

# Severable and Nonexecutory Contracts — Strategies Regarding Partial Assumption or Rejection

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# Severable and Nonexecutory Contracts — Strategies Regarding Partial Assumption or Rejection

Kimberly S. Winick<sup>\*/</sup>

## I. INTRODUCTION

At least theoretically, Debtors are required to assume or reject an executory contract or unexpired lease in toto, so that they cannot assume the beneficial elements of an agreement while rejecting the burdensome ones.<sup>1/</sup> The rigor of this requirement frequently precipitates litigation to identify and construe the contract that is the subject of a motion under Bankruptcy Code Section 365.<sup>2/</sup> Courts have opened avenues of relief from a strict reading of the rule by finding that a single document may contain a number of severable agreements, some of which are executory and others not. Where a court so deconstructs a document, the debtor is bound by the nonexecutory agreements and can independently assume or reject each of the separable executory agreements. In certain circumstances, courts also have found that, multiple documents may constitute a single contract. In other

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<sup>1/</sup> See, e.g., In re David Orgell, Inc., 117 B.R. 574,575 (Bankr. C.D. Cal, 1990) ("It is well settled that if a debtor elects to assume an executory contract or unexpired lease it must assume the entire contract or lease cum onere . . . .") See also, City of Covington v. Covington Landing Limited Partnership, 71 F.3d 1221, 1226 (6th Cir. 1995) (debtor must assume both benefits and burdens and, absent agreement of nondebtor party, the court may not excise from the contract material obligations owing to that party); In re Nitec Paper Corp., 43 B.R. 492, 498 (S.D.N.Y. 1984) (citing Hurley v. Atchison, Topeka & Santa Fe Railway, 213 U.S. 126, 133, 29 S.Ct. 466, 468, 53 L.Ed. 729 (1909) ("[T]he trustee takes the property of the bankrupt ... in the same plight and condition that the bankrupt himself held it, and subject to all the equities impressed upon it in the hands of the bankrupt....")); In re Atlantic Computer Systems, Inc., 173 B.R. 844, 849 (S.D.N.Y. 1994) (accord); In re Holland Enterprises, Inc., 25 B.R. 301, 302 (E.D. N.Car. 1982) (debtor not permitted to assume lease and concurrently reject one burdensome provision in lease); In re Braniff, Inc., 118 B.R. 819, 845 (Bankr. M.D. Fla. 1990) (where multiple documents were part of one unified contract, debtor could not separately assume or reject each document). It is clear that this theory is tempered by the latitude taken by courts in analyzing what constitutes a single executory contract or unexpired lease. Of course, this theory is further tempered by the reality that courts commonly utilize the Bankruptcy Code prohibitions against the enforcement of ipso facto and anti-assignment clauses (11 U.S.C. § 365(e) and (f)), as well as the power to authorize the use, sale, and lease of assets other than in the ordinary course (11 U.S.C. § 363(b)), to eliminate and excise burdensome portions of contracts, while allowing assumption of the remainder. However, the application of these Sections is beyond the scope of this article.

<sup>2/</sup> All "Section" references herein are to the Bankruptcy Code, 11 U.S.C. § 101 et seq., except as otherwise indicated.

circumstances, courts analyzing contracts and leases under Section 365 have been prone to opine that all or part of an agreement creates a right or obligation which is not “executory,” and hence not “rejectable” pursuant to Section 365.

Whether negotiating and drafting agreements, or litigating over the treatment of agreements in bankruptcy, parties should be familiar with the concepts of severability and integration of contracts, as well as the possibility that all or part of a contract may be exempt from the effects of Section 365. This article focuses on the interplay of these concepts in the context of assumption or rejection under Section 365. Obviously, these concepts also are relevant to analyses regarding other bankruptcy issues, including the use, sale, or lease of assets, as well as allowance and treatment of claims under any plan.

