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Bankruptcy Courts are Divided on Reducing a Debtor's Obligation to Pay Rent When Government Regulations Restrict a Debtor's Ability to Generate Income

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INTRODUCTION

Many indoor retail establishments and restaurants that faced shutdowns due to the COVID-19 pandemic (the "Pandemic") filed voluntary petitions for relief under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"), and subsequently requested rent abatement under § 365(d)(3) of the Bankruptcy Code or state law.[1] Notwithstanding the unique and extreme circumstances caused by the Pandemic, not all bankruptcy courts agree on the extent to which judges have the discretion to grant abatement motions for rent payments that are otherwise due under § 365(d)(3).[2] Some bankruptcy courts have granted debtors the ability to

[1] *See* 11 U.S.C. § 365(d)(3) (2018).
[2] *See In re* CEC Entertainment, Inc., 625 B.R. 344, 352–53 (Bankr. S.D. Tex. 2020); *see also In re* Circuit City Stores, Inc., 447 B.R. 475, 510 (Bankr. E.D. Va. 2009).

defer post-petition rent payments, especially in the early months of the Pandemic.[3] However, rent abatement is not a guarantee in chapter 11.[4]

This Memorandum addresses the varying views of bankruptcy courts with respect to rent abatement. Part I examines the different rationales based in the Bankruptcy Code or contract doctrines for rent abatement. Part II illustrates examples of bankruptcy courts' approach to rent abatement motions throughout different stages of the Pandemic.

I. Bankruptcy Courts Advance Different Rationales on Abatement Motions Based in Statute or Contract Doctrines

Section 365(d)(3) of the Bankruptcy Code requires a debtor to "timely" perform its lease obligations "until such lease is assumed or rejected."[5] If a debtor shows cause, courts may extend the debtor's time for performance by up to 60 days.[6] Additionally, section 105 of the Bankruptcy Code allows courts to use their equitable powers as "necessary or appropriate" to carry out the Bankruptcy Code provisions, including delaying payments.[7] Bankruptcy courts have been faced with the issue of whether to allow rent abatement beyond the 60 days provided for in § 365(d)(3) because of a required government shutdown order caused by the Pandemic, and if such excuses performance under *force majeure* or "frustration of purpose" doctrines.[8]

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[3] *See In re* Modell's Sporting Goods, No. 20-14179 [Docket No. 166], ¶ 3(b) (Bankr. D.N.J., March 27, 2020); *see also In re* Pier 1 Imports, Inc., 615 B.R. 196, 201–02 (Bankr. E.D. Va. 2020).
[4] *See In re* CEC Entertainment, 625 B.R. at 352–53.
[5] *See* 11 U.S.C. § 365(d)(3).
[6] *See id.*
[7] *See* 11 U.S.C. §105 (2018).
[8] *See In re* CEC Entertainment, 625 B.R. at 353–64; *see also In re* Hitz Restaurant Group, 616 B.R. 374, 377 (Bankr. E.D. Ill., June 3, 2020).

Modell's Sporting Goods was one of the first major retail debtors to have its rent abated for over 60 days beyond the petition date despite the express 60-day limitation in § 365(d)(3) of the Bankruptcy Code.[9] On March 20, 2020, Governor Andrew Cuomo issued various stay-at-home executive orders that restricted most retail businesses from operating.[10] As a result, on March 27, 2020, pursuant to sections 105 and 305 (a)(1) of the Bankruptcy Code, which allows a court to dismiss or suspend a case if "the interests of creditors and the debtor would be better served," Judge Vincent Papalia suspended Modell's chapter 11 case pending in the District of New Jersey for 34 days.[11] Debtors argued it could not conduct liquidation sales because of government-imposed restrictions that forced the closure of debtor's storefronts.[12] During the suspension, Judge Papalia permitted the debtor to defer rent payments that were otherwise due under § 365(d)(3).[13] Subsequently, the bankruptcy court in the Eastern District of Virginia granted similar relief.[14] However, a bankruptcy court in the Southern District of Texas denied such relief, finding neither a statutory basis nor the doctrines of *force majeure* or frustration of purpose were sufficient to abate rent beyond the 60-day limitation outlined in § 365(d)(3).[15]

[9] *See In re* Modell's Sporting Goods, No. 20-14179 [Docket No. 166], ¶ 3(b) (Bankr. D.N.J., Mar. 27, 2020).
[10] *See* Executive Order [A. Cuomo] No. 202.8 (9 NYCRR 8.202.8).
[11] *See In re* Modell's, 20-14179, p. 5–6 (N.J. 03/27/20) at 3(b); *see also* 11 U.S.C. §305(a)(1) (2018).
[12] *See In re* Modell's, 20-14179, p. 5–6 (N.J. 03/27/20) at 3(b).
[13] *See id.*
[14] *See In re* Pier 1 Imports, Inc., 615 B.R. 196, 205 (Bankr. E.D. Va. 2020).
[15] *See In re* CEC Entertainment, 625 B.R. at 364.

