

Whether a Contract is Divisible for Purposes of Section 365 of the Bankruptcy Code

Christopher Bolz, J.D. Candidate 2015

Cite as: *Whether a Contract is Divisible for Purposes of Section 365 of the Bankruptcy Code*, 6 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 4 (2014).

Introduction

Section 365 of the Bankruptcy Code governs the assumption, rejection, and assignment of executory contracts and unexpired leases in bankruptcy cases.¹ Although the definition of an executory contract has not been codified, it is considered to be a contract that has not been fully performed. The assumption or rejection of an executory contract is achieved through court approval, except in certain instances concerning Chapter 7 bankruptcy.² Rejection leads to a non-administrative unsecured claim for damages.³ Following rejection, neither the estate nor the other party owes performance to one another.⁴

The trustee or debtor in possession must assume or reject an executory contract in its entirety.⁵ However, when a “contract” is actually several different contracts, the “contract” may be divisible.⁶ State law governs divisibility.⁷ This makes it difficult to pinpoint exactly what conditions make a contract divisible. However, case law tends to cite the intent of the parties as

¹ See 2 Norton Bankr. L. & Prac. 3d § 46:4.

² See *id.* § 46:12.

³ See *id.* § 46:24.

⁴ See *id.*

⁵ See *id.* § 46:1.

⁶ See *id.* § 46:4.

⁷ See *id.* § 46:5.

the most important factor governing divisibility.⁸ But, if a court finds that two or more “contracts” are part of an integrated transaction, the contract must be assumed or rejected in its entirety.⁹

This Article will focus on the rules of divisibility in Kansas, New Jersey, Texas, and Illinois. Kansas focuses on the intent of the parties.¹⁰ New Jersey looks to intent and the noninterrelatedness of the obligations of the parties to the agreement.¹¹ Texas looks at the intent of the parties, the subject matter of the agreement, and the conduct of the parties.¹² Finally, Illinois looks at whether the parties would be willing to exchange part performance irrespective of subsequent events or whether the divisions made are simply for the purpose of requiring periodic payments.¹³ Part I of this Article examine the rejection of executory contracts generally. Part II will examine how the rules of divisibility are applied in Kansas, New Jersey, Texas, and Illinois. Finally, Part III will highlight the practical implications of divisibility in regards to the two parties to the contract.

I. Rejection of Executory Contracts

Only executory contracts and unexpired leases may be assumed or rejected under section 365.¹⁴ Neither the Bankruptcy Code nor the Bankruptcy Act provides a statutory definition of an executory contract.¹⁵ However, the House and Senate Committee Reports define executory

⁸ *See id.* § 46:11.

⁹ *See id.*

¹⁰ *See In re: Hawker Beechcraft, Inc., et al., Reorganized Debtors*, No. 12–11873, 2013 WL 2663193, at *3 (Bankr. S.D.N.Y. Jun. 13, 2103).

¹¹ *See In re T & H Diner, Inc.*, 108 B.R. 448, 455 at *450(D.N.J. 1989).

¹² *See In re Wolflin Oil, L.L.C.*, 318 B.R. 392, 398 (Bankr. N.D.T. 2004).

¹³ *See Fid. & Deposit Co. v. Rotec Indus.*, 392 F.3d 944, 947 (7th Cir. 2004).

¹⁴ *See 2 Norton Bankr. L. & Prac.* 3d § 46:1.

¹⁵ *See 2 Norton Bankr. L. & Prac.* 3d § 46:5.

contracts as, “contracts on which performance remains due to some extent on both sides.”¹⁶

Rejection of an executory contract can occur in two ways. Firstly, the executory contract can be deemed rejected in a Chapter 7 case if the trustee does not act quickly in assuming the contract.¹⁷

Secondly, and more common, a court must approve the rejection of an executory contract.¹⁸

Rejection lies solely with the trustee, subject to court approval.¹⁹

When an unassumed executory contract is rejected after the commencement of a case, the rejection leads to a nonadministrative unsecured claim for damages.²⁰ Rejection constitutes a breach that is deemed to have occurred immediately before the filing of the petition.²¹ Following rejection, the trustee loses the benefit of performance by the other party and avoids future performance by the state.²² Rejection leaves the other party with a prepetition claim for damages.²³ The damages are determined by state law to the extent that they do not conflict with the Code.²⁴ Because the claim is considered a prepetition obligation, the debtor usually pays pennies on the dollar. If the breach is considered a post-petition obligation, the breach will give rise to an administrative expense, which the debtor will have to pay in full.