## II. ONE DOCUMENT MAY CONTAIN MULTIPLE SEPARATE AGREEMENTS

Debtors often find it advantageous to argue that a single document contains multiple, severable, agreements, each of which may be dealt with independently of the others in the debtor’s bankruptcy case. When this argument prevails, the debtor is permitted to assume and reject portions of a single document. Nondebtor parties, on the other hand, usually seek to compel assumption or rejection *in toto* and therefore argue against severability. The results of courts’ severability analyses generally seem oriented toward the goal of benefiting the bankruptcy estate, rather than on consistently applying stated legal principles. Thus, debtors generally obtain the benefits of severability, except in the rare cases where the court concludes that the debtor is grossly overreaching and that a ruling in the debtor’s favor would cause severe, likely noncompensable, injury to the nondebtor party.

Bankruptcy courts generally refer to state law when analyzing the severability of a contract. Butner v. United States, 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed. 2d 136 (1979). While the case law may vary from state to state, the following factors generally are relevant to any severability analysis: (1) whether the nature and purpose of the agreements within the one document are distinct, (2) whether there is separate and distinct consideration for each agreement, and (3) whether the obligations of each party to the document are either interdependent or interrelated. In re Gardinier, Inc., 831 F.2d 974, 976 (11th Cir. 1987); accord, Hudson v. Wylie, 242 F.2d 435, 446 (9th Cir. 1957)(Bankruptcy Act) (Court reviewed state court opinions from across the United States and identified the same criteria as the Gardinier Court) . The Ninth Circuit has opined that “[s]everability is determined by the intent and actions of the contracting parties,” and has adopted the position that “[w]hether a contract is entire or severable generally is a question of intention,

to be determined from the language employed by the parties, viewed in the light of the circumstances surrounding them at the time they contracted.” In re Qintex Entertainment, Inc., 950 F.2d 1492, 1495 (9th Cir. 1991)(quoting Christian v. Christian, 42 N.Y.2d 63, 73 (1977)(contract which concerned four motion pictures and provided for compensation to be calculated on the basis of the performance of those movies as a group was not severable). As a practical matter, a contract should not be severable unless a party’s failure to perform one promise would not defeat the purpose of, or excuse the other party’s performance under, the entire agreement.

Courts frequently apply the severability analysis to the advantage of the debtor and the bankruptcy estate. In Hudson v. Wylie, the Court affirmed the severing of a construction contract into two elements, the obligation of the debtor to procure certain contracts, which the court found to have been fully performed before the bankruptcy filing, and the remaining, unperformed obligation to perform the construction. 242 F.2d 435, 447-48. This determination enabled the bankruptcy trustee to collect payments due on account of the performed portion of the contract without performing the debtor’s remaining obligations. The Court in Gardinier applied the severability factors and found that a brokerage agreement contained within a purchase and sale agreement was a separate contract that had been fully performed prepetition by the nondebtor party, a real estate broker. Thus, the brokerage agreement was not an executory agreement. Accordingly, the Court affirmed the order permitting the debtor to assume the purchase and sale agreement, but not the brokerage agreement. As a result, the bankruptcy estate reaped the benefits of the property sale, without having to pay the full cost of obtaining that benefit; the broker who arranged the sale held a prepetition, unsecured claim for fees, instead of a postpetition, administrative claim.

A similarly advantageous result recently was obtained for the bankruptcy estate in the Fifth Circuit case of Stewart Title Guaranty Co. v. Old Republic National Title Ins. Co., 83 F.3d 735, 741 (5th Cir. 1996). The debtor in Stewart Title was a lessee under a property lease that included provisions permitting the debtor, upon termination of the lease, to copy materials contained in the leased property. After the debtor filed its bankruptcy case, the bankruptcy trustee sold the duplication rights to Stewart Title, and rejected the lease in which those rights were provided. Stewart Title sued to enforce its duplication rights, and lost on summary judgment. The District Court concurred with the Bankruptcy Court. However, the Fifth Circuit reversed the District Court, finding that the subject contract contained two severable agreements, an executory lease, which the bankruptcy trustee was permitted to reject, and a right to copy materials, which constituted property of the bankruptcy estate. Because this right was not executory, it was not affected by rejection of the lease; the right property was sold by the trustee and was enforceable

by Stewart Title. See also Monument Square Associates, Inc. v. the Resolution Trust Corporation, 792 F.Supp. 874, 876 (D.Mass. 1991)(nonbankruptcy court found lease relating to two separate premises severable, where terms were separately negotiated for each location, and landlord maintained separate accounting for each location, and permitted RTC to disaffirm lease as to just one location).

