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FAO Schwarz in Chapter 22: Too Big for its Britches

Andrea Kuban, Chris Reiley and Mary Walker

Workouts and Reorganizations – Spring 2005

It surprises many laypeople to learn that countless people who file for personal bankruptcy have and keep the trappings of wealth. Bankruptcy also serves the mansion-dweller who overcommitted himself with loans for a boat, a vacation home, a sports car, and a custom-built playhouse (complete with running water and electrical systems)[1] for the kids. Likewise, it surprises laypeople when luxury retailers and the companies behind renowned brands file for bankruptcy. It is hard to imagine that a retailer famous as a destination shop for extravagant, high-margin, recession-resistant goods would be in financial trouble.

I. Early Childhood

This, however, was the case with FAO Schwarz in the year 2003. Prior to that year, FAO Schwarz had been operating in New York City since 1870.[2] Under the guidance of F.A.O. Schwarz himself and later the Schwarz Family Foundation, the business had grown from humble beginnings to occupy a 78,000 square foot Fifth Avenue flagship store[3], which had become an NYC icon, appearing in feature films[4] and countless sets of vacation pictures. The New York flagship was and still remains a premiere shopping destination for tourists and locals, thanks in large part to savvy brand management and a strategy of never underestimating the excesses that children can inspire in their loved ones. The New York flagship was very much a destination; adults

visited because they specifically wanted to see toys, and FAO toys at that. People were not buying FAO toys as impulse purchases or cave-ins to shopping day tantrums.

FAO had also maintained a successful catalog business. Their mail catalog had been in continuous operation for decades. It was supplemented by an Internet shop by 1998.[5] Both catalog operations were robust and effective ways to reach affluent parents and nostalgic New Yorkers further afield. The catalogs did represent a limited departure from the very attentive service for which FAO first became famous; the customer service representative on the other end of the phone line is not at the same level of luxe as the private shopper who finds the perfect gift while the store staff members keep the kids entertained. However, there is just no buying a famous FAO teddy bear from the Sears catalog and FAO loyalists were willing enough to pay premium prices for their unique goods.

II. Pre-teen Growth Spurt and Strange New Friends

In the boom years of the late 1990's, FAO Schwarz experienced explosive growth. In addition to the new Internet business, FAO had forty brick-and-mortar locations across the United States by 2001. Most of these were in upper-middle class shopping malls and retail-oriented tourism districts. None of these were featured in major motion pictures. FAO's business model with these satellite locations relied on the brand image as the primary attractor for customers. The prices and products were still at a premium.

FAO was not just growing in terms of storefront. It was also growing on the back end. In 1998, FAO was planning to nearly triple its toy inventory from 350 products to over 1000.[6] By 2000, FAO had added Pokemon, Teletubbies, Furbies, Fisher Price and

Nickelodeon branded toys to its faithful line of teddy bears and limited edition Barbies. Especially after the attacks of September 11, 2001, and the consumer downturn that followed, it seemed that diversification was the safest strategy.[7] Kids being bribed for good behavior at the mall wanted action figures like their friends got at Toys 'R Us, not vintage rocking horses just like Grandma's. To be competitive in that shopping environment, FAO had to move far away from its classic Fifth Avenue mindset.

The height of all this change and end of all this growth came in the fall of 2001, when FAO Schwarz (formerly a privately held company) was acquired by a public company, The Right Start, Inc. After the merger, Right Start acquired rights to use the FAO name from its past and present owner, the Schwarz Family Foundation.[8] The new FAO, Inc. shut down 18 underperforming locations and then went on something of an acquisitions binge. In addition to the 38 Right Start retail locations and the 22 surviving FAO Schwarz locations, Right Start had recently bought the catalog operations that had been sold to Targoff out of Zany Brainy's foreclosure sale and 89 retail locations that were left over from Zany Brainy's bankruptcy earlier in 2001.[9] By January of 2002, Right Start, Inc. had become FAO, Inc., which served as an umbrella for the remaining Right Start, Zany Brainy and FAO Schwarz stores.