A. *Divided: Statutory Basis for Delay of Rent Payments*

Like *Modell's*, in *In re Piet 1 Imports*, Judge Kevin R. Huennekens of the Eastern District of Virginia found a statutory basis for temporary rent reduction during the pandemic.[16] Judge Huennekens reasoned that a debtor's failure to pay rent timely under a commercial property lease results in an administrative expense claim payable on the effective date of a plan.[17] The claim does not have super-priority status.[18] If the plan provides for payment of administrative expense claims on the plan effective date, payment is timely.[19] Furthermore, the court determined that, to the extent that adequate protection is requested, the debtor's "deferred payment of rent while they continue the use of the leased premises[] does not decrease the value of any Lessor's interest in the property."[20] The court further noted that "COVID-19 presents a temporary, unforeseen, and unforeseeable glitch in the administration of the Debtors' Bankruptcy Cases."[21]

But in *In re CEC Entertainment, Inc.*, the a Texas bankruptcy court denied the debtor's motion for a rent abatement where the debtor asserted that government regulations reducing the number of patrons or terminating operations prevented the debtor from functioning.[22] Judge Marvin Isgur of the Southern District of Texas concluded that § 365(d)(3) unambiguously "prohibits the [c]ourt from allowing extensions of more than sixty days after the order for relief."[23] Furthermore, the "[c]ourt cannot override [this] statutory mandate."[24] Therefore, according to the

[16] *See In re* Pier 1 Imports, 615 B.R. at 196.
[17] *See id.*
[18] *See id.* (citing *In re* Circuit City, 447 B.R. 475 at 511).
[19] *See id.*
[20] *In re* Pier 1 Imports, 615 B.R. at 203 (explaining that a landlord may be entitled to adequate protection under §§ 361 and 363(e) of the Bankruptcy Code if the value of their interest in real estate decreases); *see also* 11 U.S.C. § § 361, 363(e) (2018).
[21] *Id.*
[22] *See* 625 B.R. at 364.
[23] *Id.* at 352 (citing 11 U.S.C. § 365(d)(3)).
[24] *See id.* at 353 (citing *In re* Mirant Corp., 378F.3d 511, 523 (5th Cir. 2004) ("A court's powers under § 105(a) are not unlimited as that section only 'authorizes bankruptcy courts to fashion such orders as are necessary to further the substantive provisions of the Code,' and does not permit those courts to 'act as roving commissions to do equity.'")).

court, the Bankruptcy Code does not permit bankruptcy courts to "equitably alter CEC's state law rent obligations."[25]

B. The Force Majeure *and Frustration of Purpose Doctrines*

After analyzing the statutory framework in *In re CEC Entertainment*, the court also did not excuse performance under *force majeure* and frustration of purpose doctrines. If either the lease or state law (i.e., a *force majeure* clause) allows the debtor to abate or reduce rent payments, then a debtor's "obligation to perform under § 365(d)(3) will reflect such abatement or reductions."[26] The doctrine of frustration of purpose "excuses a party's nonperformance when circumstances beyond the parties' control frustrate the purpose of the deal."[27] The remedy is usually the recission of the contract.[28] Unlike a *force majeure* clause, "frustration relates to the purpose of a contract, as opposed to a party's actual inability to perform."[29] If parties included a frustration of purpose provision or included risks arising from a frustrating event in a contract, then "they may not invoke the doctrine of frustration to escape their obligations."[30]

In *In re CEC Entertainment*, the court examined the *force majeure* clauses in the debtor's leases to determine if performance of the lease obligations was not excused.[31] The court found that although the *force majeure* clauses may have given the debtor relief in some circumstances, they all "expressly provide that a *force majeure* event cannot excuse prompt payment of rental charges."[32] Next, the court examined the debtor's frustration of purpose argument, noting that the remedy under state law for frustration of purpose is recission, not rent abatement.[33] Furthermore,

