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COVID-19 and Chapter 11

Suspension Orders and Their Impact on Creditors' Rights

Editor's Note: *ABI recently launched its Coronavirus Resources for Bankruptcy Professionals website (abi.org/covid19), which aggregates information for bankruptcy professionals to assist clients and provide guidance due to the fallout from the COVID-19 pandemic.*

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The impact of the novel coronavirus, COVID-19, on chapter 11 cases continues to develop, and courts have responded to this crisis in myriad ways. As a result, the dire tension between debtors and general unsecured creditors has and likely will continue to be affected, and it is unclear whether the pandemic's fallout will have long-term repercussions on this relationship. Stay-at-home measures have resulted in many businesses shuttering or limiting operations, and unprecedented reactions have been seen from debtors and courts in an effort to counter the ill effects on debtors in existing chapter 11 cases, which found their restructuring planning shaken because of the virus's global impact. As a result, debtors and courts are attempting to adjust to find new and creative remedies within the Bankruptcy Code to preserve the value of their businesses.

For example, some brick-and-mortar retail and other debtors that rely on consumer foot traffic for revenue, and that looked to chapter 11 to provide relief through well-laid plans of orchestrating going-out-of-business sales or systematic restructurings, have turned to requesting novel and extraordinary equitable relief under §§ 305(a) and 105(a). Debtors are looking to suspend or "mothball" their cases under § 305(a)[1] and/or 105(a)[2] as a result of the pandemic, while others have been forced into chapter 7 liquidation, unable to convince stakeholders that the company should stay in chapter 11.[3] This article explores these suspension orders and assesses the resulting treatment of the claims and rights of general unsecured creditors in the wake of this pandemic.

Suspension Orders Under the Bankruptcy Code

In recent months, professionals have seen bankruptcy courts grant extraordinary equitable relief to already financially distressed companies that have been further impacted by the COVID-19 pandemic. The harsh new reality has prompted certain debtors to request temporary suspensions of their chapter 11 cases pursuant to the courts' equity powers provided by the Bankruptcy Code, with some turning to § 305(a) while others have used § 105(a) in combination with nonbankruptcy law. Some courts have granted these "mothball" motions in cases of nonessential business, such as brick-and-mortar retail and restaurants.

The hope was to suspend the chapter 11 proceedings in order to provide additional breathing space to preserve their restructuring or liquidation efforts. These efforts included the following: (1) the debtor could preserve the value of its business and preserve jobs; (2) lenders could preserve the value of their collateral by not seeking the premature sale or liquidation in a depressed market; and (3) unsecured creditors could continue to do business with a viable reorganized entity or extract

1 *See, e.g., In re Modell's Sporting Goods Inc.*, No. 20-14179, D.E. 166, 294 (Bankr. D.N.J. March 27, 2020, further extended by order dated April 30, 2020).

2 *See, e.g., In re Craftworks Parent LLC*, No. 20-10475, D.E. 217, 220 (Bankr. D. Del. March 30, 2020); *In re Pier 1 Imports Inc.*, No. 20-30805, D.E. 493 (Bankr. E.D. Va. April 6, 2020).

3 *See In re Art Van Furniture LLC*, No. 20-10553, D.E. 263 (Bankr. D. Del. April 7, 2020) (converting case to chapter 7). The proposed chapter 7 trustee to the Art Van estates has proposed his own form of suspension procedures. *See also In re VIP Cinema Holdings Inc.*, No. 20-10345 (Bankr. D. Del. April 7, 2020) (approving motion to pay post-petition severance). VIP Cinema was a manufacturer of movie theater seats and sought chapter 11 relief in Delaware in February 2020. It filed a consensual prepackaged plan to reduce its balance sheet. However, the pandemic saw VIP Cinema's market quickly disappear, along with the feasibility of its plan. VIP Cinema was forced to pivot from a reorganization to a liquidation as management resigned and plan supporters withdrew.

value from a liquidated entity that would be liquidating based on fair market value.

The first case to file a mothball motion resulting from the effects of COVID-19 was in *Modell's Sporting Goods Inc*., which is pending in the U.S. Bankruptcy Court for the District of New Jersey. In this case, the debtors anticipated generating revenue through closeout sales, but because of the store closures and the lack of foot traffic, the revenue stream stalled and an immediate lack of cash to pay landlords while liquidating precipitated the need for the extraordinary requested relief. Cases in the Delaware[4] and Virginia[5] bankruptcy courts entered similar orders over the objections of landlords and other creditors in an effort to preserve value to the chapter 11 estates.

The *Modell's* motion sought relief pursuant to § 305(a), which permits the dismissal or suspension of a case if "the interests of creditors and the debtor would be better served," and § 105. Historically, § 305 has been used where state court litigation might cause a bankruptcy proceeding to be duplicative or unnecessary, or such as when minority creditors attempt to force an involuntary bankruptcy as negotiation leverage.[6] *Modell*'s mothball proposal sought to pay only critical expenses, such as wages and insurance, during the suspended period while other expenses were deferred, yet also sought to maintain the automatic stay and adjourn deadlines through 21 days past the suspended period of the cases.

