***City of Chicago, Illinois v. Fulton, et al.*, 19-357, 2021 WL 125106 (U.S. Jan. 14, 2021)**

Issue

Whether Section 362(a)(3)'s stay prohibiting "any act" to "exercise control" imposes an affirmative obligation to turn over estate property.

Holding

Section 362(a)(3) ***does not*** impose an affirmative turnover obligation; rather, Section 362(a)(3) only prohibits affirmative acts that would disturb the status quo of estate property as of the petition date.

Factual Background

The city of Chicago (the "City") impounded vehicles for failure to pay fines, and some of the vehicle owners (as a similarly situated group, the "Debtors") filed chapter 13 bankruptcies and demanded turnover of their vehicles. The City refused, and the Debtors sought recourse through their respective bankruptcy courts, relying on Section 362(a)(3)'s stay prohibiting the City from "any act" to "exercise control" over the Debtors' respective vehicles.

Procedural Background

Bankruptcy courts and the Seventh Circuit Court of Appeals held that the City's refusal to turn over the vehicles violated Section 362(a)(3)'s stay, creating a circuit split as to whether such a refusal to comply with a turnover demand constitutes a stay violation. In an 8-0 opinion authored by Justice Alito, the United State Supreme Court vacated those lower court decisions, instead holding that the City's refusal to turn over the vehicles did not violate Section 362(a)(3)'s stay.

Legal Analysis

Upon filing bankruptcy, Section 541(a)(1) broadly defines property of the bankruptcy estate, and Section 362's automatic stay generally prohibits efforts to collect pre-petition debts outside the bankruptcy forum, including Section 362(a)(3)'s prohibition against "any act to obtain possession of property of the estate or of property from the estate *or to exercise control over property of the estate*." 11 U.S.C. § 362(a)(3) (emphasis added).

Separately, Section 542 provides that, subject to certain exceptions, an entity (other than a custodian) in possession of property of the bankruptcy estate "shall deliver to the trustee, and account for" that property. 11 U.S.C. § 542.

Justice Alito examined dictionary definitions of "stay," "act," and "exercise"; explored the legislative history of Section 362(a)(3)'s 1984 addition of the subject "exercise control" language; and ultimately reconciled the distinct purposes of Section 362(a)(3) and Section 542 by reasoning that Section 362(a)(3)'s stay of "any act to… exercise control over" property of the bankruptcy estate only prohibits acts (or omissions) that would change the status quo with respect to tangible

property, not "mere retention of estate property" post-petition: "The better account of the two provisions is that §362(a)(3) prohibits collection efforts outside the bankruptcy proceeding that would change the status quo, while §542(a) works within the bankruptcy process to draw far-flung estate property back into the hands of the debtor or trustee."

Takeaways

While the US Supreme Court's decision conclusively establishes the limits of Section 362(a)(3)'s prohibition against "exercising control over" estate property, Justice Alito was careful to narrow its applicability to Section 362(a)(3) disputes. Justice Alito specifically noted that the court was not asked to decide "how the turnover obligation in §542 operates," or whether the City's refusal to turn over the subject vehicles may have violated any other Section 362 stay prohibitions: "We hold only that mere retention of estate property after the filing of a bankruptcy petition does not violate §362(a)(3) of the Bankruptcy Code."

***In re CEC Entertainment, Inc.*, 2020 WL 7356380 (Bankr. S.D. Tex. Dec. 14, 2020)**

Issues

1. Whether Section 365(d)(3) and Section 105(a) give bankruptcy courts equitable powers to alter a debtor's rent obligations;

2. Whether the COVID pandemic and related government regulations are "force majeure" events that allow this debtor to delay performing its lease obligations under Washington law; and

3. Whether, in light of the COVID pandemic and related government regulations, the doctrine of "frustration of purpose" relieves this debtor's obligation to timely pay rent under Washington law.

