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Practice Update

Equitable Arguments in Bankruptcy During the COVID-19 Pandemic

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A new trend is brewing in bankruptcy courts: debtors are increasingly able to use the courts' general equitable powers for assistance in weathering the current economic storm. These pandemic-related equitable arguments may significantly impact the marketplace—positively or negatively depending on your position—specifically as it relates to lease performance and also in general. While we haven't yet seen a material uptick in bankruptcy filings, a significant increase is expected and you should be thinking about whether your business partners and contractual counterparties are likely to file. Moreover, in planning and negotiating in this environment it's important for you to understand the potential ramifications of a bankruptcy filing and how the courts are reacting in light of the pandemic.

As demonstrated in three very recent bankruptcy cases—discussed in more detail below—debtors are employing Bankruptcy Code section 105 in requesting drastic latitude, and courts are listening. By way of background relative to the below cases, the Bankruptcy Code requires that post-petition rent be paid on time, but in no event later than 60 days after the case is filed. In essence, the automatic stay provides to the debtor some breathing room and for 60 days the debtor may utilize the leased premises while rent accrues. For nonresidential leases, the

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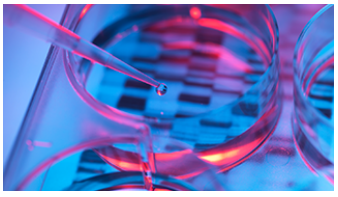

debtor has 120 days (plus an additional 90 upon demonstration of cause) to assume or reject the lease. Courts are now showing a willingness to rely upon Bankruptcy Code section 105, which confers broad equitable powers upon a bankruptcy court. Normally, bankruptcy judges are reluctant to use this catch-all provision. In this environment, however, we expect debtors and courts to cite it routinely to override unambiguous deadlines and other mandatory provisions.

- **Modell's Sporting Goods, Inc.** (Bankruptcy Court for the District of New Jersey). Modell's filed its petition with plans to liquidate. Shortly after filing, Modell's was unable to conduct going-out-of-business sales because shelter-in-place orders are in effect where its stores are located. Accordingly, the debtor mothballed its operations to preserve value and petitioned the court to (i) suspend the proceedings before going-out-of-business sales would be conducted; and (ii) defer all lease-related expenses including rent and utilities for 60 days. The court agreed and relied on a little-used provision of the Bankruptcy Code, section 305, which allows a court to suspend proceedings and all related deadlines. The order is not appealable.
- **Pier 1 Imports, Inc.** (Bankruptcy Court for the Eastern District of Virginia). Pier 1 Imports entered bankruptcy in mid-February hoping to sell as a going-concern. Less than six weeks later, it had furloughed 9,400 employees with overall sales off 65%. Ultimately, because the its products were not "essential" under shelter-in-place orders, Pier 1 proposed a "Limited Operation Period" to enable it to stave off liquidation. During such period, rent and other expenses would not be paid to landlords, even though they had not agreed to rent concessions. Although the debtor's proposal was entirely at odds with the requirements of Bankruptcy Code section 365, the court issued an order pursuant to section 105 thereby temporarily relieving the retailer from paying post-petition rent.

- **CraftWorks Parent, LLC** (Bankruptcy Court for the District of Delaware). CraftWorks, the owner and franchisor of restaurant brands including Logan's Roadhouse, Old Chicago Pizza & Taproom, and Rock Bottom Restaurant, filed for bankruptcy protection in early March saddled with $235 million in debt and a serious need for liquidity. It, like Pier 1, planned to reorganize around a smaller footprint of key locations. The debtor's pre-petition lenders were willing to provide DIP financing. Within three weeks of filing, the debtor had laid off 18,000 employees, rejected 77 leases, and ceased operating its remaining 261 locations. To make matters worse, the debtor's CEO and CFO were terminated for cause two weeks after filing for bankruptcy because of improper post-petition payments to taxing authorities. Nevertheless, as part of the debtor's request for a final DIP financing order, the debtor proposed pursuant to section 105 to pay only "critical expenses" (i.e., not lease-related expenses) for six weeks. The court agreed over objections from the debtor's landlords.

The Take-away. For the foreseeable future bankruptcy judges are likely to go to great lengths to preserve reorganization opportunities for debtors. Any company or individual seeking bankruptcy protection is likely to gain more mileage out of equitable arguments. This seems to open the door for debtors to have the "win-win" of prolonging customary deadlines while also utilizing the automatic stay. Moreover, the potential impact extends far beyond landlord-tenant issues. We expect similar equitable arguments will be made as against requests for adequate protection payments, to extend the automatic stay to non-parties, in proposing cramdown reorganization plans, and more. As bankruptcy courts maintain equitable discretion, we should come to expect extraordinary and creative outcomes.

Please contact the authors if you have any questions.