II. Divisibility of Executory Contracts

A trustee or debtor in possession must assume or reject an executory contract in its entirety.²⁵ He may not choose favorable provisions to assume and unfavorable provisions to

¹⁶ *See id.*

¹⁷ *See* 2 Norton Bankr. L. & Prac. 3d § 46:12.

¹⁸ *See id.*

¹⁹ *See id.*

²⁰ *See* 2 Norton Bankr. L. & Prac. 3d § 46:24.

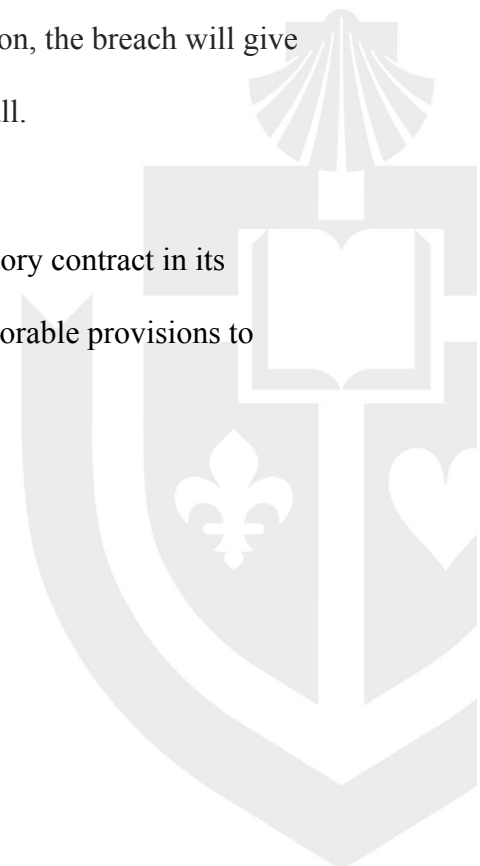
²¹ *See id.*

²² *See id.*

²³ *See id.*

²⁴ *See id.*

²⁵ *See* 2 Norton Bankr. L. & Prac. 3d § 46:1.



reject. The contract must be assumed *cum onere*.²⁶ However, not every document denoted as a contract must be treated as a single, indivisible whole. A “contract” may be a term applied to a document that is actually several different contracts put together.²⁷ The contract may be considered severable if this is the case.

State law typically governs whether a contract is divisible.²⁸ Intent seems to be a factor that is looked at by most states and is the most important aspect a court looks at when determining the severability of a contract.²⁹ Federal courts often apply a three-factor test when judging intent. The factors are (1) the differing nature and purpose of parts of the agreement, (2) the separate and distinct consideration which may be attributed to different parts of the agreement, and (3) the noninterrelatedness of obligations of the parties to the agreement.³⁰ There is an exception to these guidelines set out by these courts. If a court finds that two or more “contracts” are part of an integrated transaction, the trustee or debtor in possession must assume or reject the contracts in their entirety.³¹ Since it is difficult to state a concrete rule about the divisibility of executory contracts, the remainder of this section will focus on how federal courts apply different state laws to the issue.

A. Divisibility Under Kansas Law

In *In re Hawker Beechcraft, Inc.*, the United States Bankruptcy Court for the Southern District of New York applied Kansas state law to determine the divisibility of a contract.³² There, the debtor and supplier entered into purchase order agreements and two master

²⁶ *See id.*

²⁷ *See id.*

²⁸ *See* 2 Norton Bankr. L. & Prac. 3d § 46:11.

