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Feature

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Mothballing Motions from Retail Debtors to Avoid Rent Payments Due to COVID-19 Pandemic

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Editor's Note: *To stay up to date on the pandemic, bookmark ABI's Coronavirus Resources for Bankruptcy Professionals website (abi.org/covid19).*

The COVID-19 pandemic has had a particularly harsh effect on the retail industry. Stay-at-home orders spawned by the pandemic have forced many retailers to close their brick-and-mortar shops, causing severe and unexpected cash-flow shortages. Most retailers lease their store locations, therefore the cost of rent constitutes a large proportion of their operating expenses.

Some retailers that have filed for bankruptcy protection amid the crisis (including J. Crew, True Religion, Modell's, Pier 1 and J.C. Penney) have cited the pandemic and its effects as a reason for the court to defer payment of post-petition rents. They have argued, among other things, that because they have been forced to "mothball" their store locations, any obligations to pay current rents should also be postponed unless and until they are allowed to fully reopen store locations.

Commercial landlords have strenuously objected to mothball motions. They assert that the well-known rule under § 365(d)(3) of the Bankruptcy Code, which requires that a debtor continue to "timely" perform its post-petition obligations such as paying rent as it becomes due, should not be ignored — even during the current public health crisis. To date, a majority of bankruptcy courts have been sympathetic to the exigent circumstances created by the COVID-19 pandemic. They have allowed debtors to remain in possession of the premises and temporarily cease paying rents while at the same time continuing to pay other administrative expenses, such as salaries and professional fees. The willingness of courts to allow debtors to defer their post-petition rent obligations in light of the ongoing uncertainty caused by COVID-19 signals a divergence from the strict enforcement of the protections previously afforded commercial landlords under § 365(d)(3), and it requires landlords to shoulder more of the risk of a debtor's potential administrative insolvency.

Bankruptcy Code Protections for Commercial Landlords

Section 365 contains the well-known rule that a debtor may assume or reject an executory contract at any time prior to plan confirmation. However, § 365(d) exempts commercial landlords from the general rule. With respect to commercial real estate, a debtor/tenant has 120 days after the petition date to decide whether to assume or reject an unexpired lease of such property. Failure to assume a commercial lease within such 120-day period will result in the lease being deemed rejected.[1] The 120-day period may be extended up to an additional 90 days for cause.[2] While the debtor is deciding whether to assume or reject, the commercial landlord is protected by § 365(d)(3), which provides:

> The trustee shall timely perform all of the obligations of the debtor ... arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected.[3]

This provision requires that a debtor must continue to pay all post-petition rent notwithstanding the commencement of its bankruptcy case, until a

1 11 U.S.C. § 365(d)(4)(A).
2 11 U.S.C. § 365(d)(4)(B)(i).
3 11 U.S.C. § 365(d)(3).

determination has been made to reject the lease. Thus, commercial landlords are protected from having large rejection-damages claims if the debtor ultimately rejects the lease. The Code provides that the court may extend "for cause" the time for performance of any such post-petition rent obligation for up to an additional 60 days.[4] The Code also provides that administrative claimants, including landlords and estate professionals, must be treated equally.[5]

"Mothball" Motions Proliferate and Expand

Modell's Sporting Goods was the first major retail debtor to have its mothball motion granted as a result of the COVID-19 pandemic. Modell's filed for chapter 11 protection in the U.S. Bankruptcy Court for the District of New Jersey on March 11, 2020 — on the eve of the proliferation of shutdown and stay-at-home orders that eventually cascaded across the nation. Shortly after filing, Modell's requested that the court temporarily suspend its chapter 11 case pursuant to 11 U.S.C. §§ 105 and 305.[6] Modell's claimed that it had been prevented from pursuing its planned liquidation sales, citing the "unprecedented, exponential spread" of COVID-19 over the course of the first week of its case, "along with the resulting, state-imposed limitations and prohibitions on non-essential retail operations."[7]

Modell's relied on § 305(a)(1) of the Bankruptcy Code for legal authority, which is a rarely used provision that is usually only relevant when state-court litigation may cause the bankruptcy case to be duplicative or unnecessary, or where an involuntary proceeding is unjustly commenced. Section 305(a)(1) allows the court to suspend all proceedings in the case if "the interests of creditors and the debtor would be better served by such ... [a] suspension."[8]

Multiple landlords objected, arguing that the requested relief would involuntarily force them to take on the role of a post-petition lender, requiring them to subsidize the recovery of secured lenders. Despite the landlords' opposition, on March 27, 2020, the court entered an order suspending the chapter 11 case,[9] which was further extended multiple times.[10]

