ALERT MEMORANDUM

Bankruptcy Court for the Southern District of Texas Denies Restaurant Debtors' Rent Abatement Motion in *CEC Entertainment*

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On December 14, 2020, the U.S. Bankruptcy Court for the Southern District of Texas (the "Court") issued a memorandum opinion (the "Opinion"),[1] denying CEC Entertainment, Inc. (collectively with the affiliated debtors, "CEC")'s *Motion for Order Authorizing Debtors to Abate Rent Payments At Stores Affected by Government Regulations* (the "Abatement Motion"),[2] seeking abatement of post-petition rent for CEC's Chuck E. Cheese restaurants that were closed or otherwise limited in operations as a result of the global pandemic and resulting government restrictions. The decision represents an important departure from a recent series of cases in which courts had begun to almost routinely grant similar abatement motions in the hospitality and retail industries in the post-COVID 19 environment.

This Opinion addressed the issues of (1) courts' authority to alter lease obligations under §365(d)(3) of the Bankruptcy Code, (2) applicability of *force majeure* clauses in certain leases of CEC, and (3) applicability of the doctrine of frustration. As more fully described below, the Court left open the issue of remedy in situations where there is a §365(d)(3) violation (i.e., when a debtor fails to "timely perform" its post-petition lease obligations). With respect to the doctrines of *force majeure* and frustration of purpose, this Opinion focused on the precise language of *force majeure* provisions and the governing law of the lease in determining whether debtors can benefit from such provisions and other common law defenses to contractual performance.

[1] *In re CEC Entertainment, Inc.*, No. 20-33163 (S.D. Tex. Dec. 14, 2020) [ECF 1482].
[2] *In re CEC Entertainment, Inc.*, No. 20-33163 (S.D. Tex. Aug. 3, 2020) [ECF 487].

Background

CEC operates a nationwide chain of Chuck E. Cheese restaurants, which offer a mixture of dining, arcade games and entertainment in a kid-friendly atmosphere. As with other restaurants and retail businesses, the COVID-19 pandemic and related government regulations, including various restrictions with respect to on-premise dining and entertainment, have hindered CEC's business, which led CEC to file voluntary petitions for relief under chapter 11 on June 24, 2020.

On August 3, 2020, CEC filed the Abatement Motion, seeking an order "abating rent payments for stores closed or otherwise limited in operations as a result of any governmental order or restriction until such restriction or order has been lifted and to reflect the extent and duration of such forced governmental closures or limitations."[3] CEC argued that it is entitled to the requested relief because (1) the pandemic-related governmental restrictions "entirely frustrated the fundamental purpose" of the leases at issue, (2) the pandemic and resulting regulations triggered certain *force majeure* provisions in the leases, excusing CEC from its rent obligations, and (3) the Court can and should exercise its equitable powers to protect CEC from paying rent in return for which it receives no or a significantly limited benefit.[4]

Although multiple landlords initially objected to the Abatement Motion, many of them had consensually resolved their objections prior to a hearing.[5] After a number of hearings on the Abatement Motion, on December 14, 2020, the Court issued the Opinion, addressing the still-outstanding objections of six lessors of CEC locations in North Carolina, Washington and California.

The Opinion

Interpretation of §365(d)(3) of the Bankruptcy Code and Courts' Authority to Alter Lease Obligations

The Court started with CEC's argument that the Court can exercise its equitable powers under §105 to grant the Abatement Motion. Rejecting CEC's argument, the Court held that, although the Bankruptcy Code allows courts to delay performance of lease obligations for sixty days after the petition date under §365(d)(3), it does not provide any authority to alter lease obligations beyond the sixty-day period.[6]

The Court focused on the language of §365(d)(3) which states that a debtor-lessee of nonresidential real property must "timely perform all obligations of the debtor" under any unexpired lease until such lease is assumed or rejected and stated that the intent behind §365(d)(3) was to "prevent commercial lessors from unwillingly extending credit to debtor-lessees during the pendency of a chapter 11 case."[7] In light of the text and the intent of §365(d)(3), the Court held that the requirement to "timely perform" lease obligations under §365(d)(3) is unambiguous, and accordingly it "cannot override that statutory mandate" or equitably alter CEC's state law rent obligations.[8]

Notably, the Court specifically noted that it is not deciding on the issue of appropriate remedy for a violation of §365(d)(3) and stated that "[t]he Court's equitable powers will be tested at the remedy stage."[9] At the same time, the Court expressed its disagreement with the Bankruptcy Court for the Eastern District of Virginia's decision in the *Pier 1* case with respect to how the *Pier 1* court dealt with the debtors' failure to timely perform its obligations ("although perhaps on the margins").[10] In *Pier 1*, the court allowed deferral of rent payment beyond the sixty-day period with

[3] Abatement Motion at 2.
[4] *Id.* at 3.
[5] Opinion at 5.
[6] *Id.* at 6-7. Additionally, the Court noted that the Bankruptcy Code "expressly prohibits delays beyond sixty days after the order for relief." *Id.* at 6. *See* 11 U.S.C. 365(d)(3) ("The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period.").
[7] *Id.* at 7, 9.
[8] *Id.* at 9.
[9] *Id.*
[10] *Id.*

respect to certain stores impacted by various government restrictions.[11] The *Pier 1* court noted that §365(d)(3) "does not give the [l]essors a right to compel payment from the Debtors in accordance with the terms of the underlying leases," and if a debtor fails to perform its obligations, the lessors have an administrative expense claim which would be paid on the effective date of the plan.[12] Accordingly, the court rejected the argument that the lessors were entitled to payment at the time of the debtors' motion.

