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Practice Update

Bankruptcy Courts Continue to Accept Equitable Arguments for Deferring Rent Payments During the COVID-19 Pandemic

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Previously we reported on debtors' appeals to bankruptcy courts' general equitable powers for assistance in weathering the COVID-19-induced economic storm. (Our original article may be viewed here.) This trend remains and bankruptcy courts are demonstrating a continued willingness to entertain and offer such relief. Unsurprisingly, over the past month or so bankruptcy filings have increased primarily in the retail and hospitality spaces. J Crew, J. C. Penney, Neiman Marcus, Hertz, Golds Gym, and many others filed petitions under chapter 11 with varying degrees of support from their stakeholders. We anticipate many more filings in the retail space, especially in light of recent reports indicating that only slightly more than 50% of commercial retail tenants paid rent in April and May. Even seemingly strong corporations such as Starbucks reportedly have notified landlords that the need exists for rent deferral or abatement. The trickledown effect almost certainly will create an additional round of bankruptcy filings from landlords, mall owners, property management companies, contractors, vendors, and others. No amount of government stimulus will effectively bail out each industry, and some will suffer more than others.

Whereas many landlords were willing and able to offer to tenants rent deferral and even abatement,

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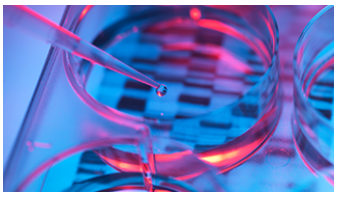
most concessions were limited to 90 days. After all, landlords can hold their lenders at bay only for a limited period of time before the lender takes action to realize upon its collateral. Moreover, stays on eviction proceedings are expiring.



States are reopening—some far more rapidly than others. Even in those states that have opened more quickly, such as Florida and Texas, openings have slowed due to the ongoing national protests. Thus, despite the easing of shelter-in-place restrictions, tenants are still looking for lifelines from their landlords, insurance companies, and state and bankruptcy courts. (While bankruptcy courts have remained active, state courts are reopening and tenant-defendants in forcible entry and detainer actions will seek relief at the trial court level.) Landlords are being stretched thin or are at the end of their rope. Insurance companies are generally denying claims for business interruption losses as not stemming from damage to property. (Some parties are responding with creative arguments including that COVID-19 exists and is transmitted on property surfaces and therefore property damage exists. We are unaware of any courts directly addressing this argument and decisions are likely months if not years away.) As the ongoing fight for limited resources unfolds in state and bankruptcy courts, what can we extract from recent opinions? Decisions this week from bankruptcy courts in Illinois and Kansas offer many points for consideration in navigating through these unprecedented times.

Force Majeure Clause Leads to Partial Rent Abatement: *Hitz Restaurant Group* (Bankruptcy Court for the Northern District of Illinois)

Hitz Restaurant Group operates a restaurant in Chicago and on February 24, 2020 filed a small business chapter 11 in response to receiving a 5-day lease termination notice. Shortly after filing, the restaurant's landlord brought motions to (i) compel payment of post-petition rent under Bankruptcy

Code § 365(d)(3); and (ii) modify the automatic stay under § 362(d)(1). As rent payments were due on or before the first of each month, the court deemed February rent as pre-petition and March and subsequent months post-petition. As the court noted, the Bankruptcy Code usually requires "full payment of the March 2020 rent and all rental payments falling due thereafter." However, the lease contains the following force majeure clause:

> Landlord and Tenant shall be excused from performing its obligations or undertakings provided in the Lease, in the event, but only so long as the performance of any of its obligations are prevented or delayed, retarded or hindered by . . . laws, governmental action or inaction, orders of government . . . Lack of money shall not be grounds for Force Majeure.

There were, of course, government orders and actions that hindered the restaurant's ability to open and sell food. On March 16, 2020,[1] Illinois Governor J. B. Pritzker entered an executive order specifically pertaining to restaurants, which required, among other things, that they suspend service for on-premises consumption. On the other hand, the order allows and encourages restaurants to serve food and beverages via delivery, take-out, and curbside pick-up, so that they may be consumed off-premises.

The court analyzed whether the Governor's order (similar to that in many other localities) triggered the force majeure clause. Initially, the court held that the lease's force majeure clause did not excuse payment of March rent because the order was enacted on the 16th and March rent was due on the 1st. Next, the court considered the application of the force majeure clause on rent for April, May and June.

The landlord advanced three primary arguments against application of the force majeure clause.[2] The court dismissed all arguments and found that the force majeure clause applies. It looked to Illinois law on contract interpretation and further found that

the clause was only entitled to limited application. Specifically, the court holds (emphasis added): "Debtor's obligation to pay rent is reduced in proportion to its reduced ability to generate revenue due to the executive order." The debtor conceded—without an evidentiary hearing—that 25% of the restaurant's square footage (consisting of the kitchen) could have been used for carry-out, curbside pick-up, and delivery purposes. Thus, the court concludes that the debtor owes 25% of the rent amount under § 365(d)(3). Lastly, the court is requiring payment on or before June 16 of 25% of rent, common area maintenance (CAM), and property taxes for April, May and June, otherwise "cause" would exist under § 362(d)(1) to lift the stay.

