

SEVERING AND COMBINING CONTRACTS IN BANKRUPTCY ISSUES AND IDEAS

by Kimberly S. Winick*

At least theoretically, Chapter 11 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.¹ This requirement frequently precipitates litigation to identify and construe the contract that is the subject of a motion to assume or reject under Bankruptcy Code section 365.² Courts have opened avenues of relief for debtors and non-debtor parties from strict application of this requirement 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 can independently assume or reject each of the separable executory agreements. Conversely, courts also have found that multiple documents may constitute a single contract. In other circumstances, courts have opined 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 or litigating over treatment in bankruptcy, attorneys should be familiar with the concepts of assumption, rejection, severability and integration of contracts under the Bankruptcy Code. All too often this familiarity comes only after the agreement has been construed — some would say misconstrued — by a bankruptcy court.

ONE DOCUMENT, MANY 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 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).

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. However, it often appears that a bankruptcy court's perception of the benefits of its holding to the estate colors the analysis. See, e.g., *Hudson v. Wylie*, 242 F.2d at 447-48; *Gardinier*, 831 F.2d at 976. Sometimes, however, application of

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* The author is Counsel to Mayer, Brown & Platt, resident in the firm's Los Angeles office.

1 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"). This theory is tem-

pered by the latitude taken by courts in analyzing what constitutes a single executory contract or unexpired lease and 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. The application of these sections is beyond the scope of this article.

2 All "section" references herein are to the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*, except as otherwise indicated

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the severability analysis is not to the debtor's advantage. See, e.g., *In re Qintex Entertainment Inc.*, 950 F.2d 1492 (9th Cir. 1991), (contract to colorize and distribute four films that Debtor had performed as to colorization of two films was not severable into contract to colorize and contract to distribute); *In re Downtown Properties, Inc.*, 162 B.R. 244 Bankr. W.D. Mo. 1993) (lease with tenant improvement financing rebate not severed into lease at full rate to be assumed and financing rebate that could be restructured); *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).

SEVERAL DOCUMENTS, ONE CONTRACT

Nondebtor contract parties often try to protect their interests and preserve the entirety of their arrangements with a debtor 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 a single document. The analysis is based on state law, which generally looks to the parties' intent as evidenced by the language and substance of the agreement. *In re Pollock*, 139 B.R. 938, 940 (BAP 9th Cir. 1992). 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 *Gardinier*. Like the severability analysis, the integration analysis usually is applied in a manner that maximizes the value of the bank-

ruptcy estate. See, e.g., *Pollock*, 139 B.R. at 940 (declining to integrate a sublease and a related promissory note).

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: "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." *In re Steen*, 509 F.2d 1398, 1402 (9th Cir. 1975)(nonbankruptcy case). 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 (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." *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 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 docu-

ments is executed by the same parties.")

UNREJECTABLE PARTS OF A CONTRACT

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.

The potential value to a debtor of this approach is demonstrated by the *Stewart Title* case. 83 F.3d 735 (5th Cir. 1996). There, 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. Either as a severable contract, or as a nonexecutory element of an executory contract, the tenant's right could not be "rejected." *Stewart Title*, 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"). 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).

Severance of contracts and determinations of partial executory or non-executory characterizations have interesting results in the real estate arena, especially with regard to easements, homeowner association CC&R's and the like. See, e.g., *Saravia v. 1736 18th St. N.W., Limited Partnership*, 844 F.2d 823,

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826 (D.C. Cir. 1988) (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 not withstanding rejection of leases which had similar requirements); *Gouveia v. Tazbir*, 37 F.3d 295 (7th Cir. 1994) (trustee not permitted to reject covenant restricting development to single story homes or sell property which violated covenant); *In re Lenz*, B.R. 458 (Bankr. D.Colo. 1988) *aff'd*, 110 B.R. 523 (D.Colo. 1990) (declarations, covenants and CC&R's 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 Rvan*, 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").

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. Counsel 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 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 the opposite. Both may increase their prospects of success by understanding how to divide or aggregate contracts for treatment under Section 365 at the drafting stage. ■

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Message from the Chair:

AN "INTERESTING" YEAR

by Marie F. Hogan, Executive Committee Chair

The Year Past. The now familiar Chinese saying, "May you live in interesting times", has certainly proved true this year. The year has been a roller coaster of efforts and emotions which have brought us back to our starting point for those of us "cursed" to follow the State Bar's legislative and financial travails.

Save me from the details — is the Business Law Section alive and well and will I continue to receive the Business Law News and all the other benefits I have come to expect from the Section? YES and YES!

The Business Law Section in mid-October, a year ago, learned that the dues bill introduced in the California Legislature on behalf of the State Bar provided that the Business Law Section, and the other 16 sections, were slated to become a "voluntary bar" without monetary or administrative support of the State Bar after January 1, 1999. No one had

the slightest inkling what a voluntary bar entailed, what it would look like, who would be part of this bar or the cost to run such a bar.

In the meantime, the Business Law Section had work to do. The 15 Committees of the Section had educational programs, legislation, and reports to produce. And the Committees did work this year. Since you have the *Business Law News* in your hand, you know the *Business Law News* continues to be published, the Committees were successful on the legislative front and the committees continued providing educational programs up and down the State. The Partnerships Opinion Report, included in the previous issue, is a first for the country.

At the same time, the Business Law Section, together with the other Sections, *(Continued on Page 2)*

1998 Outstanding Achievement Award

Jointly Awarded to Richard W. Jennings & R. Bradbury Clark

In 1997, the Business Law Section inaugurated its Outstanding Achievement Award, to be given each year to a member or members of the State Bar who have made significant contributions to the Section or to the practice of Business Law generally in the State of California. Last year the award was given to Harold Marsh; this year it is being awarded jointly to Richard W. Jennings and R. Bradbury Clark.

Richard W. Jennings

Richard Jennings spent his career as a master teacher of generations of California law students at the University

of California School of Law, Berkeley, an author of articles and casebooks, a nationally recognized authority on federal, securities regulation and corporations law, and an advisor to California, Federal and private agencies on corporate and securities law matters.

He graduated Phi Beta Kappa front Park College with an AB degree in 1927 (later receiving an honorary LL.D degree from that institution), and received a Masters Degree from the University of Pennsylvania in 1939. He proceeded to Boalt Hall in Berkeley to receive his JD

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