Master Leases and Cross Default Clauses in Bankruptcy

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Using powers granted by the Bankruptcy Code, tenants in bankruptcy who are leasing multiple properties from the same landlord may be able to "cherry pick," continuing performance under some leases and rejecting others. How can landlords lessen this risk?

Landlords who lease multiple properties to the same or related tenants face unique risks in the event that the tenant or tenant group files bankruptcy. Among the special powers granted to debtors and trustees in bankruptcy is the power to decide whether to assume a lease and continue performance under it or reject the lease and no longer perform under it.[1] In the context of multiple related leases, these powers could allow a bankrupt tenant to assume those leases with pricing or other terms favorable to the tenant, while rejecting leases that are favorable to the landlord but unfavorable to the tenant. The risk of such a result is unacceptable to most landlords, who often entered into the multiple leases as part of a single integrated business deal, with risk for both landlord and tenant spread over a number of properties. The landlord loses the benefit of its bargain when the debtor tenant is allowed to use its bankruptcy to "cherry pick" the good leases. How great is this risk, and what steps can a landlord take to alleviate it in drafting a lease? This article addresses two approaches to the problem, and the treatment those approaches have received in the courts.

First, this article discusses whether a landlord that is leasing multiple properties to a single tenant can bind the lease for each property under a single master lease, so that if the tenant becomes subject to a bankruptcy proceeding, it must assume or reject the lease for all properties as a single unit, rather than assuming the lease for certain properties and rejecting it for other properties. Although the answer to this question ultimately turns on state law rules governing the severability of leases and contracts, and is therefore likely to vary from state to state, it is possible to gain some general guidance on the issue by looking at bankruptcy court decisions.

The second issue addressed is whether bankruptcy courts will enforce cross-default provisions in separate leases, so that rather than allowing a debtor to assume favorable leases and reject unfavorable ones, the debtor is forced to cure defaults under all leases subject to the cross-default provision, or reject them all. The case law suggests that while many bankruptcy courts are not inclined to enforce these provisions, other courts will enforce them when the underlying lease agreements are sufficiently intertwined.

Severability Of Individual Leases Under A Master Lease

Bankruptcy law determines when a debtor in bankruptcy may assume and reject leases.[2] It is well established under bankruptcy law that a debtor cannot retain the beneficial aspects of a single contract while rejecting the contract's burdens; rather, the debtor must either assume or reject the entire contract.[3] The issue of whether tenants can engage in piecemeal assumption or rejection of properties under a master lease thus hinges on whether the components of the master lease can be severed; that is, whether the court will accept the argument of a debtor or bankruptcy trustee that a

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document which appears to be a single lease should be treated for assumption or rejection purposes as multiple separate leases.

State law governs issues of lease severability.[4] Because contract law varies from state to state, there exists no uniform test for evaluating the severability of master leases. As noted in 17 *Am. Jur. 2d Contracts* § 325, "[n]o formula has been devised which furnishes a test for determining in all cases what contracts are severable and what are entire." Severability of contracts is often determined using an open-ended "facts and circumstances approach."[5] This approach leaves bankruptcy courts free to focus on the characteristics of each lease that they determine to be most indicative of the parties' intent, and correspondingly makes it difficult to positively predict the outcome of cases involving issues of lease severability.

Nevertheless, there are a number of factors that courts generally consider important in determining whether a lease or executory contract is severable. The following paragraphs discuss these factors. Because the particular factors that a court will consider depend on state law and, to some extent, the proclivities of that court, all courts may not give the same weight to each factor, and not every court will consider each of the factors discussed below.

Parties' Intent

As a general matter, "the intention of the parties is the governing principle in contract construction."[6] Most courts seem to agree that "the most important factor in determining whether a contract is 'entire' or 'divisible' is the intent of the parties."[7] To determine whether a lease is severable under this "intent test," the court asks "whether the parties assented to all the promises [in the contract] as a single whole, so that there would have been no bargain whatever, if any promise or set of promises were struck out."[8] However, the means by which courts ascertain the parties' intent differ from case to case. Courts will certainly consider an express statement by the parties that they intend to enter into a single indivisible agreement, but when such a statement is not present—and often even when such a statement is present—courts will seek to discern the parties' intent by looking to key terms of the agreement and the surrounding circumstances.

Courts may begin by looking to whether the lease or contract contains, on its face, a clear statement that the parties intended to create a single, non-severable agreement.[9] For example, the parties may include in a master agreement an explicit statement that the parties intend for it to be a single, integrated and indivisible contract. They might even go further and state that in the event of a bankruptcy of either party, that party would be required to assume or to reject the entire agreement. If multiple documents are at issue, the parties may include cross-references between the various documents, conditioning them upon one another and making clear that although there is more than one document, the documents are intended to constitute collectively a single contract.[10] Conversely, to the extent that multiple documents do not expressly incorporate or refer to one another, courts may note the absence of that factor in finding the agreements severable.[11]

While a clear statement by the parties that an agreement is intended to be non-severable is a factor courts will consider in their analysis, such a statement will not prevent severance of a master lease if a court concludes that, despite the parties' express statement, the terms of the agreement and other facts and circumstances indicate that it actually consists of severable obligations. Accordingly, courts have severed leases and contracts despite language clearly indicating the parties' intent to create a unified contract.[12] Another court held that if "a document purports to contain a single contract but in reality contains separate severable agreements ... the debtor may reject a severable executory agreement."[13]

In sum, bankruptcy courts tend to elevate substance over form. For that reason, bankruptcy courts are unlikely to rely solely on the parties' stated intent where it appears that, based on the terms of the agreement, the parties actually intended an arrangement that, in substance, would more appropriately be characterized as a series of separate leases. Nonetheless, a clear statement of the parties' intent is probably helpful, since bankruptcy courts have noted that the parties' stated intent is at least a factor to be considered in the severability analysis.

Terms Of Contract As Indicative Of Intent

As noted above, even where parties have expressly stated their intent, courts may not be willing to base their analysis solely on that statement. Rather, they will also consider the terms of the contract and surrounding circumstances in an effort to infer intent.[14] One treatise has listed the contractual terms that courts will find most informative when analyzing the parties' intent with regard to severability:

> (i) whether the leases ... are coterminus [sic]; (ii) whether rent provisions establish the same rent for each lease, one rental payment for all leases, or appropriate different rentals for each building; (iii) whether notice of termination of one lease constitutes termination of all leases; (iv) whether leases could be assigned or sublet to a party that does not propose to take an assignment or sublease of all properties; and (v) whether separate consideration supports each lease agreement.[15]

If the court determines that the parties did not intend to bind all individual leases or lease subsections under a single non-severable master lease, it is likely to allow the tenant in a bankruptcy proceeding to assume or reject the lease with respect to each property individually. The following sections discuss how the factors listed above may be analyzed by a court.