Holdings

1. Section 365(d)(3) and Section 105(a) ***do not*** give bankruptcy courts equitable powers to alter a debtor's rent obligations; rather, while Section 365(d)(3) and Section 105(a) allow bankruptcy courts to delay a debtor's performance of lease obligations, the Bankruptcy Code expressly prohibits delays beyond 60 days after the order for relief, and does not provide bankruptcy courts with authority to alter lease obligations beyond that 60-day window (although if abatement were authorized under applicable non-bankruptcy law, the 60-day limitation would not apply);

2. The COVID pandemic and related government regulations ***are not*** "force majeure" events that allow this debtor to delay performing its lease obligations under Washington law, because the subject leases' majeure provisions that expressly exclude payment of rent and performance of other obligations due to lack of funds; and

3. The doctrine of "frustration of purpose" ***does not*** relieve this debtor's obligation to timely pay rent under Washington law, because the subject leases' majeure provisions foresaw government regulations affecting performance and excluded payment of rent and performance of other obligations due to lack of funds under those circumstances.

Factual Background

Debtor CEC Entertainment, Inc. (including affiliated debtors, the "CEC") operates a nationwide chain of Chuck E. Cheese venues, primarily geared toward entertaining groups of children, generating most revenue from on-site dining and entertainment (*e.g.*, birthday parties average 10 kids, and include dining and arcade entertainment). CEC generally leases its venues from unaffiliated landlords, and the subject leases were entered into before the global COVID pandemic.

When the COVID pandemic struck, state and local governments responded by enacting regulations aimed to limit social gatherings, effectively prohibiting some business operations and limiting

others. Specifically, certain states *including Washington* enacted regulations that negatively impact CEC's business in three primary ways: (i) prohibiting the operation of gaming and arcade establishments, (ii) restricting the capacity of in person dining, and (iii) prohibiting large group gatherings.

At the time, Washington's regulations prohibited arcades and gaming establishments, and limited in-person dining to 60% capacity. There was never any dispute among CEC and its landlords that (i) the pandemic was unforeseen when the subject leases were negotiated, (ii) the pandemic-related government regulations prevented CEC from operating its arcades, and (iii) the government regulations effectively limited CEC's dining to takeout-only, because its on-site dining was so reliant on its arcade operations.

Procedural Background

In June 2020, CEC filed chapter 11 bankruptcy in Houston, Texas, and soon after filing, sought relief for 141 venues across 12 states, including Washington. CEC sought rent abatement or reduction based on three legal theories (discussed below), and many landlords objected. CEC resolved many of the disputes consensually with its landlords, leaving six venues in dispute for the bankruptcy court to resolve, including two venues in Washington (Lynnwood and Spokane).

Judge Isgur held hearings in September and December 2020, ultimately taking the matter under advisement and issuing a Memorandum Opinion on December 14, 2020, rejecting all of CEC's arguments for abatement or reduction of its lease obligations.

Legal Analysis

1. *Bankruptcy Court Discretion Under Section 365(d)(3) and Section 105(a).*

Section 365(d)(3) commands debtors 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)…" 11 U.S.C. § 365(d)(3). Section 365(d)(3) goes on to state that "[t]he 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." *Id.*

Judge Isgur relied upon authorities discussing the plain language of Section 365(d)(3) and its legislative history to conclude that "Section 365(d)(3) unambiguously requires that debtors timely perform obligations under commercial leases. The Court cannot override that statutory mandate [with its Section 105(a) powers]… As such, the Bankruptcy Code does not permit this Court to equitably alter CEC's state law rent obligations."

Judge Isgur noted, however, (i) other bankruptcy courts have been more receptive to debtors seeking rent relief in light of the COVID pandemic, citing *In re Pier 1 Imports, Inc*., 615 B.R. 196, 198 (Bankr. E.D. Va. 2020) (reasoning that "COVID-19 presents a temporary, unforeseen, and unforeseeable glitch in the administration of" the subject bankruptcy case), and (ii) while the bankruptcy court's ability to alter a debtor's rent obligations is limited by Section 365(d)(3), if a

debtor fails to fulfill those obligations, "the Court's equitable powers will be tested at the remedy stage," again citing *Pier 1 Important* (reasoning that Section 365(d)(3) lacks a remedy to effect payment "[i]f a debtor fails to perform its obligations")

2. *"Force Majeure" Under Washington Law*.