Sometimes, however, application of the severability analysis is not to the debtor's advantage. For example, one of the debtors in In re Qintex Entertainment, Inc., 950 F.2d 1492 (9th Cir. 1991), had a contract with Otto Preminger that provided for the debtor to colorize and distribute four films. The debtor had colorized only two of the films and sought to sever the distribution agreement from the colorization agreement in order to avoid the cost of colorizing the remaining two films while garnering profits by selling to a third party the rights to distribute all four films. The Ninth Circuit reversed the District Court's unsupported holding of severability, and found no evidence that the parties intended the contracts to be severable.<sup>3/</sup> Id., 950 F.2d at 1495. As a result, the debtor was unable to sell its rights under the contract unless it cured its defaults and assumed the contract in its entirety. Id., 950 F.2d at 1497. The Bankruptcy Court in In re Downtown Properties, Inc., 162 B.R. 244 (Bankr. W.D. Mo. 1993), also declined to permit a debtor to sever a contract to the disadvantage of the nondebtor party. The Downtown Properties debtor was a real property lessor. At the time the debtor entered into the lease prior to the bankruptcy case, the real property required expensive repairs that the debtor could not afford. Pursuant to the lease, the tenant paid for the repairs and accepted a rebate in rent in the amount of the repair costs. In its plan of reorganization, the debtor proposed to sever the lease into two agreements, a lease at the nonrebated rate, which the debtor intended to require the tenant to pay on a current basis, and a loan from the tenant to the debtor of the rebate amount, which the debtor intended to reduce and "restructure" under its plan of reorganization. However, the Court found that the parties intended for the lease to be a single, unified contract and that they had acted consistently with that intent. Id., 162 B.R. at 247-48. Accordingly, the Court declined to advantage the debtor at its tenant's expense. Id. See also, In re The Beare Company, 177 B.R. 879, 881 (Bankr. W.D. Tenn. 1994)(single contract entitled Management Agreement and Option to Purchase not severable where grant of purchase option was partial consideration for management services and nondebtor party would not have contracted to provide management services at agreed low monthly rate if it had not received the purchase option).

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<sup>3/</sup> The outcome might have been different if the District Court had referenced any evidence of elements of severability in support of its ruling.

### III. SEVERAL DOCUMENTS MAY BE ONE CONTRACT

Nondebtor contract parties often try to protect their interests by arguing that several documents constitute a single agreement. When the argument is successful, the debtor must assume or reject the entire package of documents without cherry-picking among the constituent elements. Courts analyze the integration of multiple documents much as they do the severability of provisions of a single document. The analysis is based on state law, which generally looks to the intent of the parties as evidenced by the language and substance of the agreement. In re Pollock, 139 B.R. 938, 940 (BAP 9th Cir. 1992). As in the severability context, courts consider “(1) whether the nature and purpose of the obligations are different; (2) whether the consideration for the obligations is separate and distinct; and (3) whether the obligations of the parties are interrelated.” Id., quoting In re Gardinier, 831 F.2d 974, 976 (11th Cir. 1987). Like the severability analysis, the integration analysis usually is applied in a manner that maximizes the value of the bankruptcy estate.

The tendency of courts to apply the integration analysis to the debtor’s advantage is illustrated by the Pollock case, where the Court prevented a forfeiture of the debtor’s assets and made reorganization possible (arguably at the expense of the nondebtor) by declining to integrate a sublease and a related promissory note. The debtor in Pollock was the sublessee of a campground. The sublease was executed in conjunction with the debtor’s execution of a promissory note for the purchase of the campground. The sublease required rent of \$1.00, plus payment of county franchise fees and liability insurance, and recited that consideration for the sublease included the debtor’s promissory note. Id., 139 B.R. at 939. After constructing improvements on the leasehold, the debtor filed its bankruptcy case and moved to assume the sublease even though it was in default under the note. Despite finding “some factors” to support the landlord’s integration argument, the Court upheld the bankruptcy court’s ruling that the note and sublease were not integrated agreements and that the debtor’s obligations under the note were distinct from its obligations under the sublease. As a result, the debtor was permitted to assume the sublease without curing its delinquencies under the note, and was protected from the forfeiture of its leasehold improvements. Id., 139 B.R. at 941. The Pollock Court based its ruling on its finding that the sublease and note did not form an indivisible transaction. The Court bolstered its finding with determinations that the two agreements were not expressly incorporated into each other, each agreement arguably had separate consideration, the documentation was ambiguous, and

