Is there a Future for Retail after COVID-19: A Look at Modell's and Pier 1 and their Bankruptcy Proceedings

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This article discusses the impact of the COVID-19 pandemic on the retail industry and retail bankruptcy cases. Even before COVID-19, the retail industry was at the top of the bankruptcy watchlist. It was widely known that retailers were facing financial difficulties as they were unable to meet projected income targets partly because of tough competition by online giants like Amazon. While Amazon is also leasing the majority of its warehouses, it obviously is not dependent on customer foot traffic the way most retailers are since Amazon is essentially operating as a shipping company. The majority of large and small retailers are burdened with high monthly rents for their many stores located in shopping malls or strip centers that are dependent on customers visiting and purchasing goods within the shops.

While already struggling to attract customers into their stores, the COVID-19 shutdown has now forced shops, malls, and shopping strips to close its doors, bringing retailers' struggle to total capitulation.

Before COVID-19, Retailers Were Assisted by the Bankruptcy Code

Prior to COVID-19, retailers might still have had hope that filing for bankruptcy could have assisted them in restructuring their debts by allowing them to reject expensive store leases, close down non-profitable stores and renegotiate lease payments for profitable stores. In short, the plan would be to downsize, restructure, and re-emerge as a smaller, but on-going business, and the Bankruptcy Code would have assisted in accomplishing all that.

How COVID-19 has Changed Retail Bankruptcy Proceedings

COVID-19 not only changed previous retail bankruptcy proceedings, it is forcing bankruptcy judges, debtors, landlords, lenders, and creditors into an entirely new and unexpected arena. Generally, bankruptcy proceedings are marked by important timelines and milestones that must either be met by debtors, or debtors must seek approval from the bankruptcy court to extend these deadlines.

For example, debtors have 60 days from the date of the petition to reject or assume and assign retail leases; debtors have an exclusive period of 120 days to file their plans for restructuring or liquidation, and have 180 days after the filing of their plans to solicit acceptance from creditors of their plans (the foregoing dates may be extended to a certain point). These timelines are given to debtors to provide them with the time needed to successfully restructure their debts

often through sales of some, or substantially all, of their assets and by obtaining debtor in possession financing or being allowed to use their lenders' cash collateral.

Along with the bankruptcy petition and first day motions, corporations filing for Chapter 11 file a declaration from either their chief executive officer, chief restructuring officer, or any other person in charge of running the company. The declaration explains, inter alia, the reasons for the bankruptcy filing and the debtor's strategies of restructuring or liquidating its business. For the majority of retailers, one strategy includes having going-out-of-business sales in either all of their stores if the retailer is liquidating all of its assets, or only the ones that will be closed permanently if the retailer is trying to continue to operate but on a downsized scale.

How Modell's Sporting Goods' Bankruptcy Action is Proceeding During this Pandemic

On March 11, 2020, Modell's Sporting Goods, Inc. and thirteen affiliated debtors filed for Chapter 11 in the United States Bankruptcy for the District of New Jersey. Modell's is a family-owned retailer of sporting goods, athletic footwear, and active apparel. It was founded in 1889 by Morris A. Modell, making it the oldest family-owned retailer in the United States. Modell's has 134 stores located in strip centers and shopping malls throughout the Northeastern and Mid-Atlantic United States.

In his declaration, the chief restructuring officer of Modell's set forth the proposed course of the Chapter 11 cases which included, among other measures, the use of cash collateral required to continue operations during the liquidating process and to generate further revenue from store closing sales. On March 16, 2020, only 5 days after submitting the proposal, the governor of New Jersey ordered a near-shutdown due to the outbreak of COVID-19, of the entire New Jersey state, where 33 of Modell's stores are located. This mandate closed down all movie theaters, casinos, and gyms, and within a few days of this order, the New Jersey governor extended it to include indoor malls and all other non-essential, public gathering places. Multiple other states followed suit with orders to enforce social distancing to prevent the spread of COVID-19 infections.

Less than a week after this national shutdown, Modell's filed a motion with the bankruptcy court, seeking a suspension of its Chapter 11 cases.

Can a Retail Bankruptcy Matter be Suspended?

Pursuant to Section 305 of the Bankruptcy Code, the bankruptcy judge, after notice and a hearing, may "suspend all proceedings in a case under this title, at any time if – (1) the interests of creditors and the debtor would be better served by such dismissal or suspensions." 11 U.S.C. § 305(a)(1). Bankruptcy courts have noted that a suspension of a bankruptcy proceeding is an "extraordinary remedy."

What could be more extraordinary than the current COVID-19 pandemic that has caused entire countries to shut down? In the motion asking the bankruptcy judge to suspend its Chapter 11 proceeding, Modell's pointed out to the court that "[t]he cornerstone of these cases is the liquidation of the Debtors' 134 stores and e-commerce site through store closing sales." See Debtors' Emergency Motion for Entry of an Order Temporarily Suspending their Chapter 11 Cases, Docket No. 115, Case No. 20-14179-VFP. On March 27, 2020, the court entered the order suspending the case.