By November of 2002, some 39 weeks after the last of the merger dust had settled, FAO was reporting some $267 million in sales, with assets totaling almost $258 million and liabilities of $238 million, including millions in secured debt with various financers and liabilities assumed as part of the Zany Brainy buyout.[10] What these numbers do not show is the influence Wal-Mart was beginning to have on the market. Competition was already fierce for FAO and comparable retailers like Toys 'R Us and

KB Toys, and FAO's business model had never involved undercutting competitors' prices. When Wal-Mart decided that its next area of conquest would be toys, the high-volume, low-overhead retail giant was prepared to adopt price cutting strategies wholly foreign to FAO.[11] FAO could sell its premium toys to star-struck buyers at high prices. But FAO was absolutely unable to undercut Wal-Mart on Pokemon cards at a time when it had staked its financial future on being able to woo shopping center visitors around the country.

III. Troubled Teenager

After the holiday season of 2002, it became clear to FAO that it was not going to make it through the post-Christmas retail doldrums without major financial changes. The financial projections given to the major lenders on January 6, 2003, were bleak and Wal-Mart was still very much a player in the toy business. [12] Accordingly, FAO (the umbrella corporation) and its subsidiaries FAO Schwarz, Inc. (FAO-branded toy stores); ZB Company, Inc (Zany Brainy); Targoff-RS, LLC (an entity formed during Right Start's acquisition of Zany Brainy assets); and The Right Start, Inc (formed to manage Right Start-branded stores, but not operational at the time of filing) filed for bankruptcy on January 13, 2003.[13] The Bankruptcy Court they chose was in the District of Delaware, famous for accommodating business and infamous for imposing too little discipline on reorganizing debtors. In 2003, Delaware's rate of failed reorganizations was the highest in the United States, at a whopping 30%, compared to a mere 5% in most other parts of the country.[14]

FAO in particular wanted a fast, amicable reorganization at all costs. Management believed that a long bankruptcy would threaten the company's ability to refresh its

inventory and survive the post-holiday slow times.[15] FAO's management believed that their business model was essentially sound; they just wanted to streamline their financing and liquidate a few underperforming units.[16] Their secured creditors seemed inclined to agree, raising few major objections to FAO's plans. The lenders represented on the creditors' committee were led by Wells Fargo Retail Finance as the agent, with LaSalle Business Credit, Orix Financial Services, Hilco Capital, and Kayne Anderson Private Investors ("the lenders").[17] These lenders all had a secured interest in the repayment of $74 million in loan principal from a post-merger agreement.[18] FAO's other major creditors included the landlords at far-flung shopping centers, taxing agencies, and parties who were still owed compensation from the Zany Brainy buyout. All told, there would be fourteen classes of debt recognized in this bankruptcy.[19]

FAO, as Debtor in Possession[20], hit the ground running. Neither a trustee nor an examiner was appointed.[21] Within a day of filing, FAO had gotten an interim order governing the use of the $74 million in cash collateral from the lenders.[22] A little more than one week after the filing, the US Trustee had appointed the unsecured creditors' committee.[23] The last two days of January were action packed. "Heavy" negotiations with the lenders resulted in longer-term solutions for a Final Cash Collateral Order and for the adequate protection of the lenders' interests.[24] Plans were being made to finish liquidation of certain underperforming stores and assets by April 4 of 2003. [25] Most significantly, on January 31 (only nineteen days after the bankruptcy petition was filed), the initial joint plan of reorganization was filed. [26]

After this maelstrom of activity, February was relatively quiet. In the middle of the month FAO motioned for an order allowing the retention of some business

consultants and for retention of Fulbright & Jaworski, LLP, as special counsel under § 327(e) of the Bankruptcy Code.[27] Nothing really big happened until the last day of February, when the first amended plan of reorganization was filed. [28] The plan would put some 94 Zany Brainy, Right Start and FAO Schwarz stores out of business. It hinged on getting $30 million in equity financing and $70 million in exit financing, although no willing financier had been located at that time.