Are Lease Agreements Coterminous?

In analyzing severability, a number of bankruptcy

court decisions have focused on whether leases or other agreements are coterminous.[16] For example, a court found that one factor indicating that a franchise agreement and lease were "inextricably interwoven and for all practical purposes comprise[d] a single contractual relationship" was that they were coterminous.[17] Where leases or other agreements are not coterminous, courts point to that factor as one basis for finding agreements to be separate and distinct.[18] Although lease agreements must usually be conterminous in order to be considered a single lease, this fact alone may not prevent courts from severing them in a bankruptcy proceeding.[19]

Because it is not particularly difficult to examine the terms of the leases in a master lease and determine whether this factor is present, courts do not devote a large amount of time to its analysis. Nevertheless, its importance should not be discounted with regard to a master lease that governs multiple properties. For each property under the lease, the lease term and any extension periods should be coterminous with any other property governed by the same master lease.

Apportionment of Rent

Another key factor in determining the severability of lease agreements bound under a master lease is whether rent is apportioned among the lease agreements or properties. Courts are less likely to sever a master lease requiring a single payment for multiple properties than a master lease referencing independent payments for each property.[20] Courts have held that the absence of apportioned consideration for lease agreements under a master lease "clearly indicates [these agreements] have no independent identity."[21] When lease agreements do not contain individual provisions for rent, they "do not make economic sense taken alone" and should not be severable.[22] A state court addressing the severability of a lease of four signs held that, because the lease involved "a single instrument for all four signs" and "provided for a single monthly rental," rather than apportioning the rental among the signs, the contract was indivisible.[23]

However, where other factors suggest that the parties intended the agreement to be divisible, a court may look past the fact that the agreement calls for a single payment, especially if the parties have expressly allocated rent to individual properties. For example, one court held that even though a master lease called for a single rent payment for all leased properties, this fact "had little significance since such payments could be allocated at any time using an allocation that was in place for just such purpose."[24]

Similarly, in *Integrated Health Services* the court considered whether three leases and a non-competition agreement were supported by separate consideration, *i.e.,* whether rent was apportioned.[25] The court emphasized the fact that each lease had a separate rental payment obligation and the non-competition agreement had its own payment obligation, and found that they did not constitute an integrated agreement even though the amount of rental payment obligations was tied to, and could be reduced by, payment on the related non-competition agreement.[26]

Termination of Leases

In evaluating the severability of master leases and contracts, courts also consider whether the termination of an individual lease or contract effects the termination of the entire contract. If the landlord or tenant has the ability to terminate what purports to be a single integrated master lease with respect to some of the demised properties, but not others, that would likely be a factor suggesting that the leases are severable. However, if termination can occur only with respect to the entire lease even if a default relates only to one particular property, that would be a factor suggesting the lease should not be severable.

In *Convenience USA,* a master lease contained several such provisions that lead the court to conclude it was a severable agreement. First, the lease provided that if one property were condemned, the lease would terminate only with respect to the condemned property.[27] Similarly, destruction beyond repair of a building on leased property would terminate the lease only as to that property.[28] Finally, the master lease contained a provision granting the landlord the right to sell or otherwise transfer any number of the leased properties at any time during the lease term.[29] The court reasoned that with respect to each of these provisions, the parties could have provided for termination of the entire lease, rather than termination only as to the affected property.[30] In the court's view, the parties' choices reflected the economic realities of their bargain: the master lease was in substance an economically separable agreement, and each of the provisions indicated an intent to have a divisible contract.[31]

Thus, a landlord that wants to minimize the chance that its master lease will not be severed should make sure that the termination provisions in the master lease apply to all of the properties, regardless of the default or other event that gives rise to the termination.[32]

The case law suggests that this issue could arise in one of two other circumstances in a leasehold context. First, courts have found that where multiple agreements are, by their nature, "inextricably intertwined," the termination of one agreement will effectively constitute termination of related agreements. For example, *In re Karfakis* involved the severability of a franchise agreement and a lease.[33] The debtor-tenant executed the franchise agreement and the lease on the same day.[34] The lease related to a location for the operation of a Dunkin' Donuts, and the franchise agreement permitted the tenant to operate a Dunkin' Donuts at the leased premises.[35] The court held that the contracts were not severable because "one agreement [was] of no utility without the other."[36] Without the franchise

agreement, the tenant could not fulfill its obligations under the lease, and without the lease it could not fulfill its obligations under the franchise agreement. Thus, a termination of one of the contracts should result in termination of both—not only because the parties included that provision in the agreement, but also because linking the agreements in that manner makes business sense given the interrelated nature of the two contracts, since there would be no purpose to either contract once the other contract was terminated. To the extent contractual arrangements depend upon each other in this way, the contract may be protected from severance in a bankruptcy proceeding.[37]

Although the *Karfakis* case is not directly relevant to the issue of a master real property lease for several properties, it is probably relevant by analogy. To the extent that a landlord can persuade a court that there is a compelling business relationship between the various property leases, such that the leases would not make sense separately, or would not have been entered into separately, the risk of severability is reduced. Naturally, this will depend on the nature and use of the leased properties, and the relationship between the properties' uses. In appropriate cases it may be worthwhile to explain the nexus between the properties and their uses in the master lease document, and the fact that because of this nexus the parties would not have entered into the leases or other contracts on a separate basis.

