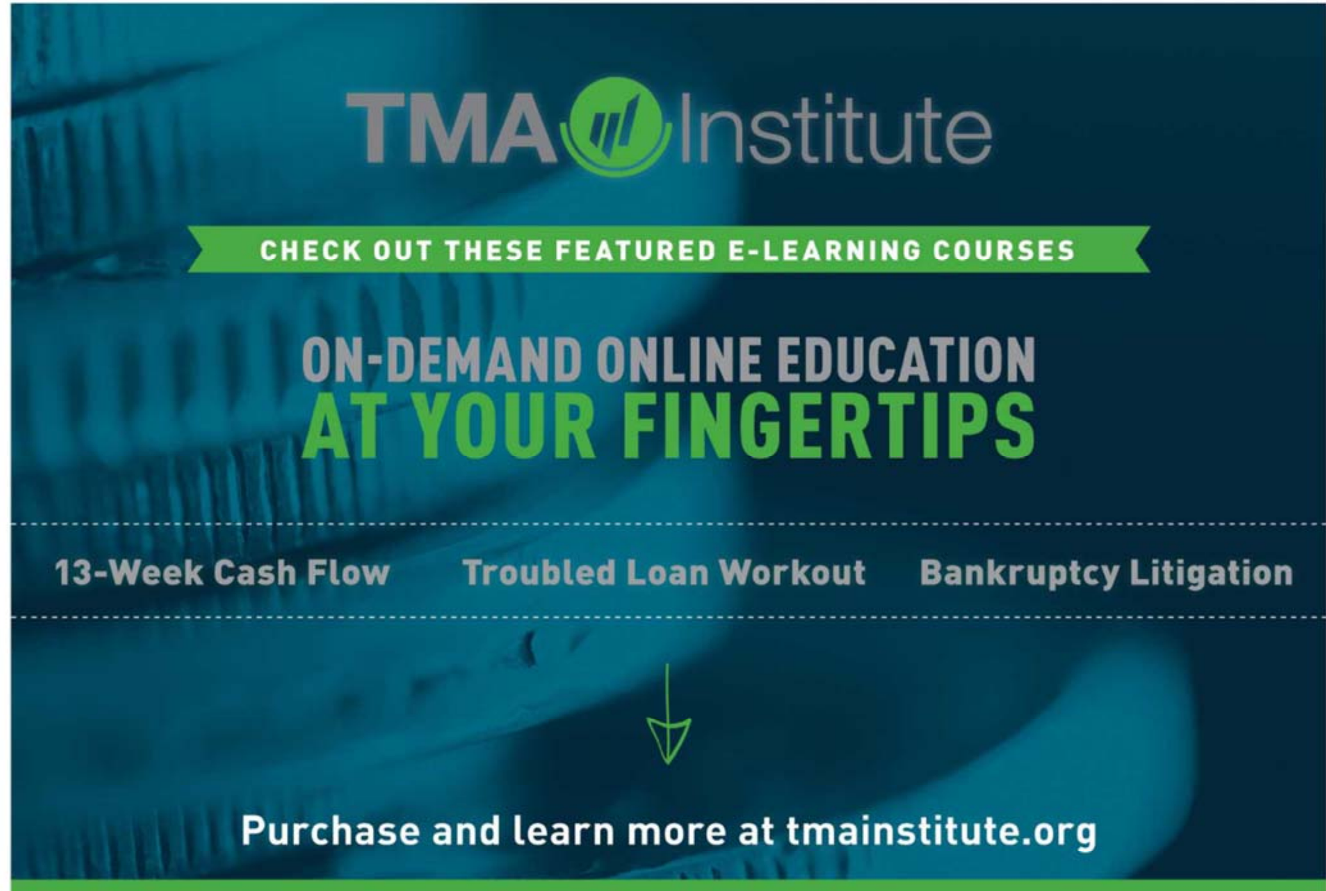

FIGURE 2: VALUE EXITING ESTATE VS. VALUE PROVIDED TO ESTATE

	VALUE EXITING ESTATE	VALUE PROVIDED TO ESTATE
SALE OF PROPERTIES	Properties	$2.7 billion in cash, additional liquidity, ability to fund operations
MASTER LEASE AGREEMENT	Necessary rent payments, loss of flexibility due to recapture and other terms	Rent discount, option to exit underperforming stores

Value Received, Relinquished

A court would likely consider the sale and the lease-back together, rather than view each as a separate transaction, and evaluate the value Sears relinquished (*i.e.*, the properties and stakes in joint ventures) against the value it received (*i.e.*, $2.7 billion and the right to rent the properties at below-market rates but with uncertainty concerning eviction) (**Figure 2**).