Landlords objected to the debtors' request, arguing that such relief would result in their subsidizing the recovery of secured lenders. The court granted the motion with certain restrictions, including the suspension of an initial 30-day period, and allowed the parties relief from the court during the suspension "with respect to exigent and unforeseen circumstances" that could not be consensually resolved.[7]

In late April 2020, *Modell's* debtors sought to extend the initial 30-day case suspension for an additional 30 days. The debtors argued that the creditors would benefit in the long term by further extending the mothball order because the suspension would enable the debtors to recommence store closing sales at a later date for the benefit of all parties-in-interest. The *Modell's* debtors also argued that they were excused from making payments under the doctrine of frustration of purposes and intervening impossibility because they were without any other options than to suspend the store liquidation process resulting from the government-mandated shutdowns.

By order dated April 30, 2020, the court granted the requested relief over the objection of certain creditors, including landlords. The landlords objected to the continued suspension of the cases, arguing, among other things, that the suspension should be conditioned upon § 365(d)(3), which sets a 60-day limit on rental deferrals. Specifically, they argued that § 365(d)(3) provides that "[t]he court may extend, for cause, the time for performance of any [lease] 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."[8] The landlords argued that the requested relief under §§ 305 and 105 exceeded statutory authority because § 365 requires performance of post-petition obligations no later than 61 days after the petition date. Further, the landlords noted that the request under § 105 could not be used as a basis to support the continued request because § 105 cannot be used to extend or override existing provisions of the Bankruptcy Code, pointing to Hon. **Mary F. Walrath**'s recent decision in *Forever 21*.[9] Cases that are coming into bankruptcy in more recent days and weeks, after the stay-at-home orders have been in effect for a few weeks or longer, are filing suspension motions as part of the requested first-day relief.[10] The requested relief relies primarily on § 365(d)(3) to provide the 60 days of suspension, with § 105 playing a supporting role.[11]

In a different procedural posture, in *Pier 1* the bidding deadline for its auction had passed when the debtors filed their emergency motion on March 31, 2020. The debtors argued to the U.S. Bankruptcy Court for the Eastern District of Virginia that the governmental shutdown of their stores had inhibited their opportunity for any going-concern transactions, and as a result, they were left with offers of liquidation.[12] Rather than rely on § 305(a), the debtors sought bankruptcy court approval of their suspension order under the court's equitable powers under § 105(a), with § 365(d)(3) unavailable, arguing instead that the governmental shelter-in-place order constituted a government taking that triggered abatement clauses in their leases and that they were further excused from performance under doctrines of impossibility and frustration of purpose.

The *Pier 1* debtors also sought to enforce contracts with vendors and other nonlease creditors during the suspension period and proposed alternative procedures under which creditors could seek administrative expenses. The motion was granted, and the debtors were relieved from paying rent to landlords who did not otherwise agree to a rent reduction and were permitted to not make payments to certain vendors, shippers and other suppliers during the period of the order. In *Pier 1*, like the other courts granting motions to suspend, requested monthly hearings to address material disputes.

On May 10, 2020, in a subsequent memorandum opinion, the court in *Pier 1* granted the debtors' motion seeking to temporality halt payment of rent.[13] The court permitted the debtors to skip rent payments during the pandemic (April and May) pursuant to § 365(d)(3) although "timely" payment is required.[14] The debtors were able to suspend the rent payments, but they would remain obligated

4 *See In re Craftworks Parent LLC*, No. 20-10475 (Bankr. D. Del.); *In re Forever 21 Inc.*, Case No. 19-12122 (Bankr. D. Del.).

5 *In re Pier 1 Imports Inc.*, No. 20-30805 (Bankr. E.D. Va. April 6, 2020), Order Granting (I) Relief Related to the Interim Budget, (II) Temporarily Adjourning Certain Motions and Applications for Payments, and (III) Granting Related Relief.

6 Congress acknowledged that bankruptcy courts should decline jurisdiction over certain cases with the enactment of § 305. *See In re Bus. Info. Co. Inc.*, 81 B.R. 382 (Bankr. W.D. Pa. 1988); *see also In re DGE Corp*., 2006 WL 4452846, *3 (Bankr. D.N.J. 2006) ("Several courts have held that abstention or dismissal is appropriate when another forum is available to determine the parties' interests and, in fact, such an action has been commenced.").

7 *See Modell's Sporting Goods* March 27, 2020, Suspension Order, at ¶ 2.b.

8 11 U.S.C. § 365(d)(3).

9 In *Forever 21*, the purchaser requested modification of the sale order in which the court denied stating that "the Supreme Court has told us in *Law v. Segal* that any relief granted under [Section] 105 must be in furtherance of a Bankruptcy Code provision and not in contravention of any specific provision." *See* Transcript, *In re Forever 21 Inc., et al.*, Case No. 19-12122 (Bankr. D. Del. April 21, 2020).

