

Lease Rejection in Shiekh Shoes

By David Kupetz and Asa Hami

Store closing or liquidation sales are a routine part of Chapter 11 cases involving retail debtors. These sales are consistently authorized by bankruptcy courts, despite lease provisions purporting to forbid them. *See, In re R.H. Macy & Co.*, 170 B.R. 69, 77 (Bankr. S.D.N.Y. 1994). The sales are usually conducted in accordance with “sale guidelines” proposed by the debtor for court approval. Moreover, bankruptcy courts can authorize store closing sales that would otherwise violate state and local laws since federal bankruptcy law may preempt laws that contravene the underlying policies of the Bankruptcy Code. *See, In re Shenango Group, Inc.*, 186 B.R. 623, 628 (Bankr. W.D. Pa. 1995).

Generally, leases of stores that are closed, unless the lease is a below market lease, are rejected pursuant to section 365 of the Bankruptcy Code and lease termination damage claims are capped under

section 502(b)(6). The primary goal of Chapter 11 is rehabilitation of the debtor. *NLRB v. Bildisco & Bildisco*, 104 S. Ct. 1188, 1197 (1984). In furtherance of this goal, there is a long-standing principle of bankruptcy law that a debtor should not be compelled to perform under a pre-bankruptcy contract that is burdensome to the estate. *Id.*, at 1198.

SHIEKH SHOES

On June 15, 2018, the U.S. Bankruptcy Court for the Central District of California (Judge Vincent Zurzolo) entered an order approving the plan of reorganization of Shiekh Shoes, LLC, in the company’s Chapter 11 bankruptcy (Case No. 2:17-bk-24626-VZ). Shiekh is a retailer of shoes, apparel and accessories. The company commenced its Chapter 11 case on Nov. 29, 2017. At that time, Shiekh operated 125 retail stores in 10 states, and had annual revenues of approximately \$180 million.

Shiekh successfully emerged from Chapter 11, having beneficially modified dozens of leases, eliminated millions of dollars of debt, obtained new financing and closed unprofitable locations. At its inception, however, Shiekh’s Chapter 11 case was dependent upon the court approving store closing sales

at certain of Shiekh’s locations, the rejection of leases for irreversibly unprofitable locations, and modification of leases to turn other stores profitable. The store closing sales were designed to achieve a number of goals critical to the debtor’s ongoing viability, including: 1) generating cash to help address liquidity issues; 2) eliminating the expense of maintaining poorly performing stores; and 3) reducing the store footprint to a level that would support a viable reorganization.

Section 363 of the Bankruptcy Code provides that the Debtor “after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate.” 11 U.S.C. §363(b). This includes going out of business sales. *See, In re Ames Dept. Stores, Inc.*, 136 B.R. 357, 359 (Bankr. S.D.N.Y. 1992). To approve the use, sale or lease of property out of the ordinary course of business, the court must find “some articulated business justification.” *Committee of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1070 (2d Cir. 1983).

THE DEBTOR’S STRATEGY

In the *Shiekh* case, the company ran two sets of store closing sales following the commencement of the

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case. The first was run under a sale promotion consulting agreement with an outside liquidator that the debtor assumed pursuant to court approval. The second was self-managed and conducted by the debtor.

In each instance, the decision to close a store was based on the profitability of the store, the costs of maintaining the store, whether Shiekh was able to negotiate more favorable rent or other forms of lease modifications for a store, the store's location and overall significance and necessity to Shiekh's business model and operations, the debtor's cash position and level of liquidity, and the overall benefits and burdens of maintaining the particular store and related lease. Shiekh presented evidence to the court that, in the exercise of its business judgment, it was necessary to close specified stores.

Shiekh requested that the court authorize it to conduct closing sales pursuant to relatively typical "sale guidelines" designed to protect consumers and create the least amount of burden on the debtor's landlords (primarily mall operators) during the sales, while at the same time maximizing the recovery to the estate, and without requiring compliance with lease terms or state or local law. The sale guidelines included provisions regarding sale hours, types and size of signage, sale and abandonment of furniture, fixtures, and equipment, augmentation of inventory, and access to premises.

RESTRICTIVE CLAUSES

Many retail leases contain clauses that restrict or prohibit the les-

see from conducting liquidation or store closing sales. Such provisions have been deemed unenforceable in Chapter 11 cases as an impermissible restraint on a debtor's ability to maximize the value of its assets under Section 363. *See, Ames*, 136 B.R. at 359; and *In re Tobago Bay Trading Co.*, 112 B.R. 463, 467 (Bankr. N.D. Ga. 1990).

In *Ames*, the lessor opposed the debtor's proposed going-out-of-business sale based on a lease provision prohibiting such sales. The court in that case rejected the lessor's argument, stating: "to enforce the anti-GOB sale clause of the Lease would contravene overriding federal policy requiring Debtor to maximize estate assets by imposing additional constraints never envisioned by Congress ... Section 363(e) reserves for bankruptcy courts the discretion to condition the time, place and manner of Phase I GOB Sale, thereby providing adequate safeguards to protect shopping center landlords and their other tenants, while allowing the Trustee to fulfill its fiduciary obligations." *Id.* at 359.

