Slicing and Dicing Executory Contracts

by Michael St. James ©2000

michael@stjames-law.com

www.stjames-law.com

I. Introduction

As recent cases have made clear, although debtors and trustees are required to assume or reject the executory contracts, it is often far from clear what constitutes *the* executory contract for the purposes of Section 365. Some courts have found that a single written document actually includes more than one separate executory contract for the purposes of section 365 and have permitted different aspects of the same document to be assumed and rejected. Other courts have found a number of separate documents constituted a single executory contract which must be assumed or rejected *in toto.*

Only one Circuit of Appeals has attempted to establish a test to determine what constitutes the executory contract. This article will suggest that the test proposed by the Eleventh Circuit in *In re Gardinier*, which has been cited with approval by the Bankruptcy Appellate Panel for the Ninth Circuit, is so amorphous that it can only be applied on a *post hoc* basis: "Tell me the answer and I will explain how it is consonant with the *Gardinier* test."

Whether or not they city the *Gardinier* test, judges have uniformly looked to a handful of determinative factors to decide what constitutes an executory contract. This article suggests that these factors, rather than the language of the *Gardinier* test, should be the focus of judicial inquiry when determining what constitutes the outer dimensions of an executory contract.

Almost all of the case law on the subject arises out of two common fact patterns in which the court is asked either to aggregate separate documents into a single contract or to sever provisions of a single document, creating multiple executory contracts. The first fact pattern generally arises where the buyer and the seller of a business enter into a number of written contracts (lease assignment or sublease, promissory notes, security agreements, covenants not to compete, etc), the buyer files a bankruptcy case and argues that it can assume some of the contracts but can reject or need not perform others. Here, the question is whether the collection of contracts can be aggregated to form a single executory contract which must be assumed or rejected as such, or whether the various documents represent severable obligations which may be separately assumed or rejected.

The other fact pattern involved a single executory contract (generally, a real property lease or a purchase and sale contract) which contains provisions which are arguably separate or severable (*e.g.*, a tenant improvement loan or an agreement to pay a broker's commission). Here, the question is whether the obligations are truly severable, such that the underlying contract may be assumed while rejecting or failing to give effect tot he severable provision or, on the contrary, whether the contract is a single integrated

agreement which must be assumed or rejected *in toto*. For ease of discussion, this article will talk in terms of the second fact pattern and the standards required to "sever" a provision.

Although case law tends to arise in the context of these two dominant fact patterns, the principles at issue are far broader in scope. One commentator has noted that this is potentially a multi-million dollar issue in the context of shopping center developments, because the key concessions which a developer must seek from its anchor tenants may later be treated by those tenants as "rejectable" executory contracts, totally undermining the economic expectations of the parties. Depending on the specific circumstances and the practical consequences of doing so, one can expect debtors and creditors to argue for an expansion or contraction of the impact of section 365, asserting that specific provisions of a contract should be "severed" or that numerous contracts should be aggregated together into a single executory contract.

II. The Law

A. The Ordinary Rule and the Issue

The ordinary rule, well-established as a matter of law and dating back to the Bankruptcy Act, is that an executory contract must be assumed or rejected *in toto*. The debtor may not pick and choose among contractual provisions, accepting some and rejecting others. Rather the debtor assumes or rejects the executory contract in its entirety.

Many questions have determined that multiple contracts constitute a single executory contract for the purposes of section 365. Conversely, other opinions have determined that a single contract can be analyzed , for the purposes of section 365, as consisting of two or more severable executory contracts.

Courts have had difficulty articulating a useful rule for discerning when a single contract can be divided into multiple executory contracts. As described below, one Circuit Court of Appeals has attempted to enunciate a test but it is not clear that the test is particularly helpful, and even in cases where it is cited with approval, it is not clear to what extent the test was actually applied. A survey of the case law, however, suggests that three factors have been consistently dispositive, regardless of whether the court purported to apply the test: (1) whether the underlying transaction objectively gave birth to one integrated agreement or two (or more) severable agreements; (2) whether the application of ordinary principles of contract construction favors finding a single underlying contract or severable agreements; and (3) equitable considerations regarding the appropriateness of the result sought.