"Unprecedented Circumstances" Warrant Relief to Preserve Debtor's Opportunity to Reorganize: *Bread & Butter Concepts, LLC* (Bankruptcy Court for the District of Kansas)

A consolidated group of debtor restaurants operating in the Kansas City area filed chapter 11 proceedings in November 2019 due to decreasing sales, an increasing debt load, and mounting pressure from landlords. According to the court, "[b]efore the coronavirus pandemic struck, Debtors demonstrated potential for a successful reorganization." On March 17, 2020, the debtors and all other area restaurants were ordered to cease operations. Roughly one month later, the debtors filed an emergency motion to suspend certain Bankruptcy Code requirements including, without limitation, the need to (1) pay post-petition rent to landlords; and (2) assume or reject unexpired leases prior to the May 5th deadline. [3] The debtors' landlords objected.

The bankruptcy court cites to recent opinions in the *Pier I Imports, Inc.* and *Craftworks* cases in stating that "no reasonable alternative" exists and the relief sought offers "a short-term allocation of those scarce resources to meet immediate needs and preserve the value of the Debtors estates for all creditor constituencies." Moreover, the court specifically cites

to its equitable powers in overriding the black letter of the Code:

> These unprecedented circumstances require flexible application of the Bankruptcy Code and exercise of the Court's equitable powers under 11 U.S.C. § 105 to grant further relief, including extension of time to assume or reject the Debtors' nonresidential leases, notwithstanding the absence of written consent of the lessors under 11 U.S.C. § 365(d)(4)(B)(ii). Section 105(a) is understood as providing courts with discretion to accommodate the unique facts of a case consistent with the policies or directives set by the other applicable substantive provisions of the Bankruptcy Code.

In essence, the bankruptcy court exercised its equitable power in overriding the landlords' statutory right to payment of post-petition rent in favor of maintaining (1) the debtors' perceived going-concern value and (2) prospects for recovery to all creditors. And this is true despite the case having been filed more than four months prior to entry of the shelter-in-place orders.

The Take-away

The *Hitz* and *Bread & Butter Concepts* decisions further open the door for tenant-friendly court opinions and should be closely considered when engaging in lease-related negotiations. To be sure, each situation is unique and must be examined individually. The parties must consider a significant amount of variables, some of which include:

(1) the lease's force majeure clause (find a detailed analysis of these clauses and some state specific requirements here);

(2) the particular state's timeline for reopening;

(3) the tenant's likelihood of recovery as a going concern;

(4) the current market for a replacement tenant;

(5) the landlord's ability and appetite to forbear; and

(6) any existing state and federal court binding precedent.

It is important to note that force majeure clauses are not one-size-fits-all and may vary widely from one lease to another. Perhaps the Hitz Restaurant Group wouldn't have fared as well if the operative lease had been drafted to expressly carve-out from the force majeure clause all of the tenant's rental and monetary obligations. In addition, equity is examined on a case-by-case basis with reference to the facts and circumstances.

In conclusion, under the *Hitz* analysis a tenant will argue that it is operating at X% capacity due to the binding governmental restrictions—i.e., maximum on-premises capacity is 10 or less people, patrons must be at least 6 feet apart, etc. As a consequence, the tenant should be required under the lease to pay a corresponding X% of monetary obligations. These arguments are likely to gain increased traction. It isn't difficult to see the potential impact of the *Hitz* methodology on facilities such as gyms, salons, bars, concert venues, and even educational, hospital, assisted living, airline, rental car, hotel, and other similar operations. Of course, every state is opening at a different pace. Florida is reopening quickly and others are following. Illinois has adopted a tiered approach. Nonetheless, tenants are likely to argue in every state that significant restrictions remain. Moreover, even if the force majeure clause in the operative lease is not particularly debtor-friendly, the *Pier I Imports*, *CraftWorks*, *and Bread & Butter Concepts* cases remind us that bankruptcy courts maintain equitable discretion and are likely to use it in a pro-debtor fashion for the foreseeable future. Plan and negotiate accordingly.

Please contact the authors if you have any questions.

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[1] The sunset date of the order was later extended until May 29.

[2] The debtor's landlord argued: (1) the executive order did not shut down the banking system or post offices and therefore the debtor should have been able to write and send rental checks; (2) debtor's failure to perform was due to a "lack of money" and therefore did not meet the terms of the force majeure clause; and (3) the debtor's failure to apply for a PPP loan prevents it from enforcing the force majeure clause. The court called the first argument specious and the second and third arguments misplaced because (a) the executive order was the proximate cause of the debtor's inability to generate revenue and pay rent and (b) the lease plainly does not require the debtor to apply for a loan in connection with seeking to rely upon the force majeure clause.

[3] The landlords had consented to a 60-day (from March 5) extension to the statutory deadline to assume or reject under Code § 365(d)(4).