The second scenario will arise in circumstances where, rather than governing multiple properties within a single master lease, a landlord enters into separate leases for each property and then attempts to link them with an overarching master lease, and with cross-default provisions in each of the subsidiary leases. In this way, a landlord could attempt to prevent tenants from terminating individual leases, and force them to either cure defaults relating to all of the properties or terminate the leases with respect to all properties. The general question of the enforceability of cross-default provisions in bankruptcy is discussed in more detail below. In the present context, it should be noted that this method of linking leases may not be independently effective as a factor preventing severance, as courts have held that, "in the bankruptcy context, cross-default provisions do not integrate otherwise separate transactions or leases."[38] Nevertheless, courts have pointed to cross-default clauses as one factor indicating the non-severability of an agreement.[39] As these cases show, courts are split on the significance of cross-default provisions. Some, such as *Karfakis* and *Easthampton Sand & Gravel,* seem to take a cross-default provision as evidence that agreements are interrelated. In contrast, other courts will not enforce such provisions absent other, independent evidence that the agreements are interrelated.[40]

Although the cross-default factor typically arises in cases where there is more than one lease agreement (perhaps linked by an overarching master lease), a similar analysis appears relevant where a single master lease agreement is used. While a cross-default clause does not make sense in the context of a single agreement, it does make sense for the agreement to make clear that any default under the master lease is a default under the entire master lease, giving the landlord remedies with respect to the entire lease, even if the default relates to only a single property under the lease. Partial defaults that relate to individual properties and afford remedies only with respect to those particular properties would seem to undercut the concept of an integrated master lease.

Does The Master Lease Permit the Tenant to Assign or Sublease?

One treatise suggests that another factor that may merit consideration is whether the master lease may be assigned or subleased only as a unit, or whether this may be done on an individual basis.[41] If a lease agreement purports to create a master lease, but permits the tenant or tenants to sublet individual properties under the master lease, rather than requiring the entire premises subject to the master lease be sublet as a whole, courts could view this as evidence that the master lease is severable. It does not appear that this factor has been relied upon to any significant extent in the case law. However, a landlord trying to avoid severance of a master lease should permit assignment or subleasing only as to the entire premises, absent a compelling business reason to do otherwise.

Separate Consideration For Each Lease

A lease or contract (or a part of a master lease) that is supported by "separate and distinct" consideration, may indicate to a court that the parties intended it to be a separate agreement or transaction, which should be able to be assumed or rejected separately.[42]

A situation could arise where individual leases or contracts (or individual parts of what purports to be a master lease) are supported by separate consideration. This might occur, for example, where separate business deals, reached independently and for unrelated reasons, are wrapped into a single "master contract" or "master lease" for the purpose of trying to assure that they are rejected together or assumed together. In such a case, the separate consideration for the agreements at issue is likely to be a factor in favor of finding severability.

For example, in the *Gardinier* case, the debtor sought to assume, as one agreement, its contractual obligations to (i) sell real property, and (ii) pay a brokerage commission related to the sale.[43] The creditors' committee objected, arguing that the debtor should assume the land sale agreement but reject the brokerage contract, on the theory that the brokerage contract, while incorporated in the same document as

the sale contract, was actually a separate agreement.[44] The court agreed with the committee, finding that the consideration paid to the broker by the seller was completely separate and distinct from the consideration that flowed between buyer and seller.[45] The debtor in the case was allowed to assume the contract for the sale of land and reject the brokerage agreement, even though they were part of a single document.

In *In re Integrated Health Services, Inc.,* the debtor sought to assume three leases of health facilities, under which the debtor was the tenant, and reject a non-competition agreement entered into simultaneously with the leases.[46] The bankruptcy court allowed the debtor to reject the non-competition agreement and assume the leases, finding that the leases were severable from the non-competition agreement.[47] As noted above, one element that was important to the court's analysis was that the rental payment obligation to the landlord under each of the leases was separate from the payment obligation to the individual under the non-competition agreement.[48] But another factor appears to have been the court's belief that the non-competition agreement was a separate business deal from the real estate leases, and that the separate payment constituted distinct consideration for that agreement.

This factor is probably somewhat less likely than others discussed herein to be applied in the context of a master real estate lease, but it does illustrate the importance of making clear in the master lease that the entire transaction is a single integrated deal, with no separate consideration, and the risk of adding into a master lease separate or unrelated business arrangements in an effort to try to require such arrangements to be assumed or rejected along with the master lease.

Surrounding Facts And Circumstances

The foregoing cases show that courts will attempt to determine the parties' intent with regard to severability of master agreements both from the parties' stated intent and also from the terms of the contract itself. In addition to those considerations, courts may also consult other factors not necessarily contained within the documents themselves. As with the analysis of lease terms, no single factor will be determinative, and different courts will attribute different weight to each factor. Further, to the extent that a court can satisfy itself of the parties' intent based on the language and terms of the agreement, it may not consider attending facts and circumstances at all.[49]

One factor courts may consider is whether all elements of the contract were included in a single document, signed at the same time by all parties. Where this is the case, the contract is more likely to be treated as non-severable.[50] While a single document may indicate a non-severable contract, the presence of countervailing factors cannot be discounted, and other bankruptcy courts have held that "a single document may contain two distinct contracts which may be separately enforced."[51] On the other hand, a court may also find that multiple documents constitute a single, non-severable agreement.[52] In cases where multiple documents are involved, a court may look to whether they were executed simultaneously as a factor supporting the finding that they constitute a single agreement.[53]

The underlying subject matter of the agreement may also be an important factor. For example, in *Convenience USA,* the subject matter of the master lease was 27 convenience stores in 18 different cities, each of which could be operated separately and independently.[54] Thus, the court found that based on the nature of the properties, the lease could be divided into separate and independent leases for purposed of assumption and rejection in bankruptcy.

As another example of looking to surrounding facts and circumstances, one court considered the fact that leases for different floors of an office building were "contracts for different spaces," and that "one [lease] agreement is not the subsidiary of the other."[55] The debtor was the lessee of three floors of an office building and sought to reject leases for two of the floors and to assume and assign the lease for the third floor.[56] The court found that leases for separate floors should not be construed as a single instrument, and allowed the debtor to assume and assign the lease for one floor while rejecting the others.[57] The surrounding circumstances, namely the fact that the properties were economically and physically separable, was a basis for the court's finding that the leases could be treated independently under Section 365.[58]

"Business Establishment" Severability Test

The forgoing tests and general principles governing severability are based on state law. In a 1999 decision, a bankruptcy court in California articulated and applied a severability test with an independent basis in federal bankruptcy law.[59] *Plitt Amusement* involved a company's lease of three theaters from a single landlord. In the bankruptcy proceeding, the landlord argued that the three lease agreements were "one indivisible, nonseverable transaction" that must be assumed or rejected in its entirety.[60] In analyzing the case, the court first noted that, unlike partnership and corporation law, bankruptcy law may not be superceded by agreement of the parties and therefore is not "subject to artful drafting."[61] The court stated that the "chief purpose" of bankruptcy law "is to relieve debtors of their improvident agreements."[62] Accordingly, it is important for a trustee or debtor-in-possession to be able to "pick and choose" advantageous executory contracts and leases, within the limits of Section 365.[63] With these policy goals in mind, the court formulated its "business establishment" severability test.[64]

