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From the Bankruptcy Courts: The Effect of a Cross-Default Provision on the Ability to Assume an Executory Contract or Unexpired Lease

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The Bankruptcy Code gives a trustee or debtor in possession the power, subject to court approval, to assume or reject executory contracts and unexpired leases.[1] The power to assume is as important as the power to reject in that it allows the trustee or debtor in possession to take full advantage of favorable contracts and leases. This power is especially important in Chapter 11 reorganization cases because it allows the debtor to continue to enforce and reap the benefits of beneficial agreements needed to rehabilitate its business.

The power to assume, however, is not without restrictions. An important restriction—designed to protect the rights of the nondebtor party to the agreement—is that the trustee or debtor in possession must, with limited exceptions, cure defaults or give adequate assurance that defaults will be cured promptly.[2]

It is common for parties with multiple agreements to provide that a default of an obligation under one agreement, in and of itself, will constitute a default under a different agreement. Courts have struggled with the question of whether, as a condition to assuming an executory contract or unexpired lease containing such a "cross-default" provision, the trustee or debtor in possession must cure a default of an obligation arising under a separate contract. If the bankruptcy court enforces a cross-default provision, the trustee or debtor in possession may be prevented from assuming a valuable

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[1] *See* 11 U.S.C. § 365(a). The Bankruptcy Code does not define "executory contract," but most courts define it to mean a contract under which the obligations of both parties are so far unperformed that the failure of either to perform would constitute a material breach. *See, e.g., In re* Streets & Beard Farm Partnership, 882 F.2d 233 (7th Cir. 1989); *In re* Wegner, 839 F.2d 533 (9th Cir. 1988); Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. Rev. 439, 460-462 (1973). The legislative history to the Code indicates that Congress intended the term to mean a contract "on which performance is due to some extent on both sides." *See* H.R. Rep. No. 95-595, p. 347 (1977).

[2] *See* 11 U.S.C. § 365(b).

contract or lease solely because of its inability to cure a default in another agreement.

This issue was recently examined in *In re Kopel*,[3] a case in which the bankruptcy court, based on the particular facts of the case, upheld a cross-default provision in a commercial lease so that the debtor in possession could not assume the lease without curing defaults under a promissory note and consulting agreement.

The Facts

Pasquale Campanile, a veterinarian, is the sole shareholder of Campanile P.C., which owned a veterinary medicine practice known as Gateway Veterinary Arts until 1988. He is also the sole shareholder of Overbaugh Real Estate Corporation, a real estate company that owns the veterinary hospital in which the Gateway Practice operates.

When Campanile decided to sell his veterinary practice in 1988, he sold it to his employee, Martin Kopel, another veterinarian, and provided seller financing for the transaction. The transaction is described generally in the preliminary statement to an asset acquisition agreement signed on August 23, 1988, by Pasquale Campanile, Campanile P.C., Overbaugh, and Martin Kopel:

> [Kopel] is employed by [Campanile P.C.] and desires to purchase the assets of the Gateway Practice. [Kopel] thereafter desires to continue the practice and wishes to enter into certain agreements with Pasquale Campanile in connection therewith. [Kopel] desires to lease the building in which the business operates from Overbaugh. Overbaugh desires to lease the Gateway Building to [Kopel].[4]

In connection with the transaction, the parties entered into several agreements in addition to the asset acquisition agreement, all signed on the same day. Martin Kopel issued to Campanile a promissory note representing $350,000 of the $425,000 purchase price. They also signed a 15-year commercial lease with Kopel as tenant and Overbaugh as landlord, and a consulting agreement which provided for Campanile to act as a consultant for Kopel for an annual salary and which also restricted Campanile's ability to compete with Kopel. The asset acquisition agreement stated that the execution of each of these documents was an express condition precedent to the closing of the sale.

A cross-default provision was inserted in each agreement so that if Kopel defaulted under any one of the agreements, it would constitute a default under all agreements and Campanile would be able to recapture the veterinary practice as a whole. According to Campanile's affidavit, he feared that Kopel might default under the agreements and, therefore, Kopel's acceptance of the cross-default provisions was the principal inducement for Campanile to go forward with the transaction.

[3] 232 B.R. 57 (Bankr. E.D.N.Y. 1999).

[4] *Id.* at 61.

Campanile believed that the only way to recover full value of the veterinary practice in the event of default would be to quickly step in and operate the business.[5]

At the time when Martin Kopel and his wholly owned subsidiary, Martin Kopel, P.C., filed Chapter 11 petitions, the monthly rent payments as required under the lease had been made. But Kopel had not made payments under the promissory note or the consulting agreement, and had accumulated substantial arrears. Kopel, as debtor in possession, sought a declaration that the cross-default provision was unenforceable so that he could assume the lease without curing defaults under the note and consulting agreement. Kopel probably would then attempt to restructure or modify his obligations under the note and consulting agreement. Campanile responded by seeking a declaration that the defaults under the note and consulting agreement must be cured for the debtor to assume the lease.

