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Expert Analysis

Delaware Bankruptcy Court Decides Who Is Master of a Master Lease

By **Steven M. Herman**

During the recent cycle of real estate financings, a popular structure emerged to segregate the real estate assets from the operating assets of a company. The structure became commonly known as Opco/Propco transactions.

In its simplest form, the real estate assets are owned by a property company (Propco), which is a single-purpose, bankruptcy remote entity. Typically, a single Propco would own either many properties such as hotels, retail properties, gaming facilities or skilled nursing facilities or multiple Propcos would individually own such properties.

Either multiple individuals or a single operating company (Opco) would operate the properties. Central to this structure is a lease by Propco to Opco of the properties. Propco would usually enter in a master or unitary lease of all of the properties.

The master lease served three primary purposes.

First, the rent payable pursuant to a master lease constitutes "rents" for purposes of Section 552(b)(2) of the Bankruptcy Code. Consequently, "business income" would, through the lease, be converted to "rents" and have the benefits of §552(b)(2), which extends a pre-petition security interest to post-petition rents.

Second, a lease structure isolates the liabilities of an operating business from the ownership of the real estate.

Lastly, a master lease is designed to prevent a debtor from cherry-picking leased real property in a bankruptcy. Pursuant to Section 365, a debtor has the express right to assume or reject an unexpired lease. A master lease structure, if properly documented and entered into, is intended to limit such rights in bankruptcy to an assumption or rejection of the master lease in whole and prevent the debtor from picking and choosing which of the many properties leased pursuant to the master lease it wishes to assume or reject.[1]

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A recent case, *In re Buffets Holdings Inc.*, 387 B.R. 115 (Bankr. D. Del. 2008), addressed whether a master lease was a single, indivisible whole that could only be assumed or rejected in whole, or separate, severable agreements pursuant to which a debtor could reject one agreement and not another.

The U.S. Bankruptcy Court for the District of Delaware held that the master leases in issue were indivisible agreements. The *Buffets* decision is instructive in that it reviews existing case law on the issue at hand and provides general guidelines to structure and interpret master leases.

In order to recapitalize, the debtor in *Buffets*, in addition to other related transactions, entered into a sale/leaseback transaction in which they assigned ground leases and sold the buildings (29 restaurants) to a third party, which then subleased the land and buildings back to the debtor pursuant to four master leases.

As part of the recapitalization, the debtor received approximately $35 million in cash, the restaurants were no longer on the debtors balance sheet, prior debt on the restaurants was paid off and other secured debt was refinanced, which resulted in a dividend to shareholders.

The issue before the court on motion was whether the master leases were divisible or could only be assumed or rejected in whole.

It is fairly well-settled law that a debtor in bankruptcy has the right pursuant to Section 365 of the code to assume or reject an unexpired non-residential lease. The debtor must however "assume all the terms of the lease and may not pick and choose only favorable terms to be assumed."[2]

The *Buffets* court notes in its review of relevant case law that provisions within a lease restricting the right to assume are unenforceable, including cross-default provisions between and among multiple leases and contracts:

> [W]here a debtor is a party to a number of expired leases, cross-default clauses that would serve to prevent the debtor from assuming some of the leases without assuming the others at the same time are unenforceable under §365(f).[3]

While a master lease would structurally do away with this concern, the court was quick to note that demonstrating a contract or lease as a single document does not mean that it is not indivisible. The court makes it clear that divisibility is a question of state law turning primarily on the intent of the parties.

The court goes on to analyze the law governing the master leases in question: Illinois law. The court establishes that the law in Illinois with respect to the test for severability hinges on "the intention of the parties as established by a reasonable interpretation of the terms and provisions of the contractual document itself, by the circumstances of the transaction at issue, and by the subject matter to which the contract has reference."[4]

In addition, the court notes that pursuant to Illinois law, Illinois courts will limit their analysis and review to the "four corners" of the document at issue "if it is not ambiguous to ascertain the parties intentions in executing it."[5]

In analyzing the master leases, the court states that the two leases in issue covered 10 and 11 properties, respectively, in four and eight states, respectively. Each underlying lease covered by the master leases pertains to a separately operated restaurant that provides separate financial reports.

While the master leases have a total rent, such rent was allocated to each property. The ability to apportion or allocate the rent, while an important factor, is not conclusive, according to the court. Again, the intent of the parties in entering into the contract or lease is what is determinative.

The master leases also allowed the tenant to divide and consolidate individual leases to create new master leases, to sell an underlying property and sever that lease from the master lease and upon a condemnation of an individual property, substitute another property for the condemned property.

In addition, with consent, individual leases could also be assigned or substituted. While the debtor argued that these provisions are evidence that the master lease could be severed, the court took the opposite view that the master lease was intended to be "an integrated agreement except for certain specifically identified circumstances."

The court took note of a non-merger provision of the lease whereby the leases would not merge even if the landlord and tenant were the same party as bolstering the argument that the intent of the parties was for a single indivisible master lease.

Rental Obligation

The master lease provided that the rental obligation was joint and several whereby each tenant is liable for the entire rent. In addition, the rent under the master leases was not abated if one or more properties were unusable due to casualty, condemnation or termination of a ground lease. Furthermore, the term of the master lease could only be extended if all underlying ground lease terms are extended. Finally, the master lease also allowed the landlord to declare the entire master lease in default upon a default of an individual tenant or to only default the individual lease.

