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Chuck E. Cheese and *Pier 1* Rulings Highlight Risks and Considerations for Commercial Property Landlords and Tenants in Bankruptcy Proceedings

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On December 14, 2020, the Bankruptcy Court for the Southern District of Texas in Chuck E. Cheese's chapter 11 proceeding reaffirmed that section 365(d)(3) of the Bankruptcy Code generally requires commercial tenants in bankruptcy to continue to perform all of their lease obligations, including the payment of rent, subject to the bankruptcy court's limited authority to modify the timing of performance for obligations that arise within the first sixty (60) days of the bankruptcy proceeding. Notably, the opinion disagreed with a May 10, 2020 ruling from the Bankruptcy Court for the Eastern District of Virginia overseeing Pier 1's bankruptcy that the lack of an effective remedy for landlords under section 365(d)(3) empowers the court to expand the time for performance *beyond* the sixty-day threshold stated in section 365(d)(3).

Although the *Chuck E. Cheese* ruling shows that the impact of the *Pier 1* ruling may be limited, the worsening COVID-19 pandemic and a recent change to the Bankruptcy Code make it important for both commercial landlords and commercial tenants to understand their rights, remedies and risks in the event of a tenant bankruptcy.

Section 365(d)(3) of the Bankruptcy Code

Section 365(d)(3) codifies the basic principle that a debtor-tenant must "timely perform all the obligations . . . under any expired lease of nonresidential real property, until such lease is assumed or rejected . . . ." 11 U.S.C. § 365(d)(3). Although section 365(d)(3) empowers the bankruptcy court to "extend, for cause, the time for performance of any such obligation that arises within 60 days after" the petition date, it also prohibits the court from extending the "time for performance . . . beyond such 60-day period." The

case law makes clear that even the modest extensions permitted by section 365(d)(3) are granted infrequently. At the same time, however, section 365(d)(3) does not specify a remedy or entitle an aggrieved creditor-landlord to anything more than a claim with the same priority of payment as other administrative claims (*e.g.*, payments to the debtor's professionals).

***In re Pier 1 Imports, Inc.*, 615 B.R. 196 (Bankr. E.D. Va. 2020)**

On February 17, 2020, various debtors comprising the Pier 1 Imports retail chain filed for bankruptcy in the Eastern District of Virginia. After shelter-in-place orders and other effects of the COVID-19 pandemic virtually eliminated foot traffic in Pier 1 stores, the debtors filed a motion which sought, among other things, authority from the bankruptcy court to delay rent payments to certain landlords through a date up to May 31, 2020, *i.e.*, 104 days after the petition date. Unsurprisingly, a large number of landlords objected to the debtors' motion and sought to compel timely payment of rent under the applicable leases.

The bankruptcy court ultimately overruled these objections and granted the debtors' motion. Although the court acknowledged that the debtors' requested relief "would seem . . . [to] be in express contradiction of section 365(d)(3)," the court noted that section 365(d)(3) "does not provide a separate remedy to effect payment." Accordingly, if a debtor-tenant fails to pay rent or perform its other lease obligations, "all a [l]essor has is an administrative expense claim . . . [and] not a claim entitled to superpriority." Absent superpriority status, administrative expense claims generally must be paid by debtors on the effective date of any plan of reorganization confirmed by a bankruptcy court. The court also denied the objecting landlords' request for adequate protection, finding that the Pier 1 debtors' "deferred payment of rent while they continue use of the leased premises[] does not decrease the value of any [l]essor's interest in the property" because the debtors continued to pay for insurance, security, utilities and other similar obligations.

***In re CEC Entertainment, Inc.*, 2020 WL 7356380 (Bankr. S.D. Tex. Dec. 14, 2020)**

On June 25, 2020, the companies that owned the Chuck E. Cheese brand of family restaurants filed for bankruptcy in the Southern District of Texas. Much like Pier 1 Imports, Chuck E. Cheese's revenue was substantially impacted by the COVID-19 pandemic. In August, the Chuck E. Cheese debtors filed a motion seeking to delay rent payments at 141 of its approximately 540 locations for which government restrictions and orders closed or substantially limited their operations. Although the debtors negotiated payment plans for most of the 141 leases at issue, six landlords objected to the motion.

Unlike in *Pier 1*, however, the bankruptcy court granted the landlords' objections and denied the debtors' motion, holding that the "extent and the intent of [section 365(d)(3)] are clear: commercial real property lessees must continue to perform after filing for bankruptcy."

