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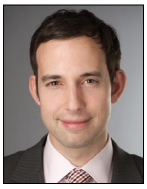
TRANSACTIONAL REAL ESTATE

Expert Analysis

Master Lease Severability



By **Peter E. Fisch**

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Section 365 of the Bankruptcy Code grants debtors the ability to assume or reject any executory contract or unexpired lease. Debtors must assume or reject a lease in its entirety and are not free under Section 365 to assume only favorable provisions of a lease. *See In re Village Rathskeller, Inc.*, 147 B.R. 665, 671 (Bankr. S.D.N.Y. 1992). Courts, however, have consistently held that they will not find a multi-property master lease to be a unitary lease merely because such properties are demised in a single document. *See, e.g.*, *In re Buffets Holdings*, 387 B.R. 115, 120 (Bankr. D. Del. 2008).

In sale-leaseback transactions involving a portfolio of properties, landlords often require that properties be grouped in master leases rather than several individual leases—despite the resulting loss of flexibility for both landlord and tenant—in order to protect against the risk that the tenant can "cherry pick" by rejecting leases for less desirable properties in a bankruptcy.

Debtors in bankruptcy cases frequently challenge the master lease structure and the premise that a master lease agreement is a single, unitary contract that must be assumed or rejected in its entirety. Whether a master lease agreement is unitary or severable is a question of state law. That said, the Bankruptcy Code provides some relevant guardrails, as courts must decline to treat a master lease as a unitary contract if there is no reason for the leases to be integrated beyond the landlord's desire to maximize their recovery in bankruptcy. *See Buffets Holdings*, 387 B.R., at 124.

There is tension between the desire among both landlords and tenants to maintain flexibility under master leases, and the ability of landlords to show that a master lease is unitary in bankruptcy. Terms that grant the parties flexibility with respect to individual properties in a master lease structure are the kinds of terms that courts will typically point to as evidence that a master lease was intended to be severable.

Courts are not, however, entirely consistent on this issue. Some courts consider certain provisions that afford the parties flexibility under master leases as exceptions that prove the rule that the parties intended the agreement to be integrated, while other courts consider such provisions to be evidence of an intent to treat the lease as severable.

Divisible contracts are those contracts wherein "performance by one party consists of several distinct and separate items and the price paid by either party is apportioned to each item." *In re Foothills Tex., Inc.*, 476 B.R. 143 (Bankr. D. Del. 2012). Courts have characterized individual properties within master lease agreements as being intuitively divisible because they cover operationally and geographically independent premises for which rent can easily be apportioned. *See, e.g.*, *In re FFP Operating Partners*, 2004 Bankr. LEXIS 1192, *15-16 (Bankr. N. D. Tex. 2004); *In re Cafeteria Operators*, 299 B.R. 384, 392 (N.D. Tex. 2003); *In re Convenience USA, Inc.*, 2002 Bankr. LEXIS 348, *18 (Bankr. N.D.N.C. 2002).

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The commercial reality of master lease agreements and the desire of both parties (particularly the tenant) to have flexibility can create further pressure on the unitary lease analysis. Both landlords and tenants desire a baseline level of flexibility and the ability, in certain circumstances, to treat an individual property differently from the other properties in the agreement.

Landlords, for example, may want the ability to selectively apply default provisions to terminate the lease only as to individual properties affected by a default, or to sell individual properties, which requires moving those properties from the master lease into a separate lease.

Tenants may want a right to remove obsolete or underperforming properties from the master lease through the substitution of a new property for the obsolete or underperforming property; a right of first refusal in the event a landlord attempts to sell a property that is subject to a master lease; or a right to terminate the master lease only as to an individual property affected by a condemnation or casualty.

Both parties may want to have separate expiration dates for various properties within the agreement, and tenants often negotiate to permit extension of the lease term only for a portion of the demised properties. Some of these rights require an upfront allocation of the rent by property and/or a mechanism for apportioning rent such that individual properties may be more easily removed from the agreement. Courts often view efforts to provide such flexibility as supporting an inference of an intent among the parties for the master lease to be severable. *See, e.g.*, *Cafeteria Operators*, 299 B.R., at 390-391; *Convenience USA,* 2002 Bankr. LEXIS 248, at *11-14.

Courts, however, are inconsistent in their interpretation of provisions that provide such flexibility. In *In re Buffets Holdings*, the landlord retained the ability to consolidate individual properties into new master leases, to sell individual properties and sever the master lease into separate leases, and to selectively enforce property-specific defaults against a particular defaulting property or the master lease as a whole. Tenants were also given the ability to terminate the lease as to individual properties in the event of condemnation and, upon landlord's consent, to substitute a new property for an individual demised property for any reason.

These provisions, however, were not interpreted to undermine the parties' intent for the agreement to be unitary.

Given the tension between maximizing flexibility and achieving unitary lease treatment, and because state law generally looks first and primarily to the intent of the parties, landlords often require clear and express statements of intent in the master lease.

"The fact that the master leases could in certain circumstances be severed by their terms does not mean that the parties intended them to be separate agreements for all purposes," explained the *Buffets Holdings* court. "In fact, it demonstrates the opposite: that the parties intended each master lease to be an integrated agreement except for certain specifically identified circumstances." 387 B.R., at 123. The Bankruptcy Court for the District of Kansas deployed identical reasoning in *In re Dickinson Theaters*. 2012 Bankr. LEXIS 4798, *14 (Bankr. D. Kan. 2012).

Given the tension between maximizing flexibility and achieving unitary lease treatment, and because state law generally looks first and primarily to the intent of the parties, landlords often require clear and express statements of intent in the master lease, and furthermore may include in any integration clause a description of the consideration exchanged for such integration.

