AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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# When Contracts Spontaneously Multiply

## How to Deal with Bifurcation and Integration Issues under § 365

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There was a day when a person's word was his or her bond, when contracts were sealed with handshakes and when a document said something, all parties understood its meaning. A new day has dawned.


*Gregory G. Hesse*

A trend has emerged where a party can now use § 365 of the Bankruptcy Code, along with the misconception that hindsight is always 20-20, to rewrite executory contracts and leases to what that party *wishes* those documents had meant when originally drafted. Now a single lease covering 50 oil and gas parcels may be separated into 50 separate leases and cherry-picked for rejection, using hindsight to make a more favorable business deal than originally negotiated. Similarly, a building lease, a noncompete agreement and an employment agreement may be deemed a single binding agreement for purposes of assumption or rejection, offering an executive tied to all three through a merger much more protection in bankruptcy than he originally bargained for. No longer does an executory contract or lease seem to say what it means, or mean what it says. Contractual integration and bifurcation rule the day. Client certainty does not thrive in this type of world.

This new approach to assumption and rejection causes problems for both debtors and creditors and creates uncertainties that can, at best, become expensive distractions. Only where a party fully understands the federal and state law mechanics of this legal argument can it effectively plan how to manage its risks in a bankruptcy scenario. While the bankruptcy rules associated with bifurcation and integration under § 365 are relatively straightforward, the state law rules are somewhat more varied, and certainly not standard. A full appreciation of both will help avoid client uncertainty and can aid in drafting contracts that close this loophole before an intervening bankruptcy occurs.

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While seeming good news for all parties, the inquiry unfortunately does not end here. While an "integrated" executory contract or unexpired lease cannot be split into component parts for purposes of assumption or rejection, "where a lease or contract contains several different agreements, and the lease or contract can be severed under applicable non-bankruptcy law, section 365 allows assumption or rejection of the severable portions of the lease or contract."[2] Questions regarding integration and severability remain unanswered by federal law.[3] State law on contractual interpretation must be consulted.

## On the Edge

### Bifurcation and Integration Must Coexist with § 365

When faced with bifurcation or integration of an executory contract or unexpired lease, courts first look to well-established bankruptcy principles. The question is whether § 365 allows a party to assume or reject only a portion of an executory contract or unexpired lease. The simple answer is unequivocally "no." Courts have stated in no uncertain terms that an unexpired lease or executory contract must either be assumed or rejected *in its entirety*.[1]

### State Law Controls How Agreements Are Viewed

The state law questions inherent to this issue are somewhat more complex and certainly more varied in their outcome than those presented by bankruptcy law. There is, unfortunately, no single rule that can be applied across all state jurisdictions. The closest to a universal "test" that can be applied is to question the parties' intent at the time the contract or lease was entered into, but this significantly oversimplifies the matter.

A severable/divisible contract has been defined as "two or more promises

1 *In re Philadelphia Newspapers LLC*, 424 B.R. 178, 183 (Bankr. E.D. Pa. 2010) (holding that debtor "must either assume the whole contract, *cum onere*, or reject the entire contract, shedding obligations as well as benefits"); *Stewart Title Guarantee Co. v. Old Republic Nat. Title Ins.*, 83 F.3d 735, 741 (5th Cir. 1996); *In re Exide Techs.*, 340 B.R. 222, 228 (Bankr. D. Del. 2006) ("[A]ll of the contracts that comprise an integrated agreement must either be assumed or rejected, since they all make up one contract.").

2 *In re Adelphia Bus. Solutions Inc.*, 322 B.R. 51, 54 (Bankr. S.D.N.Y. 2005).

3 *In re Teligent Inc.*, 268 B.R. 723, 728 (Bankr. S.D.N.Y. 2001) (it is well settled that state law governs whether agreements are separate or indivisible for purposes of § 365); *In re Mirant Corp.*, 197 Fed Appx. 285, 289 (5th Cir. July 19, 2006) ("[S]everability for purposes of § 365 rejection is determined by applying the nonbankruptcy, general legal rules applicable to the agreement at issue.").