The COVID-19 shutdown orders throughout the United States simply make it impossible for Modell's to liquidate its inventory through going-out-of-business sales, and Modell's was subsequently forced to cease all operations and to terminate all of its employees. One of the reasons a suspension is an "extraordinary remedy" is that while the debtor is continuously protected by the automatic stay, its creditors' and landlords' protections are also suspended. In other words, the usual timelines that Modell's would have to adhere to, including but not limited to, the time to decide which store leases will be rejected or assumed and assigned, are put on hold. The landlords are being asked to forego their rent payments for the time being – until the pandemic has been brought under control, but how long will it take to accomplish such a monumental task?

Under normal circumstances, when a debtor rejects a commercial lease, the landlord is entitled to a rejection damage claim against the bankruptcy estate, and the debtor is required to surrender the premises after rejecting the lease. A debtor is only permitted to assume and assign a lease to a new tenant after fulfilling any outstanding rent payments. Without the ability to hold store closing sales, Modell's is not only unable to generate revenue, it also will be incapable of clearing out the inventory within the stores and to surrender the premises to the landlords as it would be required to do after rejection. Of course, with the current suspension, Modell's is not even considering which store leases to reject and which ones to assume (the assumed leases will be the leases that Modell's is able to sell to a purchaser of the

lease rights). In a bankruptcy proceeding, a debtor's decision to reject or assume leases or executory contracts is a very valuable one not only because it can terminate leases or contracts with unfavorable terms, but also because it could assume and assign a lease to another tenant for a higher value and retain the difference.

A Retail Apocalypse – How Pier 1 Obtained a Suspension

Interestingly, Pier 1 Imports, Inc., another large retailer that filed for Chapter 11 on February 17, 2020, recently obtained a similar suspension order that specifically addressed abandoned inventory in its stores in connection with suspending its deadline to decide whether to reject or assume leases.

Pier 1 is a retailer of home furnishings and home accessories that at its peak operated close to 1,000 stores in Canada and throughout the United States. Pier 1's restructuring efforts already began in 2018 and 2019 when its revenues continuously declined due to online competitors such as Amazon and Wayfair.

Indeed, in his first-day declaration, Pier 1's Chief Executive Officer and Chief Financial Officer opened with "[t]he so-called 'retail apocalypse' has truly taken on a life of its own… No retail company or consumer in the United States has been immune from its reach over the last several years." See Declaration of Robert J. Riesbeck, Docket No. 30, Case No. 20-30805. And his "retail apocalypse" reference pre-dated the COVID-19 crisis. It is not surprising that by the time of its bankruptcy filing on February 17, 2020, Pier 1 had already commenced the process of closing up to 450 of its stores and was planning to continue operating only 540 stores.

While Pier 1's suspension order was similar to that granted in Modell's, it interestingly also contains a provision that for the store leases which the debtors had already rejected but were unable to remove all inventory from it, the landlords cannot claim that the lease was not timely rejected because of the remaining abandoned property in the store. Again, this relief was granted to the debtors because of the current extraordinary situation of COVID-19. Due to being closed down, Pier 1 is prevented from clearing out its inventory from its stores through going-out-of-business sales.

In its emergency motion seeking the suspension order, Pier 1 argued that COVID-19 measures triggered certain lease provisions that entitle it to an abatement of rent. For example, Pier 1 noted that its "leases provide, in relevant part, that in the event any part of the leased premises or a substantial portion of the shopping center in which the leased premises is located is taken by any competent authority, Debtors shall have the right to continue the lease in full force and effect with a reduced fixed rent commensurate with the reduced area and/or reduced utility of the shopping center – which reduced rental will become effective upon the date of such taking." See Debtors' Emergency Motion, Docket No. 438, Case No. 20-30805-KRH.

Pier 1 continues to assert that the government-ordered lockdown in response to the COVID-19 outbreak constitutes an execution of police powers to protect the public from a pandemic and as such meets one of the two elements of the takings doctrine, namely, the taking by the government must be for public use. The second element is that the government that took the property even for public use must compensate the owner of the property that was taken. Pier 1 does not assert that the government must compensate the landlord for mandating the closing of all unnecessary stores to protect the public from the spread of COVID-19. Rather, it asserts that it is entitled under the terms of its leases to an abatement of rent commensurate with the reduced utility of the leased premises.

Extraordinary Times and Extraordinary Suspensions with Novel Arguments

These are novel arguments and actions that are called for during this extraordinary and unique time. It is extraordinary to suspend not one, but several bankruptcy proceedings.

It is novel to:

- Allow debtors to park their inventory in stores for which they rejected their leases
- Put bankruptcy proceedings and its timelines on hold during this pandemic, thereby essentially asking debtors' landlords to forego collecting rents
- Invoke the takings doctrine in connection with store leases for retail debtors to be granted an abatement of rent

But these are only temporary measures, complying with the government stay-in-shelter mandates.

