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Impact of Covid-19 on Debtor's Obligations to Comply with Duties to Pay Rent

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Introduction

Under section 365(d)(3) of title 11 of the United States Code (the "Bankruptcy Code"), a debtor-in-possession is required to "timely perform all the obligations of the debtor . . . arising from and after the order for relief under any unexpired lease of nonresidential real property until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title."¹ Section 365 was implemented to relieve landlords from the burden of proving the rent payments owed by the debtors prior to rejection were "actual and necessary" costs of preserving the bankruptcy estate.² Section 365 has been heavily litigated since early 2020 due to the new respiratory Coronavirus Disease 2019 ("Covid-19").

On March 11, 2020, the World Health Organization ("WHO") declared Covid-19 a global pandemic.³ By the end of March 2020, forty-two states, in addition to numerous counties

¹ See 11 U.S.C. § 365 (d)(3) (2018).

² See *In Re Hitz Rest. Grp.*, 616 B.R. 374, 376 (Bankr. N.D. Ill. 2020).

³ See Stephanie Cooper Blum, *Federalism: Fault or Feature- An Analysis of whether the U.S. Should Implement a Fed. Pandemic Statute*, 60 WASHBURN L.J. 1 (2020).

and cities were under some sort of stay-at-home order, which affected approximately 94 percent of the population.⁴

This memorandum examines whether Covid-19 impacts a nonresidential debtor's duties to comply with its lease obligations. Part I of this memorandum discusses the debtor's obligations post-petition to comply with its duties to pay rent. Specifically, the debtor's obligations under section 365(d)(3) and section 503(b)(1) of the Bankruptcy Code. Part II of this memorandum discusses how force majeure might excuse a debtor from paying rent. Lastly, Part III discusses the common law remedies that can be argued along with a force majeure clause.

Discussion

I. Bankruptcy Code Requires Debtor to Fulfill Obligations of a Nonresidential Lease

“Section 365(d)(3) requires a debtor-in-possession to timely perform all the obligations of the debtor.”⁵ The legislative history emulates the congressional concern that lessors of nonresidential property have been frequently forced to extend credit to an estate during the time period for assumption or rejection of the lease.⁶ Generally, courts are in agreement that section 365(d)(3) requires Chapter 11 debtors to continue performance until the lease is assumed or rejected.⁷ To determine whether an obligation arises from or after the order for relief, under section 365(d)(3), the first step is to look at the terms of the lease.⁸ For example, in *In re Hitz*, the lease agreement provided for a “minimum base rent schedule,” which was due on the first of each.⁹ Consequently, the debtor filed a Chapter 11 petition on February 24, 2020, which resulted

⁴ See *id.* at 32–33 (affecting 308 million people).

⁵ *In re Hitz Rest. Grp.*, 616 B.R. at 376.

⁶ See *id.*; see also 130 Cong. Rec. S8894-95 (daily ed. June 29, 1984) (statement of Sen. Hatch) reprinted in App. 4 Collier on Bankruptcy, at XX-70 - XX-71 (Lawrence P. King et al. eds., 15th ed. 1992).

⁷ See *In re Burival*, 406 B.R. 548, 551–52 (8th Cir. BAP 2009); see also *Adelphia Bus. Solutions, Inc. v. Abnos*, 483 F.3d 602, 606 (2d Cir. 2007); *In re Racing Servs., Inc.*, 340 B.R. 73 (8th Cir. BAP 2006).

⁸ *In re Hitz Rest. Grp.*, 616 B.R. at 376.

⁹ See *id.*

in the February 2020 rent payment being a pre-petition obligation and the March 2020 rent being a post-petition obligation.¹⁰ Some courts view the language of section 365(d)(3) “as clear and their job of applying the language as straightforward: any obligation of a debtor under a lease which becomes due after the entry of the order for relief under the Bankruptcy Code and before the lease is assumed or rejected must be paid or otherwise fulfilled when due.”¹¹ Additionally, this view has created a bright-line test, which states if a rent payment is due during the post-petition period it must be paid pursuant to section 365(d)(3).¹² Other courts interpret section 365(d)(3) as ambiguous and prorate rent payments into pre-petition and post-petition components and hold that section 365(d)(3) only requires payment of the post-petition component.¹³ This ambiguity is caused by the lack of a definition for the term obligation in the Bankruptcy Code.¹⁴

II. Force Majeure Excuses Debtor’s Post-Petition Rent Obligations

“A force majeure clause is a contractual clause that excuses performance of contractual obligations—either wholly or for the duration of the force majeure—upon the occurrence of a covered event in which is beyond the control of either party to the contract.”¹⁵ “Force majeure is a phrase coined primarily for the convenience of contracting parties wishing to describe the facts that create a contractual impossibility due to an act of god.”¹⁶ Force Majeure provisions can be triggered by various circumstances, such as natural disasters, acts of god, civil unrest,

¹⁰ *See id.*

¹¹ *See In re Burival*, 406 B.R. at 552.

