Enforceability of Cross-Default Clauses in Bankruptcy

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So, your distressed tenant filed for bankruptcy? Commercial landlords in this situation often are "surprised" to learn that their tightly wound lease agreements can be unraveled at the proverbial snap of a finger. The Bankruptcy Code, for instance, allows a debtor 60 days after the petition date to bring its lease obligations current. 11 U.S.C. § 365(d)(5). In addition, debtors that file in the middle of a month are relieved from timely paying rent for their post-petition occupancy and use within that first month. *See In re Circuit City Stores, Inc.*, 447 B.R. 475, 511 (Bankr. E.D. Va. 2009) (finding that a debtor's "stub rent" obligations arising post-petition, while entitled to administrative expense priority, could be paid when all other administrative claims in a case are paid).

Of even more significance, to facilitate a debtor's reorganization in Chapter 11 bankruptcies, the Bankruptcy Code grants a debtor an unfettered right to "reject" burdensome lease agreements. *See generally* 11 U.S.C. § 365. A lease agreement that is rejected is treated as a breach. 11 U.S.C. § 365(g)(1). All lease agreement that are not rejected must be "assumed." Lease agreements that are assumed will continue in accordance with their terms as they normally would, except that they can be assigned to a new party, regardless of whether the lease agreement prohibits such an assignment. 11 U.S.C. § 365(f)(2). As a rule, payment obligations under an assumed lease agreement must be paid in full and are entitled to administrative expense priority. 11 U.S.C. § 1129(a)(9)(A). By contrast, upon rejection, a landlord is left with a general unsecured prepetition claim for damages that often will amount to pennies on the dollar—if anything.

Complications arise when multiple lease agreements are governed by a master lease instrument, or when a borrower's obligations under a promissory note, easement, or other burdensome agreement are incorporated into a lease agreement ("multi-obligation lease arrangements"). Landlords with multi-obligation lease arrangements often attempt to intertwine distinct obligations by incorporating a cross-default clause: "a contractual provision under which default on one debt obligation triggers default on another obligation." Black's Law Dictionary (11th ed. 2019), available at Westlaw BLACKS.

In theory, cross-default clauses should give landlords some measure of control over the treatment of their multi-obligation lease arrangements in a tenant's bankruptcy by preventing leases from being assumed or rejected in piecemeal fashion. This is because a basic principle of bankruptcy is that

contracts must be assumed or rejected *cum onere*—that is, in their entirety, with all of the benefits and burdens. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531–32 (1984). For this reason, before a lease agreement can be assumed, generally the debtor must cure all defaults; it must take the lease with its burdens. 11 U.S.C. § 365(b)(1)(A). Because the rejection of a lease agreement effectively constitutes a breach, the rejection of any portion of a multi-obligation lease arrangement seemingly would trigger a cross-default clause, precluding the debtor from assuming other profitable or beneficial portions.

As a practical matter, however, bankruptcy policy "is offended where [a] non-debtor [landlord] seeks enforcement of a cross-default provision in an effort to extract priority payments under an unrelated agreement." *In re Kopel*, 232 B.R. 57, 65 (Bankr. E.D.N.Y 1999); *see also In re Liljeberg Enterprises, Inc.*, 304 F.3d 410, 445 (5th Cir. 2002) (describing cross-default clauses as "inherently suspect"). This is not to say that cross-default provisions never are enforceable, but the party seeking enforcement likely will face an uphill battle.

The chief issue that courts consider when confronted with a cross-default clause is whether the multi-obligation lease arrangement is "indivisible" under state law. *Butner v. United States*, 440 U.S. 48, 54 (1979). States tend not to deviate much on this issue; the outcome usually results from an analysis of the "intent of the parties," which is gleaned by interpreting the plain language and terms of the contract. *See, e.g.*, *In re Convenience USA, Inc.* 2002 WL 2300772, at *3 (Bankr. M.D.N.C. 2002) ("The factor that weighs most heavily in deciding whether [a multi-obligation lease arrangement] is an entire contract or is divisible, is the intent of the parties as reflected in [its] provisions."). Through this analysis, a court must convince itself that all obligations under a multi-obligation lease arrangement are part of a single, integrated transaction, such that severing certain portions and obligations would prevent the non-debtor landlord from obtaining an important benefit of the bargain. *See Kopel*, 232 B.R., at 63. Even then, a court may exercise its equitable discretion to refuse to enforce a cross-default provision where "there is no substantial economic detriment to the [non-debtor landlord] shown and where enforcement would preclude the bankruptcy estate from realizing the intrinsic value of its assets." *In re Village Rathskeller, Inc.*, 147 B.R. 665, 672 (Bankr. S.D.N.Y. 1992) (citing *In re Joshua Slocum Ltd*, 922 F.2d 1081, 1092 (3rd Cir. 1990)).

The takeaway here is that courts are reluctant to enforce cross-default clauses within multi-obligation lease arrangements. This especially is true when enforcing them would disrupt the debtor's ability to reorganize and maximize the value of the estate for the benefit of the debtor's creditors. To ensure that a landlord will be in the best possible position in the event that its tenant files for bankruptcy, multi-obligation lease arrangements must be drafted such that there is clear and overwhelming evidence that the contracting parties intended for it to be indivisible.

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