The Whole Loaf, or Only a Slice?: *Interstate Bakeries* and the Increased Importance of Integration Clauses in Contracts with Bankrupt Counterparties

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As a recent number of bankruptcy cases have illustrated, contract integration clauses can have profound and unintended effects when, upon the bankruptcy of a counterparty, the contract becomes subject to section 365 of the Bankruptcy Code. Typically, integration clauses in contracts provide that all the terms of the parties' agreements are captured within one or more referenced written contracts. The primary purpose of these clauses is to define clearly the "four corners" of the parties' written contract and prevent the parties from later claiming that there are oral or other agreements outside the four corners of the referenced written contract. But, as indicated by the recent Eighth Circuit decision in *Interstate Bakeries/Hostess*, integration clauses can take on additional importance in the bankruptcy context.

A debtor in bankruptcy has the right to assume or reject executory contracts and unexpired leases pursuant to section 365 of the Bankruptcy Code. This right allows a debtor to keep valuable contracts and jettison burdensome ones. As a general rule, however, a debtor must assume or reject the entire agreement and cannot "cherry pick" the best provisions or carve out those that are burdensome. As a result, bankruptcy courts have a unique task in contract interpretation, for they must determine the precise contours of a single contract for purposes of determining what can be assumed or rejected. This can be particularly difficult when agreements among parties are contained in a number of related, written contracts. Bankruptcy courts regularly turn to integration clauses to evaluate whether a set of agreements should be considered single or multiple contracts for purposes of section 365 of the Bankruptcy Code.

The recent decision from the Eighth Circuit emphasizes the relationship between contract "integration" and the treatment of contracts in bankruptcy under section 365. In *Lewis Brothers Bakeries Inc. v. Interstate Brands Corp.* (*In re Interstate Bakeries Corp.*), No. 11-1850, (8th Cir. June 6, 2014), the en banc Eighth Circuit concluded that a license agreement was not an executory contract based substantially on the court's determination that the agreement was merely one part of a larger, integrated contract governing the transaction between the parties. As a result, the license was not subject to rejection by the bankruptcy estate, and the rights of the licensee were protected from the effects of rejection.

The Context: Asset Sale Pursuant to an Antitrust Judgment

In 1995, Interstate Bakeries announced its acquisition of Continental Baking Company, the owner of the Wonder and Hostess brands and trademarks. The US Department of Justice challenged that transaction on antitrust grounds. The final judgment entered in the antitrust litigation required Interstate Bakeries to divest itself of certain of its brands in certain territories. In accordance with that judgment, in 1996 Interstate Brands Corporation (IBC), a subsidiary of Interstate Bakeries, entered into two agreements with Lewis Brothers Bakeries, Inc. (LBB): (a) an Asset Purchase Agreement, under which IBC agreed to sell its Butternut and Sunbeam operations and assets in certain territories to LBB in exchange for $20 million, and (b) a License Agreement, under which IBC granted to LBB a “perpetual, royalty-free, assignable, transferable, exclusive” license to use the brands and trademarks in the respective areas. The parties allocated $11.88 million of the $20 million purchase price to various tangible assets, with the remaining $8.12 million allocated to intangible assets, including the license. Of note, the License Agreement also provided mutual duties of notification regarding infringement, required that the goods sold under the marks be of a certain character and quality, and provided that LBB’s failure to maintain such quality would constitute a material breach of the agreement.

In 2004, Interstate Bakeries and certain of its affiliates, including IBC (collectively, the Debtors), filed chapter 11 petitions. In 2008, LBB filed a complaint seeking a declaratory judgment that the License Agreement was not an executory contract and therefore, was not subject to assumption or rejection by the debtor under section 365 of the Bankruptcy Code (which generally permits debtors in bankruptcy to assume or rejects contracts that are “executory”). The bankruptcy court found that the License Agreement was an executory contract because both IBC and LBB had material, unperformed (or continuing) obligations under that agreement. The district court affirmed on appeal, reasoning the License Agreement was executory because LBB’s failure to maintain the character and quality of goods sold under the trademarks would constitute a material breach of the agreement. On appeal to the Eighth Circuit, a divided panel affirmed. The majority found that the License Agreement was executory because both LBB and IBC had at least one remaining material obligation under the agreement.

