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Commercial Landlords (and Their Lenders) Beware: Bankruptcy Courts Are Shifting Risks to Lessors in Response to the Exigent Circumstances Brought on by COVID-19

*Brett H. Miller, Mark S. Edelstein, and Erica J. Richards**

Retailers, whose brick-and-mortar locations were already struggling to adapt to an increasingly online marketplace, have been among the hardest hit in the COVID-19 pandemic. The authors of this article discuss the impact of retail bankruptcies on commercial landlords and their lenders.

The COVID-19 pandemic has triggered unprecedented levels of business disruption and forced numerous companies into bankruptcy in an effort to preserve dwindling liquidity and postpone creditor demands. Retailers, whose brick-and-mortar locations were already struggling to adapt to an increasingly online marketplace, have been among the hardest hit.

A number of bankruptcy judges, faced with the prospect of an avalanche of forced liquidations, have thrown these debtors a lifeline by approving requests to suspend lease payments. This relief is a stark departure from prior precedent and could mean that commercial landlords will be disproportionately impacted should debtors prove to be administratively insolvent. The impact of this relief would, of course, filter through to commercial landlord lenders.

Landlord Rights Under the Bankruptcy Code

The Bankruptcy Code contains specific protections for commercial landlords. Bankruptcy Code Section 365(d)(3) generally requires debtors to remain current on their post-bankruptcy commercial lease obligations until the corresponding lease is assumed or rejected.[1]

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However, Section 365(d)(3) also allows bankruptcy courts to temporarily defer a debtor's lease obligations during the first 60 days of a bankruptcy proceeding if good cause for the deferral is shown and lease obligations are not deferred beyond the 60th day of the bankruptcy filing. Historically, this exception was rarely used, and the 60-day limit was strictly enforced by bankruptcy courts.

In addition, Section 365(d)(4) imposes a 210-day deadline for debtors to assume or reject nonresidential (i.e., commercial) real property leases.[2] If a lease has not been assumed by the end of the period, the lease will be deemed rejected, absent an agreement by the lessor to the contrary.

Further, under Section 363(e), "at any time, on request of an entity that has an interest in property . . . leased . . . by the trustee [or debtor in possession], the court . . . shall prohibit or condition such . . . lease as is necessary to provide adequate protection of such interest."[3] When adequate protection is required, a debtor-in-possession may provide such adequate protection by:

(1) Making a cash payment or periodic cash payments;

(2) Granting an additional or replacement lien in favor of the lessor; or

(3) Granting other relief that will result in the realization by lessor of the "indubitable equivalent" of the lessor's interest in the property.[4]

As defined by the statute, "adequate protection" is intended to compensate a non-debtor to the extent the debtor's use of leased property during its bankruptcy case results in a decrease in the value of such non-debtor party's interest in the property.[5]

Post-Pandemic Bankruptcy Court Decisions

Landlords have traditionally relied on Section 365(d)(3) to collect on lease obligations pending a decision by the debtor on whether to assume or reject the lease. Following the onset of the COVID-19 pandemic, however, multiple retail debtors have sought and received rent deferments even beyond the 60-day limit provided under Section 365(d)(3).

Despite heavy opposition from landlords and creditors' committees, deferrals have been approved in approximately a dozen relatively large bankruptcy cases to date, including those of:

- Modell's Sporting Goods;[6]
- Pier 1 Imports;[7]
- 24 Hour Fitness;[8] and
- CEC Entertainment, the parent of Chuck E. Cheese.[9]

Modell's Sporting Goods was the first debtor to seek a "mothballing" order due to COVID-19. On March 23, 2020, the retailer filed a motion seeking to suspend its Chapter 11 cases pursuant to Sections 105 and 305, including a request to defer, among other obligations, its rent obligations. Modell's argued that state-imposed limitations and prohibitions prevented them from conducting proposed going-out-of-business sales and operating their stores, and required them to reevaluate their bankruptcy strategy.

The court granted the motion and sus-

pended the proceedings through April 30, 2020, without prejudice to Modell's right to seek a further extension of time. Modell's then sought a further suspension of its Chapter 11 cases through and including May 31, 2020 - beyond the 60-day limit specified in Section 365(d)(3). Many of the Modell's landlords objected, arguing that Section 365(d)(3) barred the extension. The court held a hearing on the matter and granted the extension, overruling the landlords' objections.

Pier 1 quickly followed suit and also obtained court approval of rent deferrals beyond the 60-day period. Unlike the Modell's court, the Pier 1 court issued a memorandum opinion explaining the reasoning behind its decision.[10]

The court explained that it was exercising its equitable authority under Section 105(a) to grant a further deferral in light of its view that there was no feasible alternative.