Similarly, in *Tobago Bay*, a landlord argued that the debtor's liquidation sale violated a lease provision prohibiting "going-out-of-business, auction, distress, fire or bankruptcy or similar sale." The court, however, refused to enforce the lease provision finding that "[w]here provisions of an unexpired lease conflict with these policies [to facilitate the debtor's reorganization and maximize the returns for the benefit of creditors] to prevent or hinder reorganization, the court may find such provisions to be unenforceable." *Tobago Bay*, 112 B.R. at 467.

In *Shiekh*, the court found that the sale guidelines provided adequate safeguards to protect the lessors, while at the same time permitting the debtor to fulfill its fiduciary obligations to obtain the greatest recovery for the estate. Similarly, in *Tobago Bay*, the court held: "Here, as in most cases, the prohibition of a bankruptcy or similar sale would result in onerous and burdensome costs to an already financially distressed debtor's estate by requiring removal of assets to an off-site location. Further, the debtor's estate would lose the benefit of the market that it had developed. The potential harm and injury to creditors and to the debtor's estate is substantially greater than the potential harm to the objectors." *Id.* at 467.

THE COURT'S RULING

The closing stores in *Shiekh* were located in 10 different states and various municipalities. In granting the relief sought by Shiekh, the court exempted the debtor from complying with: 1) any provision in any of its leases or related contracts restricting the closing sales; 2) state and local wage requirements; and 3) applicable state and local statutes, rules, regulations, or ordinances, or any license or other requirements regarding "going out of business," "store closing," "sale on everything," "everything must go," "inventory liquidation," or similarly-themed sales (including laws restricting safe, professional, and non-deceptive, customary advertising, such as signs, banners, posting of signage, use of sign walkers in connection with the closing sales and ordinances establishing license

or permit requirements, waiting periods, time limits or bulk sale restrictions that would otherwise apply to the closing sales, but excluding those designed to protect public health and safety.)

While preemption of state law is not always appropriate, it is appropriate where, as here, the only state or local laws involved concern economic regulation rather than the protection of public health and safety. *See, Baker & Drake, Inc. v. Pub. Serv. Comm'n of Nevada (In re Baker & Drake, Inc.)*, 35 F.3d 1348, 1353-54 (9th Cir. 1994). Importantly, the waivers requested by Shiekh were narrowly-tailored to facilitate the successful conduct of the closing sales that were scheduled for a discrete period.

Rejection of a closed store lease goes hand-in-hand with closing the store. Bankruptcy Code Section 365(a) provides that, subject to court approval, a Chapter 11 debtor “may assume or reject any executory contract or unexpired lease of the debtor.” 11 U.S.C. §§365(a) and 1107(a). Section 365(a) does not provide a standard for determining when rejection of an unexpired lease is appropriate. However, courts traditionally have applied a “business judgment” standard in determining whether to authorize rejection of executory contracts and unexpired leases. *See, Bildisco* at 523. Accordingly, if the Chapter 11 debtor has reasonably exercised its business judgment in determining to reject an executory contract, the decision should be approved by the court. *See, Lubrizol Enterprises Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1046-47 (4th Cir. 1985).

In *Shiekh*, the court approved a streamlined procedure for rejecting store leases, which allowed the debtor to readily effectuate a lease rejection by providing 10 days’ notice to the landlord, with the rejection effective upon vacating the premises in broom swept condition and delivery of keys or “key codes” (as applicable) to the landlord. The debtor lessee’s rejection of a real property lease or other executory contract constitutes a breach of the lease or contract resulting in a claim that is treated as if it arose immediately prior to the commencement of the debtor’s bankruptcy case. Upon rejection, the landlord’s claim for lease termination damages is capped under Section 502(b)(6).

The Section 502(b)(6) cap is designed to limit lease termination claims to prevent landlords from receiving a windfall at the expense of other creditors. Depending upon the length of a lease, the landlord’s claim for future rent could be enormous and dramatically diminish the return to other unsecured creditors. Section 502(b)(6) limits the claim of a lessor for damages resulting from the termination of a lease of real property to: (A) The rent reserved by such lease, without acceleration, for the greater of one year, or 15%, not to exceed three years, of the remaining term of such lease, following the earlier of — (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus (B) Any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

One court summarized the effect of rejection as follows: “The

significance of rejection of an unassumed executory contract is that it not only relieves the estate of onerous and burdensome future obligations but it also gives rise to a prepetition general unsecured claim for damages rather than an administrative expense priority with the concomitant of payment of such general unsecured claim ‘in little tiny Bankruptcy Dollars which may be worth only 10 cents in U.S. Dollars.’” *In re Spectrum Information Technologies, Inc.*, 190 B.R. 741, 746 (Bankr. E.D.N.Y. 1996) (citations and footnote omitted).

CONCLUSION

Throughout the Chapter 11 case, Shiekh Shoes negotiated and obtained agreements with numerous landlords to beneficially modify lease terms, including rent reductions. The debtor also closed stores and rejected numerous leases and, at many of those locations, conducted store closing sales that were authorized by the court. Additionally, Shiekh assumed certain already profitable leases without modification. As of the effective date of its plan of reorganization (June 29, 2018), Shiekh continued to operate approximately 85 stores.

