

REDEFINING EXTRAORDINARY CIRCUMSTANCES IN THE WAKE OF COVID-19: FINDING CONSISTENCY IN DIFFICULT TIMES

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Humanity has largely embraced the “we are in this together” mentality from a health crisis perspective. Yet, even as world leaders scramble to contain the COVID-19 pandemic, we have yet to fully grasp the follow-on impact from the pandemic and particularly, how it will affect world economies. For this “second phase” of the world’s response to the pandemic, the ultimate question is whether business and financial counter-parties will equally share the risk of loss. Bankruptcy judges have jurisdiction to fashion remedies for parties in their courtroom, but Congress and COVID-19 have left them no choice but to rule on issues immediately in front of them without the ability to limit the impact of their decisions on other market players. With a goal of tempering the COVID-19 related damage, recent difficult decisions in U.S. Bankruptcy Courts have invoked unprecedented results, but employing U.S. Bankruptcy Courts as our method of policing the economic impact of the pandemic may disproportionately impact risk-shifting.

Our economy relies on numerous players, all of whom are impacted (and impact one another): (a) unemployed people can neither pay their rent nor inject discretionary spending to restart retail and other industries; (b) retail tenants that do not generate income cannot pay their rent, resulting in commercial landlords/property owners potentially defaulting on their mortgages; (c) lenders with overdrawn revolvers cannot (or will not) further extend credit to defaulting borrowers; (d) companies that are cash-strapped cannot pay employees, landlords or lenders. Stated simply, there will be an echoing breakage if a disproportionate amount of the burden is pushed to one particular market participant.

As a result of COVID-19, we are already beginning to see clear tearing of the fabrics that have held global and local business markets together. As a recent example, the financial industry was bombarded by “client alerts” and articles written by law firms (including this one) theoretically weighing whether material adverse effect provisions in loan agreements can be or have been triggered by the pandemic. While this was playing out in academia, debtors in current bankruptcy cases have struggled with how the pandemic affects their bankruptcy proceedings (and likely will affect future proceedings). For example:

- Craftworks Holdings, an operator and franchiser of steakhouses, breweries and craft-beer focused casual dining restaurants, filed for bankruptcy protection on March 3, 2020, and had received approval for a debtor-in-possession (DIP) financing facility. When the pandemic hit, Craftworks provided notice of the termination of this financing commitment without any further details. In a supplemental filing on March 27, 2020, the company disclosed the basis for the termination as the “unforeseen drastic and material decreases in the [Debtors’] business operations due to the impact of the COVID-19 pandemic, resulting in a Material Adverse Effect” in addition to a cash flow default. To “fix” this problem, Craftworks apparently negotiated (and received approval on April 1, 2020) for an interim DIP budget that provided for a moratorium on paying rent to its landlords.
- Pier 1 Imports Inc., a Fort Worth, Texas-based retailer specializing in imported home furnishings and décor, filed for bankruptcy relief on February 17, 2020. Pier 1 sought to sell its assets and prepared to go to auction on March 31, 2020. Then, the pandemic hit – Pier 1 cancelled its auction in late March 2020 due to the absence of qualified bids, at which point the lenders elected to equitize their debt. As would be expected, Pier 1’s DIP loan facility was in jeopardy, and like Craftworks, Pier 1 sought and received approval for a DIP budget that was free of rent payments to landlords (including those landlords who had not already agreed to a deferral).
- Finally, Modell’s, a sporting goods retailer, filed for Chapter 11 protection on March 11, 2020 with the intention of liquidating its inventory in all of its 153 stores. As a result of the pandemic, the company stopped these sales as government authorities mandated that non-essential merchants shut down (and residents were asked to stay at home). On March 27, 2020, Modell’s bankruptcy was paused until April 30, 2020. During that period, much like Craftworks and Pier 1, Modell’s was granted a freeze on making certain rental payments to landlords.

So, why does this matter? ***Well, as a crib sheet for bankruptcy novices, the Bankruptcy Code permits a limited extension of deadlines to pay rent obligations that arise within the 60 days following a bankruptcy filing upon a showing of cause, but unequivocally requires the payment of rent while in bankruptcy.*** Within a very short period, arrangements have been requested and approved that fly-in-the-face of bankruptcy precedent and conflict with the text of the Bankruptcy Code itself. In all these cases, landlords objected and pointed to their express statutory rights to receive post-petition rent payments under the Bankruptcy Code. We are not the only people who have noticed this issue – [Bloomberg](#) has also taken notice.

Desperate Chapter 11 debtors have asked bankruptcy courts for extraordinary relief in a time of crisis and have found these requests met with humanity. In granting these requests, the bankruptcy courts have shifted a significant risk of the pandemic from the chapter 11 debtors to their landlords. Yet, the landlords have no guaranteed moratorium on their financial commitments to their lenders

on the mortgages for the underlying properties (while some lenders are providing accommodations, it is not clear that all of them will (or will be able to do so)).

This begs the question – what will be the long-term impact of these short-term decisions, as altruistic as they may seem at the time? Even though these recent rulings are thought provoking, they raise a substantial red flag as to what's to come. In granting nonconsensual rent abatement (or perhaps waivers), no parameters have been established to enable parties to assess what rises to “extraordinary circumstances” in the wake of an unprecedented pandemic. Perhaps these rulings will provide restaurants and retailers with additional leverage to incentivize their landlords to reach a deal outside of bankruptcy. Nevertheless, while individual parties are focused on preserving what they can in light of the uncertain future, none of the tenants, landlords, companies or lenders can bear these burdens alone. Extraordinary rulings may provide a short-term fix for a microcosm of the economy – however, they will not provide the blueprint for a long-term resolution.

The “second phase” of responses to the COVID-19 crisis should be offensive rather than defensive in order to account for the long-term impact. To more collectively weather the storm, legislative measures should be taken to prevent a chain reaction and mitigate the blow to the economy that will otherwise inevitably be caused by over-pressuring a single part of the chain in a way that will simply overload the adjoining link as a result of piecemeal resolution provided by bankruptcy court decisions. For example, inclusion of temporary modifications to the Bankruptcy Code in the next economic stimulus package would permit a measured impact across bankruptcy cases and enable courts to fashion remedies that not only address the immediate issue raised to a bankruptcy court, but also the potential follow-on impact. In speaking with Mark Palmer of Theseus Strategy Group about potential solutions, he proposed that the next stimulus package could provide for loans from the federal government to parties that, as a result of bankruptcy court rulings altering their statutory rights under the Bankruptcy Code, have delayed (and risked recovery of) payment of amounts duly owed to them and arising during the bankruptcy case, on the conditions that: (a) the recipient of the loan would repay any recoveries ultimately received from the bankruptcy case on account of the relevant obligation to the government and (b) if no such recovery is received, the loaned amount would be forgiven. Thus, in the instance of Pier 1, Modell's and CraftWorks, the impacted landlords would be able to seek funding for the rental payments that would have otherwise been paid but for the court's extraordinary relief. Where a bankruptcy court decision can protect debtors from needing to immediately spend cash, it lacks jurisdiction to protect counterparties from the ramifications caused by its own court ruling. Instead, temporary legislation could more appropriately account for which concessions can be made by particular industries and endeavor to balance the burdens among constituents. While such remedies will not prevent the inevitable losses to market participants, such temporary measures could have a meaningful impact on increasing the recovery time from the anticipated COVID-19 induced downturn.

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