10 *See In re Chinos Holdings Inc.*, Case No. 20-32181 (Bankr. E.D. Va.), at Docket No. 23, entitled Motion of Debtors for Entry of Order (I) Extending Time for Performance of Obligations Arising Under Unexpired Non-Residential Real Property Leases, and (II) Granting Related Relief.

11 *Id. See also In re True Religion Apparel Inc.*, Case No. 20-10941 (Bankr. D. Del. May 6, 2020).

12 *In re Pier 1 Imports Inc.*, No. 20-30805 (Bankr. E.D. Va.).

13 *In re Pier 1 Imports Inc.*, No. 20-30805 (Bankr. E.D. Va. May 10, 2020).

14 *Id.* at p. 8.

to pay the rent and such obligation would be deemed an administrative expense.

The court did not require immediate payment, stating, "To compel payment by the Debtors now would elevate payment of rent to the Lessors to superpriority status, *i.e.*, a claim that would be paid before all other accrued but unpaid administrative expense claims."[15] Extending the moratorium until May 31, by an order dated May 5, 2020, the opinion explained the court's reasoning for its decision and stated that "[T]here is no feasible alternative to the relief sought" by the landlords.[16]

The Fallout of Suspension Orders

While the response from creditors to suspension orders is making its way through the court system, the impact of such orders on creditors is not as overt. The administrative burn created by mothballed landlords and other administrative-expense-holders may continue to result in debtors trying to pick and choose what post-petition expenses should be paid after the suspension order ends. The Bankruptcy Code requires that expenses incurred during the pendency of a chapter 11 case be paid in full prior to confirmation of a chapter 11 plan.[17]

For example, in *Pier 1*, the mothball order froze expenses associated with brick-and-mortar store locations while maintaining that the e-commerce business and payments to corresponding vendors be deemed critical to the debtors' e-commerce business. Post-petition payments to landlords, vendors, shippers and suppliers were deferred after the cases had been pending for weeks or months. Ordinarily, if administrative expenses cannot be paid in full, then the debtor is deemed administratively insolvent and the case might be converted to a chapter 7 liquidation, but these are not ordinary times.

This prioritizing of administrative creditors, while possibly acceptable as a short-term fix, will likely face its own resistance as the pandemic continues. For example, in *Toys "R" Us*,[18] the debtors sought to set aside funds to compensate vendors for goods shipped after a certain date, leaving other administrative creditors out of the money. Courts might be hesitant to enforce such a long-term practice that appears to discriminate between administrative-expense-holders, but they may have no other option if they want to avoid a liquidation.

Further, vendors — facing their own challenges in the wake of COVID-19 — might, after any suspension order is lifted, have their own difficulty continuing business, and might be unable to fulfill customer orders even presuming that ongoing trade terms might be successfully negotiated. It would not be surprising to learn that even after a debtor determines that critical-vendor or other post-petition dollars are appropriate to pay a vendor, said vendor is unable to perform based on its own supply chain or other coronavirus-related disruption, whether by shipping delays, cancellation or internal concerns at factories or fulfillment centers because of the implementation of important public health policies to prevent the spread of the virus.

Conclusion

This mothballing strategy certainly departs from the accepted norm that chapter 11 requires debtors to pay administrative expenses, including landlords and current vendors, in a timely manner. However, the suspension of the cases provides a pause with the hopes that the disruption is short-lived and liquidity may be restored in time and hopefully provide a benefit to stakeholders. The courts, when granting creeping suspension such as in *Modell's*, are permitting ongoing uncertainty to stakeholders (such as landlords) as orders are extended monthly. The impact has yet to be determined.

As the pandemic shutdown of nonessential businesses in many states has been extended beyond April 30, 2020, it is unclear whether the suspension of cases will delay an inevitable liquidation or provide the anticipated useful extension of support to allow the cases to continue in chapter 11. Of those chapter 11 debtors that survive, the COVID-19 crisis may result in efforts to fast-track funds for critical administrative expenses to employees, professionals and certain vendors in order to keep certain portions of the business (such as online sales) operational, yet leave other creditors (such as landlords and other vendors) out of the money. Such a strategy to further prop up liquidity likely also further reduces or eliminates the possibility of recovery to unsecured creditors, because if such administrative expenses cannot be paid, there is little chance that general unsecured creditors will recover on their claims. abi

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15 *Id.*

16 *Id.* at p. 10.

17 11 U.S.C. § 365(d)(3), (d)(5), 4 *Collier on Bankruptcy* ¶ 503.03[4] (Richard Levin & Henry J. Sommer eds., 16th ed.) (noting that "ordinary course of business" post-petition administrative expenses "generally are paid when due").

18 *See In re Toys "R" Us Inc.*, Case No. 17-34665 (Bankr. E.D. Va., March 25, 2018) (orders (1) authorizing wind-down of U.S. operations and postponing creditors' efforts to collect on administrative claims, and (2) establishing dates by which parties holding such administrative claims must file proofs of claim).