integration of the agreements would have necessitated the forfeiture of the debtor's principal assets, the campground improvements.<sup>4/</sup>

In the Ninth Circuit, notwithstanding the Pollock Court's ruling, multiple agreements contained in multiple documents may be construed as a single contract even when they are not expressly integrated. For example, in the Matter of Steen, 509 F.2d 1398, 1402 (9th Cir. 1975)(a nonbankruptcy case), the Court stated as follows:

While it is true that neither document refers specifically to the other, neither proclaims itself to be a complete integration of the agreement between the parties. Given the size of the transaction, the related subject matter of the two documents, the fact that they were contemporaneously negotiated, drafted, executed and delivered, and the substantial certainty that neither would have been executed without the other, it is apparent that they integrate a single large transaction. Where two or more written agreements are contemporaneously executed as part of one complete transaction, we have labeled 'elemental' the proposition that they must be construed together.

Id., citing Parker v. Commissioner, 166 F.2d 364, 367 (9th Cir. 1948). Other courts also have looked at the totality of the circumstances, including (a) the language of the documents, (b) the fact they were negotiated and executed contemporaneously by the same parties, for the same purpose and in the course of the same transaction, (c) additional evidence that they were functionally intertwined, and, ultimately, (d) "whether the parties assented to all the promises as a whole, so that there would have been no bargain if any promise or set of promises had been stricken," and have concluded that multiple documents constitute a single agreement for purposes of assumption or rejection under Section 365. In re Atlantic Computer Systems, Inc., 173 B.R. 844, 850-51 (S.D.N.Y. 1994)(cataloging extensive list of cases concerning integration of multiple documents into one contract); In re Karfakis, 162 B.R. 719, 724 (E.D. Pa. 1993)(franchise agreement and lease comprised a single contractual agreement where they were simultaneously executed, they were coterminous and cross-defaulted, and it was "readily apparent" that one was of no utility without the other); In re Ritchey, 84 B.R. 474, 479 (Bankr. N.D. Ohio 1988)(contracts for purchase of business and related real property constituted single, indivisible contract under Ohio law); In re Braniff, Inc., 118 B.R. 819, 844 (Bankr. M.D. Fla. 1990)(holding that a separate lease commitment, partial assignment, and purchase

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<sup>4/</sup> This result also left the landlord with a secured claim for payment of the note, and denied the landlord the windfall of gaining title to the extensive improvements purchased by the debtor.

agreement concerning twenty-six aircraft constituted one unified executory contract assumable by the debtor). Compare, In re Martin Toolmakers, Inc., 796 F.2d 1435, 1440 n.7 (11th Cir. 1986) (“unified construction of multiple documents is appropriate only when each of the documents is executed by the same parties.”)

#### IV. PORTIONS OF AN APPARENTLY EXECUTORY CONTRACT MAY NOT BE SUSCEPTIBLE OF REJECTION

Some courts have held that an apparently executory contract actually was not executory for purposes of Section 365, but rather was an amalgam of executory and nonexecutory obligations, and that the latter obligations would not be affected by rejection of the executory contract. This kind of analysis effectively results in the severing of the contract, thus enabling the debtor to enjoy the benefit of the nonexecutory portion of the contract, while separately assuming or rejecting the executory portions thereof.