Property Value. A court analyzing the SRG transaction would evaluate the value Sears gave up by selling the properties, which is almost certain to require an economic analysis of the fair market value of those properties. As is common but not required in many transactions, Sears obtained a "fairness opinion" from a third-party financial advisor[1] that analyzed the value of the properties and gave an opinion that the financial consideration to be paid by SRG was within a range of reasonable values for the properties.

According to Sears's public filings, its advisor determined an enterprise fair market value range for the properties as a REIT, using discounted cash flow (DCF), comparable public companies, and comparable transactions analyses. The DCF analysis, a calculation of the present value of estimated future cash flows, was based on projected market rent the properties could generate, rather than the below-market rent Sears paid.

The comparable public companies and comparable transactions analyses included the advisor's selection of nine REITs and four REIT M&A transactions, an analysis of the financial performance of those REITs and the consideration paid in those transactions, and the use of implied valuation multiples based on those other REITs as applied to Sears's properties' projected financial performance based on qualitative and quantitative comparisons. These analyses led the advisor to opine that the properties'

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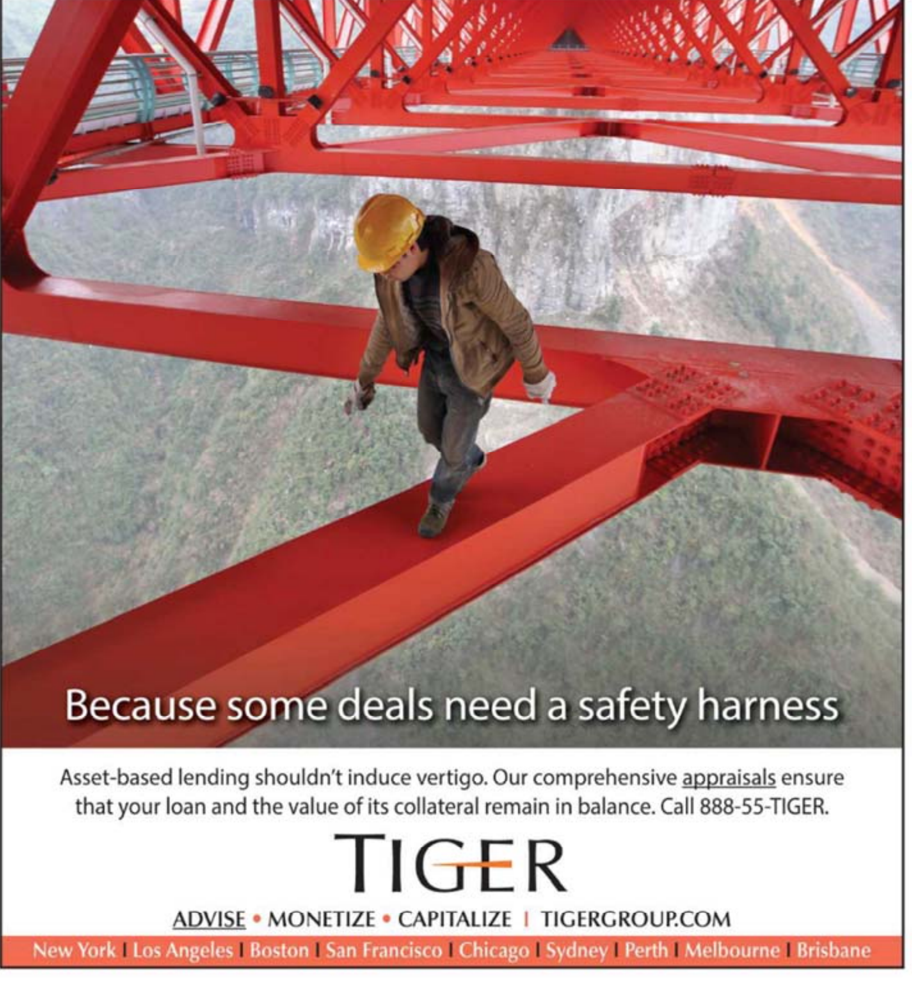

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enterprise value was within a range between $2.6 billion and $3.1 billion.

Sears also retained a specialized commercial real estate appraiser that evaluated each property in the transaction.[2] The appraiser did on-site inspections, analyzed rental data, and investigated the regional and local economies in which each property was located. The appraiser then valued each property using three real estate valuation techniques: cost, sales comparison, and income capitalization.[3] The appraiser concluded that the portfolio of properties sold by Sears had an estimated market value of $2.7 billion.

The MLA. A Bankruptcy Court would also evaluate the value of the MLA to Sears, including both the value of the rights the company obtained and the obligations it incurred. This would likely require a more complex economic analysis than the valuation of the properties. Under the MLA, Sears has the right to occupy the properties as a tenant for a 10-year period at below-market rents as well as a limited right to terminate the lease on any property for which the rent is greater than Sears's EBITDAR (cash flows excluding interest, taxes, depreciation, and rent) for the property during the prior 12-month period.