[that] 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."[4] In contrast, an indivisible contract has been defined as one where "by its terms, nature and purpose, it contemplates and intends that each and all of its parts and the consideration therefor shall be common each to the other and interdependent."[5] These definitions seem relatively straightforward, but they unfortunately only enlighten rather than control the standards extant in the various states. While general principles guide each state's interpretation of the common law on this issue, each state seems to take its own unique approach. While an exhaustive study of each state's requirements for bifurcation/integration would require far too lengthy an analysis, a brief review of standards from various jurisdictions is instructive and sheds light on the variation to be expected from jurisdiction to jurisdiction.

### New Jersey

New Jersey law holds that "a contract is said to be divisible when performance is divided in two or more parts with a definite apportionment of the total consideration to each part."[6] The divisibility of the contract "depends upon the intention of the parties as gathered from the agreement itself and the circumstances surrounding it."[7] While generally focused on the intent of the parties, as many other states also are, it appears that New Jersey also requires the specific apportionment of consideration between the various parts of an agreement. Without such "definite apportionment," it appears that bifurcation is not possible. Unlike many states, it appears that New Jersey may allow a party to introduce parol evidence to prove intent from the "circumstances surrounding" the making of the agreement.

### Illinois

Illinois courts consider that "the ability to apportion the consideration to different parts of [a] contract is one factor to be considered in determining the intent of the parties, but it is not conclusive."[8] Ultimately, the Seventh Circuit has stated that the intention of the parties is critical to a determination of severability, and that "even if the parties entered a multi-part contract, that contract cannot be severed after the fact if the parties entered it 'as a single whole, so that there would have been no bargain whatever, if any promise or set of promises were struck out.'"[9]

### New York

Courts in New York have found that "when a contract is separable or divisible into a number of elements or transactions, each of which is so far independent of the others that it might stand or fall by itself, and good cause for rescission exists as to one of such portions, it may be rescinded and the remainder of the contract affirmed."[10] Additionally, a contract "is considered severable and divisible when by its terms, nature and purpose, it is susceptible of division and apportionment."[11] For purposes of integration under New York law, and as stated above, "as a general rule, a contract is entire when, by its terms, nature and purpose, it contemplates and intends that each and all of its parts and the consideration therefor shall be common each to the other and interdependent."[12]

### Missouri

Missouri law appears to require less evidentiary proof of integration/bifurcation than other states and allows a party to bring in parol evidence. Under Missouri law, "several instruments made at the same time, and relating to the same subject matter may be read together as one contract...[but] it does not necessarily follow that those instruments are one contract. As a minimum prerequisite, there must be some reasonable basis for finding that the parties so intended."[13] "In determining the parties' intent as to the separateness of the [agreement, courts in Missouri] review...all relevant evidence, including prior or contemporaneous negotiations and agreements."[14] While some would find that this violates the state's parol evidence rule, courts have found that because "the purpose of Missouri's parol evidence rule is to preserve the sanctity of written instruments that are fully integrated.... The parol evidence rule does not bar evidence relating to the threshold determination of whether the parties intended to integrate their agreements into a single contract."[15]

### District of Columbia

While the vast majority of contracts in the U.S. are governed by law other than that of the District of Columbia, the District of Columbia has well-established and coherent tests for severability from which many other jurisdictions could learn. Under the law of the District of Columbia, a court first inquires "whether the parties, at the time the agreement was entered, intended the contract to be severable."[16] The *Howard University v. Durham* court went on to clarify that while the intent of the parties certainly controls, "there is no set answer to the question of when a contract is divisible."[17] The *Howard* court concluded that the following factors should be reviewed when determining whether a contract is severable: "1) whether the parties assented to all the promises as a single whole; 2) whether there was a single consideration covering various parts of the agreement or whether consideration was given for each part of the agreement; and 3) whether [the] performance of each party is divided into two or more parts, the number of parts due from each party being the agreed exchange for a corresponding part by the other party."[18]

### Texas

Texas has a well-established test for determining when a contract is divisible. Under Texas law, courts look to three factors to determine whether a contract is severable or may be integrated with another. First, Texas courts look to the intent of the parties to determine severability/integration.[19] Intent is determined "from the language of the contract and the surrounding circumstances," alluding to the fact that parol evidence, in certain circumstances, may be introduced to prove intent.[20] Second, Texas courts look to the subject matter of the agreement(s) to determine whether they are uniform and undifferentiated, or whether they contain diverse subjects that are capable of bifurcation.[21] Finally, Texas courts look to the conduct of the parties themselves to determine whether severability

