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Last in Line

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Avoiding Contract Divisibility to Get You Paid as an Unsecured



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Contract divisibility could be critical for unsecured creditors that are counterparties to executory contracts. Whether the bankruptcy court ultimately decides to view a creditor's multiple, interrelated agreements with the debtor as divisible for purposes of assumption, can mean the difference between being the last in line to get paid on a unsecured claim or skipping ahead. Contract assumption can also provide immunity against preference litigation. This article explores what makes a contract inseverable for purposes of assumption and how that can benefit creditors. It also provides guidance to unsecured creditors in negotiating future agreements with their clients.

What Makes a Contract Divisible?

It is well settled that when a debtor assumes an executory contract, it must assume the contract as a whole; a debtor cannot cherry-pick the contract provisions it wants to assume while rejecting others. Since courts generally apply the principle of *cum onere* to the assumption of an executory contract under 11 U.S.C. § 365,¹ if the debtor assumes the contract, it would be required to do so "subject to the benefits and burdens thereunder."² Similarly, where multiple contracts are intended to comprise one agreement or transaction, a party might not sever them for purposes of assumption or rejection.³

Divisibility is a question of state law,⁴ and the parties' intent is often a factor used in determining divisibility of a contract.⁵ If the parties' intent is not clear from the plain language of the agree-

ments, courts often look to the interrelatedness of the obligations,⁶ the subject matter of the agreement,⁷ the conduct of the parties⁸ and whether the parties would be willing to exchange part of the performance irrespective of subsequent events, or whether the divisions made are simply for the purpose of requiring periodic payments.⁹ Ultimately, creditors seeking to prevent a debtor counterparty from severing multiple agreements in bankruptcy need to be mindful in how they structure the agreements under the law governing such agreements.

Contract Indivisibility Can Get You Paid and Shield You from Preference Litigation

Contract indivisibility can benefit an unsecured creditor in at least two ways. Both stem from the requirement that "before a debtor assumes an agreement, [it] must cure all defaults and make the other party to an agreement whole."¹⁰ The more obvious benefit is that as a result of the requirement to cure, the debtor must pay the creditor in full on all agreements that have been deemed by the court to be a single, indivisible contract. The less known is commonly referred to as the "Kiwi" defense to preference litigation.

Getting Paid in Full on Your Claims

If the bankruptcy court finds that the "contract" is severable into individual agreements, the debtor might be permitted to pick which agreements it wishes to assume and reject. The result for unsecured creditors would be being paid in full only on

1 *In re Fleming Cos. Inc.*, 499 F.3d 300, 308 (3d Cir. 2007).
2 *Id.* See also *In re Physiotherapy Holdings Inc.*, 538 B.R. 225, 233 (D. Del. 2015) (citing *In re Fleming Cos. Inc.*, 499 F.3d 300, 308 (3d Cir. 2007)).
3 *In re Buffets Holdings Inc.*, 387 B.R. 115, 120 (Bankr. D. Del. 2008).
4 *In re Contract Research Sols. Inc.*, No. 12-11004 KJC, 2013 WL 1910286, at *2 (Bankr. D. Del. May 1, 2013) (citing *In re Buffets Holdings Inc.*, 387 B.R. 115, 120 (Bankr. D. Del. 2008)).
5 Christopher Bolz, "Whether a Contract is Divisible for Purposes of Section 365 of the Bankruptcy Code," *John's Bankr. Research Libr.* No. 4, p. 4 (2014).

6 *In re T&H Diner Inc.*, 108 B.R. 448, 455 at *450 (D.N.J. 1989) (applying New Jersey law).
7 *In re Wolflin Oil LLC*, 318 B.R. 392, 398 (Bankr. N.D. Tex. 2004) (applying Texas law).
8 *Id.*
9 *Fid. & Deposit Co. v. Rotec Indus.*, 392 F.3d 944, 947 (7th Cir. 2004) (applying Illinois law).
10 *In re NewPage Corp.*, 2017 WL 571478 *3 (Bankr. D. Del. Feb. 13, 2017).

those claims related to the contracts that have been assumed by the debtor. However, if the court finds that the agreements are indivisible, the debtor likely has no choice but to assume all of the creditor's contracts and cure any defaults thereunder. The result for unsecured creditors is having their unsecured claims transformed into administrative-priority claims, which must be paid in full by the estate.