¹² *See id.*

¹³ *See id.*; *see also Heathcon Holdings, LLC v. Dunn Indus., LLC (In re Dunn Indus., LLC)*, 320 B.R. 86, 90 (Bankr. D. Md. 2005) (“Obligations can be read to arise when billed or when accrued.”).

¹⁴ *See Heathcon Holdings, LLC.*, 320 B.R. at 90.

¹⁵ *See In re Cec Entm’t, Inc.*, 2020 Bankr. LEXIS 3493, at *16 (Bankr. S.D. Tex. 2020).

¹⁶ *See id.*

governmental actions or orders and several other unforeseen events.¹⁷ An act of government is one of the commonly listed force majeure events, which turns on whether the government act was the actual cause of the disruption to performance, and whether the disruption met the contractual threshold.¹⁸ Courts turn to state law to determine if an event triggers a force majeure clause in a lease because it's a matter of contractual law.¹⁹ When analyzing force majeure clauses courts look to several elements, such as “(1) whether the event qualifies as force majeure under the contract, (2) whether the risk of nonperformance was foreseeable and able to be mitigated, and (3) whether performance is truly impossible.”²⁰

In Illinois, for example, contracts are enforced according to their terms and a force majeure clause will only excuse contract performance if the event cited by the nonperforming party was the proximate cause of that party's nonperformance.²¹ In *In re Hitz*, Governor Pritzker's executive Covid-19 stay-at-home order unambiguously triggered the force majeure clause in the restaurant lease for three reasons.²² *First*, the governor's order unquestionably constituted both a governmental action and an order contemplated by the language of the clause.²³ *Second*, the order hindered the debtor's ability to perform because the debtor was

¹⁷ See Perrie Weiner, *The Progression of Covid-19 Force Majeure Litigation*, LAW360 LEXIS 1 (Aug. 28, 2020) <https://plus.lexis.com/document?pdworkfolderid=82f1d998-a46f-495e-868a-941e822c9723&pdcontentfullpath=%2Fshared%2Fdocument%2Fanalytical-materials%2Furn%3AcontentItem%3A60PM-1K71-JJSF-227M-00000-00&pdcontentcomponentid=122100&pdisurlapi=true&cbc=0&pdmfid=1530671&crd=5fbfa74c-ceba-4124-a899-07a77e5d5005#>.

¹⁸ See J. Hunter Robinson et al., *Article: Use the Force? Understanding Force Majeure Clauses*, 44 AM. J. TRIAL ADVOC. 1, 15 (2020).

¹⁹ See *In re Hitz Rest. Grp.*, 616 B.R. at 377.

²⁰ See Alan M. DiSciullo, *Feature the Covid-19 Issue the Effect of Covid-19 on Lease Negotiations*, 35 PROBATE & PROPERTY 46, 47 (2021).

²¹ See *In re Hitz Rest. Grp.*, 616 B.R. at 377.

²² See *id.*

²³ See *id.* (“Landlord and Tenant shall each be excused from performing its obligations or undertakings provided in this 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.”).

prohibited from offering on premises consumption of food and beverages.²⁴ *Third*, the order was the proximate cause of the debtor's inability to pay rent because the debtor was prevented from operating normally and was restricted to only providing take-out, curbside pick-up, and delivery.²⁵ The Illinois court found, therefore, that the debtor was excused from paying 75 percent of the rent, but had to pay 25 percent of the rent, for the kitchen space used for take-out and delivery.²⁶

Additionally, in *In re Cinemax USA Real Estate Holdings, Inc.*, the force majeure clause excused all payment of rent during the closure, but based on the plain language of the lease, added time on to the end of the lease term based on such closure.²⁷ Therefore, the court in this case held the tenant was excused from paying rent until they were allowed to reopen, but the tenant will have to pay the rent on the back end of the lease according to the lease provision.²⁸ The tenant argued they should only have to pay fifty percent of the rent since they are only allowed to reopen at limited capacity.²⁹ In support of their argument, the tenant cited to *In re Hitz*, which held the debtor was only allowed to offer takeout and delivery services and the debtor was required to pay rent proportional to the limited services.³⁰ However, the *Cinemax USA* lease differed from *In re Hitz*, because the force majeure clause here, states rent will be excused during the closure and will add on time to the end of the lease.³¹

²⁴ See *In re Hitz Rest. Grp.*, 616 B.R. at 377.

²⁵ See *id.* at 377–78 (explaining “(1) an unexpected intervening event occurred, (2) the parties' agreement assumed such an event would not occur, and (3) the unexpected event made contractual performance impossible or impracticable”).

²⁶ See *id.* at 378–80.

²⁷ See *In re Cinemax USA Real Estate Holdings, Inc.*, 2021 Bankr. LEXIS 200, at *17 (Bankr. S.D. Fla. 2021).