[25] *Id.* at 351.
[26] *See id.* at 353.
[27] *Id.* at 357.
[28] *See id.*
[29] *Id.*
[30] *Id.* at 361 (citing Glenn R. Sewell Sheet Metal, Inc. v. Loverde, 70 Cal.2d 666 (Cal. 1969)).
[31] *See id.* at 353.
[32] *Id.* at 357.
[33] *See id.*

the *force majeure* clauses in the debtor's North Carolina and Washington state leases superseded the frustration of purpose doctrine because the parties specifically allocated the risk of unusual governmental regulation when the parties expressly agreed that exceptional government regulation does not relieve CEC's obligation to pay rent.[34] Two of three of the debtor's California leases excused most nonperformance caused by government regulations but expressly required rent payments notwithstanding frustrating restrictions.[35] The third California lease also superseded the frustration of purpose doctrine because it contained an anti-*force majeure* clause that did not refer to government regulations.[36] Instead, the anti-*force majeure* clause stated that a party is not excused from performance if that party's performance was prevented or delayed "by reasons of strike, labor troubles, acts of God, or any other cause beyond the reasonable control of either party."[37] The court explained that the doctrine should only apply to cases of "extreme hardship," where the "frustrating event was not reasonably foreseeable, and the value of the counter-performance is nearly totally destroyed."[38] Therefore, the court held that government regulations that render performance unprofitable do not frustrate a lease.[39]

Alternatively, an Eastern District of Illinois bankruptcy court analyzed the *force majeure* clause in a restaurant debtor's lease and held that the impact of the government shutdown order caused by the pandemic excused performance, at least for the period the restaurant had to suspend its on-premises dining.[40] To determine whether the Governor of Illinois' executive order suspending restaurant service triggered the *force majeure* clause in the debtor's lease, the court turned to Illinois state law which states that a *force majeure* clause will only excuse contractual

[34] *See id.* at 359.
[35] *See id.* at 356.
[36] *See id.*
[37] *In re* CEC Entertainment, 625 B.R. at 356.
[38] *Id.* at 363.
[39] *See id.* at 364.
[40] *See In re* Hitz Restaurant Group, 616 B.R. 374, 377 (Bankr. E.D. Ill. June 3, 2020).

performance if the triggering event cited by the nonperforming party was, in fact, the proximate cause of that party's nonperformance.[41] The court found that the *force majeure* clause in the lease was a clear result of Governor Pritzker's executive order because: (1) it was a government action contemplated by the language of the clause, (2) the order undoubtedly "hindered" the debtor's ability to perform, and (3) the order was "unquestionably the proximate cause of Debtor's inability to pay rent, at least in part, because it prevented Debtor from operating normally and restricted its business to take-out, curbside pick-up, and delivery."[42]

II. Bankruptcy Courts Grant Abatement Motions During the Pandemic

Modell's was the first significant debtor to have its rent abatement motion granted in the very early stages of the Pandemic.[43] Shortly after that, other bankruptcy courts also granted debtors' motions requesting relief from rent owed under § 365(d)(3).[44] As the Pandemic continued, bankruptcy courts also found that rent abatement resulting from Pandemic-related government regulations is not a guarantee.[45]

A. Early Months of the Pandemic

True Religion, a denim apparel retail company, filed for relief under chapter 11 of the Bankruptcy Code shortly after the initial Pandemic stay-at-home orders were imposed.[46] On its first day of filing, the debtor filed an abatement motion under § 365(d)(3), seeking a 60-day

[41] *See id.* at 377 (citing Northern Ill. Gas Co. v. Energy Co-op., Inc., 461 N.E.2d 1049 (Ill. App. Cit. 1984)).
[42] *Id.* at 377–78.
[43] *See In re* Modell's, 20-14179, p. 5–6 (N.J. 03/27/20) at 3(b).
[44] *See In re* Pier 1 Imports, 615 B.R. at 205.
[45] *See In re* CEC Entertainment, 625 B.R. at 364.
[46] *See In re* True Religion Apparel Inc., Case No. 20-1091, [Docket No. 27], ¶ 3 (Bankr. D. Del. April 13, 2020).

suspension of rent payments.[47] The court granted the motion, citing the "unprecedented and unforeseen outbreak of COVID-19, the national state of emergency declared by President Trump on March 13, 2020, pursuant to the Proclamation on Declaring a National Emergency . . . and the numerous state orders that limit or preclude the Debtors' operations."[48] However, the same bankruptcy court denied an asset-purchaser's motion to stop paying rent while maintaining possession of stores, notwithstanding the Pandemic.[49] The *Forever 21* decision indicates that a court may only be willing to grant abatement motions if the deferment directly benefits a debtor, not a third-party purchaser.[50]

B. Late Spring: Initial Reopening of Retail Stores

In May 2020, J. Crew, also a clothing retail company, sought court approval on the first day of its case to defer its commercial lease obligation for 60 days.[51] In this case, the Eastern District of Virginia bankruptcy court, in granting the debtor's rent abatement motion, ordered that it would stay any action seeking to enforce lease obligations during the 60 days, and that no adequate protection payments were required.[52] Despite that the court's order granting the abatement motion was around the time when many stay-at-home orders had expired or were about to expire, and retail stores were reopening, and that the debtor was in the process of reopening