Since the Court did not elaborate the reasoning for its disagreement with the *Pier 1* decision and simply stated "[t]he remedy for a violation of 365(d)(3) is beyond the scope of this opinion,"[13] it is unclear how the Court would decide on the remedy that the objecting lessors could obtain as a result of CEC's failure to timely pay its rent.

Force Majeure

The Court next addressed CEC's argument that the *force majeure* clauses in its leases excuse its performance as the global pandemic and resulting government regulations are *force majeure* events.

Based on its review of each of the leases at issue here, the Court held that the applicable *force majeure* provisions do not affect CEC's monetary obligations under the leases. The Court noted that the *force majeure* clauses in all but one of the objectors' leases specifically stated that they do not apply to an "inability to pay any sum of money" or a failure to perform any obligation "due to the lack of money," "Tenant's obligation to pay, when due and payable, the rents," or "prompt payment of any rental or other charge required of Tenant."[14] One of the leases did not even have a *force majeure* clause; rather, it had a so-called anti-*force majeure* clause that stated lease obligations are not affected by certain enumerated circumstances, including "acts of God" or "any other cause beyond the reasonable control of either parties."[15]

The Court held that these lease provisions foreclose CEC's argument for nonpayment of rent.

Frustration of Purpose

With respect to the doctrine of frustration of purpose, the Court held that while each of North Carolina, Washington and California recognizes it as a defense to contractual performance, the *force majeure* clauses in the leases superseded the common law frustration of purpose defense.[16] The Court explained that North Carolina, Washington and California allow contracting parties to expressly allocate the risk of frustration and that that is what occurred here: the *force majeure* and anti-*force majeure* clauses expressly delegated the risk that "unusual" governmental regulations may disrupt business operations to CEC, as evidenced by the parties' agreement to add in the *force majeure* clauses that unusual government regulations shall not relieve CEC's obligation to pay rent.[17] The Court held that this prevented application of the frustration doctrine.

On the merits of CEC's frustration of purpose claim, the Court was also not convinced that a near "total destruction" of the purpose of the lease or the value of counterperformance occurred here. For example, the Court noted that if CEC believed the leases were valueless, it could have rejected them and that there was no evidence that CEC considered other permitted uses for the leased premises.[18]

Additionally, the Court noted that the remedy in situations where the frustration of purpose doctrine applies is generally rescission of the contract, and accordingly, if the doctrine applies to CEC, it would

[11] *In re Pier 1 Imports, Inc.*, 615 B.R. 196, 205 (Bankr. E.D. Va. 2020).
[12] *Id.* at 202.
[13] Opinion at 9.
[14] *Id.* at 10, 12, 13, 15, 25. Although the exact wording of such exclusionary languages differ, the Court noted that they are substantively identical.
[15] *Id.* at 14.
[16] *Id.* at 20, 23, 24.
[17] *Id.* at 16, 17, 19, 22, 26. With respect to the one lease which has an anti-*force majeure* provision, the Court held that it "demonstrates the parties' express agreement that frustrating events do not excuse performance." *Id.* at 26.
[18] *Id.* at 20-21.

not be entitled to reduction of its rent obligations or postpone the payment of rent.[19]

Implications of the Opinion

The Opinion has various implications for landlords and tenants seeking to negotiate rent abatements and deferrals both in and outside of bankruptcy proceedings.

If applied by other courts, the Court's narrower view of §365(d)(3) and its holding that specific lease provisions may supersede common law defenses to contractual performance may weaken the tenant's hand when making arguments regarding *force majeure* and frustration, at least in situations where the lease contains the relevant risk allocating clauses that could trump the common law defenses under relevant state law. However, the Court's opinion does nothing to undermine a debtor's ability to seek relief from rent obligations within the 60 day period provided for under §365(d)(3).

Additionally, in such situations, this Opinion may provide support to landlords in their attempt to force earlier rejections or limit the rent deferrals to 60 days, or in their opposition to rent abatement or deferral motions that had been routinely granted up to this point in various bankruptcy cases of retail and hospitality businesses affected by the pandemic, including Modell's,[20] Pier 1[21] and Hitz Restaurant Group.[22]

However, given that the Court left the remedy for a §365(d)(3) violation for another day, it is possible that the Court could use its equitable powers to reduce or minimize the impact of such a violation. The outcome of the Court's ultimate determination of the scope and contours of a remedy will also significantly inform the impact and import of this decision.

Lastly, it is worth noting that the Court's Opinion was issued at a late stage of the case, after CEC had proposed its reorganization plan and secured support from various creditor groups. In fact, the Court confirmed the plan the day after its issuance of the Opinion. In other words, there was a lower risk for the Court to deny the Abatement Motion as it was expected that administrative claims would be addressed under the plan. It remains to be seen whether the Court's reasoning would carry equal weight in a case where the path forward on a potential plan of reorganization and treatment of administrative creditors remain to be determined.

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[19] Opinion at 16, 23.
[20] *In re Modell's Sporting Goods, Inc.*, No. 20-14179 (Bankr. D.N.J. Mar. 27, 2020) [ECF 166]; *In re Modell's Sporting Goods, Inc.*, No. 20-14179 (Bankr. D.N.J. Mar. 23, 2020) [ECF 115].
[21] *In re Pier 1 Imports, Inc.*, 615 B.R. 196, 202, 205 (Bankr. E.D. Va. 2020).
[22] *In re Hitz Rest. Grp.*, 616 B.R. 374, 378-79 (Bankr. N.D. Ill. 2020).