ALERTS

Bankruptcy Court Grants Tenant Partial Rent Abatement Under Force Majeure Clause (COVID-19)

June 29, 2020

In a decision of first impression entered on June 3, 2020, a Chicago bankruptcy court ("Court") held that a restaurant tenant was excused from paying a significant portion of its rent under the force majeure provisions of its lease because of the governor's executive order prohibiting in-house dining during the COVID-19 pandemic.[1] This decision is highly significant for landlords and tenants whose ability to service their clients has similarly been restricted by government orders. Unlike other tenants that have merely sought to defer rent payments, here, the tenant sought to couple the force majeure clause in its lease with the governor's executive order, to eliminate a portion of its rent obligation altogether, and succeeded in doing so.

Background

Hitz Restaurant Group ("Tenant") operated a restaurant under a lease ("Hitz Lease") with Kass Management Services Inc. ("Landlord"). On Feb. 24, 2020, Tenant filed for bankruptcy after, among other things, failing to pay its February rent. Soon after Tenant filed for bankruptcy, Illinois Governor Pritzker issued an executive order ("Executive Order") limiting restaurant operations to curbside pickup and delivery, and expressly prohibited in-house dining.

Landlord moved for an order instructing Tenant to pay its February, pre-bankruptcy filing, and to timely pay all post-petition rent.[2] Landlord cited section 365(d)(3) of the Bankruptcy Code, which requires a debtor to

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"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 … ." 11 U.S.C. § 365(d)(3). Under the Bankruptcy Code, rent payments are "not mere administrative expenses" because they must be timely paid pursuant to the lease terms, whereas other administrative expenses may be paid as late as the end of the bankruptcy case.[3]

Tenant argued that the Executive Order triggered the force majeure clause in its lease and excused Tenant from paying post-petition rent. The lease's force majeure clause provided:

"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." (emphasis added)[4]

Determining whether the Executive Order triggered the lease's force majeure provision required the Court to examine Illinois state law. Under Illinois law, a force majeure clause will excuse performance under a contract only if the triggering event was the proximate cause of such nonperformance.[5]

Force Majeure Clause 'Unambiguously Applies'

While courts generally interpret force majeure clauses in leases narrowly, here the Court held that the force majeure provision was "unambiguously triggered" by the Executive Order because the order was a "governmental action" and an "order of government" as set forth in the clause.[6]

The Court rejected as "specious" Landlord's argument that Tenant was physically able to pay rent because banks and post-offices remained open. It also rejected Landlord's argument that Tenant could have applied for a Small Business Administration loan to cover its rent obligations, as that was not required by the plain language of the lease's force majeure clause.

In reaching its decision, the Court considered that the Executive Order did not absolutely proscribe restaurant operations and "not only

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permitted, but also encouraged, restaurants to continue to perform take-out, curbside pick-up, and delivery services."[7] Therefore, the Court determined that Tenant remained obligated to pay partial rent for the duration of the Executive Order, but only "in proportion to [Tenant's] reduced ability to generate revenue due to the [Executive Order]."[8] Neither party proposed a methodology by which the Court should calculate the proportionate rent owed, and therefore, the Court relied on Tenant's estimation that 75% of its square footage was "rendered unusable" by the Executive Order.[9] Accordingly, the Court preliminarily ordered that Tenant pay 25% of the post-petition rent it owed to Landlord, pending the outcome of an evidentiary hearing.[10]

Takeaways

For Tenants

This decision is important because many states' governors have issued executive orders that, like the Illinois Executive Order, restrict or prohibit business activities for tenants. It should be noted that the decision was for a restaurant lease and the court might have reached a different conclusion for an office or retail lease. Plainly, the language of each state's applicable executive orders must be carefully parsed. If such orders forbid in-house dining or other ordinarily allowable business activities that negatively impact a tenant's income, and a lease's force majeure clause contains language regarding government action or orders constituting force majeure events, then the tenant may be entitled to a rent abatement during the time such orders are in effect. Depending on the language in the force majeure clause of the lease, the decision stands as a persuasive (though not binding) authority that should give tenants confidence to make arguments based on this type of provision. It is important to note that, unlike the Hitz Lease, most force majeure clauses in commercial leases expressly exclude relief from rental payment obligations. Moreover, the methodology used by the Court to determine the amount of the rent abatement did not include other relevant factors, such as lost revenue or other concrete metrics. It's possible that other methodologies might result in more (or less) significant rent abatements.