Pier 1 Imports Inc. entered bankruptcy on Feb. 17, 2020, in the U.S. Bankruptcy Court for the Eastern District of Virginia with plans to be sold as a going concern.[11] The pandemic intervened to thwart the debtor's plan, and by the end of March, Pier 1 had sought court approval to mothball its case on account of the effects of the pandemic, including immediate cessation of all rent obligations that would otherwise be owing pursuant to § 365(d)(3).[12]

Over the strenuous objections of its landlords, the court granted the mothball motion,[13] and it subsequently issued a memorandum opinion in support of its decision.[14] In its opinion, the court noted that although at the beginning of Pier 1's case no one "predicted that the world would effectively grind to a halt," this is exactly what happened.[15] Therefore, the court determined that the nation's public health crisis justified Pier 1's mothball strategy, pursuant to which the debtor would not be required to pay post-petition rents. The court further justified its holding by noting that the landlords would be protected by virtue of their rights to an administrative claim for any deferred rent, which could be paid at the end of the case.[16]

Since the court believed that the landlords were not prejudiced by the delay, they could be forced to wait for administrative rent payments. The court also found that, to the extent that the landlords were entitled to adequate protection, they had received it in the form of the continued payments of related non-rent payments and the promise of future cure payments.[17]

However, mothball motions have not always been successful. In the chapter 11 case of Forever 21 Inc., which had been pending in the U.S. Bankruptcy Court for the District of Delaware since September 2019, Hon. **Mary F. Walrath** denied a mothballing motion by an asset-purchaser[18] to cease paying rent while maintaining possession of the stores, notwithstanding the crisis caused by the COVID-19 pandemic.[19]

Cases such as *Modell's* and *Pier 1* demonstrate the courts' willingness to pause bankruptcy proceedings for the benefit of debtors if a suspension is warranted by exigent and unforeseen circumstances that arise post-petition, even if such relief postpones or disadvantages the rights of other parties under the Bankruptcy Code (*e.g.*, commercial landlords). However, cases such as *Forever 21* illustrate that a court's willingness to grant such motions may only apply if the suspension directly benefits a debtor, not a third-party purchaser.

It might be possible to rationalize the results in *Modell's* and *Pier 1* by noting that those cases were pending before the advent of the COVID-19 crisis, and that it would be inequitable to penalize a debtor for the occurrence of an unanticipated catastrophic event. By that logic, the same rationalization might not apply to a case that was commenced after the beginning of the stay-at-home orders. Nevertheless, some courts have used their equitable powers to grant mothball motions for the benefit of debtors that have filed for bankruptcy *after* the commencement of the pandemic, even going so far as to grant such motions as part of the first-day orders.

Mothball Motions After the Advent of COVID-19

Denim brand and retailer True Religion Apparel Inc. filed for chapter 11 protection in the U.S. Bankruptcy Court for the District of Delaware on April 13, 2020, and it was the first major retailer to file after the initial stay-at-home orders were imposed in response to the COVID-19 crisis.

4 *Id.*
5 11 U.S.C. §§ 507(a)(1), 1123(a)(4); *Sapir v. C.P.Q. Colorchrome Corp. (In re Photo Promotion Assocs. Inc.)*, 881 F.2d 6, 8 (2d Cir. 1989) (ruling that bankruptcy court appropriately required creditor to return payments notwithstanding creditor's entitlement to chapter 11 expense priority under § 503(b), because all chapter 11 administrative creditors must be treated equally).
6 *In re Modell's Sporting Goods*, Case No. 20-14179, [Docket No. 115] (Bankr. D.N.J. March 23, 2020).
7 *Id.*
8 11 U.S.C. § 305(a).
9 *In re Modell's Sporting Goods*, Case No. 20-14179, [Docket No. 166] (Bankr. D.N.J. March 27, 2020).
10 *Id.* [Docket No. 294] (April 30, 2020); [Docket No. 371] (June 5, 2020).
11 *In re Pier 1 Imports Inc.*, Case No. 20-30805-KRH.
12 *Id.* [Docket No. 438] (March 31, 2020).
13 *Id.* [Docket Nos. 493, 629].
14 *Id.* [Docket No. 637] (May 10, 2020).
15 *Id.* at 2.
16 *Id.* at 8.
17 *Id.* at 10.
18 *In re Forever 21 Inc.*, Case No. 19-12122 (MFW) [Docket No. 1115] (April 1, 2020).
19 *Id.* [Docket No. 1220] (April 23, 2020).