It was here that the lenders first got really nervous. Beyond the $100 million in financing that remained unaccounted for, the 94 stores being closed represented a significant part of the secured creditors' collateral. Moreover, while FAO had anticipated some losses during the post-holiday period, the actual damage was 50% in excess of what they had feared. Part of these losses were covered by going out of business sales (which were scheduled to end soon), and the rest came out of the lenders' cash collateral.[29] In the early March motion expressing these concerns, the lenders dropped threatening references to their ability under the Final Cash Collateral Order to request an alternative remedy of liquidation.[30]

A few days later, another wrench was thrown into the works by the Ingram Book Company, a creditor from the 2001 Zany Brainy bankruptcy. That bankruptcy had become adversarial, with Ingram maintaining several claims against Zany Brainy, and later FAO.[31] Ingram sought to get out from underneath the automatic stay in the FAO bankruptcy for its claim against Zany Brainy for the purpose of continuing its litigation in the adversarial Zany Brainy bankruptcy court[32]. FAO did not contest the motion to escape the automatic stay.[33] Zany Brainy, however, objected vigorously to allowing any relief from the stay to Ingram.[34] Zany Brainy was concerned that FAO would renege on its

obligations to former Zany Brainy creditors under the asset purchase agreement, and made mention of unpaid assumed liabilities by FAO.[35] Eventually, it was settled among FAO, Ingram and Zany Brainy that relief from stay would be granted and the adversarial proceeding would be allowed to continue.[36]

Meanwhile, FAO's lenders were trying to salvage what they could in the reorganization. Some controversy arose over the proposed sale of the 5th Avenue lease. FAO had responded to the possibility of a drastic reorganization by finding a just-in-case buyer for its most recognizable asset, the New York FAO Schwarz store.[37] FAO and its lenders were taking the possibility of a complete liquidation seriously. They were worried enough to quibble over brokers' fees for the hypothetical sale of the 5th Avenue lease.[38] This was not without reason. As of March 24, 2003, the $100 million of equity and exit financing needed under FAO's plan had not been acquired. The stores that FAO deemed to be winners were still hemorrhaging money and the end of liquidation-derived largesse was in sight.[39] The future was looking bleak for FAO.

A week later, the sun was shining and choirs of investor angels were singing FAO's praises. FAO had entered agreements with Fleet Retail Financial and Back Bay Capital Funding to provide exit financing in the amount of $77 million and expected to have its equity financing in very short order.[40] The creditors impaired by the plan had largely voted in favor of it, with the allowed unsecured creditors (such as landlords for failed stores) expecting to receive between a 21 and 38 percent rate on their claims.[41] On March 31, 2003, FAO filed its last major motion in the case, arguing in favor of confirmation for the first amended joint plan under § 1129 of the Bankruptcy Code.[42]

A few minor loose ends remained to be tied after FAO entered the motion in favor of confirmation. The lenders filed a token objection merely to preserve their right to litigation if the plan failed.[43] The Office of the United States Trustee objected on two grounds[44]: first that FAO had not yet adequately stipulated its exit and equity financers, and second that FAO had improperly released some of its affiliates from pre- and post-petition claims under the test set forth in the case of *In re Zenith Electronics*.[45] The US Department of Customs and the named plaintiff in a nascent shareholder class action both filed objections which were quickly addressed.

Lastly, Zany Brainy filed an objection on three points: an alleged violation of the absolute priority rule, a failure to consider claims from Zany Brainy regarding the 2001 asset purchase agreement, and a request for clarification that the plan would not impair Zany Brainy's future claims against FAO.[46] Perhaps Zany Brainy objected to the plan where other FAO subsidiaries did not because Zany Brainy management knew that for them, at least, the light at the end of the tunnel was actually an oncoming train. Zany Brainy stores, which had been in trouble long before the bankruptcy, were the most affected by the liquidations in FAO's plan. Zany Brainy was concerned particularly that if its old landlords failed to extract their recompense from FAO as the asset purchase agreement mandated, they would revert to making claims against Zany Brainy.[47] Ingram was still holding on to claims relating to the 2001 bankruptcy.[48] It made sense for Zany Brainy executives to value future indemnification over present goodwill with shareholders and creditors.