The potential value to a debtor of this approach is demonstrated by the Stewart Title case. 83 F.3d 735. In Stewart Title, the Court decided that the tenant’s right to duplicate materials was conveyed at the inception of the lease, to be exercised at the termination of the lease. Therefore, either as a severable contract, or as a nonexecutory element of an executory contract, the tenant’s right could not be “rejected.” Stewart Title, 83 F.3d at 741 (“only the executory portions of the document are subject to rejection . . . the executed portions of the contract remain intact, and property rights acquired under the contract prior to filing become property of the estate . . . [notwithstanding] rejection of the unperformed obligations of the contract.”).

In some cases, courts have found that certain obligations could not be rejected as a matter of public policy or because they constituted real estate covenants that “run with the land,” and more properly were viewed as creating real property attributes that could not be separated from the property. These rulings generally are beneficial to the nondebtor party, and underscore the potential advantage a creditor may gain by focusing the court’s attention on considerations of public policy or real property, rather than contract. For example, the debtor landlord in Saravia v. 1736 18th St. N.W., Limited Partnership, 844 F.2d 823, 826 (D.C. Cir. 1988), rejected its tenants’ leases, and accordingly was released from performing the landlord obligations under those leases. Nonetheless, the D.C. Court of Appeals held that the landlord was required by the public housing laws, which promote public health, safety, and welfare, to continue to maintain the property and to provide adequate utility and other basic services to the tenants. Id., 844 F.2d at 826-27. Similarly, the Seventh Circuit Court of Appeals has ruled that a reciprocal land use covenant that

restricted owners to improving their property with one-story, single family residences created a real property interest, and was not an executory contract that could be rejected in an owner's bankruptcy case. The court was not moved by the fact that the debtor already had violated the covenant, prior to filing bankruptcy, by building the objectionable second story. Gouveia v. Tazbir, 37 F.3d 295 (7th Cir. 1994)(trustee not permitted to reject covenant or sell property which violated covenant. It appears demolition may have been required).<sup>5/</sup>

Nondebtor parties have obtained similarly favorable results in cases involving homeowner association conditions, covenants and restrictions ("CC&R's") or analogous agreements. The applicable state laws vary, but the general result of bankruptcy court analyses is that condominium or homeowners' association fees relate to the maintenance and upkeep of common areas, which necessarily confers a benefit on the owner, and that, so long as the owner continues to hold title, the owner (as well as the unit) is liable for the applicable association fee. In re Lenz, 90 B.R. 458 (Bankr. D.Colo. 1988) aff'd 110 B.R. 523 (D.Colo. 1990)(declarations and covenants are not executory contracts that can be rejected under Section 365, and debtors are personally liable for assessments until divestiture of title; homeowners became liable for fees upon taking title to the subject property); In re Case, 91 B.R. 102, 103 (Bankr. D. Colo. 1988)(condominium declarations create covenants running with the land, and cannot be rejected by condo owner; to "reject" declarations, condo owner "must give up all benefits, including all ownership and all rights in the common areas."); In re Ryan, 100 B.R. 411, 416 (Bankr. N.D. Ill. 1989)(a "debtor cannot reject the obligation to pay postpetition [condominium] association assessments while retaining the benefits of possession and ownership."). These rulings fundamentally are equitable. After obtaining a "fresh start" through the bankruptcy process, a debtor should not be able to get a free ride at the expense of others. In fact, it seems that even a simple quantum meruit argument should apply to the extent that post-discharge assessments relate to benefits conferred on the homeowner after the discharge. In any event, in 1994, in response to litigation regarding a debtor's ability to reject or discharge its postpetition obligations to homeowners associations, Section 523(16) was added to the Bankruptcy Code to

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<sup>5/</sup> As noted in Saravia, 28 U.S.C. §959(b) may offer nondebtor contract parties additional support for enforcement of certain agreements, including those relating to compliance with zoning or environmental laws. Section 959(b) provides, in pertinent part:

... a trustee, ... including a debtor in possession, shall manage and operate the property in his possession [in such capacity] according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

prohibit the discharge of postpetition obligations incurred while the debtor occupies or receives rent for the use of its premises.<sup>6/</sup>