²⁹ *See id.*

³⁰ *See id.*

³¹ *See id.*

³² *See In re: Hawker Beechcraft, Inc., et al., Reorganized Debtors*, No. 12–11873, 2013 WL 2663193, at *3 (Bankr. S.D.N.Y. Jun. 13, 2103).

agreements. After filing, the debtor wanted to assume some purchase orders while rejecting other purchase orders. The supplier objected, arguing that the master agreements and purchase orders constituted a single, indivisible contract.³³

Under Kansas law, courts examine the intent of the parties to determine if a contract is divisible. In another Kansas case, *Blakesley v. Johnson*, the court stated, “[w]hether or not a contract is entire or divisible is a question of construction to be determined by the court according to the intention of the contracting parties as ascertained from the contract itself and upon a consideration of all the circumstances surrounding the making of it.”³⁴

In *In re Hawker Beechcraft, Inc.*, several factors demonstrated that the master agreement and purchase orders were intended to be independent contracts. The integration clause in the master agreement omitted any reference to the purchase orders, demonstrating that the two agreements were not to be looked at as a whole.³⁵ The court also looked to the performance, termination, and assignment provisions in the master agreement, which showed further evidence that the purchase orders were to be treated as separate contracts. For example, “If the [m]aster [p]lastics [a]greement was terminated, any outstanding release which is partially or totally unfiled on the date of termination shall continue to be subject to all the terms and conditions hereof.”³⁶

B. Divisibility Under New Jersey

Under New Jersey law, courts also focus on the intent of the parties as a guiding factor in determining whether a contract is divisible. For example, in *In re T & H Diner, Inc.*, The United States District Court for the District of New Jersey found that a contract was not

³³ *See id.*

³⁴ *See id.* at *8.

³⁵ *See id.*

³⁶ *See id.* at *20.

divisible, providing a nice contrast to the ruling seen in *In Re Hawker Beechcraft, Inc.*³⁷ In *T & H Diner*, the debtor executed a purchase agreement with its landlord for a restaurant facility. The parties also executed a lease agreement. Nine years later, the debtor filed for bankruptcy. They moved to assume the lease agreement while rejecting the purchase agreement, citing divisibility.³⁸ The *In Re T & H Diner, Inc.* court, focused on the third factor of the three-factor test mentioned above: the noninterrelatedness of obligations of the parties to the agreement. The Court stated, “In this matter the lease and purchase agreements are inextricably intertwined.”³⁹ Evidence backing this up includes the fact that, “the sub-lease specifically states that a default under the notes will be a default under the sub-lease.”⁴⁰ The court also tied this fact into the concept of the intent between the parties. The court stated, “Since the sub-lease says what it says in that regard, absent evidence to the contrary or modification or other [parol] evidence, that provision that the defaults under the notes would be part of the defaults under the sub-lease, was the intention of the parties at the time they signed the sub-lease.”⁴¹

C. Divisibility Under Texas Law

In, *In re Wolflin Oil, L.L.C.*, the United States Bankruptcy Court for the Northern District of Texas determined that a master agreement was divisible under Texas law, which applies its own three-factor test to determine severability. Under Texas law, the court will consider the following three factors in determining whether a contract is divisible: “(1) the intent of the

³⁷ *See In re T & H Diner, Inc.*, 108 B.R. 448, 455 (D.N.J. 1989).

³⁸ *See id.* at *450.

³⁹ *See id.*

⁴⁰ *See id.*

⁴¹ *See id.*

parties; (2) the subject matter of the agreement; and (3) the conduct of the parties.”⁴² The intent of the parties is given the most weight of the three factors.⁴³

In *In re Wolflin Oil, L.L.C.*, the debtor was an operator of six quick lube service centers. They were leased from the landlord under six leases. Each lease provided that a default would occur upon the failure to pay rent. The debtor wanted to assume four of the leases while rejecting the other two. The landlord claimed that the leases were part of one integrated contract.⁴⁴ The court defined a severable contract as a contract that includes, “two or more promises which can be acted on separately such that the failure to perform one promise does not necessarily put the promisor in breach of the entire agreement.”⁴⁵

The *In re Wolflin Oil, L.L.C.* court first looked to the second factor of the test and found that the subject matter weighed in favor of divisibility.⁴⁶ There was nothing in the lease agreement that said each store could not be operated independently from each other.⁴⁷ This means that it is unlikely that the contracts were part of an integrated transaction. The court then looked to the third factor of the test and found that the conduct of the parties favored divisibility.⁴⁸ This was due to the fact that the debtor made payments on the stores individually as opposed to one master payment.⁴⁹ “A severable contract may exist when the performance by one party consists of several distinct and separate items and the price paid by the other party is apportioned to each item.”⁵⁰ The court then turned its focus to the final factor—intent. The

⁴² See *In re Wolflin Oil, L.L.C.*, 318 B.R. 392, 397 (Bankr. N.D.T. 2004).