The "business establishment" test grants the debtor-in-possession or trustee the right "to assume or reject a lease independently as to each business establishment that is property of the estate."[65] A "business

establishment'' is ''what the business community ordinarily treats as a business entity or as a unit of commerce.''[66] The court noted that a separate business establishment will not always exist merely because a debtor's business is spread out over multiple geographic sites; each geographic site ''must constitute a business that can, and typically does, operate separately.''[67] The court held that the three theater leases could be individually assumed or rejected by the tenant, regardless of whether the landlord intended the leases to form a single integrated agreement, because each theater constituted a separate ''business establishment'' under the court's approach.[68]

The court illustrated its reasoning with the following hypothetical:

> Consider a business consisting of 666 retail establishments, each operated on leased property. Suppose that the debtor has purchased the entire business from a third party, who has retained a lessor or sublessor interest in each of the properties. Further suppose that, in consequence of intervening circumstances, many but not all of the leases have turned out to be improvident. By artful drafting the seller could try to prevent the debtor from assuming the profitable business locations, and rejecting the unprofitable, and argue that the debtor could only assume or reject the entire 666-store transaction. In the section 365 context, such an argument would make no sense: it would altogether frustrate the ability of the debtor to rehabilitate the business by assuming the profitable portions of the business. Where a debtor has purchased multiple business establishments from a seller in the same transaction, artful drafting of the sales documents cannot be used to circumvent section 365.[69]

Although the *Convenience USA* case does not mention or cite to *Plitt Amusement,* a portion of the *Convenience USA* case appears to invoke a business establishment test.[70] As noted above, in analyzing the subject matter of a master lease agreement to determine whether that agreement would be severable under state law, the court considered the fact that the master lease governed ''27 separate and distinct convenience stores located in 18 different cities and scattered over a wide area of North Carolina.''[71] Because it appeared to the court that the stores could be operated separately and independently of each other, the court found that the lease could be divided into separate leases for one or more of the properties.[72] In essence, the court found that each convenience store constituted a separate ''business establishment.''

The scope and limits of the ''business establishment'' test are not clearly defined in *Plitt Amusement,* although it has the potential to be quite expansive. It seems to allow a bankruptcy court to largely disregard the way in which the lease is drafted and the parties' intent, and instead to focus on the question of whether separate properties are operated in an integrated way or as separate, stand-alone businesses. This is a pro-debtor test, which would make it difficult to draft a master lease for separate properties that is likely to be upheld. It suggests, however, that where there is a business relationship between the separate properties that are included under a master lease, such that they might properly be considered to be part of a single business, that fact should be set forth in the master lease document.

Because the case also found the leases severable under state law, it is not clear how this test, independently based on a policy interpretation of federal bankruptcy law, might be reconciled with state law in a case where state law clearly established the non-severability of a particular lease or contract.[73]

Enforceability Of Cross Default Provisions

The foregoing sections address the use of a single master lease governing multiple properties. Another approach landlords sometimes use in an effort to link leases to the same or related tenants, and avoid piecemeal assumption or rejection, is to incorporate cross default clauses in each lease, which provide that a default under any of the leases is a default under all of them. The landlord's hope is that by including this provision, the tenant who desires to assume any of the leases must cure defaults under all of the leases, including those leases which the tenant might otherwise choose to reject. A number of bankruptcy court decisions hold that landlords may not use cross-default provisions to ensure that, in the event of a bankruptcy, tenants must assume and cure the default on all leases, or reject all leases containing cross-default provisions. Some courts, however, acknowledge that cross-default provisions are not *per se* invalid, and may be enforced when they are an integral part of the transaction.

Cross-default provisions in a leasehold context may be preempted or prohibited by three sections of the bankruptcy code.[74] First, cross-default provisions may be unenforceable because a debtor's ability to assume and assign leases may be limited only as provided in Section 365(c) of the Bankruptcy Code,[75] and not by the terms of a private agreement. Under Section 365(f)(1), a trustee may assign a lease even if the landlord and tenant included provisions in the lease prohibiting the tenant from assuming or assigning the lease in the event of bankruptcy. In *Sambo's,* the bankruptcy court held that, because ''[a]ny contractual restriction on assignment other than those specified in § 365(c) is proscribed by § 365(f),'' cross-default provisions are not enforceable in a leasehold context.[76]

Secondly, cross-default provisions may be unenforceable in a leasehold context because Section 365(e)(1)(A) prohibits contractual provisions that are conditioned on the financial condition of the debtor.[77] In *Sambo's,* the bankruptcy court held that, because a debtor's inability to perform under a lease is indicative of the debtor's financial condition, ''cross-default provisions operate as financial condition clauses.''[78] The court noted that the use of cross-default provisions had been proposed as an artful way of requiring tenants to cure the default on all leases and assume them as a

group, or reject them all, without expressly including contractual provisions conditioned on the financial condition of the debtor.[79] In evaluating attempts to employ this strategy, courts have held that landlords should not be able to circumvent the intent of Section 365(e)(1)(A) by artfully drafting leases so that all are linked by cross-default provisions. Following the court's reasoning in *Sambo's,* bankruptcy courts have held that cross-default provisions are not enforceable where they affect a debtor's right to assume and assign unexpired leases.[80]

A final argument against cross-default provisions in the leasehold context is that they permit a landlord to claim damages in excess of the maximum amount established by Section 502(b)(6), which limits the maximum amount a landlord is entitled to recover as damages when a debtor rejects a lease under Section 365. Linking all leases with cross-default provisions requires tenants to cure defaults on all leases before they can assume any individual lease, and this puts landlords "in a position of recovering an amount in excess of that allowed by [Section 502(b)(6)]."[81]

The unfavorable light in which some bankruptcy courts have cast cross-default provisions stems from a concern that such provisions limit a debtor's flexibility in administering the estate. Indeed, it appears that bankruptcy courts may be stretching to find a justification in the Bankruptcy Code for declining to enforce cross-default provisions in order to maximize a debtor's flexibility. In explaining their concern with cross-default provisions, bankruptcy courts have stated that, if cross-default provisions were given effect, "[d]ebtors would be unable to assume and assign any of [their contracts] without assuming *all* of them and in so doing, curing *all* defaults under *all* the [contracts]."[82] Courts finding that cross-default provisions are unenforceable in bankruptcy have argued that they "impermissibly restrict the Debtors' ability to assume some of the [contracts] and reject others."[83] The persuasiveness of this policy-based rationale should not be discounted.