4 *Stewart Title*, 83 F.3d at 739 (citing *Black's Law Dictionary* 1373-74 (6th ed. 1990)).
5 *First Savs. & Loan Ass'n v. Am. Home Ins. Co.*, 277 N.E.2d 638, 639 (N.Y. 1971).
6 *Integrity Flooring v. Zandon Corp.*, 32 A.2d 507, 509 (N.J. 1943) (as quoted by *In re Nickels Midway Pier LLC*, 255 Fed. Appx. 633, at *9 (3d Cir. Nov. 27, 2007)).
7 *Id.*
8 *See City of Chicago v. Sexton*, 2 N.E. 263, 264 (Ill. 1885) (contract to furnish ironworks with multi-story building was not divisible, even though consideration was "made up by stating the estimated cost of each story separately, and the roof, and then adding the whole together"); *Meredith v. Knapp*, 211 N.E.2d 151, 153 (Ill. App. Ct. 1965) (holding that double-indemnity provision within larger insurance policy was not separate contract even though separate premium was charged for it).
9 *In re Buffets Holdings Inc.*, 387 B.R. 115, 121-22 (Bankr. D. Del. 2008) (citing *In re United Air Lines Inc.*, 453 F.3d 463, 468-470 (7th Cir. 2006)).
10 *Shoptalk Ltd. v. Concorde-New Horizons Corp.*, 897 F.Supp. 144, at n. 6 (1995) (citing *Ripley v. Int'l Railways*, 171 N.E.2d 443 (N.Y. 1960)).
11 *Am. Home Ins. Co.*, 277 N.E.2d at 639.
12 *Id.*
13 *In re Adelphia Bus. Solutions Inc.*, 322 B.R. at 55-56 (interpreting Missouri law).
14 *Id.*
15 *Id.*
16 *See Mirant Corp. v. Potomac Elec Power Co. (In re Mirant Corp.)*, 197 Fed. Appx. 285, 290 (5th Cir. July 19, 2006) (citing *Holiday Homes v. Briley*, 122 A.2d 229, 232 (D.C. 1956) ("Whether a number of promises constitutes one contract or more than one is primarily a question of intention of the parties.").
17 408 A.2d 1216, 1219 (D.C. 1979).
18 *Howard University*, 408 A.2d at 1219.
19 *Stewart Title*, 83 F.3d at 740.
20 *Nat'l Iranian Oil Co. v. Ashland Oil Inc.*, 817 F.2d 326, 333 (5th Cir. 1987), *cert. denied*, 4844 U.S. 943 (1987).
21 *Stewart Title*, 83 F.3d at 740.

would be appropriate.[22] Under this third factor, "conduct that is particularly telling...is the method of payment arranged by the parties."[23] Using this three-factor test, courts have found that "where the subject matter of the contract is divisible and the consideration is apportioned, these qualities are consistent with and indicative of a severable contract."[24]

## Protecting a Client

How do lawyers protect their clients from bifurcation and/or integration claims? While state law standards vary, the ability to prove intent is key in each situation. Integration clauses and nonintegration agreements, preferably drafted in as conspicuous a manner as possible, will certainly help show intent and are an important part of any defense against a bifurcation/integration attack. Additionally, any further agreements/parol evidence that show intent may be weighed in certain jurisdictions in favor of either integration or bifurcation. Planning ahead in a jurisdiction that allows parol evidence can be very helpful in providing your client with a later defense. Finally, the apportionment or nonapportionment of consideration among various portions of a contract or lease, or among multiple contracts or leases, is an important defense that can be planned for and implemented long before litigation erupts. Ultimately, the key to providing a cogent defense for your client is to plan ahead. Being involved from the time the contract or lease is drafted is key and will save a client time, hassle and expense down the road. ■

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22 *Id.*
23 *Id.*
24 *In re Ferguson*, 183 B.R. 122, 126 (Bankr. N.D. Tex. 1995).