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ANALYSIS

Scope of a Lessee's Power to Reject Parts Of Multiple-Unit Leases

By Ronald Barliant

It is not unusual for parties to equipment leasing transactions to have a master lease or agreement and separate documents covering multiple-leased units. The master agreement covers terms generally applicable to the entire set of transactions; the separate documents deal with terms specific to the individual units. Such was the arrangement between Comdisco Inc. and Metro-media Fiber Network Services Inc. that came to my attention when I presided over Comdisco's Chapter 11 bankruptcy case. See *In re Comdisco Inc.*, 270 B.R. 909 (Bankr. N.D.Ill. 2001).

Comdisco, under one set of documents, leased access to "dark" fiber strands on Metromedia's telecommunications network. An "option agreement" gave Comdisco the right to lease fiber on Metro-media's network subject to stated general conditions.

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Comdisco exercised its option to lease a particular fiber by serving a notice, and the lease was confirmed with a product order. As stated in the option agreement, the "pricing and other specific terms and conditions" of each fiber lease were in the product order.

Another set of documents provided for the enabling of data transmission on the leased fiber (or "lighting" the "dark" fiber). A "managed network agreement" contained the general terms, but the identity of the specific fiber to be lit and other specific terms were contained in separate product orders.

One of the fiber strands leased and used by Comdisco served the World Trade Center in New York. After the destructive events of Sept. 11, Comdisco had no need for that fiber. Using the power of a debtor in possession under Bankruptcy Code § 365, Comdisco filed a motion to reject the product orders to lease the dark fiber under the option agreement and to light it under the managed network agreement. Comdisco did not want to reject the whole deal; it only wanted out of the specific lease servicing the World Trade Center. That is why it moved to reject the two product orders but not

the option agreement or managed network agreement.

Losers to the Lessor

In any lease transaction, the debtor in possession will naturally want to keep the most profitable parts of the deal and turn the losers back to the lessor. But that is exactly the risk the lessor may have shifted to the lessee. A lease, by its nature, promises a fixed return to the lessor and shifts the risk of loss for the term of the lease to the lessee. Even if the equipment turns out to be unprofitable, the lessee must pay the rent.

In bankruptcy, however, the debtor in possession's power to reject leases under § 365 threatens the economics of the deal if the lessee is allowed to cherry-pick the best part of the transaction and make the lessor take back the losers. But the purpose of § 365 is to allow the debtor in possession to keep profitable agreements and shed unprofitable deals. That enhances the estate for all stakeholders.

The law deals with this conflict in goals and policies by prohibiting the debtor in possession from rejecting only a part of "single agreement." The debtor in possession must either

accept the deal as a whole or reject it as a whole. It cannot cherry-pick the best parts. It's an all or nothing deal. But unfortunately it is not always clear what constitutes "all."

Metromedia argued that the two product orders were merely parts of larger, "integrated" agreements. Comdisco could only reject them if it also rejected the master agreements and all the other product orders, too. If Comdisco did not want to do that, it would have to accept, and pay for, the World Trade Center lease and enabling agreement along with all the others. But if a product order was a separate agreement, not part of a single lease covering all similar product orders, then Comdisco could, in fact, cherry-pick the best.

Comdisco first argued that it was excused from further performance of the individual product orders by the doctrine of impossibility of performance. Obviously, no data could be transmitted to the World Trade Center. But although an event that renders performance of a contract impossible may excuse the obligation to perform, it is not a ground for rejection under § 365. Comdisco might have refused to pay and defended on the ground of impossibility, or it might have brought an adversary proceeding for a declaratory judgment that it had no further obligations under those product orders. But it could not properly raise those issues on a motion to reject the product orders.

Having rejected that argument, I was required to decide whether each product order was indeed a separate lease or agreement that could be used without rejection of the master agreements and all other product orders. The case law on that issue is centered on ill-defined terms that seem to have little

connection to either the Bankruptcy Code or real life. The inquiry is usually phrased in such terms as "whether separate instruments constitute an integrated, non-severable contract." *In re Plitt Amusement Co. of Washington Inc.*, 233 B.R. 837, 841 (Bankr. CD Cal 1999). It is generally said that the intent of the parties "to make one contract or two separate contracts" controls the outcome. *In re Gardinier Inc.*, 831 F.2d 974, 976 (11th Cir. 1987).

These tests, it seemed to me, were too abstract and removed from basic bankruptcy policies to be useful. The U.S. Court of Appeals for the Fifth Circuit started on a more useful tack, but only by quoting Black's Law Dictionary: "A severable contract 'includes two or more promises which can be acted on separately such that failure to perform one promise does not necessarily put the promisor in breach of the entire agreement.'" *Stewart Title Guaranty Co. v. Old Republic National Title Insurance Co.*, 83 F.3d 735, 739 (5th Cir. 1996).