At the same time, however, some courts have stated that cross-default provisions are not unenforceable as a matter of law. These provisions may be enforced where the parties knowingly assented to a single transaction,[84] or where the cross-default provision was an integral part of the overall transaction.[85] To establish that a cross-default provision was an integral part of the overall transaction, a landlord should be able to show "either: (1) special consideration furnished by the lessor in connection with the provision; or (2) prejudice to the lessor's lease bargain by its nonperformance."[86]

One court has held that "[b]efore enforcing such a provision ... a court should carefully scrutinize the facts and circumstances surrounding the particular transaction to determine whether enforcement of the provision would contravene an overriding federal bankruptcy policy and thus impermissibly hamper the debtor's reorganization."[87] While recognizing the case law holding particular cross-default clauses unenforceable, the *Kopel* court reasoned that cross-default clauses should only be unenforceable in certain circumstances, namely, when a creditor is attempting to use them to force a debtor to assume *unrelated* obligations and thus improve its overall recovery:

> An overriding principle can be gleaned from these and similar cases: Federal bankruptcy policy is offended where the non-debtor party seeks enforcement of a cross-default provision in an effort to extract priority payments under an unrelated agreement. A creditor cannot use the protections afforded it by section 365(b) (which requires curing of defaults and adequate assurances of future payments as a precondition to assumption of an executory contract or unexpired lease) in order to maximize its returns by treating unrelated unsecured debt as a *de facto* priority obligation.[88]

The *Kopel* court ultimately articulated the following test:

> where the non-debtor party would have been willing, absent the existence of the cross-defaulted agreement, to enter into a contract that the debtor wishes to assume, the cross-default provision should not be enforced. However, enforcement of a cross-default provision should not be refused where to do so would thwart the non-debtor party's bargain.[89]

The court in *Kopel* upheld the cross-default provision in bankruptcy, finding that the cross-default provision in that case—which linked a contract for the sale of a business with a lease of the related property—was an integral part of the transaction.[90] Since there is no federal policy that requires severance of a lease condition solely because it makes a debtor's reorganization more feasible, the cross-default would be enforced.[91] The debtor was therefore required to cure arrears under a note before assuming the related lease.[92]

More recently, the Fifth Circuit Court of Appeals substantially adopted the reasoning in *Kopel* to enforce a cross-default provision linking a mortgage, lease and pharmacy management agreement.[93] In *Liljeberg,* the debtor and its lender had entered into five separate agreements related to the construction, lease, and operation of a hospital complex, along with a pharmacy management agreement and a mortgage securing the construction loan.[94] The pharmacy management agreement contained a cross-default clause which linked that agreement to defaults under "any other contractual agreement" to which the debtor and lender were both parties.[95] The debtor ultimately breached certain mortgage covenants when it defaulted on the note secured by the mortgage, and a judicial lien attached.[96]

The appellate court reversed as clearly erroneous the district court's ruling that the mortgage and pharmacy agreement were not sufficiently interrelated to enforce the cross-default provision.[97] The court found that there was "ample support for the conclusion that the lease and collateral mortgage of the hospital are interrelated with the pharmacy agreement and that there would have been no pharmacy agreement without the lease of the hospital or the loan secured by the col-

lateral mortgage.''[98] Thus, because the lease, mortgage and pharmacy agreements were all part of an integrated transaction, the lender/lessor's bargain would have been ''thwarted'' if the debtor were allowed to assume the pharmacy agreement after the occurrence of incurable defaults on its obligations under the mortgage.[99]

The *Wheeling-Pittsburgh* case also noted that although a court may not enforce a cross-default clause to the extent it interferes with a debtor's ability to assume executory contracts and unexpired leases, a bankruptcy proceeding does not completely invalidate these clauses.[100] In other words, the cross-default clause is not excised from the lease or contract because of the bankruptcy proceeding. Rather, it is inapplicable only during the instant bankruptcy case for the purposes of disposition of the unexpired lease.[101] If the debtor assumes the lease or contract containing the cross-default provision, that provision will remain a part of the lease post-bankruptcy. Although this reasoning leaves open the possibility that the cross-default provisions would be enforceable outside of bankruptcy, or post-bankruptcy with respect to those leases or contracts that are not rejected, this may be of limited use to the landlord, since it is in the bankruptcy context that the cross-default provision is likely to be most important.

Thus, the case law suggests that courts are reluctant to enforce a cross-default provision when doing so would hinder the debtor's right to assume and reject contracts and leases under Section 365, and/or seriously impair the debtor's prospects for reorganization. However, courts will not completely disregard the bargained-for rights of creditors, and to the extent that a creditor can show that a cross-default provision was an integral part of the transaction at issue, the *T & H Diner, Kopel* and *Liljeberg* cases suggest that those rights may be enforceable.

Conclusion

Mainly due to variations in state law and in the facts and circumstances of each case, the case law does not reveal an unassailable method for drafting master lease agreements containing lease arrangements for several independent properties, so that, in the event of a bankruptcy, the tenant must assume or reject the lease *in toto*. However, the cases do suggest that there are provisions to include, and others to avoid, to reduce the risk that a tenant or tenant group in bankruptcy will be able to selectively assume and reject favorable and unfavorable leases. To the extent possible, landlords should anticipate these risks in structuring such a leasing arrangement and drafting the necessary documents.

The master lease should clearly and conspicuously state that it is the parties' intent to enter into a single, non-severable lease agreement. This statement of intent will not prevent a court from severing a lease it finds to contain, in substance, separate agreements, but it is relatively easy to include and some courts have indicated they will give such a statement weight in their overall analysis.

