Reinhart

Splitting Contracts in Bankruptcy – Debtors Take the Good Without the Bad

POSTED:

Aug 28, 2012

RELATED PRACTICES:

[Corporate Law](https://www.reinhartlaw.com/practices/corporate-law)

https://www.reinhartlaw.com/practices/corporate-law

Favorable contracts are an important asset for a bankruptcy estate. If a contract is an executory contract (a contract with performance remaining by both parties), the Bankruptcy Code gives a debtor the choice of either assuming and performing under the contract going forward, or rejecting the contract and leaving the resulting rejection damages as a claim against the bankruptcy estate. Similarly, a debtor may choose to perform or not perform under a non-executory contract for which it has continuing obligations. The protection for contract counterparties underlying the treatment of contracts in bankruptcy is cum onere, the "all-or-nothing" principle that a debtor may not assume the benefits of a contract and while rejecting the contract's burdens. Recently, however, debtors have successfully circumvented this principle by being able to show that a contract is really two separate contracts by virtue of having two interdependent contracts in one document.

In the *American Home Mortgage Holdings* bankruptcy in the District of Delaware (Case No. 07-11047), the debtor was party to numerous Master Servicing Contracts. These contracts involved the sale of loans by the debtor and the agreement by the debtor to service those contracts going forward. The contracts gave the purchaser the rights to "put back" nonperforming loans by selling them back to the debtor. With the collapse of the housing market, the debtor faced a large number of loans it was obligated to repurchase from the purchasers, which made the Master Servicing Contracts significant liabilities for the debtor. The servicing aspects of the contracts remained valuable. Seeking to retain the benefit of the servicing rights while rejecting the burden of the "put back" obligations in the sale agreement, the debtor argued the servicing agreement was a separate contract from the sale agreement, despite the fact that both were included in the same legal document. The debtor then proposed to keep the servicing contract and reject the sale contract.

Certain creditors objected, arguing that the sale and servicing agreements were part of the same bargain. In resolving the objection, the Bankruptcy Court evaluated whether (i) the nature and purpose of the agreements are different, (ii) the consideration of the agreements is separate and distinct and (iii) the obligations of each party to the instrument are not interrelated. Applying these factors, the Court found that the Master Servicing Contracts were in fact two

All materials copyright © 2023 Reinhart Boerner Van Deuren S.C. All rights reserved.

separate contracts contained in a single agreement.

To protect contracts from being "split" in bankruptcy, contract parties should design their agreements such that the consideration for each part of the contract has an economic relation to the consideration of the other parts of the contract. Courts have found that a simple cross-default provision does not in itself make separate parts of a contract economically interdependent. Courts look to the economic substance of the contract to determine whether failure to perform under one part of the contract deprives the counterparty of the benefit of its bargain under the other part of the contract.

Please contact your Reinhart attorney or any attorney in Reinhart's Business Reorganization Practice if you have any questions concerning protection from the splitting of contracts in bankruptcy.

These materials provide general information which does not constitute legal or tax advice and should not be relied upon as such. Particular facts or future developments in the law may affect the topic(s) addressed within these materials. Always consult with a lawyer about your particular circumstances before acting on any information presented in these materials because it may not be applicable to you or your situation. Providing these materials to you does not create an attorney/client relationship. You should not provide confidential information to us until Reinhart agrees to represent you.

All materials copyright © 2023 Reinhart Boerner Van Deuren S.C. All rights reserved.