The bankruptcy court in *Dickinson Theaters* held that an express statement of intent for a master lease to be indivisible is itself sufficient to establish integration under Kansas law. *Dickinson Theatres*, 2012 Bankr. LEXIS, at *6-8. When such an express integration provision is present, reasoned the court, there is no need apply rules of construction to the agreement. *Id.*

The court further noted that disputes over master lease agreement severability typically only arise where parties fail to include an express integration clause. *Id.* at 8. An express integration clause may be sufficient in the majority of states that primarily focus on the intent of the parties when determining whether a single agreement is severable, and that look first to the express terms of the agreement when determining the parties' intent.

It is possible, however, that notwithstanding an express integration clause, a court could find a master lease severable in bankruptcy under both state contracts law and the Bankruptcy Code. Under state law, a court may decide that the terms of the agreement so clearly indicate that the parties meant for the lease to be severable that the court will override express integration language.

This happened in *In re Cafeteria Operators*, in which the Bankruptcy Court of the Northern District of Texas applied Michigan law and found that a master sublease agreement was severable despite the inclusion of an express integration clause. 299 B.R. 384, 391 (N.D. Tex. 2003). In fact, the court reasoned that the express integration clause was *itself* evidence that the agreement was meant to be divisible because the clause stated that the master sublease agreement remained

integrated even if the landlord decided to not enforce the agreement with respect to an individual property. *Id.*

It should be noted that Michigan is a minority jurisdiction, in that the "singleness or apportionability of consideration," rather than intent, is the principal test in determining contract severability. *Dumas v. Auto Club Ins. Assoc.*, 437 Mich. 521, 473 (1991). In most jurisdictions, the apportionability test is one of multiple factors that courts look to in determining the parties' intent.

Under the apportionability test, a court would look to whether consideration was apportioned across the various leases. If a lump-sum rent is paid for all properties and there are no mechanisms to apportion rent across individual premises, then a court would be more likely to find that a master lease is unitary.

Some, however, have characterized the Michigan approach as merely being the intent approach under a different name. *See Pirinate Consulting Group v. Meyer & Sons Co.*, 2017 Bankr. LEXIS 413, *14 (Bankr. D. Del. 2017). In fact, while the *Cafeteria Operators* court found a sublease agreement severable under the singleness or apportionability test because each of the subleased properties was capable of "standing on its own," the court also found the agreement severable under a more traditional intent analysis that focused on flexibility carveouts provided to the landlord and tenant. *Cafeteria Operators*, 299 B.R. 384, 391-92. We also note that the *Buffets Holdings* and *Dickinson Theaters* cases were decided after, and specifically referenced and distinguished, the *Cafeteria Operators* case.

While the question of whether an agreement is severable is typically a question of state law, some debtors have argued that courts should refuse to enforce provisions that integrate master leases to treat them as a single contract because such provisions constitute "cross-default" provisions that impermissibly restrict a debtor's ability to assume or reject leases in bankruptcy. *See In re FPSDA I, LLC*, 450 B.R. 392, 396 (Bankr. E.D.N.Y. 2011); *Buffets Holdings*, 387 B.R., at 119-120; *Convenience USA*, 2002 Bankr. LEXIS 348, *21.

The bankruptcy courts, more than state courts, attempt to maximize the value of the debtor's estate and are more likely to treat a master lease as severable. While cross-default provisions are not *per se* invalid in bankruptcy, some courts will not enforce such provisions unless the creditor can show that the lease agreements are somehow economically interdependent – i.e., consideration for one lease supported consideration for another. *Buffets Holdings*, 387 B.R., at 119-120.

The need to show economic interdependence should not be an issue for landlords party to master leases that were signed as part of a sale-leaseback transaction. In such circumstances, courts are perfectly willing to recognize the economic value of bundling the leased properties. *See, e.g.*, *Buffets Holdings*, 387 B.R., at 124. But when the master lease is created through bundling of separate leases between affiliates of a common landlord and tenant, courts are more skeptical of efforts to tie together what they see as intuitively separate leases. *See, e.g.*, *FFP Operating Partners*, 2004 Bankr. LEXIS, at*15-16; *Convenience USA*, 2002 Bankr. LEXIS, at *18.

Parties to master lease agreements outside of the sale-leaseback context who want to maximize the likelihood that their agreement is treated as a unitary lease should therefore articulate in their integration clause the interdependent nature of the leased properties. Parties should also note any consideration (like rent reductions) given in exchange for unitary lease treatment.

In short, parties who want a unitary lease must give the courts a reason to reject the argument that there is no business reason for integration beyond maximizing a landlord's potential bankruptcy recovery.

Landlords commonly point to their cross-default provisions (i.e., the fact that a property-specific default is a default under the entire lease) in their master lease agreements as evidence of intent for the agreement to be one integrated whole. Courts generally do not find that cross-default provisions, standing alone, function as a clear statement of integration.

Furthermore, as discussed above, courts will sometimes interpret cross-default provisions that grant the landlord flexibility in its enforcement as evidence that the individual leases were intended to be *severable*. Landlords who want to minimize the "cherry picking" risk should add an explicit integration clause in addition to any cross-default provisions.

Tenant debtors frequently argue that boilerplate severance clauses (i.e., "If any provision of this Agreement is held illegal or unenforceable…") show that the master lease was intended to be severable. Courts routinely reject this argument, finding that such clauses address the severability of individual contractual provisions, not the severability of the subject matter of the agreement. *See, e.g.*, *Dickinson Theaters*, 2012 Bankr. LEXIS 4798, at *14-15.

Both landlords and tenants want to maintain some flexibility within master lease agreements. This flexibility is often in tension with any desire to ensure that a master lease agreement is upheld as a single, unitary contract. Parties who intend to enter a unitary lease should include in the lease clear statements of such intention and of the economic value of integrating the individual leases.