None of these objections were adequate to prevent the confirmation of FAO's plan on April 7, 2003.[49] FAO left bankruptcy with $4,364,619.84 in its Rule 3020

Account[50] and a rosy view of the bankruptcy that had brought it to that point. According to FAO "...the Debtors have conducted a review of their entire store base in order to identify and close underperforming stores and eliminated most of those locations..." and "[the plan] will create a capital structure that will allow the Reorganized Debtors to maintain and enhance their business and operations, have adequate funding availability to meet seasonal purchasing requirements and be viable and profitable entities."[51] The memorandum in support of confirmation of the plan ended with praise for the Delaware court's expedience in processing the reorganization:

> These bankruptcy cases were filed on January 13, 2003. Since the Petition Date, the Debtors have proceeded expeditiously toward confirmation, having filed the Plan and Disclosure Statement on January 31, 2003, obtained approval of the Disclosure Statement on February 28, 2003, obtained the endorsement of the Creditors' Committee, and obtained the necessary financing and equity commitments. These results were achieved in two and a half months, despite having no agreements in place at the time of filing, and having had to overcome the objections and "concerns" of the Lenders encountered consistently throughout these cases. If these cases are confirmed in such an extraordinarily short period of time, with all the challenges that have had to be met, the result will be remarkable considering the size and complexity of these cases and the absence of any "lockup" or prepackaged agreements. Clearly, the Court's willingness to accommodate the time constraints, as well as the extraordinary efforts by the Debtors and their employees to do what needed to be done within the allotted time, contributed significantly to the ability to obtain such a result.[52]

IV. Reform School

It was advantageous that there was such affection between FAO, the Delaware courts and Judge Joel B. Rosenthal (who presided in the early 2003 bankruptcy) because FAO was in Chapter 11 again before the end of the calendar year. FAO's hurried, optimistic plans from the first bankruptcy (hereinafter "FAO I") failed to account for several important factors. One of these was business model; FAO was still trying and failing to compete with Wal-Mart in the Pokemon sector of the toy market. In the third

quarter of 2003, sales were half of what they had been for that period in 2002, and the company had 3Q losses of $18.8 million.[53] A number of disputed claims arose from FAO I to exacerbate the problem.

FAO had underestimated the claims it would face from its Class 8 unsecured creditors, particularly the landlords of closed stores.[54] It had distributed over $2 million from the Rule 3020 Account servicing Class 8 by December 3, leaving a fierce contest for the remaining $1.9 million in the Account.[55] By that date, it had become clear that no amount of Christmas uplift would save FAO from its own poor planning. FAO was facing an imminent failure to pay inventory suppliers and staff for its 14 remaining FAO Schwarz stores, 89 Zany Brainy stores and 38 Right Start stores.[56] With the 2003 holiday season in full swing, FAO II was filed.

If the expedience of FAO I met the management's wildest dreams, then the time scale for FAO II was an executive's worst nightmare. Zany Brainy went straight to liquidation, with no attempt to reorganize that part of the business.[57] After a December 4, 2003, bankruptcy filing and a December 11 appointment of the creditors' committee, FAO faced an initial deadline of December 15 for selling FAO Schwarz and Right Start.[58] The Court and the creditors were hearing no discussion of more subtle solutions.

Of course, finding a buyer for a nationwide retail chain is no simple task, and the December 15 deadline proved wholly inadequate. The deadline came and went with only sluggish bidding, and was later moved to December 17. This, too, failed to bring in any new bids, but for unspoken reasons the Court did not attempt to liquidate FAO Schwarz the week before Christmas. So the search for buyers continued as shelves and warehouses were ransacked in a de facto going out of business sale. Donald Trump was rumored to

be interested at one point, as was inventor Ken Hakuta, but in the end neither was willing to shoulder FAO's enormous debt burden.[59]

The one bid that was submitted in this period came from Hancock Park, a financer from FAO I. Hancock Park bid $6.25 million for the 38 Right Start stores left in operation after FAO I.[60] This bid was initially rejected, following strenuous objections from Right Start landlords, who wanted to see those assets sold piecemeal, rather than in bulk.[61] But very shortly after Judge Rosenthal denied the Hancock Park transaction, questioning if the proposed new management could run the business for even a year, he approved an emergency request by FAO to allow the transaction if only 34 of the stores would change hands.[62]