B. The Gardinier Test

In *Gardinier*, the Eleventh Circuit considered whether a single contract, which called for the sale of a parcel of land and the payment of a brokerage commission, could be treated as two separate executory contracts. In holding that it could, thereby permitting the sale contract to be assumed while the commission contract was rejected, the Court of Appeals identified three factors which it considered in determining the severability of the contract provisions before it:

First, the nature and purpose of the agreements are different. One agreement

> addresses the sale of property and the other contemplates an employment contract related to the sale of the property. *Second*, the consideration for each agreement is separate and distinct. Burley agreed to pay Gardinier in excess of $5 million in consideration for the Goldstein tract. Gardinier separately agreed to pay Kilgore a commission as consideration for services rendered in making the sale of the property.... *Finally*, the obligations of each party to the instrument are not interrelated. Gardinier obligated itself to deliver the deed to Burley upon payment of the purchase price, and it obligated itself to pay a commission to Kilgore upon completion of the broker's responsibilities. There are no promises running between the broker and the purchaser; their only reaction is that each has separate contractual rights with the seller.

The Eleventh Circuit Court noted that the consequence of its decision was that the sale contract would be assumed, generating funds for the estate, while the commission contract would be rejected, "relegating [the broker] to the status of a general unsecured creditor."

Lower courts have cited the *Gardinier* decision as presenting a "test" to determine whether a contractual provision is severable, enunciating the *Gardinier* test as asking: "(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 obligations of the parties are interrelated."

Gardinier represents the only attempt by a circuit court to enunciate a rule on this subject, and consequently has been dutifully cited by a number of lower courts. However, after citing or quoting the *Gardinier* test, these opinions routinely fail to apply it, demonstrating through their analyses the test's lack of utility.

The lack of guidance in the *Gardinier* test can be seen most clearly by comparing *Pollock* and *T&H Diner*, two appellate cases that cited *Gardinier* with approval and claimed to apply its *"test"* to essentially identical fact patterns, but obtained diametrically opposite results. In each case, a business was sold, the buyer executed one or more promissory notes to pay the purchase price, the buyer received a lease or sublease of the business premises from the seller as part of the sale transaction, the sublease provided that a default in the promissory note would constitute a default in the sublease. In *Pollock*, the Bankruptcy Appellate Panel for the Ninth Circuit, after citing the *Gardinier* test as its guide, held that the sublease and the promissory note were severable and that the former could be assumed without curing the latter. In *T&H Diner*, the District Court for the District of New Jersey, after citing the *Gardinier* test as its guide, held that the sublease and the promissory note were not severable and the sublease could be assumed only if the debtor cured the defaults under the promissory note.

One may fairly say that the *Gardinier* test may be more useful as a rationale to support a decision which has already been made than as a test to use in reaching a decision. Whether the purpose or obligations contained in two parts of a contract are "related" is not likely to be obvious until one knows what the ultimate decision will be.

C. Alternative Analysis

Rather than starting from the *Gardinier* test, it may be more helpful to canvass the cases which have addressed this issue, and evaluate the criteria which actually determined their outcome. Such an analysis reveals that three factors have been regularly replied upon by the courts in deciding whether a single contract is severable into two or more different executory contracts: (1) whether the underlying transaction objectively gave birth to one integrated agreement or two severable agreements; (2) whether the application or ordinary principles of contract construction favors finding a single underlying contact or severable agreements; and (3) equitable considerations regarding the appropriateness of the result sought.

1. The Underlying Transaction

One of the factors which has generally proved most outcome-dispositive is the nature of the underlying transaction: as a factual matter, were the separate contracts different but inherently integrated aspects of a single underlying transaction, or were they merely put together. Often, courts speak in terms of the intent of the parties: did they intent the two agreements or provisions to be inherently and inextricably intertwined? For example, some courts have found the sale of a business which includes a lease of the business premises to be an "inherently integrated" transaction; on the other hand, contracts for the payment of a brokerage commission which are included in the underlying sales contracts have been found to be merely "put together."