Such was the outcome in *Buffets*, where the bankruptcy court held that individual leases for various properties located in four states, incorporated into two master lease agreements, were indivisible. Therefore, the court held, if the debtor wanted to assume one, it had to assume all.¹¹

The debtor in *Buffets* operated a large steak-buffet-style restaurant chain, which included more than 600 company-operated restaurants, each located in a separate leased space.¹² The tenants wired the total rent to the lessor in a lump sum, but the rents were allocated among each of the restaurants.¹³ The bankruptcy court reasoned that standing alone, the apportionment of payments among individual components was not determinative of whether parties intended to treat the contract as divisible.¹⁴

The court also found that just because the mix of individual leases governed by the master agreements might change under certain circumstances, this was not an indication as to an intent to have the individual leases considered separate agreements under all circumstances.¹⁵ Arguments that cross-default provisions in the agreements were invalid under relevant bankruptcy law were similarly rejected. The court ultimately concluded that the landlords' economic interest was in the aggregate package of leases, so allowing the debtors to assume or reject leases on an individual basis would deny the landlords the benefit of their bargain.¹⁶

However, courts have also found that master agreements and purchase orders issued under the such agreements are divisible.¹⁷ For example, *Hawker Beechcraft* (the debtor) was a party to two pre-petition master-purchase agreements with one of its suppliers.¹⁸ The master agreements set forth the general terms that were to be incorporated into any purchase orders issued for the manufacture and delivery of various aircraft components.¹⁹ *Beechcraft* sought to assume the master agreements and some of the purchase orders, but reject purchase orders for parts used in discontinued aircraft lines.²⁰

The bankruptcy court allowed the debtor to assume only some of the purchase orders, citing language in one of the master agreements, which stated that "the Purchase Orders were separate from the Master Plastics Agreement."²¹ The court also discussed the definition of "transaction agreements," which did not include a reference to the purchase orders, and the integration clause ... which stated "[t]he Transaction Agreements ... constitute the entire agreement between the Parties."²² The court further noted that each pur-

chase order had an integration clause clearly stating that it contained the entire agreement of the parties and did not refer to the master agreement or the asset-purchase agreement.²³ Thus, the debtor's rejection of some purchase orders would not have resulted in a default under the master agreement.

Had the master agreements and purchase orders contained language clearly describing the parties' intent to treat them as a single, interrelated contract, the debtor's rejection of some purchase orders would have triggered a default under all agreements. The debtor would not have been able to assume some purchase orders without paying the creditor's claims in full.

How Assumption of an Executory Contract Can Work as a Defense to a Preference Action

In preference litigation, the trustee has the burden to demonstrate under 11 U.S.C. § 547(b)(5) that if not recovered, the alleged preferential transfers would enable the defendant creditor to receive more than such creditor would receive than it would have received if the payment had not been made and it had been received a distribution under chapter 7.²⁴ The *Kiwi* defense essentially bars a preference claim because "before a debtor assumes an agreement, [it] must cure all defaults and make the other party to an agreement whole."²⁵

When the underlying agreement between the debtor and creditor has been assumed in bankruptcy, the trustee cannot sustain its burden under § 547(b)(5) because the defendant is no longer an unsecured creditor; it was entitled to all payments under the assumed contract. Therefore, assumption can create a complete defense to a preference action.