The fact that an executory contract creates rights affecting real property does not, however, necessarily insulate those rights against rejection, as is illustrated by the opinion in Steffan v. McMillan (In re Coordinated Financial Planning Corp.) (“CFP”), 65 B.R. 711 (BAP 9th Cir. 1986). The Chapter 7 debtor in CFP was the joint owner of real property in California. The recorded memorandum of ownership established the mutual rights of first refusal between the debtor and its co-owner in the event of any sale. Id., 65 B.R. at 712. The Court found that the right of first refusal clearly was a covenant that ran with the debtor’s property. Id.<sup>7/</sup> However, it observed, “[c]ovenants are not a property interest but are viewed as physically attached to the land. Id., 65 B.R. at 711, citing 3 Witkin, Summary of Cal. Law §384 (8th ed. 1973). The Court further stated:

Ordinary principles of contract law are also applicable. Property principles are involved, but in this case, they merely operate to bind a non-contracting party to a covenant. Once a running covenant is established it is enforced according to contract principles. And once a bankruptcy is filed Federal law comes into play.

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<sup>6/</sup> This legislation is meant to put an end to litigation on this issue and to reverse legislatively the few court decisions permitting debtors to discharge their future association assessment obligations, yet retain ownership of their unit. E.g., In re Elias, 98 B.R. 332, 335-336 (N.D. Ill. 1989)(court acknowledged that Bankruptcy Code seemed to give debtors a “head start . . . by enabling them to reside in their homes unencumbered by assessments, no matter how long after the discharge,” but nonetheless ruled that assessments were discharged as “claims.”)

<sup>7/</sup> California Civil Code §1468 provides that a covenant runs with the land if the following requirements are met:

- (a) The land of the covenantor which is to be affected by such covenants, and the land of the covenantee to be benefited, are particularly described in the instrument containing such covenants;
- (b) Such successive owners of the land are in such instrument expressed to be bound thereby for the benefit of the land owned by, granted by, or granted to the covenantee;
- (c) Each such act relates to the use, repair maintenance or improvement of, or payment of taxes and assessments on, such land or some part thereof, or if the land owned by or granted to each consists of undivided interests in the same parcel or parcels, the suspension of the right of partition or sale in lieu of partition for a period which is reasonable in relation to the purpose of the covenant; and
- (d) The instrument containing such covenants is recorded in the office of the recorder of each county in which such land or some part thereof is situated.

CFP, 65 B.R. at 712, quoting California Civil Code Section 1468.

Id., 65 B.R. at 712. The Court applied federal law to affirm the bankruptcy court's holding that the right of first refusal was an executory contract. Id. The trustee therefore was permitted to reject the right of first refusal and sell the property to a third party.<sup>8/</sup> See also, In re Arden and Howe Associates, Ltd., 152 B.R. 971 (Bankr. E.D. Cal. 1993)(after lessor rejected lease, tenant was entitled to retain possession of premises and offset damages against rent due, but was not entitled to enforcement of restrictive use covenants that encumbered lessor's property interest and prohibited lease of property to another grocery store).<sup>9/</sup>

## V. CONCLUSION

Surprising results may be obtained under Section 365 when courts find that a contract consists of less, or more, than the parties expect. Parties should be aware of severability and integration concepts when negotiating and documenting agreements. They also should be prepared to apply these concepts creatively in a party's bankruptcy case—debtors to cherry-pick benefits while avoiding burdens, and to shift as many obligations as possible from the category of administrative claim to that of prepetition claim. Creditors have precisely the opposite objectives. Both may increase their prospects of success by understanding how to divide or aggregate contracts for treatment under Section 365.

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<sup>8/</sup> The jilted co-owner was granted a lien against the property to secure repayment of any consideration it paid for the preemption agreement. Id., 65 B.R. at 713; 11 U.S.C. §365(j).

<sup>9/</sup> This case is distinguishable from one in which the tenant is the rejecting party in that Section 365(h)(2) specifically limits the contract rights and remedies of tenants who elect to remain in possession after a landlord rejects a lease. In any event, in response to cases like this one, the Bankruptcy Code was amended in 1994 to provide that a landlord debtor's rejection of a shopping center lease "does not affect the enforceability under applicable nonbankruptcy law of any provision in the lease pertaining to radius, location, use, exclusivity, or tenant mix or balance." 11 U.S.C. §365(h)(1)(C).