With regard to the Debtor-specific "force majeure" and "frustration of purpose" issues, Judge Isgur turned to state law, including Washington law with respect to CEC's Lynwood and Spokane leases.

Judge Isgur noted that "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 which is beyond the control of either party to the contract… 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." (internal citations/quotations omitted).

CEC's Washington leases both included force majeure clauses, but while those force majeure clauses generally excused the Debtor's performance of lease obligations upon written notice to the landlords when and act of God or government regulations delayed or prevented performance, those force majeure clauses *also* included provisions rendering them inapplicable to payment or rent or other non-performance due to lack of funds. (Respectively, "*This Section shall not apply to the inability to pay any sum of money due hereunder or the failure to perform any other obligation due to the lack of money or inability to raise capital or borrow for any purpose*."; and "*Notwithstanding anything to the contrary herein contained, however, the provisions of this Article 27 shall not be applicable to Tenant's obligation to pay, when due and payable, the rents, charges or other sums reserved hereunder: and in addition, lack of funds and inability to procure financing shall not be deemed to be an event beyond the reasonable control of Tenant*.").

Judge Isgur concluded that while the force majeure clauses' respective phrasing differed, "the substance is nearly identical," therefore, for both Washington leases, under Washington law, "CEC cannot abate or reduce rent at the Spokane or Lynnwood venues because the force majeure clauses do not apply to CEC's obligation to pay rent."; citing Washington case *Inn at Center, LLC v. City of Seattle*, 2004 WL 418021, at *5-6 (Wash. Ct. App. March 8, 2004) (finding force majeure provision that expressly excluded monetary obligations did not excuse payment obligation to city). Judge Isgur also rejected the Debtor's force majeure argument with respect to its leases under other state laws for similar reasons (California and North Carolina).

3. *"Frustration of Purpose" Under Washington Law*.

Finally, turning his attention to the Debtor's "frustration of purpose" argument, Judge Isgur quoted Washington's standard for "commercial frustration" set forth by the Washington Supreme Court in *Weyerhaeuser Real Estate Co. v. Stoneway Concrete, Inc*., 637 P.2d 647, 650 (Wash. 1981) (en banc): "Where the assumed possibility of a desired object or effect to be attained by either party to a contract forms the basis on which both parties enter into it, and this object is or surely will be frustrated, a promisor who is without fault in causing the frustration, and who is harmed thereby, is discharged from the duty of performing his promise unless a contrary intention appears." Judge

Isgur also quoted extensive from other Washington authorities to further elaborate on the doctrine, including references to Washington's "quite liberal application of the frustration doctrine" and remedy that the frustrated party is "discharged from performing its duties," equating to rescission of the contract. (Washington case citations omitted).

Judge Isgur reasoned, however, that Washington (like other states) does not apply the doctrine of frustration when "the contract between the parties disclosed an allocation of that risk to one party or the other." Citing *Scott v. Petett*, 816 P.2d 1229, 1236 (Wash. App. 1991). He then found that CEC's Washington leases *did* allocate the applicable risk "because both leases allocate the risk when government regulations impact performance," referencing the respective force majeure clauses that expressly "acknowledge that government regulations might impact a party's ability to perform." While the parties could not have foreseen that a global pandemic would *cause* government regulations to frustrate the leases' purpose, "the parties expressly recognized that government regulations could delay or prevent contractual performance," and the force majeure clauses "generally excuse performance in those situations, thus allocating the risk to the nonperforming party," but "payment of rent is excepted from the force majeure clauses, which demonstrates that the parties assigned the risk of paying rent during a force majeure event to CEC."