While this was happening, FAO had received a very quiet bid from "a private equity firm" for its FAO Schwarz stores.[63] The bidder was later revealed to be D.E. Shaw Laminar Portfolios, a venture capital and investment firm with a reputation for secrecy and innovation.[64] D.E. Shaw's bid of $20 million, though low by some estimates, was accepted with gratitude. D.E. Shaw announced that it would liquidate nearly all of FAO Schwarz's assets at the end of the holiday season. The long term goal was to remodel the New York and Las Vegas flagship stores, which had long been FAO Schwarz's most profitable locations. Additionally, D.E. Shaw bought the rights to FAO Schwarz's catalog and Internet businesses.[65] The one remaining hurdle was that the savvy Schwarz family had kept the rights to the FAO name and certain intellectual property in trust, with approval rights on any sale of the brand license.[66] D.E. Shaw apparently met the Schwarz family criteria, because their bid was the final winner.

V. All Grown Up (or "Oh My God, I'm Just Like My Dad!")

The FAO Schwarz of today is very similar to the FAO Schwarz of twenty years ago. It is a private company selling extravagant toys from two exclusive stores, bolstered by a robust catalog operation. The clock tower in the Fifth Avenue store still runs. A search on their website turns up a dozen varieties of teddy bear, but no Pokemon products.[67] Because FAO Schwarz is privately held now, it is hard to say whether it is turning a profit, although analysts' predictions at the end of the second bankruptcy seemed positive.[68] It seems impossible that the business could be compared to Wal-Mart or Toys 'R' Us, let alone compared unfavorably. [69] The whole sordid shopping mall debacle could have been the play of children acting out their worst fears.

There are small reminders of FAO, Inc., in the market today. The Zany Brainy stores are gone, but The Right Start has lasted beyond the one year span predicted by Judge Rosenthal. Most of all, there are holes in shopping centers across America. The Class 8 landlords from FAO I continued to litigate over the distribution of the Rule 3020 Account through FAO II and into 2004.[70] But FAO Schwarz seems to have finally realized that even in the world of toys, there is such a thing as "too much."

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[1] Available from FAO Schwarz Online at www.fao.com/catalog/boutique.jsp?parentCategoryId=280 &categoryId=337 as of April 5, 2005, with prices starting at $30,000.
[2] FAO Schwarz online. http://www.fao.com/custsvc/custsvc.jsp?sectionId=121 as of April 23, 2005.
[3] Stempel, Jonathan. 2003. "FAO Plans to Sell NY Store, Other Portions of Firm" *Seattle Times*. December 27.
[4] The Internet Movie Database ("IMDb"). http://www.imdb.com/List?tv=on&&keywords=fao-schwartz&&heading=19;fao-schwartz (sic) as of April 23, 2005.
[5] The Internet Archive. http://web.archive.org/web/19980109044727/http://fao.com/ as of April 23, 2005.
[6] Id.