For Landlords

The Executive Order specifically states that it was not to be construed as relieving any tenant of the obligation to pay rent and to comply with other

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lease obligations. Landlord could have asserted that this language prohibited application of the force majeure clause, but surprisingly did not. Further, the force majeure clause provided that "[l]ack of money shall not be grounds for Force Majeure." Landlord did argue that Tenant was not paying rent because it lacked money to do so, and, therefore, this sentence prohibited application of the force majeure clause.[11] While the Court acknowledged that this language created a potential conflict, it held that the preceding language "order of government" and "government action" in the force majeure clause were more specific than "lack of money." The Court cited existing Seventh Circuit case law that provides "[i]n interpreting an Illinois contract, when there is a conflict between a clause of general application and a clause of specific application, the more specific clause prevails."[12] It is apparent that courts may differ on interpreting the "lack of money" provision as being less specific.

The Court also acknowledged that Landlord failed to make any arguments regarding the methodology it should use to calculate an appropriate rent abatement and, thus, was left solely with the Tenant's proposed method. Therefore, landlords should propose a methodology to calculate a rent abatement as an alternative argument in connection with any court submission regarding this issue.

This case exemplifies the importance of a carefully drafted lease agreement. Force majeure provisions are strictly construed, and so the specific language of such clauses is critical and should not be considered mere boilerplate. Courts likely will reach different conclusions in cases where a lease's force majeure clause expressly excludes relief from rental payment obligations or excludes governmental action or orders as triggering events, or where the clause requires that performance be more than merely "hindered" before the force majeure clause is applicable.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] *See* Illinois Executive Order 2020-7. A subsequent order was issued on March 20, 2020, which contained substantially the same COVID-19 restrictions as Executive Order 2020-7, but added language that "[n]o provision contained in this Executive Order shall be construed as relieving

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any individual of the obligation to pay rent ... or to comply with any other obligation that an individual may have under tenancy ... ." *See* Ill. Exec. Order 2020-10. Governor Pritzker twice extended the duration of the COVID-19 restrictions as they related to in-house dining in restaurants through May 29, 2020. *See* Ill. Exec. Order 2020-18 and Ill. Exec. Order 2020-33. For purposes of this article, these orders are collectively referred to as the "Executive Order."

[2] The Court did not determine whether the pre-bankruptcy rent was due at this time because it was a pre-bankruptcy claim not entitled to immediate payment. If Tenant wants to assume the lease with Landlord, it will be required to cure all pre-bankruptcy defaults and pay the February rent. 11 U.S.C. § 365.

[3] *In re Hitz Rest. Grp.*, No. BR 20 B 05012, 2020 WL 2924523, at *1 (Bankr. N.D. Ill. June 3, 2020).

[4] *Id.* at *2.

[5] *Id.* at *3 (citation omitted).

[6] *Id.* *2.

[7] *Id.* at *3.

[8] *Id.*

[9] *Id.* at *4.

[10] As March 2020 rent became fully due and payable on March 1, 2020, and the Executive Order did not become effective until two weeks thereafter, the Court concluded that the force majeure clause did not excuse payment of past-due March 2020 rent.

[11] *Id.* at *3.

[12] *Id.* at *5, FN 2 (citations omitted).

This is a fast-moving topic and the information contained in this Alert is current as of the date it was published.

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