The Court's Analysis

The bankruptcy court recognized as axiomatic the principle that an executory contract must be rejected or assumed in its entirety—a debtor cannot assume parts of a contract while rejecting the other parts. However, it also noted an exception to the all-or-nothing rule that could justify not enforcing a particular contract provision notwithstanding assumption of the contract:

> In limited circumstances, . . . a court may exercise equitable discretion to refuse to enforce a provision where "there is not substantial economic detriment to the [non-debtor counterparty] shown and where enforcement would preclude the bankruptcy estate from realizing the intrinsic value of its assets."[6]

Courts that have considered whether a cross-default clause is enforceable in the context of a motion to assume an executory contract or unexpired lease have generally based their decisions upon the notion that federal bankruptcy policy is offended where a non-debtor party seeks enforcement of a cross-default provision to extract priority payments under an unrelated agreement. The court stated:

> [W]here 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.[7]

The bankruptcy court examined a number of cases in which cross-default provisions were either enforced or denied enforcement. In *Bistrian v. Easthampton Sand & Gravel Co., Inc.* (*In re Easthampton Sand &*

[5] *Id.* at 62.

[6] *In re* Kopel, 232 B.R. 57, 64 (Bankr. E.D.N.Y. 1999) (citing *In re* Village Rathskeller, Inc., 147 B.R. 665, 672 (Bankr. S.D.N.Y. 1992) which quoted from *In re* Joshua Slocum Ltd., 922 F.2d 1081, 1092 (3d Cir. 1990)).

[7] *Id.* at 66.

Gravel Co., Inc.),[8] a case involving facts similar to those in *Kopel*, the debtor leased a facility and purchased a manufacturing business operating in it by giving the seller a note representing a substantial percentage of the purchase price. The bankruptcy court enforced a cross-default provision in the lease that made a default on the note a default under the lease, stating:

> [E]quity will not countenance the debtor's exercise of [section] 365 to relieve itself of conditions which are clearly vested by the contracting parties as an essential part of their bargain and which do not contravene overriding federal policy . . . . [To do so] would deny the creditor the benefit of his bargain and would result in an unjust windfall for the debtor.[9]

The court in *Easthampton* focused on whether the transaction, taken as a whole, would have closed absent the insertion of the cross-default provisions in the interrelated contracts. The court enforced the cross-default provision based on a finding that the provision was part of the bargained for exchange.

In *In re T & H Diner, Inc.*,[10] the debtor executed a series of promissory notes representing the purchase price of a restaurant business operating in the premises leased from the former owner. The court found that the lease and series of notes formed one indivisible agreement constituting a single contract for purposes of state law so that the debtor's default under the notes precluded assumption of the lease.[11]

Conversely, in *In re Wheeling-Pittsburgh Steel Corporation*,[12] the court refused to enforce a cross-default provision where a series of separate insurance policies containing the provision were not interrelated. "A loan agreement and accompanying security agreement are inherently related in a way that separate policies of insurance and separate leases are not."[13]

Other courts have refused to enforce cross-default provisions on the grounds that the provisions impermissibly infringe on the debtor's right to assume and assign leases.[14] These courts have relied on section 365(f) of the Bankruptcy Code,[15] which permits a trustee or debtor in

[8] 25 B.R. 193 (Bankr. E.D.N.Y. 1982).

[9] *Id.* at 198-99.

[10] 108 B.R. 448 (D.N.J. 1989).

[11] The court in Kopel expressly avoided the issue of whether the lease, note, and consulting agreement before it constituted one contract under state law. It was not necessary to answer that question because the court held that the cross-default provisions were enforceable in view of the relationship between the documents. *See In re* Kopel, 232 B.R. 57, 65 n.4 (Bankr. E.D.N.Y. 1999).

[12] 54 B.R. 772 (Bankr. W.D. Pa. 1985).

[13] *Id.* at 779, n.9. See also In re Plitt Amusement Co. of Wash., Inc., 233 B.R. 837, 847 (Bankr. C.D. Cal. 1999) (stating "[i]t is well-settled that, in the bankruptcy context, cross-default provisions do not integrate otherwise separate transactions . . . . The cross-default provisions must be disregarded in the bankruptcy law analysis, because they are impermissible restrictions on assumption and assignment.").