The court viewed all of these provisions as evidence of a single integrated contract. The joint and several rental obligation is characterized as being only consistent with an indivisible contract since why else would one of the underlying tenants be liable for rent on a building it is not occupying.

While the debtor argued that many of these provisions are merely unenforceable cross-default provisions, the court disagreed, noting first, that flexibility in the exercise of remedies is typical of most contracts and second, that "cross-default provisions are not per se invalid under section 365."

Prior Scrutiny

The court pointed to its prior scrutiny and decision in *The Shaw GroupInc. v. Bechtel Jacobs Co. LLC (In re The IT Group Inc.)*, 350 B.R. 166, 179-180 (Bankr. D. Del. 2006), indicating that the relevant analysis of cross-default provisions and the critical feature in rendering such provisions enforceable is "that the agreements linked by the cross-default clause were economically interdependent: the consideration for one agreement supported the other."[6]

The court concludes that the individual leases making up the master lease are economically interdependent as the landlord was leasing the total package of properties for a total rent and that "to allow the Debtors to reject one of the leases without continuing to pay the total rent would be to destroy the essence of [the landlord's] bargain."

The debtor makes the argument that severance is necessary for it to effect its reorganization. The court rejects this argument stating that "there is no federal policy which requires severance of a lease condition solely because it makes a debtor's reorganization more feasible."[7]

It should be noted that the court cites multiple cases with similar facts where courts have severed leases and contracts. However, the court distinguishes these cases based on the intent of the parties in the transaction being decided. In this case, the "Debtors, after entering into the leases, bundled them for purposes of monetizing them."

> The 'Buffets' decision is demonstrative of the need to carefully structure, draft and negotiate transactions that utilize master or unitary leases.

Contrary to the debtor's argument that the only reason for entry into the master lease was for credit enhancement which does not "integrate otherwise divisible, separate agreements," the court states that "all business transactions are done for financial reasons."

In the case at hand, a substantial sum of money was paid by the landlord "in exchange, inter alia, for the right to bundle the leases into four master leases and restrict the exercise of rights by the individual tenants."

This point is really the determinative factor for the court. The ability to monetize the leases was the main business intent of the transaction and the court took note of the fact that the intention to treat the lease as indivisible was "clear from the face of these agreements."

The court even goes to great length to address the debtor's arguments regarding certain ambiguities in the lease by reviewing the parties negotiations. It notes that the parties' course of dealing evidenced an intent that the master lease was indivisible.

Examples given by the court included, the debtor agreeing to the master lease structure due to the more favorable terms it could receive, the treatment of the master lease as an operating lease from an accounting perspective, and the fact that the landlord could not have consummated the transaction without a master lease.

The fact that the landlord was not the original landlord and was being asked by the debtors to monetize their leases is the persuasive argument for the court. Even though the landlord may have wanted to securitize (or resell) its position, the court noted that the "primary goal was to assure that it would recover its investment."

The debtors received significant consideration in exchange for an indivisible contract. There was no independent reason for the landlord to enter into separate individual leases. The court goes on to acknowledge the economic reality that the landlord's entering into this transaction with a master lease was based upon its economic analysis of the "determination of the average of the terms of the leases and the total rent paid by the Debtors collectively."

The *Buffets* decision is demonstrative of the need to carefully structure, draft and negotiate transactions that utilize master or unitary leases.

The courts will analyze the language and terms of the documentation, as well as the course of conduct of the parties to ascertain the intent of the parties. The intent of the parties will be determined by the courts with a keen view of the economic substance of a transaction.

While it is always easy to view a transaction with 20-20 hindsight, this case is a recent example of the need to be sure that legal substance mirrors economic reality.

1. The foregoing is a simple outline of the basic structure of an Opco/Propco transaction with a master lease. The intricacies of such a structure, including issues of whether a master lease is a "true lease," are beyond the scope of this article.
2. *Buffets*, 387 B.R. at 119.
3. *Buffets*, 387 B.R. at 120, quoting *In re Convenience USA Inc.*, No. 01-81478, 2002 WL 230772, at *7 (Bankr. M.D.N.C. Feb. 12, 2002).
4. *Buffets*, 387 B.R. at 120, quoting *Super Stop Petroleum Inc. v. Clark Retail Enters. (In re Clark Retail Enters.)*, 308 B.R. 869, 888 (Bankr. N.D. Ill. 2004).
5. *Buffets*, 387 B.R. at 120; *Neuma Inc. v. AMP Inc.*, 259 F.3d 864, 873 (7th Cir. 2001); *Clark Retail*, 308 B.R. at 884; *Bourke v. Dun & Bradstreet Corp.*, 159 F.3d 1032, 1036 (7th Cir. 1998).
6. *Buffets*, 387 B.R. at 124, citing *The Shaw Group Inc. v. Bechtel Jacobs Co., LLC (In re The IT Group Inc.)*, 350 B.R. 166, 179-180 (Bankr. D. Del. 2006), citing *United Air Lines*, 346 B.R. at 470, citing *Lifemark Hosps. Inc. v. Liljeberg Enters. (In re Liljeberg Enters.)*, 304 F.3d 410, 445 (5th Cir.2002); *Kopel v Pasquale Campanile*, 232 B.R. 57 at 67 (Bankr. E.D.N.Y. 1999).
7. *Buffets*, 387 B.R. at 124, quoting *Bistrian v. Easthampton Sand & Gravel Co. Inc. (In re East Hampton Sand & Gravel Co. Inc.)*, 25 B.R. 193, 199 (Bankr. E.D.N.Y. 1982).