[7] *In re FAO, Inc.* 2003 WL 23964905. "Memorandum of Law in Support of Confirmation of First Amended Joint Plan of Reorganization of FAO, Inc. and Its Debtor Subsidiaries (As Modified)" (March 31, 2003).
[8] Unattributed. 2003. "FAO, Inc.: Attempt to Sell Right Start Rejected by Bankruptcy Court." *The Wall Street Journal*. December 24.
[9] 2003 WL 23964905.
[10] Id.
[11] Id.
[12] *In re FAO, Inc.* 2003 WL 23964885. "Response of Wells Fargo Retail Finance, LLC, as Agent, to Motion for Order" (March 10, 2003).
[13] *In re FAO, Inc.* 2003 WL 23964854. "Response of Wells Fargo Retail Finance, LLC, as Agent, to the Motion of the Debtors and Debtors in Possession for Entry of an Order" (January 21, 2003).
[14] Woolner, Ann. 2003. "Bankruptcy Courts Competing for Cases." *Los Angeles Business Journal*. December 15, p. 59.
[15] 2003 WL 23964905.
[16] Id.
[17] Id.
[18] *In re FAO, Inc.* 2003 WL 23964900. "Response of Wells Fargo Retail Finance, LLC, as Agent, to Motion for Order" (March 24, 2003).
[19] 2003 WL 23964905.
[20] Bankruptcy Code §§ 1107-08.
[21] *In re FAO, Inc.* 2003 WL 23964876. "Response of Wells Fargo Retail Finance, LLC, as Agent, to [requests for counsel and consultants]" (February 17, 2003).
[22] 2003 WL 23964885.
[23] 2003 WL 23964905.
[24] 2003 WL 23964876.
[25] 2003 WL 23964885.
[26] Id.
[27] 2003 WL 23964876.
[28] 2003 WL 23964885.
[29] Id.
[30] Id.
[31] *In re FAO, Inc.* 2003 WL 23964890. "Response of Debtor and Debtor in Possession to Motion of Ingram Book Company for [determination re: automatic stay]" (March 14, 2003).
[32] *In re FAO, Inc.* 2003 WL 23964903. "Response of Ingram Book Company to Motion of Zany Brainy, Inc." (March 28, 2003).
[33] 2003 WL 23964890.
[34] *In re FAO, Inc.* 2003 WL 23964891. "Response of Zany Brainy, Inc. to Motion of Ingram Book Company" (March 14, 2003).
[35] 2003 WL 23964891.
[36] *In re FAO, Inc.* 2003 WL 23964912. "Response of Ingram Book Company to Objection of Debtors to Claims Filed by Zany Brainy, Inc." (April 8, 2003).
[37] 2003 WL 23964900.
[38] Id.
[39] Id.
[40] 2003 WL 23964905, paragraph 71.
[41] Id., paragraph 28.
[42] Id., paragraph 33.
[43] *In re FAO, Inc.* 2003 WL 23964908. "Debtors' Supplemental Response in Support of Confirmation of First Amended Joint Plan of Reorganization of FAO, Inc. and Its Debtor Subsidiaries (As Modified)" (April 3, 2003).
[44] Id.
[45] 241 B.R. 92 (Bankr. D. Del. 1999).
[46] 2003 WL 23964908.

[47] *In re FAO, Inc.* 2003 WL 23964916. "Response of Zany Brainy, Inc. to Objection of Debtors to Claims Filed by Zany Brainy, Inc." (April 8, 2003).
[48] 2003 WL 23964912.
[49] *In re FAO, Inc.* 2004 WL 943553. "Joint Motion of Debtors and Debtors in Possession and the Official Committee of Unsecured Creditors for an Order" (April 5, 2004).
[50] Id.
[51] 2003 WL 23964905, paragraph 77.
[52] Id., paragraph 87.
[53] Clack, Erin E. 2004. "Trouble in Toyland – Toys 'R' Us Tightens Ship While FAO Schwarz Heads Into Second Round of Bankruptcy." *Children's Business*. January 1, p. 4.
[54] 2004 WL 943553, paragraph 9.
[55] Id., paragraph 10.
[56] Treaster, Joseph B. 2003. "Deal Will Preserve Flagship Store of F.A.O. Schwarz Chain." *The New York Times*. December 27, p. C1.
[57] Unattributed. 2003. "Untitled." *Warren's Consumer Electronics Daily*. Vol. 3: 248. December 29.
[58] Id.
[59] Tharp, Paul. 2003. "Time Running Out; Buyers Not Biting As FAO Schwarz Deadline Looms." *The New York Post*. December 13, p. 19.
[60] Kapner, Suzanne. 2003. "1 Down, 1 To Go in Bids for FAO." *The New York Post*. December 24, p. 30.
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[62] Unattributed. 2003. "FAO gets approval to sell 34 The Right Start stores." *Deseret News*. December 26, p. D8.
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[64] Treaster 2003.
[65] Id.
[66] Kapner, Suzanne. 2003. "Court May Salute Fund's FAO Play."
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[68] Treaster 2003.
[69] Moon, David. 2003. "FAO Schwarz Toying with its future." *The Knoxville News Sentinel*. December 14, p. C2.
[70] See, e.g., *In re FAO, Inc.* 2004 WL 1778323. "Statement of the Official Committee of Unsecured Creditors Regarding Rule 3020 Distribution Account" (June 15, 2004).

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