An excellent example of the potentially dispositive nature of this criteria can be found in *In re Cafe Partners/Washington 1983*. In *Cafe Partners*, the debtor had obtained two tenant improvement loans from its landlord, in the aggregate amount of $1,648,000, for the development of a restaurant on the leases premises. Although repayment of the loans was a requirement of the lease, the loan repayment obligation was not denominated "rent". The debtor sought a determination that it could assume and assign the lease without curing or agreeing to repay the tenant improvement loans. Rejecting the debtor's motion, the court explained:

> [T]he use of the premises was not intended to be treated as a separate and distinct transaction from the loans, but to be conditioned on their timely repayment. Thus... the use of the premises and the loans cannot be separated into two contracts.

Similarly, *In the matter of T&H Diner, Inc.*, the debtor and a creditor had entered into multiple separate agreements for the lease of property and sale of the business on the property including 120 separate promissory notes. The debtor wished to assume the lease but was in default under its terms and the terms of the other agreements. In declining to allow the debtor to assume the lease without assuming and curing the defaults under the other agreements, the court stated:

> The notes and lease were integral parts of a single transaction which transferred the entire restaurant and diner, the land upon which it operated, its equipment and goodwill to the debtor.

*****

> The court finds that the lease and sale agreements form one indivisible transaction. Thus, the debtor's failure to make the note payments would constitute a default under the lease. This incurred default precludes assumption of the lease as the debtor has failed to comply with 11 U.S.C. §365(d)(3) which requires the debtor to timely perform **all** of its obligations under the lease until it is assumed.

In contrast, where courts have concluded that there are separate, severable contracts, the decision have generally been based on a finding that there were multiple underlying agreements, which were related but substantively distinct. This case law relies on a distinction between "agreements" and "transactions": a single underlying transaction spawning more than one agreement or executory contract.

Instructive on this point in *In re Pacific Express, Inc.*, in which the Court was faced with a transfer of equipment denominated as a "lease" coupled, as part of the same transaction, with a maintenance agreement. The Ninth Circuit explained:

> The parties agree, and we concur, that the "Lease Agreement," the Maintenance Agreement, and the software license were all parts of a single transaction. [cite omitted] However, that does not mean that they constituted a single contract for purposes of §365. If the agreement for the secured sale of the Original Agreement can be segregated from the agreement to maintain and license software for that equipment, then there are two contracts here, and each must qualify as an "executory contract" or "unexpired lease" in order for it to require assumption or rejection.
>
> *****
>
> We believe that the Maintenance Agreement and software license are sufficiently separate from the Lease Agreement as not to make an executory contract out of what was essentially a completed installment sale of the Original Equipment accompanied by a security agreement.... As such, the Maintenance Agreement did not suffice to make the entire agreement executory, but properly may be regarded as a separate transaction for the purposes of §365.

Similarly the court in *In re Cutters, Inc.*, determined that a single contract contained severable agreements. In *Cutters* the debtor had sold its catalog division, its trademarks and related property related to Singer. In addition, within the same agreement, Singer agreed to accept on consignment certain of the debtor's inventory and market it for a commission. The debtor sought to reject the purchase agreement as an executory contract in order to relieve itself of a covenant not to compete with Singer. The court concluded that there were in fact two separate agreements: the sale of the assets, including the noncompetition agreement, which was no longer executory because the assets had already been transferred and the debtor had been paid, and the consignment of the inventory, which remained executory and capable of assumption or rejection.

In each of these cases, the courts have examined the nature and content of the underlying transaction, attempting to give effect to the objective intent of the parties. Where there is a single, integrated underlying agreement, that agreement has been enforced as a whole even it it was reflected in multiple documents. Conversely, where the underlying transaction gave birth to more than one contract which was separate in nature, the courts have permitted those contracts to be administered separately, even when they were embodies in a single document.

2. Contract Terms

Although by no means as dispositive as the nature of the underlying transaction, courts have afforded a fair amount of respect to the provisions of the contract and the results which would arise under otherwise applicable non-bankruptcy law.

> For example, the court in *Cafe Partners*, stated that:
>
> The Lease documents clearly provide that the use of the subject premises is conditioned upon, among other things, timely payments of the amounts owed pursuant to the Lease, including all Rent and Additional Rent... The Lease documents are thus unambiguous that this is an entire contract....

