

# Why Rent Is Such a Contentious Issue in Bankruptcy During the Pandemic

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**R**ent has presented a complicated puzzle during the pandemic for numerous landlords and tenants, and the solutions—inside and outside of Chapter 11—have been unconventional.

As foot traffic evaporated due to restrictions prompted by health and safety regulations, and revenue fell precipitously as demand declined, consumer-facing storefront businesses struggled to make rent payments as early as April, the first full month of closures in several U.S. states. Retailers, restaurants, gyms, and similar establishments have, of course, been the worst hit. According to a National Retail Federation survey,<sup>1</sup> less than one-third of retailers paid at least 75% of June rent. Although 73% of retailers are expecting to pay back at least half of what they owe, more than one in three are seeking some sort of assistance to cover the June-to-August period.

The negotiations between landlord and tenant are complicated. Rent deferrals or abatements cause ripple effects in the finances of not only the landlord but also in those of the landlord's lenders and investors, and the specter of Chapter 11 only complicates matters. Indeed, a number of deals cut before a bankruptcy filing may be revisited or completely abandoned in Bankruptcy Courts over the next few months.

Once a company is in bankruptcy, landlords enjoy certain built-in protections for rent arising during the pendency of the Chapter 11 proceeding. Most notably, pursuant to Section 365(d)(3) of the U.S. Bankruptcy Code, debtors are required to perform their post-petition obligations as a lessee in a timely manner.

However, Section 365(d)(3) also provides that debtors can defer rent

for up to 60 days "for cause." Until the pandemic, this provision was rarely invoked, but COVID-19 and the restrictions that followed have upended the established norms in this area, and since March, postpetition rent deferrals have been granted numerous times.

In these cases, courts have permitted debtors to suspend rent payments while continuing to pay other administrative expenses, including employee salaries. And even though rent is not being paid, the debtors can remain in possession of the leased premises.

The first Chapter 11 debtors to address these issues filed right before the pandemic and therefore did not expect shutdowns. In these earliest cases, such as *Modell's Sporting Goods* and *Pier 1 Imports*, the debtors asked courts for extraordinary relief orders that essentially paused or mothballed





their Chapter 11 cases to avoid administrative expenses while they were forced to cease or significantly reduce their operations and lacked sufficient funds to pay rent obligations. As part of these suspensions, judges were willing to defer rent for up to 60 days initially for stores that were forced to close due to local restrictions. As a general matter, when locations are shut down, rent deferrals appear to have been uniformly approved.

These suspensions effectively force landlords to become postpetition lenders, at risk of recouping their "loans," especially in cases that are potentially administratively insolvent. It also puts them at risk of being treated worse than other administrative creditors. As a result, landlords have requested the courts to compel the debtors to provide for adequate protection. In *Modell's*, the

court mandated that parties participate in mediation to address how the landlords' claims would be handled going forward as well as what form of adequate protection would be given. The court recognized that all parties needed to share the burden.

#### Additional Relief

When stores reopened, many debtors opted not to seek deferrals, but some have and rent deferrals for open stores were obtained in certain cases. For example, in *J. Crew*, the Bankruptcy Court declined to accept a rule that rent deferrals were not appropriate where the company's stores were open. The court noted at the time of the ruling that only seven stores were open, and there was still significant uncertainty about whether shoppers would return to the stores. The court also appeared to be aided in this

decision by the fact that J. Crew had a debtor-in-possession (DIP) and exit facility lined up, and the landlords were therefore well positioned to receive all deferred rent "within a few months."

Likewise, in *J.C. Penney*, the judge overruled several landlord objections to give the retailer a June and July rent holiday, deferring approximately \$34 million of rent obligations, even though numerous stores were open. The debtors stated that the rent deferral would put them "in a better position to negotiate mutually beneficial rent relief agreements," which, in their argument, would ultimately help the landlords. Many landlords did not agree, but the judge noted the extraordinary circumstances created by the pandemic in granting the debtors' motion. Like *J. Crew*, *J.C. Penney* was

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a case that was very likely to end in a plan that paid administrative claims in full, and the judge also concluded that rent must be paid from sale proceeds at any locations undergoing going-out-of-business sales.

What happens when 60 days is not enough? In *Modell's*, as a result of local regulations restricting stores

from opening until June, the cases remained on "pause" beyond 60 days and rent deferrals also extended beyond 60 days. Similarly, in the 24 Hour Fitness cases, after obtaining a 60-day rent deferral, many of the debtors' gyms were still closed. Rather than litigating over whether the leases were enforceable given the shutdown, the debtors offered to pay 30% of the rent for closed gyms, while deferring 70%. Many landlords agreed to this offer.

For some debtors, a rent deferral was not enough. A Chicago-based restaurant company, Hitz Restaurant Group, successfully argued that the impact of the government-enforced COVID-19 protective measures excused their post-petition rent obligations completely. The Bankruptcy Court agreed that the restrictions constituted a force majeure, *i.e.*, an unforeseen and uncontrollable event or condition that prevents one party from performing its contractual obligations.



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The *Hitz* ruling may give other debtors ammunition to make a similar argument, though in general it is rare for courts to excuse performance under a force majeure clause of a contract. For example, in the Chuck E. Cheese bankruptcy case, the court expressed skepticism of using a force majeure clause to excuse rental obligations and wanted briefing on the following question: Assuming that a force majeure provision in a lease does not permit rent abatement but state policy would allow for rent reduction in the event of a frustration of purpose under the lease, which controls—the lease or the state policy?

The debtors initially filed a motion seeking to defer rent payments for the maximum 60-day period permitted under the Bankruptcy Code, and it was granted. Then, the debtors filed a motion to abate rent payments for 141 stores that had been closed or otherwise limited in operations due to local restrictions. Before the motion was adjudicated, the debtors and unsecured creditors' committee negotiated a settlement that allowed landlords to opt in to a 60-day standstill period with the debtors through October 31. During the standstill, the debtors would make interim payments under each lease equal to a percentage of the total rent, based on the level of operations at each store since the petition date.

## Conclusion

The respective approaches that debtors and landlords take to rent obligations in a bankruptcy remain the same, pandemic or no pandemic. However, the extraordinary state of the world over the last few months and the consequent financial, regulatory, and operational challenges faced by all businesses have added new wrinkles to negotiations. As circumstances continue to change and the world copes with the fallout of this crisis, there will be new lessons to learn and novel precedents set. It will be critical to keep track of what are essentially new rules of bankruptcy emerging out of these negotiations and rulings, as these may shape bankruptcy outcomes for years to come. ■

<sup>1</sup> [nrf.com/media-center/press-releases/landlords-and-retail-tenants-compromise-emerge-stronger-post-covid-19](https://www.nrf.com/media-center/press-releases/landlords-and-retail-tenants-compromise-emerge-stronger-post-covid-19)



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