What will happen to not just Modell's and Pier 1 but to all retailers when the lockdown is lifted?

Pier 1 remains optimistic that once it can resume its initial plan of reorganization, a successful restructuring and liquidation should still be possible through going-out-of-business sales and the sale of its assets. However, at this time it remains to be seen if customers will be emotionally and financially in a position to return to malls, strip centers, and stores for a shopping spree of non-essential items. These are unprecedented times, with questions unseen before, such as:

- Will the fear of contracting a potentially deadly virus keep people from going to large public places like shopping malls?
- Will the financial burden due to unemployment prevent customers from spending money on retail goods?
- Is it possible that all retailers will become casualties of this pandemic – the reality of the so-called retail apocalypse?
- Or is it also possible that this time of quarantine and isolation will bring a newfound appreciation for going to stores to purchase non-essential products rather than ordering online from home?

When the large bookstore chain Borders permanently closed its doors because books were replaced by Kindles, e-readers, and iPads, it seemed to have been the end of all bookstores. And yet, smaller bookstores survived because readers appreciate their atmosphere of being surrounded by books and people who enjoy reading, touching, and browsing through them. With all the convenience of online shopping at home, consumers lose the social aspect of going to a store, being assisted by and interacting with store employees, trying on new clothes, sitting on couches, and lying on mattresses.

Yes, these are dire times for retailers and for everyone as the economy is collapsing worldwide, but crisis also brings people together and can create new opportunities. Modell's and Pier 1 are currently asking their landlords, among other creditors, to be patient, to recognize that everyone is in this situation together. The filing for bankruptcy has always been an attempt to bring all parties together, giving debtors some breathing space to restructure or liquidate in the hopes that debtors will emerge as a going concern. The majority of interested parties in a corporate restructuring knew that if a debtor was able to continue as an ongoing business, it would be beneficial for everyone involved. COVID-19 has caused a precarious situation that is not only putting retailers in a dire financial position, but landlords are also put in troubled waters. Not only are landlords now asked to wait for either rent payments or return of their leased property, but what other tenants will be in a position to rent the empty stores? What can landlords do to protect their assets? Will landlords, particularly those highly leveraged, be the next wave of bankruptcy filers? Only time will tell which retailers will survive and which ones will fail. We will continue to watch the marketplace and share insight as this impact on retailers unfolds.

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Heike M. Vogel, along with Eric E. Horn, heads the bankruptcy and corporate restructuring practice group of A.Y. Strauss. She has represented creditors, investors, indenture trustees, creditors' committees and acquirers of assets. She has advised small- to mid-size companies in their restructuring efforts through Chapter 11 filings as well as individuals in their Chapter 7 petitions. In connection with her involvement in large, complex restructuring cases, she also gained experience with intellectual property, labor and employment, corporate transactions, and commercial litigation.

Heike serves as a Director of the Board of Directors of Lincoln Hall Boy's Haven & L.H. Foundation. She has written, and frequently lectures, on bankruptcy topics.

Heike began her legal career at Sidley Austin LLP and thereafter practiced law at Arent Fox LLP. Previously, she clerked for three U.S. Bankruptcy Court judges in the Southern District of New York: Honorable J.H. Gallet; Honorable A.J. Gonzalez, and Honorable R.L. Bohanon. Prior to joining A.Y. Strauss, Heike was one of the founding partners of Vogel, Bach & Horn, LLP.

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Eric H. Horn is a partner at A.Y. Strauss with a wealth of experience navigating complex corporate restructuring issues, distressed M&A transactions and other general business transactions. Acting as both a business adviser and attorney, Eric proactively engages with clients to achieve solutions that further their business objectives. He represents debtors in various sectors including balance sheet restructuring, sale cases and out of court workouts. He has served as debtor's counsel in many mid-market (assets $50mm - $100mm) chapter 11 retail cases. He regularly represents debtors in single asset real estate cases, trade creditors, landlords, lenders and asset purchasers in all aspects of chapter 11 cases. He provides transactional guidance to clients who invest in or trade distressed assets and debts in domestic and foreign jurisdictions. Also, he regularly appears in Bankruptcy Court, Federal District Court, and state court representing the interests of his clients.

Eric was selected for inclusion in Thompson Reuters' New Jersey Super Lawyers, Rising Stars. He also frequently lectures on bankruptcy topics and was a member of the deal team awarded the M&A Advisor Deal of the Year for the sale of Annie Sez and Mandee.

Eric began his legal career at Sidley Austin LLP and thereafter at Lowenstein Sandler LLP. Eric was also a senior trader at a hedge fund focused on acquisition of distressed debt. Prior to joining A.Y. Strauss, Eric served as a partner at Vogel Bach & Horn LLP.

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