The court rejected the landlords' arguments that Section 365(d)(3) gives landlords a right to compel payment from the debtors. Rather, the court ruled that, to the extent a debtor fails to timely pay rent, landlords are only entitled to an administrative expense claim - that is, a claim that is entitled to priority treatment under Sections 503(b) and 507(a)(2) and that must be paid in full in order to confirm a Chapter 11 plan.[11]

The Pier 1 court went on to find that compelling the debtors to pay rent now would elevate landlords' claims above those of other similarly situated administrative expense claimants, in effect providing the landlords with superpriority status.

No doubt encouraged by these rulings, debtors have begun requesting even more extensive relief.

Recently, CEC Entertainment, Inc. requested an open-ended abatement of rent payments for 141 stores closed or otherwise limited in operations as a result of any governmental order or restriction, "until such restriction or order has been lifted and to reflect the extent and duration of such forced governmental closures or limitations."

CEC argued that this extraordinary relief was warranted because:

(a) By shutting down or otherwise significantly limiting the debtors' business operations, governmental "shelter in place" orders have entirely frustrated the fundamental purpose of the debtors' leases;

(b) The COVID-19 pandemic and related public health measures triggered certain force majeure provisions in the debtors' leases that expressly relieve the debtors of their rent obligations; and

(c) The bankruptcy court can (and should) exercise its inherent, equitable powers to protect the debtors from paying substantial rent obligations in return for which they receive no - or a significantly limited - benefit.

After CEC's rent abatement motion was filed, CEC reached settlements with a portion of its landlords and moved forward with a contested hearing as to the remaining non-settling landlords. The bankruptcy court ultimately denied CEC's request for non-consensual rent abatement.[12] The decision

was based in large part on the court's finding that provisions of the leases at issue expressly provided that the occurrence of a force majeure event did not relieve the debtors of their obligation to make rent payments.

Key Takeaways for Commercial Landlords and Their Lenders

Object Early and Often

This advice applies to bankruptcy proceedings in general, as bankruptcy courts typically deem silence to mean acquiescence. It has even greater relevance in this context, however. Recent requests for rent deferral are grounded in arguments that the debtor is currently unable to operate due to governmental restrictions that will be in place for an uncertain timeframe.

But those restrictions - and the status of a debtor's operations - are changing daily. Landlords should closely monitor modifications in applicable restrictions and be diligent in preserving their ability to come back to court as circumstances change.

Be Flexible

Bankruptcy judges are looking for ways to equitably allocate the risk and losses caused by devastating, but hopefully temporary, shutdowns. Arguments that landlords should be paid now for rent on properties that debtors are not able to use have largely fallen on deaf ears.

That said, bankruptcy judges have been receptive to arguments that landlords should not be forced to bear a disproportionate share of risk that a debtor's estate will ultimately be administratively insolvent. Presented with rent deferral requests, landlords should consider seeking to reach agreement on a middle ground with debtors and lenders. That might include the payment of rent into escrow accounts, provisions allowing the payment of deferred rent amounts over time, or consensual extensions of the 210-day assumption/rejection deadline in exchange for partial deferrals.

Assess Availability of Adequate Protection Rights

Landlords have less leverage than they have previously enjoyed but are still entitled to adequate protection for any diminution in value of their property, including the continued payment by a debtor of all non-rent obligations, such as insurance payments, security obligations, and utility payments.

Landlords should consult with their bankruptcy counsel to ensure that their interests in the leased property are fully protected during the pendency of a tenant's bankruptcy case.

NOTES:

[1]11 U.S.C.A. § 365(d)(3).

[2]11 U.S.C.A. § 365(d)(4).

[3]11 U.S.C.A. § 363(e).

[4]11 U.S.C.A. § 361.

[5]11 U.S.C.A. § 361(1), (2).

[6]*In re Modell's Sporting Goods, Inc.*, et al., Case No. 20-14179 (Bankr. D. N.J.).

[7]*In re Pier 1 Imports, Inc.*, et al., Case No. 20-30805 (Bankr. E.D. Va.).

[8]*In re 24 Hour Fitness Worldwide, Inc.*, Case No. 20-11558 (Bankr. D. Del.).

[9]*In re CEC Entertainment, Inc.*, Case No. 20-33163 (Bankr. S.D. Tex., Aug. 3, 2020).

[10]*In re Pier 1 Imports, Inc.*, No. 20-30805, ECF# 637 (Bankr. E.D. Va. May 10, 2020).

[11]If a debtor is unable to pay all allowed administra-

tive priority claims in full and administrative claimants do not agree to accept smaller distributions on their claims, a debtor must either convert its case to a Chapter 7 liquidation proceeding or dismiss its bankruptcy case altogether.

[12] *In re CEC Entertainment, Inc.*, Case No. 20-33163 (S.D. Tex. Dec. 14, 2020) [ECF #1482].