The MLA gives SRG the discretionary right to evict Sears from most of the properties (referred to as a "recapture"), in which case the REIT could then lease the space to other tenants (including Sears's competitors), presumably at higher rents.

According to Sears, its advisor analyzed the value the company received under the MLA, including the limited right to terminate certain property leases and SRG's right to recapture the properties, to determine whether the value paid by Sears (*i.e.*, below-market rent) was fair. The advisor characterized SRG's recapture right as "option value" to SRG in the form of the ability to evict and replace Sears without the retailer's consent. The advisor also characterized Sears's limited right to terminate individual property leases as "option value" to the retailer.

To determine whether the rent paid by Sears under the MLA was sufficiently discounted, the advisor attempted to estimate the comparative dollar amount of these option values. First, the advisor estimated the present value of the properties' expected cash flows assuming that the properties were leased at market rent without the lessor's recapture right or the lessee's opt-out right. Then, the advisor estimated the present value of the properties' expected cash flows assuming that the lease included the recapture and opt-out provisions and analyzing a range of possible scenarios in which those rights were exercised.

The difference between these present values represented the net option value of the provisions to SRG. The advisor then used this difference in value to determine a range of discounts to the market rent level (estimated to be 11 to 27 percent) that would adequately compensate Sears and determined that the discount to the base rent was fair from a financial point of view.

Was the Transaction Properly Valued?

Fairness Opinion. Ironclad defenses to constructive fraudulent conveyance claims are rare, if indeed any exist. However, a seller can significantly

FIGURE 3: SEARS AND SERITAGE ENTERPRISE VALUE | JULY 2015 – DECEMBER 2015

Note: [1] Data are observed at the daily level
Sources: [1] Bloomberg, accessed on July 18, 2017 [2] Seritage Prospectus, accessed on August 9, 2017 [3] Sears 2014 Form 10-K, accessed on August 9, 2017

buttress its position that it received "reasonably equivalent value" or "fair consideration" (thereby defeating a fraudulent conveyance claim) if prior to the sale it obtains an opinion that the transaction is fair from a reputable third party that uses generally accepted methodology and reasonable inputs. It is important to note that a fairness opinion is not intended to affirm that the seller obtained the highest possible consideration. Rather, it states only that the consideration received was within a range of reasonable values such that the transaction was fair from a financial point of view.

A trustee challenging a transaction may—and often will—dispute a seller's and its advisor's valuations, including by contesting the inputs and assumptions (*e.g.*, the reliability of management's financial projections) and how that data is weighted. With respect to the SRG transaction, for example, the valuation of the properties assumed their status as a REIT and involved complex discount rate calculations, subjective long-term growth assumptions, and a subjective selection of comparable REITs. Small differences of opinion regarding one or all of these inputs would almost certainly result in large changes to the valuation.

The analysis of the value of the MLA was even more complex, and perhaps speculative, given that it relied heavily on projections concerning the hypothetical timing and number of SRG's store recaptures and assumptions regarding the rent levels new tenants would pay over a 10-year period. Small changes in these assumptions, too, would likely lead to large changes in the valuation.

Moreover, it is likely that certain assumptions used will turn out, over time, to have been wrong. Although a trustee challenging the transaction may attempt to use these differences