²⁸ See *id.* at 16.

²⁹ See *id.* at 17.

³⁰ See *id.*

³¹ See *id.*

In *Palm Springs Mile Associations*, however, the debtor was not excused from paying rent under the force majeure clause.³² The debtor asserted that the Florida restrictions on business operations and non-essential activities qualifies as force majeure events and their obligations to pay rent should automatically be suspended.³³ The Florida court, however, found that the debtor failed to explain how the governmental regulations resulted in its inability to pay its rent.³⁴ Instead, the debtor argued that the force majeure clause does not require any showing that the county's regulations are linked to its nonpayment of rent, which fails to identify the debtors inability to pay rent.³⁵ Further, the court noted that force majeure clauses are narrowly construed and will generally only excuse nonperformance if the event that caused the nonperformance is specifically identified.³⁶

III. Common Law Remedies in Real Estate Agreements

Several common law remedies, including frustration of purpose, impracticability, and impossibility, can be argued along with the contractual theory of force majeure.³⁷ The doctrine of frustration of purpose focuses on “whether the event at issue has obviated the purpose of the contract, rather than whether it has made a party’s contractual performance unviable.”³⁸ “The prima facie case requires that (1) an event substantially frustrating a party's principal purpose, (2) the nonoccurrence of the event was a basic assumption of the contract, and (3) the event was not the fault of the party asserting the defense.”³⁹ The doctrines of impracticability and impossibility excuse performance when a party establishes “(1) an unexpected intervening event occurred, (2)

³² See *Palm Springs Mile Assocs. v. Kirkland’s Stores, Inc.*, 2020 U.S. Dist. Lexis 163880, at *5–6 (S.D. Fla. 2020).

³³ See *id.* at 5.

³⁴ See *id.*

³⁵ See *id.*

³⁶ See *id.* at 4.

³⁷ See DiSciullo, *supra* note 20 at 48.

³⁸ See DiSciullo, *supra* note 20 at 49.

³⁹ See DiSciullo, *supra* note 20 at 49.

the parties' agreement assumed such an event would not occur, and (3) the unexpected event made contractual performance impossible or impracticable.”⁴⁰ However, a party's nonperformance will not be excused if the event preventing performance was expected or was foreseeable at the time of the contract's execution.⁴¹

For example, *In re Cinemax USA Real Estate Holdings, Inc.*, the court held the debtor was not excused under the doctrine of frustration of purpose, even though the Covid-19 pandemic was completely unforeseeable because once the theatre was allowed to reopen, they chose not to.⁴² The debtor argued reopening would result in negative operating income because of the 50 percent capacity limit and the increased costs of providing appropriate personal protective equipment and enforcement of social distancing guidelines.⁴³ The court acknowledged that the debtor's concerns were reasonable, but the concerns are one of timing, not ability.⁴⁴ Further, the court reasoned like the debtors here, many businesses have had to deal with the same reopening concerns during the pandemic and figured out how to address these concerns.⁴⁵ Therefore, the debtor was not excused because they chose not to reopen due to economic concerns.⁴⁶ Similarly, in *In re Cec Entm't, Inc.*, the debtor was not entitled to a reduction or abatement of its rent obligations under the doctrine of frustration of purpose nor force majeure because the debtor's “decision to prioritize its own long term business interests over near term profits, does not totally destroy the value of the lease.”⁴⁷ Also, even though the government regulations limited the debtor's ability to operate its primary business, the lease allowed the

⁴⁰ See DiSciullo, *supra* note 20 at 49.

⁴¹ See DiSciullo, *supra* note 20 at 49.

⁴² See *In re Cinemax USA Real Estate Holdings, Inc.*, 2021 Bankr. LEXIS 200, at *14.

⁴³ See *id.* at *12.

⁴⁴ See *id.* at *14.

⁴⁵ See *id.*

⁴⁶ See *id.*

⁴⁷ See *In re Cec Entm't, Inc.*, 2020 Bankr. LEXIS 3493, at *47.

debtors to operate any number of different businesses on the premises.⁴⁸ Thus, the operation of the current venue, a Chuck E. Cheese venue, was not the parties' primary purpose when entering the lease and the government regulations do not prevent the debtor from using the premises in accordance with the lease.⁴⁹

Conclusion

Covid-19 has forced many businesses into bankruptcy this past year and will likely continue having a negative impact on businesses. Debtors, however, will be able to seek contract remedies, such as force majeure clauses and several common law remedies. Since force majeure clauses are contractual clauses, courts will turn to state law to determine whether an event triggered a force majeure clause. Several courts this past year have excused all or partial rent payment due to Covid-19 and government stay-at-home orders triggering force majeure clauses after analyzing the debtor's obligations under section 365 of the Bankruptcy Code.

⁴⁸ *See id.* at *45–46.

⁴⁹ *See id.*