Going a step further, Judge Isgur admonished that "[e]ven if frustration applied, the remedy in Washington is rescission of the leases… CEC would not be entitled to reduce its rent obligations or postpone the payment of rent. Nor could the Court equitably grant that relief." (Washington case citation omitted). Therefore, at most, the doctrine of frustration of purpose could only give CEC the decision of whether to perform its lease obligations or terminate the leases, as opposed to the rent reduction or abatement relief CEC was actually seeking.

Takeaways

The COVID pandemic and related government regulations have generally affected commercial debtors' ability to generate revenue and pay creditors, including landlords. The Chuck E. Cheese case is a recent example of the limits of relief bankruptcy courts can provide when a debtor seeks to reduce or abate its lease obligations, under both bankruptcy law and Washington law.

Given the ongoing uncertainty surrounding the pandemic and its economic impact, these issues are becoming prevalent in bankruptcy courts, with novel arguments and splits of authority creating a new wave of caselaw interpreting well-established bankruptcy and state landlord-tenant laws. *See, e.g., In re Pier 1 Imports, Inc.*, 615 B.R. 196, 198 (Bankr. E.D. Va. 2020) (abating payment of post-petition rent due to COVID pandemic); *In re Circuit City Stores, Inc.*, 447 B.R. 475, 511 (Bankr. E.D. Va. 2009) (debtors must "timely" perform lease obligations pursuant to Section 365(d)(3), but "[t]his conclusion in no way extends the time for performance of any obligation that arises within sixty days after the Petition Date; it merely means that the Court's remedy for non-compliance with the duty under § 365(d)(3) to timely pay obligations arising from and after the order for relief is to order the Debtors to timely perform, and if they fail to do so, to grant relief from stay or court-ordered lease rejection."); *In re Hitz Rest. Grp.*, 616 B.R. 374 (Bankr. N.D. Ill. 2020) (lease's force majeure clause partially relieved debtor's Section 365(d)(3) rent obligation).

***In re PNW Healthcare Holdings, LLC*, 617 B.R. 354 (Bankr. W.D. Wash. May 20, 2020)**

Issue

Whether leases for skilled nursing facilities constituted unexpired leases of "nonresidential" or "residential" real property under 11 U.S.C. § 365(d).

Holding

The bankruptcy court held that to determine whether the leases are residential or nonresidential, the correct focus is on the intended use of such property. In this case, the leases for the skilled nursing facilities consisted of leases of "residential" real property.

Factual and Procedural Background

A collection of for-profit limited liability companies that operate skilled residential nursing facilities ("Debtors") filed chapter 11 bankruptcy. All but one of the facilities is owned by special purpose entities ("Formation Landlords"). Formation Landlords lease the facilities to Canyon Z, LLC and Canyon NH, LLC ("Canyon Landlords"). Canyon Landlords in turn sublease the facilities to Debtors under two Master Subleases. Both leases clearly acknowledge that the lessees are skilled nursing or assisted living facilities, and include many details related to the operation of the facilities and the rights of residents at the facilities. All parties to the leases contemplated that the facilities would be used as skilled nursing or assisted living facilities.

Debtors and the Official Unsecured Creditors' Committee ("Committee") filed a joint motion seeking an order (i) determining that the deadline pursuant to § 365(d)(4) to assume or reject leases of nonresidential real property did not apply to the Debtors' leases for their facilities; and (ii) determining that the other obligations of lessors of nonresidential real property under § 365(d)(3) and (d)(4) were not applicable ("Joint Motion"). *In re PNW Healthcare Holdings, LLC*, 617 B.R. 354, 358 (Bankr. W.D. Wash. 2020). The Canyon Landlords opposed the Joint Motion. At the hearing, Debtors, the Committee, and the Canyon Landlords confirmed that there were no factual disputes in the record on the Joint Motion.

Legal Analysis

As a threshold matter, the court determined it had authority to determine whether the leases in question were nonresidential in the context of a contested proceeding pursuant to Rule 9014. *See* Fed. R. Bankr. P. 6006. Despite Canyon Landlords' contention, this issue was not a proceeding to determine the "extent of … other interest in property"; thus, Rules 7001(2) and (9) were inapplicable.