True Religion commenced its case for the purpose of obtaining financing and relief from its rent obligations. It filed a mothball motion pursuant to § 365(d)(3) on the first day, seeking to suspend for 60 days its rent obligations arising under unexpired real property leases.[20] True Religion explicitly admitted that it lacked the liquidity needed to timely pay post-petition rent.[21]

Further, True Religion's proposed debtor-in-possession financing agreements explicitly conditioned borrowing availability on the entry of an order suspending all of the debtor's payment obligations related to its leases during the initial 60-day period, including April stub rents, the payment of May rents and, notably, any further payments to landlords.[22] As expected, numerous landlords filed objections, but on May 12, 2020, the court granted the motion, citing the "unprecedented and unforeseen outbreak of COVID-19, the national state of emergency declared by President [Donald] Trump on March 13, 2020, pursuant to the Proclamation on Declaring a National Emergency ... and the numerous state orders that limit or preclude the Debtors' operations."[23]

J. Crew Group Inc., which filed for bankruptcy protection in the U.S. Bankruptcy Court for the Eastern District of Virginia on May 4, 2020, also sought court approval on the first day of its case to defer its sizeable obligations under its commercial leases.[24] The court granted the retailer's request for a 60-day rent deferral over the objections of landlords and the official committee of unsecured creditors.[25] The court ordered that any action seeking to enforce lease obligations would be stayed during this period, and it found that no adequate-protection payments were required.[26]

Unlike the rulings in *Modell's* and *Pier 1*, the *J. Crew* order was entered at a time when many stay-at-home orders had expired or were about to expire, and stores were already reopening. While the court acknowledged that the debtor was in the process of reopening stores, sales had been "far short" of pre-pandemic numbers.[27] Because the debtor was not generating a significant amount of income from the stores that had already reopened, and the majority of the debtor's employees remained furloughed, the court found that the timing of the debtor's filing did not "lessen the effects of the pandemic," and that the debtor would be permitted to "utilize the tools available under the Bankruptcy Code," including deferral of payment of its post-petition obligations under its numerous leases.[28]

As the nation begins to reopen, landlords may think that the spate of mothball motions will abate and that the willingness of courts to grant such motions will recede. J.C. Penney Co. Inc. filed for bankruptcy protection on May 15, 2020, in the U.S. Bankruptcy Court for the Southern District of Texas. At the time that it filed its mothball motion, the debtor admitted that it had already reopened 474 stores and expected to open another 340 within a matter of weeks.[29] The debtor's landlords argued that, compared to debtors like Pier 1 and Modell's, J.C. Penney had ample resources to pay administrative rents and that its reopening plans suggested that its ability to pay rents would only improve.

In response, the debtor deemphasized its reliance on COVID-19 restrictions and instead relied primarily on the argument that a rent holiday would assist the debtors in negotiating rent-relief agreements with landlords.[30] The landlords replied that if granting a debtor bargaining leverage was sufficient justification for ignoring the statutory obligation to pay post-petition rents, debtors' requests for rent deferral would be granted in virtually every case and would become the norm, instead of the rare exception. Nevertheless, the court granted the debtor's motion, allowing J.C. Penney to defer approximately $34 million of post-petition rents.[31]

Conclusion

Bankruptcy courts that have granted debtors the ability to delay payments of post-petition rents that are otherwise clearly due and owing pursuant to § 365(d)(3) have done so based on the exigent circumstances faced by retail debtors in light of the COVID-19 pandemic. A majority of courts have found that the rights of landlords are not prejudiced, or that the hardship experienced by the debtor due to strict adherence to § 365(d)(3) outweighs any prejudice to the landlord.

Even in extreme cases where the debtor is simply unable to make rent payments and also pay its other administrative claims during the course of its case (*i.e.*, it would be rendered administratively insolvent), courts have still been willing to grant mothball motions despite the fact that it would effectively shift the risk of administrative insolvency to third parties such as landlords. As stay-at-home orders expire and nonessential retail is permitted to reopen across the U.S., it remains to be seen whether motions seeking to defer post-petition rent obligations will continue to be granted, and whether courts will continue to accommodate such requests as the effects of COVID-19 (hopefully) begin to wane. abi

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20 *In re True Religion Apparel Inc.*, Case No. 20-1091 (CSS) [Docket No. 27] (Bankr. D. Del. April 13, 2020).
21 *Id.*
22 *Id.* [Docket No. 118] ¶ 2 (April 24, 2020).
23 *Id.* [Docket No. 221] at 2 (May 12, 2020).
24 *In re Chinos Holdings Inc.*, Case No. 20-32181 (KLP) [Docket No. 23] (Bankr. E.D. Va. May 4, 2020).
25 *Id.* [Docket No. 323] (May 26, 2020).
26 *Id.*
27 *Id.* [Docket No. 349], Hr'g Tr. at 60:2-9 (May 26, 2020).
28 *Id.* at 60:10-61-9.
29 *In re J.C. Penney Co. Inc.*, Case No. 20-20182 (DRJ) [Docket No. 338] (Bankr. S.D. Tex. May 28, 2020).
30 *Id.* [Docket No. 659] (June 10, 2020).
31 *Id.* [Docket No. 721] (June 11, 2020).