Nevertheless, the court failed to specify what remedies are available to the objecting landlords, stating that "[t]he remedy for a violation of [section 365(d)(3)] is beyond the scope of this opinion." Consequently, the *Chuck E. Cheese* court conceded that while it "disagree[d] with *Pier 1*," its disagreement was "perhaps on the margins." As another matter, the court also discussed the "frustration of purpose" defense under Washington law (two of the six objecting landlords were in Washington state) and ultimately held that the language in the applicable leases allocated the risk of government regulations impacting performance, thus rendering the doctrine inapplicable.

Implications for Landlords and Tenants

Although the *Pier 1* ruling created much consternation for commercial landlords, its long-term impact may be relatively muted. Indeed, the opinion has only been favorably cited and applied once in the seven months since the ruling, and the only other opinion that cites *Pier 1* is the *Chuck E. Cheese* opinion that diverges from it. Moreover, the *Pier 1* court itself went to great lengths to stress that it "did not find that the Debtors do not have to pay rent" and that the "obligation to pay rent [continues to] accrue[] in accordance with the terms of the applicable lease and state law," notwithstanding the court's authorization to defer rent payments.

Perhaps most importantly of all, it is unclear whether *Pier 1* has much precedential value beyond the COVID-19 pandemic. It is beyond trite to observe that the early days of the pandemic were a stressful and unprecedented time, but the *Pier 1* opinion itself rests on the fact that "COVID-19 present[ed] a temporary, unforeseen, and unforeseeable glitch in the administration" of the *Pier 1* debtors' bankruptcy proceeding. Similarly, it was widely predicted that many debtors would seek and obtain "suspensions" of their bankruptcy proceedings following ruling by the Bankruptcy Court for the District of New Jersey in March 2020 that allowed Modell's Sporting Goods to "suspend" its bankruptcy case (including its obligation to pay rent). Such predictions, however, have not panned out. Notably, both Modell's and Pier 1 sought bankruptcy relief *prior* to when the full impact of the COVID-19 pandemic became evident, and the resultant governmental orders and restrictions essentially prohibited the companies from pursuing their original reorganization strategies.

By contrast, commercial tenants that recently filed for bankruptcy or are contemplating doing so now are fully aware of the economic devastation suffered by brick-and-mortar retailers as a result of the pandemic. Combined with the clear ruling from the *Chuck E. Cheese* court, such tenants should not rely on bankruptcy courts allowing for extensions of the obligation to pay rent beyond the early days of the bankruptcy proceeding. At the same time, as the public health situation of the COVID-19 pandemic continues to deteriorate at the start of 2021, commercial landlords of debtor-tenants should not dismiss the risk that bankruptcy courts may follow *Pier 1* or adopt similar rulings if state and local governments re-implement shelter-in-place orders or similar restrictions that mirror those in place during the earlier stages of the

pandemic.

CAA Changes

Finally, the Consolidated Appropriations Act of 2021, which was signed into law on December 27, 2020, introduced a small change to section 365(d)(3) relevant to "small business debtors" proceeding under subchapter V of the Bankruptcy Code. Now, bankruptcy courts are authorized to extend the 60-day period set forth in section 365(d)(3) by an additional 60 days (*i.e.*, for a total of 120 days) if the small-business debtor "is experiencing or has experienced a material financial hardship due, directly or indirectly, to the [COVID-19] pandemic." 11 U.S.C. § 365(d)(3)(B). Accordingly, debtor-tenants and creditor-landlords should take this new statutory provision into account when negotiating workouts, particularly with retail, restaurant, or hospitality businesses that may be eligible to seek subchapter V relief under the Bankruptcy Code.

Conclusion

While the *Pier 1* opinion raised the specter that a debtor-tenant could obtain bankruptcy court authorization to delay rent payments and therefore force a commercial landlord to subsidize its reorganization efforts, such an outcome has not become commonplace. Nevertheless, the COVID-19 pandemic is far from over, and landlord and tenant issues are likely to remain salient in bankruptcy proceedings in 2021.

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If you have any questions about section 365(d)(3), distressed commercial real estate issues, or any of the other issues raised in this alert, please contact any member of the Creditors' Rights & Bankruptcy or Real Estate, Land Use & Environmental teams.