Bankruptcy Code § 365 governs the assumption, assignment, or rejection of executory contracts and leases of a debtor in bankruptcy. If leases were deemed to be "nonresidential real property," then § 365(d)(4) would apply and the leases would have to be assumed or rejected on or before June 19, 2020. If the leases were determined to be "residential real property," then § 365(d)(2)

would apply and the Debtors could assume or reject the leases at any time up until plan confirmation.

The bankruptcy court reviewed the history of the 1984 and 2005 amendments to § 365. In 1984, Congress inserted undefined terms "unexpired lease of *residential* real property" or of "personal property" into subsections (d)(1) and (d)(2), and added new subsections (d)(3) and (d)(4) that addressed the treatment of "unexpired lease of *nonresidential* real property." Pub. L. No. 98-353, § 362, 98 Stat. 333 (1984) ("1984 Amendments") (emphasis added). Former subsection (d)(3) required performance of the obligations of the debtor under the lease of nonresidential real property but allowed the court to extend such obligations for up to 60 days after the order of relief. Subsection (d)(4) also provided for deemed rejection and immediate surrender of the nonresidential real property if the trustee did not assume the lease of such property w/in 60 days or such time later allowed by the court. The 1984 Amendments were meant to lessen the burden on shopping center landlords and other nearby tenants. H.R. Conf. Rep. 98-882H.R. Conf. Rep. 98-882 (1984), *as reprinted in* 1984 U.S.C.C.A.N. 576, 598-99.

In 2005, after many retail bankruptcies where large anchor tenants at shopping malls received significantly extended time to assume or reject leases, Congress amended § 365(d)(4) to limit the bankruptcy court's discretion to extend the deadline to assume or reject leases of nonresidential real property. Section 365 has not been changed since the 2005 Amendments. Congress has since left bankruptcy courts with significant ongoing discretion to make decisions based on the facts of individual cases, including the discretion to control decisions impacting the relative burdens and benefits, and the relationship between debtor and non-debtor parties, including when to require assumption or rejection, the extension of exclusivity, and what forms of ongoing adequate protection are required.

Section 365 does not define "residential" and "nonresidential." When defining "residential" and "nonresidential," a minority of cases focus on the nature of the lease and include all commercial leases where the debtor/lessee generates income within the terms "lease of nonresidential real property" ("Lease Test"). Most courts, however, focus on the nature of the leased property and whether people reside on such property ("Property Test"). The bankruptcy court concluded that the Property Test is most consistent with the language of § 365(d), its usage in the broader statutory context, and the legislative history of the 1984 and 2005 Amendments. Section 365 uses "nonresidential" or "residential" as adjectives to modify "real property," not "lease." Thus, equating such language to all commercial leases is inconsistent with its use in subsection (d). Additionally, legislative history focuses on retail nonresidential properties, not residential nursing facilities. A broad application of § 365(d)(4) to any facility that makes money would produce insensible and unintended consequences of immediate surrender of real property where people live and depend on a licensed operator.

The court determined that the correct focus on the definition of residential real property versus nonresidential real property should be on the intended use of such property under the lease. The Canyon Landlords were aware of and intended Debtors' facilities be used as skilled residential nursing facilities or assisted living facilities. Additionally, the leases recognized the facilities with words like "resident," "residents," or "residential" at least 40 times. Thus, the court held that the

leases constituted "residential real property," making § 365(d)(2) applicable to the leases in question.

Takeaways

The distinction between "residential real property" versus "nonresidential real property" depends on the intended use of such property under the majority "Property Test." Here, the master subleases for skilled residential nursing facilities between the chapter 11 Debtors and landlords were leases of "residential real property" not nonresidential, thereby making 11 U.S.C. § 365(d)(2) applicable to the subleases rather than § 365(d)(3) and (4).