When several interrelated agreements are subject to the *Kiwi* defense, their divisibility again becomes important. If all of the agreements must be assumed by the debtor, the trustee's preference action fails for the same reason: The counterparty to the executory contract is entitled to full payments made under the assumed agreement. In *NewPage*, the bankruptcy court addressed this issue.²⁶

NewPage and C.R. Meyer & Sons Co. (CRM) were parties to a master construction agreement, pursuant to which CRM was to provide services and items necessary to complete the work described in purchase orders to be issued under the master construction agreement.²⁷ The master construction agreement referred to each purchase order as a separate contract, and the purchase orders referenced the master construction agreement directly.²⁸ The purchase orders contained very few terms, and only served to document work and facilitate a payment.²⁹

NewPage's chapter 11 plan contained a catch-all provision that stated that *NewPage* was assuming all executory contracts not already assumed and not specifically identified on a list of rejected contracts as of the confirmation date.³⁰ The litigation trustee sued CRM seeking to avoid approximately \$2.3 million paid by *NewPage* to CRM prior to the bankruptcy filing.³¹ The issue for the bankruptcy court was

11 *In re Buffets Holdings Inc.*, 387 B.R. at 124 ("To allow the Debtors to reject one of the leases without continuing to pay the total rent would be to destroy the essence of FP's bargain.")

12 *Id.* at 121.

13 *Id.*

14 *Id.* at 121-22.

15 *Id.* at 123.

16 *Id.* at 127-28.

17 *In re Hawker Beechcraft Inc.*, No. 12-11873 (SMB), 2013 WL 2663193 (Bankr. S.D.N.Y. June 13, 2013).

18 *Id.* at *2.

19 *Id.*

20 *Id.*

21 *Id.* at *6.

22 *Id.*

23 *Id.*

24 *See In re Kiwi Int'l Air Lines Inc.*, 344 F.3d 311, 317 (3d Cir. 2003); 11 U.S.C. § 547(b)(5).

25 *Id.* at *3.

26 *In re NewPage Corp.*, 2017 WL 571478 (Bankr. D. Del. Feb. 13, 2017).

27 *Id.* at *1.

28 *Id.*

29 *Id.*

30 *Id.* at *5.

31 *Id.* at *1.

whether the transfers were insulated from avoidance under the *Kiwi* defense because the master construction agreement and each of the purchase orders constituted a single, integrated contract that had been assumed under NewPage's confirmed chapter 11 plan.³²

The court found that under applicable state law, the intent of the parties was to create separate, severable contracts because the right to payment arose under each separate purchase order.³³ For example, the master construction agreement expressly provided that each new purchase order would constitute a separate contract.³⁴ The court concluded that the parties' intent in entering into each purchase order was to form an agreement separate from the master construction agreement and outstanding purchase orders.³⁵

Because the agreement and purchase orders were deemed to be separate contracts, the court had to consider the executory nature of each agreement. The court found that the master construction agreement was an executory contract that had been assumed under the catch-all provision of the plan.³⁶ However, because no evidence was available to establish that the purchase orders were executory, the court was unable to determine whether any payments made under the purchase orders were protected by the *Kiwi* defense.

Takeaways for Creditors

The foregoing case law highlights the importance of including specific language in multiple, interrelated documents to demonstrate the parties' intent to create an indivisible agreement. The exact language to be included in the agreements will depend on the state law governing the parties' relationship. Courts will look for evidence in the agreements of the intent to create an indivisible contract.

Perhaps the most obvious drafting error to avoid is describing each agreement as a separate contract. Instead, creditors should seek to incorporate language demonstrating that the various agreements are part of one large transaction, such as including integration clauses that clearly incorporate all of the related contracts.

Another factor often reviewed by the courts is whether contract payments are apportioned among the agreements or made in a lump sum. One approach would be to structure payments on a periodic basis (*e.g.*, monthly) by sending a single invoice for payment on all related contracts instead of sending individual invoices for each project. The fact that a single invoice and payment was made by the independent tenants to the landlord was a factor that the *Buffets* court used to determine that the individual leases were "economically interdependent," and therefore indivisible. **abi**

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³² *Id.*

³³ *Id.* at *4-5.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at *6.