In setting the terms of a master lease, it is important to make the material terms for each individual property the same. There should be a single lease term for the master lease rather than separate terms for each property. Similarly, the rent should not be apportioned among the individual properties. Typically, as a business matter, it will be necessary for landlords to apportion rent among multiple properties in some manner in order to calculate the appropriate overall rent. However, to reduce the risk that the lease will be severed in bankruptcy, the apportionment should not be made explicit in the lease. Rather, the lease should state only a single, aggregate rent. Similarly, where rent is determined by a percentage of a tenant or tenant group's revenue generated at the leased premises, it would be better, where possible, if the percentage were of the aggregate revenue of all properties covered by the master lease, rather than revenue for individual properties. Along the same lines, the lease should not allow the tenant to assign or sublease various properties individually to different assignees or subtenants. This is another indication of whether the master lease consists of several, independent agreements or is an integrated whole. Finally, the master lease should make clear that a default under any portion of the lease, with respect to any individual property, will constitute a default under the entire lease. A lease that explicitly provides for partial defaults, as to individual properties, is bad precedent for arguing before a bankruptcy court that the debtor tenant should not be allowed to ''cherry-pick'' from among individual properties. Similarly, events of termination under the lease should generally terminate the entire lease, with respect to all properties. Finally, where there is a business relationship between the various properties covered by the master lease, so that they are part of a single business establishment or enterprise, that should be stated in the lease.

With regard to cross-default provisions linking separate leases, there is less a landlord can do with respect to drafting, as the courts will look at the substance of the parties' bargain rather than the form of the agreements. To the extent that such clauses operate as a significant restriction on the ability of a debtor to reorganize successfully, by forcing the debtor to adopt an all-or-nothing approach with regard to lease assumption and rejection, courts will generally hold them unenforceable and allow debtors to assume those that are beneficial to a reorganization and reject the others. This is especially true where a creditor attempts to link otherwise unrelated contracts or leases simply by inserting cross-default clauses.

On the other hand, courts have shown a willingness to uphold cross-default provisions where they are an integral part of transaction and the contracts at issue are legitimately related to one another, such that failing to enforce them would deprive a creditor of its bargain. In other words, to the extent it appears that individual leases linked by cross default clauses were in

reality an integrated bargain, such that the landlord would not have entered into one agreement without the others, a court would be more likely to enforce the cross-default. It may be helpful to point out in the agreements that contain cross-default provisions that the cross-default term was a material part of the parties' bargain, and a material inducement to the landlord to enter into the transaction. If this is stated in the contract, and is credible, it may improve the chance that the cross default provision will be enforced. Courts also may be more likely to enforce a cross-default provision where doing so will not be fatal to the debtor's prospects for a successful reorganization.

[1] *See* 11 U.S.C.A. § 365. If the debtor tenant rejects a lease, the landlord may assert a claim for damages suffered as a result of the rejection. 11 U.S.C.A. § 502(g); Fed. R. Bank. P. 3002(c)(4). However, that claim is ordinarily treated as a prepetition unsecured claim and is often paid only cents on the dollar. *See* 11 U.S.C.A. §§ 365(g)(1), 502(g). In addition, the amount of the landlord's claim for future rent is capped, generally at one year's rent, under 11 U.S.C.A. § 502(b)(6). If the debtor tenant desires to assume the lease, it must cure any monetary defaults under the lease and, if there are defaults under the lease, it must compensate the landlord for such defaults and provide adequate assurance of its ability to perform under the lease going forward. 11 U.S.C.A. § 365(b). A debtor may also assume a lease and assign it to a third party (notwithstanding any anti-assignment clause in the lease), subject to the obligation to cure any defaults and to provide adequate assurance of future performance. *See* 11 U.S.C.A. § 365(f).

[2] *See, e.g., In re Qintex Entertainment, Inc.,* 950 F.2d 1492, 1495 (9th Cir 1991) (''The assumption or rejection of an executory contract or unexpired lease is governed solely by federal bankruptcy law'').

[3] *See L.R.S.C. Co. v. Rickel Home Ctrs., Inc. (In re Rickel Home Ctrs., Inc.),* 209 F.3d 291, 298 (3rd Cir. 2000); *Century Indem. Co. v. Nat'l Gypsum Co. Settlement Trust (Matter of Nat'l Gypsum Co.),* 208 F.3d 498, 506 (5th Cir. 2000); *Three Sisters Partners, L.L.C. v. Harden (In re Shangra-La, Inc.),* 167 F.3d 843, 849 (4th Cir. 1999); *City of Covington v. Covington Landing Ltd. P'ship,* 71 F.3d 1221, 1226 (6th Cir. 1995); *see also* 3 COLLIER ON BANKRUPTCY § 365.03[1] (Lawrence P. King et al. eds., 15th ed. 1996).

[4] *See Matter of T & H Diner, Inc.,* 108 B.R. 448, 453 (D. N.J. 1989) (''divisibility is a matter of state law''); *In re Karfakis,* 162 B.R. 719, 725 (Bankr. E.D. Penn. 1993) (''[C]ontract interpretation is a matter of state law and, therefore, bankruptcy courts should rely on applicable state law to determine whether an agreement is indivisible''). *But see In re Plitt Amusement Co.,* 233 B.R. 837, 846 (Bankr. C.D. Cal. 1999) (finding independent basis for severability in federal bankruptcy policy).

[5] *See, e.g., In re Ritchey,* 84 B.R. 474, 478 (Bankr. N.D. Ohio 1988).

[6] *Byrd v. Gardinier, Inc. (In re Gardinier, Inc.),* 831 F.2d 974, 976 (11th Cir. 1987); *see also Williston on Contracts* (3rd ed.) § 863.

[7] *In re Ritchey,* 84 B.R. at 477; *see also Matter of T & H Diner, Inc.,* 108 B.R. at 453.

[8] *United States v. Bethlehem Steel Corp.,* 315 U.S. 289, 298 (1942) (citing *Williston on Contracts*); *see also McKinney v. Gannett Co., Inc.,* 660 F.Supp. 984, 1005 (D. N.M. 1981).

[9] *See In re Gardinier, Inc.,* 831 F.2d at 976 (''absent ambiguity in the terms of a contract, intent is gleaned from the four corners of the instrument''); *In re Royster Co.,* 137 B.R. 530, 532 (Bankr. M.D. Fla. 1992) (intention of parties is ''governing principal'' and absent ambiguity, ''parties' intent must be gleaned from the four corners of the instrument''); *In re Central Florida Fuels, Inc.,* 89 B.R. 242, 244 (Bankr. M.D. Fla. 1988) (same); *In re Karfakis,* 162 B.R. 719, 725 (Bankr. E.D. Pa. 1993).