⁴³ See *id.*

⁴⁴ See *id.* at *395.

⁴⁵ See *id.* at *397.

⁴⁶ See *id.*

⁴⁷ See *id.*

⁴⁸ See *id.* at *398

⁴⁹ See *id.*

⁵⁰ See *id.*

language of the contract provides the best evidence of intent.⁵¹ Each lease contained a different rent calculation. Also, the leases made no references to the other leases.⁵² The court held that it was the intent of the parties to have these contracts be divisible.

D. Divisibility Under Illinois Law

Applying Illinois law, in *Fid. & Deposit Co. v. Rotec Indus.*, the United States Court of Appeals for the Seventh Circuit did not focus on the parties' intent as much as the courts in the previously mentioned cases. Instead, on the issue of divisibility, the court looked to whether the parties had divided up their performance into installments in such a way that each prior performance by one party was compensation for a corresponding performance by the other party.⁵³ The test was whether the parties would be willing to exchange part performance irrespective of subsequent events or whether the divisions made were simply for the purpose of requiring periodic payments.⁵⁴

There, the plaintiff was a company that had acquired the debtor's contract rights. The debtor had rejected an executory contract with a construction company regarding the construction of a dam. The plaintiff claimed that the contract was divisible and looked to enforce other aspects of the contract. The court held that the contract was not divisible because the debtor had agreed to assist in preparing a bid for a construction project, to allow the bid to be submitted under its name, and to provide services once the bid was accepted.⁵⁵ Performance was not divisible and separate from the other aspects of the contract.⁵⁶ The debtor was expected to

⁵¹ *See id.*

⁵² *See id.*

⁵³ *See Fid. & Deposit Co. v. Rotec Indus.*, 392 F.3d 944, 947 (7th Cir. 2004).

⁵⁴ *See id.*

⁵⁵ *See id.* at 948.

⁵⁶ *See id.*

participate throughout the project.

III. Implications

The ability to assume or reject executory contracts, as well as the divisibility of executory contracts, is crucial to litigants in bankruptcy cases. A party that is in bankruptcy will tend to want a contract to be divisible. It gives them flexibility in their reorganization. They can reject contracts that will be detrimental to them, while accepting contracts that will benefit them.⁵⁷ Conversely, creditors will tend to prefer a contract to not be divisible. When the contract is deemed to be divisible, creditors lose control over which obligations they must fulfill.⁵⁸ This can be an economic burden on a creditor. The parties should make sure to address the potential conflict over divisibility during the drafting of contracts. They should clearly state their intent regarding the divisibility of the contract. They should also be wary of how the laws of their state deal with divisibility. However, the problem is that when parties enter into a contract, they may not anticipate a party going into bankruptcy at a later date. Therefore, the problem regarding divisibility often goes unaddressed.

Conclusion

Executory contracts can play a major role in bankruptcy proceedings. The ability to reject them, while paying pre-petition damages, allows for a smoother transition for the debtor. The divisibility of certain executory contracts further allows a debtor to tailor his bankruptcy towards his needs. These benefits often depend on the state that the debtor contracts in. State law governs whether or not an executory contract is divisible. Even though the courts apply

⁵⁷ See Elizabeth Lea Black, *What are "Administrative Expenses" Under § 503 (b) of Bankruptcy Code (11 U.S.C.A. § 503(b)) Granted First Priority for Payment Pursuant to § 507 (a)(1) of Code (11 U.S.C.A. § 507(a)(1))*, 140 A.L.R. Fed. 1 (2014).

⁵⁸ See *id.*

different standards depending on the state, intent seems to be the most important factor that the courts look at.