[47] *See id.*
[48] *Id.* p. 1 (Del. 04/13/20) at 1–2.
[49] *See In re* Forever 21 Inc., No. 19-12122 [Docket No. 1115], ¶ 17 (Bankr. D. Del. April 1, 2020).
[50] *See* Paul J. Ricotta & Kaitlin R.Walsh, *Mothballing Motions from Retail Debtors to Avoid Rent Payments Due to COVID-19 Pandemic*, XXXIX, No. 8 ABI JOURNAL (2020); *see also In re* Modell's, 20-14179, p. 5–6 (N.J. 03/27/20) at 3(b) (granting debtors rent abatement motion).
[51] *See In re* Chinos Holdings Inc., No. 20-32181 [Docket No. 23], ¶ 3 (Bankr. E.D. Va., May 4, 2020).
[52] *See id.* p. 1 (Va. 05/04/20) at 2 (finding that the timing of the debtor's filing did not diminish the effects of the pandemic and that the debtor was permitted to use the tools available under the Bankruptcy Code, including post-petition rent deferral).

stores, the court noted that sales had been "far short" of pre-pandemic sale numbers.[53] Since the debtor was not generating a considerable amount of income from the stores that had already reopened, most of the debtor's employees remained furloughed.[54]

Similar to J. Crew, in May 2020, the bankruptcy court for the Southern District of Texas granted J.C. Penny's abatement motion, allowing the debtor to defer approximately $34 million of post-petition rent even though the debtor had admittedly reopened 474 stores and expected to open another 340 within a matter of weeks.[55] The debtor proposed that a rent deferment would allow the debtor to negotiate rent-relief with the landlords.[56]

C. Developing Case: Ruby Tuesday

In November 2020, Ruby Tuesday, a casual restaurant chain, filed for chapter 11 relief with the Delaware bankruptcy court and requested temporary rent abatement for restaurants that were either closed or had limited operations because of pandemic-related government restrictions.[57] Unlike previous debtors, Ruby Tuesday sought deferment until government restrictions had been lifted.[58] The debtor requested an expedited adjudication of state law issues, like the enforcement of *force majeure* clauses.[59] Judge John T. Dorsey approved the debtor's rent abatement litigation schedule, which bifurcated rent abatement litigation into two phases: the determination phase and the quantifying phase.[60] Shortly after that, the debtor filed five adversary complaints against its landlords, arguing that pandemic-related government regulations: (1) triggered *force majeure* clauses that relieve debtors of rent obligations, (2) frustrated the

[53] *See id.* (citing *In re* Chinos, 20-32181, p. 1 (Va. 05/04/20) at 2).
[54] *See id.*
[55] *See In re* J.C. Penney Co. Inc., No. 20-20182 [Docket No. 338], ¶ 1 (Bankr. S.D. Tex. May 28, 2020).
[56] *See id.* (citing to *In re* J.C. Penney, 20-20182 [Docket No. 349] p. 2 (Tex. 05/28/20) at 2).
[57] *See In re* RTI Holding Company, LLC, No. 20-12456, [Docket No. 145], ¶ 1 (Bankr. D. Del. Oct. 16, 2020).
[58] *See id.*
[59] *See id.* 20-12456 p. 13 (10/16/20) at 29.
[60] *See id.* 20-12456 [Docket No. 689] (12/09/20) at 29).

fundamental purpose of debtor's lease, and (3) rendered debtor's performance impossible or impracticable.[61]

CONCLUSION

Some bankruptcy courts have granted debtors the ability to defer post-petition rent payments that would otherwise be due and owing under § 365(d)(3) of the Bankruptcy Code in response to debtors' pressing circumstances due to the Pandemic. In the early months of the Pandemic, this was especially true.[62] However, in *In re CEC Entertainment*, filed later in the pandemic, the court denied rent deferment requests despite government-imposed restrictions on business operations.[63]

[61] *See* Seward & Kissell, LLP, *Rent Abatement Litigation Could Continue to Alter Landlord-Tenant Landscape*, (Jan. 6, 2021) https://www.sewkis.com/publications/rent-abatement-litigation-could-continue-to-alter-landlord-tenant-landscape/ (citing *In re* RTI Holding Co., 20-12456 [Docket No. 724 p.1 (10/23/20) at 3); *see also* 11 U.S.C. § 502(b)(1) (2018) (providing that a court must allow a claim against a debtor unless "such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law," which allows debtors to assert contractual arguments or state law defenses to bankruptcy claims).
[62] *See In re* Modell's, 20-14179, p. 5–6 (N.J. 03/27/20) at 3(b); *see also In re* True Religion, 20-1091, p. 1 (Del. 04/13/20) at 1–2.; *In re* Forever 21, 19-12122, p. (Del. 04/01/20) at 17.
[63] *See In re* CEC Entertainment, 625 B.R. at 364.