[10] *See McKinney v. Gannett Co.,* 660 F.Supp. at 1006.

[11] *See Pollock v. Moore (In re Pollock),* 139 B.R. 938, 941 (B.A.P. 9th Cir. 1992).

[12] *See, e.g., In re Royster Company,* 137 B.R. at 531 (holding that each rider to a lease was severable from the master lease and could be individually assumed or rejected, despite language stating that each rider ''shall become a part of the [master lease]'').

[13] *In re Cutters, Inc.,* 104 B.R. 886, 889 (Bankr. M.D. Tenn. 1989).

[14] *See In re Gardinier, Inc.,* 831 F.2d at 976; *In re Integrated Health Servs., Inc.,* 2000 WL 33712484 at *3 (Bankr. D. Del. 2000). Bankruptcy courts may be more willing than other courts to look beyond stated intent, since they are accustomed to dealing with parties' efforts to structure transactions in a way intended to minimize the impact of a future bankruptcy. For example, they often see parties label transactions that are in substance secured loans as repurchase agreements or leases, installment sales as secured loans, equity securities as debt, etc. They are thus accustomed to looking beyond the way a transaction or an instrument is labeled.

[15] 6A NORTON BANKR. L. & PRAC. 2d § 157:12 (2002). In addition to these factors, a court may infer the parties' intent from the terms of the lease by considering whether each subsection governing a separate property contains a provision regarding the rent due date or records the location of the leased property. *See In re Plitt Amusement Co.,* 233 B.R. 837, 844-45 (Bankr. C.D. Cal. 1999).

[16] *See Moore v. Pollock (In re Pollock),* 139 B.R. 938, 941 n.6 (B.A.P. 9th Cir. 1992); *Plitt Amusement,* 233 B.R. at 844; *Kopel v. Campanile (In re Kopel),* 232 B.R. 57, 66-67 (Bankr. S.D.N.Y. 1999); *In re W.T. Grant Co.,* 53 B.R. 417, 421 (Bankr. S.D.N.Y. 1985).

[17] *In re Karfakis,* 162 B.R. 719, 725 (Bankr. E.D. Pa. 1993).

[18] *See Moore,* 139 B.R. at 941 n.6; *W.T. Grant Co.,* 53 B.R. at 421.

[19] *See Plitt Amusement,* 233 B.R. at 844 (fact that leases were coterminous outweighed by other factors).

[20] *See e.g., Stewart Title Guaranty Co. v. Old Republic Nat'l Title Ins. Co.,* 83 F.3d 735, 740 (5th Cir. 1996) (parties at lease impliedly apportioned consideration); *Tarbox v. John Q. Hammons Co. (In re Ferguson),* 183 B.R. 122, 125 (Bankr. N.D. Tex. 1995).

[21] *In re Atlantic Computer Systems, Inc.,* 173 B.R. 844, 850 (Bankr. S.D.N.Y. 1994).

[22] *Id.* at 850.

[23] *Baldwin v. National Safe Depository Corp.*, 697 P.2d 587 (Wash. Ct. App. 1985).

[24] *In re Convenience USA, Inc.*, 2002 WL 230772 at *6 (Bankr. M.D.N.C. Feb. 12, 2002).

[25] *In re Integrated Health Services, Inc.*, 2000 WL 33712484 at *3 (Bankr. D. Del. 2000).

[26] *Id.*

[27] *Convenience USA*, 2002 WL 230772 at *5.

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Id.* at *4-5.

[32] On occasion, a landlord may believe that, from a business perspective, it is important to provide for certain events that would terminate a master lease with respect to some properties but not others. These might include, for example, condemnation or casualty events relating to a particular property. However, at least one court has pointed to the existence of such provisions as a factor in finding a master lease to be severable. *See Convenience USA*, 2002 WL 230772 at *5. Thus, as a general matter, from a bankruptcy perspective, the landlord is probably best off with as few partial termination events as possible. Where there are countervailing business considerations, landlords will need to balance the desirability of partial termination events against the risk that such provisions may lead a bankruptcy court to find that the agreement is severable.

[33] 162 B.R. 719, 720 (Bankr. E.D. Pa. 1993).

[34] *Id.*

[35] *Id.* at 720-21.

[36] *Id.*. at 725.

[37] *See Matter of T & H Diner, Inc.*, 108 B.R. 448, 454 (D. N.J. 1989) (finding agreements for lease of land and sale of business operating on land "inextricably intertwined" and not divisible).

[38] *In re Plitt Amusement*, 233 B.R. 837, 847 (Bankr. C.D. Cal. 1999); *see also Braniff, Inc. v. GPA Group PLC*, 118 B.R. 819, 845 (Bankr. M.D. Fla. 1989).

[39] *See Liljeberg Enters., Inc. v. Lifemark Hosp. of Louisiana, Inc.* (*Matter of Liljeberg Enters., Inc.*), 2002 WL 1978855 (5th Cir. Aug. 28, 2002) (page references not yet available); *Karfakis*, 162 B.R. at 725; *Bistrian v. Easthampton Sand & Gravel Co.* (*In re Easthampton Sand & Gravel Co.*), 25 B.R. 193, 198 (Bankr. E.D.N.Y. 1982).

[40] *See Kopel v. Campanile* (*In re Kopel*), 232 B.R. 57, 65-66 (Bankr. S.D.N.Y. 1999).

[41] *See* 6A NORTON BANKR. L. AND PRACTICE 2d § 157.12.

[42] *See Byrd v. Gardinier, Inc. (In re Gardinier, Inc.)*, 831 F.2d 974, 976 (11th Cir. 1987). Although this factor appears not to have been applied in the case law involving severability of master leases, it is conceivable that it could be applied in that context and is therefore included in this discussion.

[43] 831 F.2d at 975.

[44] *Id.* The committee also argued that the brokerage contract was fully executed, rather than executory, since the broker had performed all of its obligations under the contract.

[45] *Id.* at 976.

[46] 2000 WL 33712484 at *1 (Bankr. D. Del. July 7, 2000). The non-competition agreement essentially provided that an individual officer of the landlord would refrain from engaging in activities that were competitive with respect to the debtor, such as leasing premises to the debtor's competitors or divulging the debtor's confidential information. Id.

[47] *Id.* at *3.