In *In re Karfakis*, the Court harmonized an analysis of the language and terms of the contract with a focus on the intent of the parties, explaining:

> In discussing the divisibility of contractual agreements, the Pennsylvania Supreme Court said "[t]he primary inquiry in resolving this question is whether the language employed in the contract clearly indicates the intention of the parties that the contract of the parties be entire or severable."
>
> *****
>
> Aside from being coterminous and containing cross default provisions, it is readily apparent that one agreement is of no utility without the order... The court is persuaded by these facts that the parties intended the two separate contracts, the Lease and Franchise Agreement, to constitute a single contractual agreement.

The *T&H Diner* court also focused on the language of the underlying contracts reaching its conclusion:

> In this matter the lease and purchase agreements are inextricably intertwined. the lease of the land and the sale of the business operating on that land are not, in the instant matter, divisible agreements.
>
> *****
>
> This [cross] default [failure to pay the promissory notes] precludes assumption of

> the lease as the debtor has failed to comply with 11 U.S.C. §365(d)(3) which requires the debtor to timely perform **all** of its obligations under the lease until it is assumed.

To the same effect is the analysis of the *Easthampton* court:

> The lease is part and parcel of one unified transaction... The documents were executed simultaneously and are replete with language indicating that a default on the the note would be considered a default on the lease... It is clear that payment on the note was a principal element of the overall agreement and it was a major consideration in effecting the lease of the premises. Severance of the note from the lease would deny the creditor the benefit of his bargain and would result in an unjust windfall for the debtor.

Finally in *In re Pollock*, the court determined that a lease for property and payments under a note for the purchase of the leased business constituted separate agreements because, in part, the lease and note were separate documents *not* expressly incorporated into each other; the court also relied on the rule of construction that ambiguity in the agreements is resolve against the drafter.

3. Equitable Concerns

A final and prevalent concern found in many of these cases is to insure that the result obtained comports with ordinary principles of equity and fair play.

this concern was eloquently described in *Easthampton*, where the debtor had executed promissory notes for the purchase of a business at the same time it leased the business premises; the lease had a cross-default clause linked to performance under the promissory notes. In rejecting the debtor's request that it be permitted to assume the lease while ignoring the promissory notes, the *Easthampton* court explained:

> [T]he debtor asserts that the rehabilitative spirit of the Bankruptcy Code allows for the severance of the two obligations upon assumption of the lease. The debtor argues that lease termination conditions, which are unrelated to the payment of rent, frustrate federal bankruptcy policy by unnecessarily encumbering a valuable asset which plays an important role in the debtor's reorganization.
>
> This argument is not convincing. While it is recognized that within the context of the reorganization this Court has the equitable power to modify lease provisions if ti would benefit the estate and not significantly prejudice the lessor (cites omitted), equity will not countenance the debtor's exercise of §365 to relieve itself of conditions which are clearly vested by the contracting parties as an essential part of the bargain and which to not contravene overriding federal policy.

This insistence on a sense that the result of the court's ultimate order be equitable runs consistently through the case law.

III. Conclusion

Bankruptcy often yields counter-intuitive results. Perhaps this is nowhere so evident as it is when bankruptcy courts slice and dice contracts, allowing the debtor to assume some provisions while rejecting other provisions. Recourse to the *Gardinier* test, which is universally cited as the "rule" regarding this issue, provides little analytical assistance or help to the practitioner who seeks to predict the most likely outcome.

The case law has consistently looked to three dominant criteria in order to select the appropriate result, regardless of whether *Gardinier* is cited with approval. Those criteria are: whether the underlying transaction objectively gave birth to one integrated agreement or two severable agreements; whether the application of ordinary principles of contract construction favors a single underlying contract or severable agreements; and equitable considerations regarding the appropriateness of the result sought. These criteria are accessible, can be applied in most cases with relatively clear results, and have substantial predictive utility. These criteria - and not the language of the *Gardinier* test - should be the focus of the inquiry for the courts and counsel.

www.stjames-law.com