Abstract Search

But the court quickly deviated from that promising start into the usual abstract search for the parties' intent about an issue about which they almost surely never thought. Nevertheless, the definition quoted from Black's, with its reference to "breach," got me thinking about what is really at issue when the question is the debtor in possession's power to reject part of a deal rather than the whole.

Start with what rejection really is: nothing more than a breach of contract. Sec. 365(g) says that "the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease." Whatever con-

sequences rejection has must stem from the statutory provision that rejection constitutes a breach.

That fact explains exactly why it is that a debtor in possession is not permitted to reject only selected parts of a single agreement. After all, it would certainly be good for the estate and creditors if the debtor in possession could keep the good parts of a deal and reject only the bad parts. And, in fact, nothing in the Bankruptcy Code prohibits the debtor in possession from doing exactly that. Yet the cases are uniform in holding that a debtor in possession may not do that. Rather, a debtor in possession must reject or assume a single contract as a whole, which is why bankruptcy judges need to worry about what is or is not a "single contract." But if the Bankruptcy Code does not prohibit piecemeal rejection, then are the courts wrong to do so?

The rule that debtors in possession cannot reject only portions of a single contract or lease is correct. The rule follows from the provision of the Bankruptcy Code, § 365(g), that rejection constitutes a breach. Under the nonbankruptcy law of contracts, the breach of a contract excuses the non-breaching party from performing the balance of the contract. Outside bankruptcy, a breaching party to a single contract would have no right to compel the other party to perform any obligations, even those not directly related to the breach. It is because of that rule of nonbankruptcy law that a debtor in possession that rejects a single contract or lease, thereby breaching it, cannot compel the other party to perform any part of that contract or lease. This understanding leads to a sensible and workable means of addressing the

question of whether a particular set of agreements constitutes a "single contract" for purposes of rejection under § 365.

The inquiry should be whether, under the terms agreed to by the parties and applicable nonbankruptcy law, the breach of one obligation under one instrument constitutes a breach of the other instrument that will excuse performance by the nonbreaching party of the obligations contained in that other instrument. (Similarly, when the question is whether one document contains two separate agreements, the question will be whether breach of the promises sought to be rejected excuses performance of all, or only some of, the obligations in the document.)

In the *Comdisco* case, once I decided to apply that test, the rest was easy. I simply read the documents with a view toward ascertaining the consequences of a breach by the debtor. In the case of the lease of the dark fiber, the pricing and other specific provisions in the product order and the general conditions, although contained in the master option agreement, were explicitly made a part of each separate product order. The default provisions were in those general conditions, which meant they were part of each product order. Breach of a product order only entitled Metromedia to terminate that product order, not the option agreement and the other product orders. Nothing in the documents suggested that Comdisco's breach of one product order, outside bankruptcy, would have excused Metromedia from performing the other product orders and the option agreement. Therefore, rejection of one product order would not have that effect, and

Comdisco could reject the World Trade Center lease without having to reject the other leases.

The documentation of the agreement to transmit data on the fiber, however, reflected a different arrangement. The master agreement, the managed network agreement, defined the word "agreement" to include both that document and the individual product orders, and a premature termination or payment default under a product order entitled Metromedia to terminate the "agreement." Moreover, a default under any product order was a default under the managed network agreement, and the term of that document was automatically extended through the end of the term of any product order, indicating that it was intended to operate in conjunction with each product order.

It was therefore easy for me to conclude that the debtor in possession could not reject the product order for data transmission to the World Trade Center without rejecting the entire deal because a nonbankruptcy default under that product order would have excused Metromedia from future performance of the master agreement and all the other product orders. I did not have to find that the parties had intended to have "one contract" or a "single, integrated" agreement. I simply had to find their intent as to the nonbankruptcy consequences of a breach of the obligations the debtor in possession, a much more straightforward and concrete inquiry.

This test has several advantages. First, it is easier and more certainly applied than trying to determine whether a transaction consists of a "single, integrated contract," a phrase of uncertain meaning to begin with.

Examining the documents and the transaction to determine whether a nonbankruptcy court would excuse performance is a much better defined exercise than trying to guess whether the parties intended to have one or two contracts.

Second, the test derives directly from bankruptcy law. As discussed previously, the only thing in the Bankruptcy Code that prevents a debtor in possession from rejecting only part of a contract or lease is that rejection constitutes a breach under § 365(g) and, as a matter of nonbankruptcy law, a breach excuses the other party's reciprocal obligations. Therefore, the obvious and correct test is to determine whether breach of the obligations than the debtor in possession wants to reject would be a performance-excusing breach of the rest of the deal.

This test also clarifies the issue for the lawyers negotiating and drafting the documentation of a lease transaction. Whether a breach of one obligation should give the other party grounds to terminate the whole deal ought to be a carefully considered and documented issue. Knowledge that the scope of the lessee's rejection power in bankruptcy depends on the resolution of that issue adds a dimension to the negotiations, but once the issue is resolved the parties should be able to predict the consequences of bankruptcy better than they can under the vague "single, integrated agreement" standard.



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