[48] *Id.*

[49] *See McKinney v. Gannett Co.*, 660 F.Supp. 984, 1006 (D. N.M. 1981) (first inquiry is into written documents); *In re Karfakis*, 162 B.R. 719, 725 (Bankr. E.D. Pa. 1993) (court should seek other aids if language of agreement does not make intent clear).

[50] *See In re Ritchey*, 84 B.R. 474, 478 (Bankr. N.D. Ohio 1988).

[51] *In re Central Florida Fuels, Inc.*, 89 B.R. 242, 244 (Bankr. M.D. Fla. 1988); *see also In re Gardinier, Inc.*, 831 F.2d 974, 976 (11th Cir. 1987); *In re Convenience USA, Inc.*, 2002 WL 230772 at *3 (Bankr. M.D.N.C. Feb. 12, 2002).

[52] *See In re Texstone Venture, Ltd.*, 54 B.R. 54, 56 (Bankr. S.D. Tex. 1985).

[53] *See Eastern Sys., Inc. v. West 45th St. Indus. Condo., Inc.* (*In re Eastern Sys., Inc.*), 105 B.R. 219, 228 (Bankr. S.D.N.Y. 1989).

[54] *Convenience USA*, 2002 WL 230772 at *6.

[55] *See EBG Midtown South Corp. v. McLaren/Hart Envtl. Eng'g Corp.* (*In re Sanshoe Worldwide Corp.*), 139 B.R. 585, 597 (S.D.N.Y. 1992).

[56] *Id.*

[57] *Id.*

[58] The decision does not expressly state whether the agreements for the separate floors were contained in separate documents or in a single document, although it implies the former. This may be a situation in which more careful drafting could have made a difference.

[59] *See In re Plitt Amusement of Washington, Inc.*, 233 B.R. 837, 846 (Bankr. C.D. Cal. 1999).

[60] *Id.* at 840.

[61] *Id.* at 847.

[62] *Id.*

[63] *Id.*

[64] *Id.* at 848.

[65] *Id.*.

[66] *Id.* at 848. In summarizing the holding in *Plitt Amusement*, the court in *Integrated Health Services* stated that "[s]everability requires a determination of whether a part of a contract or lease ... can be separated and treated as an independent legal obligation." *In re Integrated Health Services, Inc.*, 2000 WL 33712484, 3 (Bankr. D. Del. 2000).

[67] *Plitt Amusement*, 233 B.R. at 848.

[68] *Id.*

[69] *Id.* at 847-48.

[70] *See In re Convenience USA, Inc.*, 2002 WL 230772 at *6 (Bankr. M.D.N.C. Feb. 12, 2002).

[71] *Id.*

[72] *Id.*

[73] An independent federal test would seem inconsistent with the aforementioned policy of applying state law to determine contract rights in bankruptcy. *See, e.g., Matter of T & H Diner, Inc.,* 108 B.R. 448, 453 (D. N.J. 1989) (''divisibility is a matter of state law''); *In re Karfakis,* 162 B.R. 719, 725 (Bankr. E.D. Penn. 993) (''[C]ontract interpretation is a matter of state law and, therefore, bankruptcy courts should rely on applicable state law to determine whether an agreement is indivisible'').

[74] *See In re Sambo's Restaurants, Inc.,* 24 B.R. 755, 757 (Bankr. C.D. Cal. 1982).

[75] Section 365(c) sets forth four specific circumstances in which the trustee or debtor-in-possession may not assume and assign a lease or contract; according to Section 365(f), these are the only circumstances in which a trustee or debtor-in-possession's right to assume contracts may be curtailed.

First, if, under applicable law, the non-debtor party is not required to accept or render performance to an entity other than the debtor, the trustee may not assign the contract without the non-debtor party's consent. Second, the trustee may not assume or assign a contract to make a loan or issue securities of the debtor. Third, the trustee may not assume or assign a nonresidential real property lease that was terminated prior to the date of the bankruptcy petition. And fourth, if the debtor leases multiple aircraft gates or terminals, the trustee must assume and assign all or none of the leases, unless the lessor consents to assumption or assignment of less than all of them.

[76] *Id.* at 757; *see also Wheeling-Pittsburgh Steel,* 54 B.R. at 778; *Convenience USA,* 2002 WL 230772 at *7 (Bankr. M.D.N.C. Feb. 12, 2002).

[77] *See Sambo's,* 24 B.R. at 757.

[78] *Id.* at 757.

[79] *Id.*

[80] *See Wheeling-Pittsburgh Steel,* 54 B.R. 772, 778 (Bankr. W.D. Pa. 1985); *In re Garrett Road Supermarket, Inc.,* 1988 WL 98777 at *1 (Bankr. E.D. Pa. 1988). The *Wheeling-Pittsburgh* court noted that the use of cross-default clauses in this way violates the same policy that prohibits enforcement of ipso facto or bankruptcy termination clauses, explaining that ''[t]he policy underlying the prohibition of bankruptcy termination clauses under § 365(e) is that such clauses restrict the debtor's ability to assume and assign executory contracts and leases.'' 54 B.R. at 778. The Bankruptcy Code was drafted to enable debtors to assume and assign leases where doing so would benefit the estate and to prevent the use of bankruptcy termination clauses to hamper a debtor's rehabilitation efforts. *Id.*

[81] *Sambo's,* 24 B.R. at 758.

[82] *Id.* at 779 (emphasis in the original).

[83] *Id.*

[84] *See Matter of T & H Diner, Inc.,* 108 B.R. 448, 454 (D. N.J. 1989).

[85] *See Kopel v. Campanile* (*In re Kopel*), 232 B.R. 57, 65-66 (Bankr. S.D.N.Y. 1999).

[86] *See In re Madison's Partner Group,* 67 B.R. 633, 635 (D. Minn. 1986).

[87] *Kopel,* 232 B.R. at 64.

[88] *Id.* at 65-66.

[89] *Id.*

[90] *Id.* at 67.

[91] *Id.* at 67-68.

[92] *Id.* at 68.

[93] *See Liljeberg Enters., Inc. v. Lifemark Hosp. of Louisiana, Inc.* (*Matter of Liljeberg Enters., Inc.*), 2002 WL 1978855 (5th Cir. Aug. 28, 2002) (page references not yet available).

[94] *Id.*

[95] *Id.*

[96] *Id.*

[97] *Id.*

[98] *Id.*

[99] *Id.*

[100] 54 B.R. at 778.

[101] *Id.*