

Bankruptcy and Commercial Lease Issues in a COVID-19 Disrupted World

By **Jonathan Koevary and Robert Gagne**

Where feasible, companies do not file Chapter 11 petitions until after formulating both an exit strategy and plans to operate during the pendency of the bankruptcy case. For restaurateurs and retailers, this strategy will almost invariably require and depend upon cash flow for continued use of leased stores and restaurants. Planned Chapter 11 budgets must take this into account as landlords are entitled to full rent for the post-petition use of their property. To say the least, for those companies that filed for bankruptcy on the eve of the COVID-19 shutdowns, the strategies—and available cash flows to pay landlords—did not go as planned.

Underlying Facts

Three unrelated companies separately filed for Chapter 11 shortly before the COVID-19

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pandemic shut down the country. On Feb. 17, 2020, Pier 1 Imports, Inc. (Pier 1) filed for Chapter 11 in Virginia. Pier 1 sought to pursue a going concern sale and continue its previously announced restructuring efforts, which included permanently closing hundreds of stores. On March 3, Craftworks Parent, LLC (Craftworks), the owner and franchisor of several restaurant chains, filed for Chapter 11 in Delaware. Similar to Pier 1, Craftworks planned to keep its business alive through a going concern sale resulting in a smaller footprint. On March 11, Modell's Sporting Goods, Inc. (Modell's, and Pier 1 and Craftworks, each a "debtor") filed for Chapter 11 in New Jersey. Modell's plan was to liquidate its inventory through going out of business sales in its stores. The COVID-19 crisis quickly altered the bankruptcy

strategy of each of the debtors, as their plans to continue operation of their leased stores and restaurants post-filing were rendered impossible.

Each debtor requested emergency court relief, which in each case included the key features that (1) the debtor would defer payment of post-petition rent to landlords and (2) the Bankruptcy Code's automatic stay provisions that prevent actions taken against a debtor—such as continuing an eviction—would be preserved, absent further relief from the bankruptcy court. Craftworks sought relief under Bankruptcy Code Section 105 (giving courts equitable powers to carry out the provisions of the Bankruptcy Code), while Pier 1 and Modell's sought relief under both Bankruptcy Code Sections 105 and 305 (authorizing courts to suspend all proceedings).

Given the dire, unprecedented situation posed by the COVID-19 outbreak, the courts in these cases granted most of the extraordinary relief requested (the "extraordinary orders"). As the Pier 1 court noted in its opinion in support of the deferral: "[t]here

is no feasible alternative to the relief sought in the motion. The debtors cannot operate as a going concern and produce the revenue to pay rent because they have been ordered to close their business. [...] Any liquidation efforts would be ineffective and potentially squander assets that could otherwise be administered for the benefit of all creditors.” See *In re Pier 1 Imports, Inc.*, No. 20-30805 (KRH) (Bankr. E.D. Va., 2020) [Dkt. No. 637].

Legal Issues

A central question in each case was whether the extraordinary orders conflicted with the debtors’ statutory obligations to pay their landlords for the post-petition use of their stores and restaurants. Bankruptcy Code Section 105(a) provides courts with broad equitable power to issue “any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].” 11 U.S.C. §105(a). This equitable power reflects a crucial public policy charge upon bankruptcy courts: maximize value and maintain going concerns where able. However, this equitable power is limited as “[a] bankruptcy court may not contravene specific statutory provisions” of the Bankruptcy Code. *Law v. Siegel*, 571 U.S. 415, 421-22 (2014).

Section 365(d)(3) of the Bankruptcy Code, however, provides that a debtor must pay post-petition lease obligations (e.g., post-petition rent) on unexpired leases until such leases are assumed



or rejected. In addition, Section 365(d)(3) provides that the “court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, *but the time for performance shall not be extended beyond such 60-day period.* 11 U.S.C. §365(d)(3) (emphasis added). The relief requested in each of the cases included deferring the payment of post-petition rent beyond 60 days from the petition date. Accordingly, numerous landlords raised the objection that this deferral of rent was impermissible since it conflicted with Section 365(d)(3).

