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Force Majeure Clause May Excuse Debtor's Payment of Postpetition Rent in Bankruptcy

Authors: Edward Arnold, John David Folds, Lacey Elizabeth Rochester
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To curtail the spread of COVID-19, states and local governments have implemented a tidal wave of restrictions including mandatory stay home orders, closures of "nonessential" businesses, as well as occupancy regulations. Such restrictions have made it difficult for businesses that rely on in-store traffic, such as restaurants and retailers, to generate the revenue needed to pay their rent under commercial leases. Many landlords have agreed to reduce or defer rental payments temporarily while tenants adjust to local compliance and reopening guidelines. Without consensual agreements with their landlords, many of these tenants have turned to the bankruptcy courts for relief.

A tenant who files for chapter 11 (a "debtor") is given at least 120 days, and potentially longer, to determine whether it will "assume" or "reject" its leases for non-residential real property. The landlord cannot seek to evict or collect from the tenant without permission from the bankruptcy court. During this period, the tenant is required to timely perform its post-bankruptcy (or "postpetition") obligations, such as paying rent. Section 365(d)(3) of the Bankruptcy Code provides that the debtor "shall timely perform all obligations … arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected[.]" By requiring commensurate postpetition performance from the debtor, subsection 365(d)(3) aims to protect landlords from having to extend free credit to the bankruptcy estate during the postpetition period before the debtor chooses to assume or reject.

There are invariably situations wherein a debtor is unable to timely perform its postpetition obligations (i.e., pay postpetition rent). In this regard, Subsection 365(d)(3) provides that the court may extend for "cause" the time for a debtor's performance of any such obligations coming due during the first sixty days of the case. The time for performance, however, cannot be extended beyond such sixty-day period. The "cause" exception to Section 365(d)(3) has recently been invoked on account of COVID-related business disruption in several high-profile bankruptcy cases including Pier One and JCPenney. In those cases, the debtors merely sought to extend the time to perform, not excuse performance entirely. But is there a way for a debtor to use Section 365(d) to excuse all or a portion of postpetition rent? A bankruptcy court in the Eastern District of Illinois recently answered this question in the affirmative in the context of a force majeure clause in the case of *In re Hitz Restaurant Group*.

In *Hitz*, after seeking bankruptcy relief, the debtor (Hitz) failed to pay postpetition rent in violation of Section 365(d)(3). This prompted Hitz's lessor to seek permission from the bankruptcy court to bring an action to evict Hitz. In response, Hitz argued that the Force Majeure clause in its lease excused Hitz from having to perform its postpetition obligations.

The Force Majeure clause provided that Hitz "shall be excused from performing its obligations or undertakings" under its lease if the "performance of any of its obligations are prevented or delayed, retarded or hindered by … laws, governmental action or inaction, [or] orders of government." The Force Majeure clause also stated that "[l]ack of money shall not be grounds for force majeure." Hitz argued that the Force Majeure clause was triggered when the Governor of Illinois issued an Executive Order that suspended all on-premises

consumption. The Executive Order did not prohibit to-go, curb-side pickup or delivery services so long as the food and beverages served would be consumed off-premises.

Because property rights in bankruptcy are determined by state law, the court turned to Illinois law to evaluate the enforceability of the Force Majeure clause on its face. Illinois law provides that force majeure clauses are legal and enforceable so long as the triggering event cited by the nonperforming party was in fact the proximate cause of the party's nonperformance. Because Hitz asserted that such triggering event was the Executive Order, the bankruptcy court compared the plain language of the Force Majeure clause with the Executive Order.

Noting that the Executive Order constituted both "governmental action" and an "order" under the Force Majeure clause, the court reasoned that it "hindered" Hitz's ability to perform by prohibiting Hitz from providing on-premises consumption of food and beverages. It therefore concluded that such Executive 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 pickup, and delivery."

The lessor argued that the Force Majeure clause provided that "lack of money" shall not constitute grounds for force majeure. It further asserted that Hitz could have obtained the money to pay rent by applying for a Small Business Administration loan. As to the former argument, the court reemphasized that Hitz was not technically citing a lack of money as the triggering event; Hitz was arguing that the Governor's Executive Order limiting on-premises consumption was the basis for force majeure. The court rejected the lessor's latter argument on the basis that nothing in the lease or Force Majeure clause required a party affected by governmental orders or action to apply for a loan to counteract their effects.

The court did not let Hitz off the hook completely. The Governor's Executive Order permitted to-go, curb-side pickup or delivery services. Reasoning that the Force Majeure clause did not excuse Hitz's performance to the extent it could perform those services, the Court announced that it would reduce Hitz's obligation to pay postpetition rent in proportion to Hitz's ability to generate revenue under the Executive Order.

Because neither party had presented it with any evidence concerning the appropriate amount of rent reduction due to the Force Majeure clause, the court was forced to rely on Hitz's assertion that roughly seventy-five percent (75%) of the restaurant space was rendered unusable by the Executive Order. The kitchen, which comprised the remaining twenty-five percent (25%) of the space, could be utilized for to-go, curb-side pickup or delivery services. Thus, the Court preliminarily interpreted Hitz's estimation as an admission that Hitz owed at least 25 percent of the rent and ordered Hitz to pay that portion of the postpetition rent to avoid stay relief.

There are several important take-aways from the *Hitz* decision for commercial lessors. Initially, lessors should be aware that bankruptcy courts may interpret force majeure clauses in commercial leases in a way that excuses a debtor from performance of all or some portion of its postpetition rent obligations notwithstanding Section 365(d)(3). Lessors should take this into account when considering requests for deferrals or concessions, and when drafting new force majeure provisions. In addition, if facing a potential force majeure challenge to payment under Section 365(d)(3), the lessor should provide the bankruptcy court with the evidence required to establish what portion (presumably none) of the lessee-debtor's rent should be reduced in light of the debtor's ability to continue operating. The ultimate outcome will be fact specific and based upon the language of the lease and of the relevant governmental orders.

For more information please contact Hank Arnold, David Folds, or Lacey Rochester. You may also visit the Coronavirus (COVID-19): Navigating the Path Ahead information page on our website.