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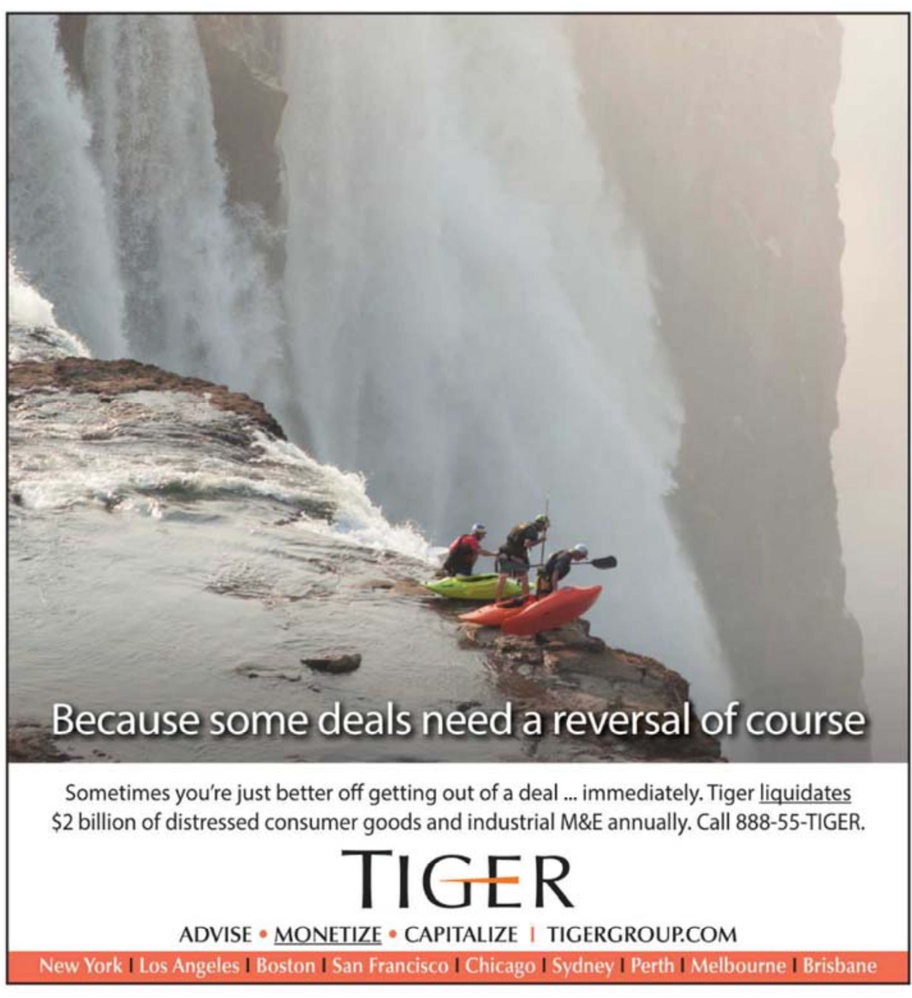

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to undermine the advisor's valuation, the relevant economic question would likely be whether the assumptions and methods employed were reasonable at the time of the analysis.

In addition to financial value received and relinquished by Sears, a court may consider whether other, less tangible characteristics of the deal added to or detracted from that value. For example, assuming Sears needed an injection of cash to continue operations and that those funds were not otherwise available, the court might consider the value of SRG's ability and willingness to provide capital. And, if Sears's corporate strategy included closing a predetermined number of stores, the transaction may have added value by creating a framework that allows Sears to effect that strategy in a controlled manner with minimum disruption to business.

By contrast, if the transaction involved the sale of properties critical to Sears's long-term strategy, if the retailer could have secured sufficient operating capital elsewhere and on better terms, or if the company had other opportunities to sell some or all of the properties for greater consideration or with fewer restrictions, then the court may find that such facts detract from the value received. Both a trustee as well as Sears and SRG would attempt to identify and highlight these less tangible considerations. And, the court would attempt to consider value in all forms.

In June 2015, certain shareholders brought derivative lawsuits in Delaware Chancery Court alleging that Sears's directors and officers breached their fiduciary duties by agreeing to the transaction. The plaintiffs alleged, among other things, that the transaction was not negotiated at arm's length, resulting in SRG paying $300 million less than fair value; that the advisor could not have provided an objective fairness opinion, given its prior relationship with Sears and the structure of its compensation; and that the fairness opinion improperly relied on "materially inadequate" property valuations by the appraiser. Those allegations, if true, would be relevant to a fraudulent conveyance claim. However, the lawsuit settled for $40 million before the allegations were litigated.

Enterprise Value. Another factor that may be considered in determining whether Sears received adequate value in the transaction is the post-transaction performance of Sears and SRG stock. As **Figure 3** (page 33) shows, following the transaction SRG's enterprise value increased by $400 million immediately after listing, while Sears's enterprise value declined by more than $1 billion. A trustee may point to these changes in value as evidence that Sears should have received more value in the transactions. Sears and SRG would argue that these changes could be explained by factors other than the value received by Sears.

Solvency. Assuming that the company received less than reasonably equivalent value, a court would then turn to whether Sears was insolvent at the time of the transaction or became insolvent as a result of it. While beyond the scope of this article, that issue

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may involve considerations of Sears's near-term liquidity, increases in long-term expenses, rapidly falling equity value, and its ability to remain a going concern for more than two years.

Relevant Considerations

The Sears-SRG transaction was highly complex and will likely be scrutinized if Sears files for bankruptcy in the near term. That scrutiny would involve an analysis of the value that the retailer received, the value that it relinquished, and how Sears understood those values at the time of transaction. Given that distressed retailers frequently seek to obtain liquidity through asset sales, fraudulent transfer considerations will continue to be relevant.

[1] Amendment No. 4 to Form S-11 filed by SRG, dated June 8, 2015, at 174-182.

[2] SRG Form S-11, at 182-183.

[3] The latter two approaches are similar to the comparable company/transactions and DCF analyses performed by the advisor; however, they are tailored specifically to commercial real estate and were done at the property level, instead of at the aggregate SRG company level.

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