It is black letter law that a landlord is entitled to an administrative claim on lease obligations for the post-petition use of its premises. Administrative claims are high priority claims that, unlike garden-variety bankruptcy claims, must be paid in full as part of a Chapter 11 plan of reorganization or liquidation. Many courts have strictly construed Section 365(d)(3) to provide an

additional protection for landlords, meaning that landlords are entitled to immediate payment of post-petition rent when due, subject only to the 60-day grace period for cause. See, e.g., *In re Pudgie’s Dev. of NY*, 202 B.R. 832, 836 (Bankr. S.D.N.Y. 1996). From the landlord’s perspective, this provision is vital. First, landlords have to carry their own expenses, which in commercial leases typically means advancement of taxes and utilities and making their own mortgage payments. Second, not all Chapter 11 cases result in a Chapter 11 plan: landlords bear the risk that even administrative claims will not be paid in full.

The court in *Pier 1* opined that Section 365(d)(3) did not create an independent obligation: that post-petition rent should be treated as any other administrative claim. However, unlike Modell’s, *Pier 1* continued to pay insurance and utilities and other incidental payments. The court held that these payments provided sufficient “adequate

protection,” against the landlords’ “perceived diminution of value” for the use of their property under Sections 361 and 363(e) of the Bankruptcy Code. Adequate protection is “derived from the Fifth Amendment protection of property interests.” H.R. REP. 95-595, 339, 1978 U.S.C.C.A.N. 5963, 6295.

Section 305(a)(1) of the Bankruptcy Code provides that the court may, “after notice and a hearing, *dismiss a case*” or “*suspend all proceedings in a case* under this title, at any time if—(1) the interests of creditors and the debtor would be better served by such dismissal or suspension.” 11 U.S.C. 305(a) (emphasis added).

Debtors may argue that Section 305 provides the basis for suspending their obligation to comply with the Bankruptcy Code’s stringent timelines. Landlords may argue that Section 305 was meant to provide for a complete pause of the case, and not to allow the debtor to park in bankruptcy with the benefit of the automatic stay without complying with its timelines.

Acknowledging the extraordinary and unprecedented nature of COVID-19 and the limited case law, the Modell’s court granted the deferral of post-petition rent payments, while leaving the automatic stay intact, and has issued periodic extensions under Section 305, while assigning the key parties to mediation: Modell’s, the group of objecting landlords, and Modell’s lender, whose collateral Modell’s was planning to liquidate

using the landlords’ stores. Issues under consideration included the risk allocation between the landlords and the lender for the risk of insolvency and whether landlords would be entitled to full rent or whether the state-mandated closures provided a defense to payment on their underlying leases. Several issues remain unsettled:

- Does Section 365(d)(3) create an independent obligation to pay all post-petition rent within 60 days of the filing? If not, what adequate protection rights may be afforded to landlords under Sections 361 and 363(e) of the Bankruptcy Code for the post-petition use of their property?
- Do established rules of statutory construction allow for partial suspensions under Section 305, such that a debtor enjoys the benefit of the automatic stay without having to comply with its obligations under the Bankruptcy Code, or do they require a complete suspension?
- What does Section 305(a) mean when it allows a court to “suspend all proceedings?” For example, one landlord briefed in Modell’s that suspending “all proceedings” cannot not mean suspending “obligations.”
- Taken to an extreme, a court could leave a case in limbo indefinitely by citing Section 305(a). Meanwhile, Section 305 provides express limitations on appellate review of suspensions. Does this limitation of the right of appeal inform whether Congress intended to grant

bankruptcy courts (which are not Article III courts) the power to grant a partial suspension?

- What do equity and public policy demand in extraordinary and uncharted circumstances and what are the practical and statutory limits on a bankruptcy court’s power? Does it alter the equation if—as in the case of COVID-19—state courts will not conduct eviction proceedings?
- What are the defenses to payment under a specific lease or state law, such as frustration of purpose?
- As states lift lockdown directives, will courts find “cause” to defer rent payments if a debtor’s operations are only partially restricted (as in the case of JC Penney Company, Inc., who filed for Chapter 11 in May and then requested a deferral after many of its stores had reopened; *see In re: JC Penney Company, Inc.*, No. 20-20182 (Bankr. S.D. Tex.))?

COVID-19 saddled parties and the courts with extraordinary circumstances and little in the way of road maps. As the nation begins to reopen, and as future extraordinary circumstances may dictate, questions such as these will rise to the forefront.

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