[14] *See e.g., In re* Sambo's Restaurants, Inc., 24 B.R. 755 (Bankr. C.D. Cal. 1982); EBG Midtown South Corp. v. McLaren/Hart Environmental Engineering Corp., 139 B.R. 585, 597 (S.D.N.Y. 1992).

[15] 11 U.S.C. § 365(f).

possession to assign a contract or lease notwithstanding a provision in the agreement that would prohibit, restrict or condition the assignment, subject to the exceptions listed in section 365(c). Cross-default provisions are not an enumerated exception to section 365(f).[16] Several courts have reasoned, therefore, that cross-default provisions are unenforceable in the bankruptcy context.[17]

The court in *Kopel*, recognized that cross-default provisions are "inherently suspect," but did not read the case law as creating any per se invalidation. Rather:

> [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.[18]

The Decision

The bankruptcy court in *Kopel* based its decision on the relationship between the agreements. The court analyzed the cross-default provision in the lease by examining it's relationship to the promissory note. The court emphasized that there were numerous references to the lease in the other transaction documents.

> [T]he documentary evidence leads to the inescapable conclusion that the Note and Lease are essential elements of a single transaction. . . . The cross default provision in the Lease must . . . be regarded as a necessary term, the absence of which would have halted the sale.[19]

The court conceded that by enforcing the cross-default provision and requiring that all defaults under the note and consulting agreement be cured as a condition to the assumption of the lease, the debtors' reorganization would be hindered. However, the court could "discern no federal policy which requires severance of a lease condition solely because it makes a debtor's reorganization more feasible."[20]

The court mentioned the fact that the various agreements involved in the sale of the veterinary practice were not all signed by the same legal entities. For example, Pasquale Campanile was a party to the note but was not a party to the lease, which was executed by Overbaugh as landlord. This fact, however, did not preclude enforcement of the cross-default provision:

> While enforcement of a cross-default provision in a lease generally should not inure to the benefit of a third party, Overbaugh is not attempting to use section 365(b) to extract priority payments for unrelated obligations. In-

[16] *See* 11 U.S.C. § 365(c).

[17] *See e.g., In re* Sambo's Restaurants, Inc., 24 B.R. 755 (Bankr. C.D. Cal. 1982); EBG Midtown South Corp. v. McLaren/Hart Environmental Engineering Corp., 139 B.R. 585, 597 (S.D.N.Y. 1992).

[18] *In re* Kopel, 232 B.R. 57, 64 (Bankr. E.D.N.Y. 1999).

[19] *Id.* at 66-67.

[20] *Id.* at 67-68 (citing Easthampton Sand & Gravel, 25 B.R. at 199).

> stead, the cross-defaults are being asserted to protect the very essence of the bargain made with Debtors by the landlord and its principal. Overbaugh entered into the Lease to facilitate a larger transaction, not simply to collect rent.[21]

With regard to the relationship between the lease and the consulting agreement, the court found the connection not as obvious as the interrelation between the note and the lease. "Whether to enforce the Lease provision that renders a Consulting Agreement breach a default under the Lease thus turns on whether the parties would have entered into the Lease absent the Consulting Agreement."[22]

The debtors cited, as evidence of the independence of the two agreements, the fact that prior to a 1994 amendment to the consulting agreement, the agreement made no reference to the lease. The debtors further contended that the consulting agreement should be construed as a contract for future employment services and not an essential part of the transaction. In response to the debtors' argument the court stated:

> A careful review of the Consulting Agreement in the context of the Gateway Practice purchase transaction . . . leads to the conclusion that the principal purposes of the agreement were to provide Campanile . . . with ongoing cash income from the practice in addition to payments from the Note and Lease, to reinforce the legal predicate for the non-competition agreement protecting Kopel's interest in the business, and to provide Campanile with a continuing connection with the business during a substantial portion of the payment period under the Lease and the Note. Campanile . . . depends on the ongoing income generated by the Gateway Practice transaction to support his family.[23]

The court concluded that "[t]he Consulting Agreement is but one of several agreements that together provide for the income stream."[24] As the consulting agreement was a fundamental part of the transaction, the court held that "enforcement of the cross-default provision between the Lease and the Consulting Agreement would not offend federal bankruptcy policy."[25]

Conclusion

Finding that the lease, note, and consulting agreement were "entered into as part of a single, integrated transaction,"[26] the court held that the lease could not be assumed without curing, or providing adequate assurance of promptly curing, defaults under the note and consulting agreement. Kopel, as debtor in possession, did not have the option of assuming the lease while restructuring his obligations under the other documents.

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[21] *Id.* at 67.
[22] *Id.* at 68.
[23] *Id.* at 69.
[24] *In re* Kopel, 232 B.R. 57, 69 (Bankr. E.D.N.Y. 1999).
[25] *Id.*
[26] *Id.* at 63.