The *En Banc* Decision: Court Unanimously Finds One Integrated Agreement; Majority and Dissent Disagree on Whether Agreement is Executory

The *en banc* Eight Circuit reversed, holding that the License Agreement and Asset Purchase Agreement constituted a single, integrated agreement and that the agreement was non-executory. Judge Colloton, the author of the dissenting panel opinion, wrote for the *en banc* majority.

The court explained that before addressing whether the agreement was executory, it had to first “identify what constitutes the agreement at issue.” Slip. Op. at 8. The bankruptcy court, district court and panel majority had all considered the License Agreement alone, but the *en banc* court found that the Asset Purchase Agreement and License Agreement should be considered together as one contract. The court explained that under Illinois law, whether a contract is a separate agreement depends on the intent of the parties; in the absence of contrary intent, instruments executed by the same parties in the course of the same transaction will be considered together; and "[a] contract should be treated as entire when, by a consideration of its terms, nature, and purposes, each and all of the parts appear to be interdependent and common to one another and to the consideration." Slip. Op. at 9. Applying these principles, the court examined the language of the relevant agreements, noting, among other things, that (a) the Asset Purchase Agreement listed the license as one of the assets sold to LBB as part of the transaction; (b) the Asset Purchase Agreement directed the parties to enter into the License Agreement "[u]pon the terms and subject to the conditions contained in [the Asset Purchase Agreement]"; (c) a model for the License Agreement was included as an exhibit to the Asset Purchase Agreement; (d) the integration clause in both the Asset Purchase Agreement and License Agreement provided that the "entire agreement between the parties" included both agreements; and (e) the License Agreement provided that "as consideration for the license, LBB 'has paid to IBC a fee of ten dollars ($10.00), and other good and valuable consideration, set forth in the Allocation Agreement described in Section 2.3 of the Purchase Agreement.'" *Id*. The court concluded that treating the Licensee Agreement as a standalone agreement would run counter to the plain language of the two agreements.

The court then addressed whether the integrated agreement was executory, concluding that it was not. In reaching that conclusion, the court relied on Professor Countryman's widely adopted definition of "executory contract": "[A] contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Slip. Op. at 10. The court found IBC's failure to perform its outstanding obligations would not constitute a material breach. The court explained that "the essence of the agreement" was the sale of IBC's Butternut and Sunbeam bread operations and assets to LBB in certain territories, of which the license of IBC's trademarks was merely one part. IBC had already transferred all of the tangible assets and inventory to LBB, executed the License Agreement, and received the full $20 million purchase price from LBB. IBC's only remaining obligations—to refrain from using its trademarks in the territories, control the quality of goods produced with the trademarks, provide notice of and defend against infringement—all pertained exclusively to the license. Considered in the context of the overall agreement, the court reasoned, those obligations were relatively minor and did not relate to the central purpose of the agreement—the sale of certain IBC operations and assets. As a result, the failure to perform those obligations would not constitute a material breach.[1]

The dissent agreed that the Asset Purchase Agreement and License Agreement constituted a single, integrated contract but concluded that the integrated agreement was executory.

Like the majority, the dissent reasoned that "the materiality of a contractual obligation depends on whether the obligation goes to the essence of the contract." Slip. Op. at 15. But the dissent found that the essence or purpose of the integrated contract was the sale of IBC's bread business *to* *comply with the antitrust final judgment*. And that judgment directed IBC to divest itself of the tangible assets reasonably necessary to allow the purchaser to make effective use of the license. Thus, the dissent reasoned, the "multitude of tangible assets listed in the Asset Purchase Agreement were there for the purpose of allowing LBB to make effective ongoing use of the license." *Id*. Accordingly, "the mere fact that the license was one asset listed among many does not indicate it plays a minor role in the transaction." *Id*. Furthermore, the dissent explained, the language of the agreement demonstrated that "the parties regarded the ongoing ligations associated with the license as more likely to be material than those regarding the asset purchase." *Id*. Judge Bye pointed to the severability provisions in each document: those in the Asset Purchase Agreement provided that, to the extent any provision was deemed invalid, it would be severed and the remainder of the agreement would remain in effect; by contrast, the License Agreement provided that, to the extent any provision was deemed invalid, either party could request renegotiation of the agreement if it deemed the invalidated provision to be material.

The dissent concluded that both IBC and LBB had ongoing obligations that would result in a material breach if not performed. LBB had such an obligation—a section of the License Agreement expressly provided that LBB's failure to maintain the quality and character of goods sold under the trademark would constitute a material breach. Judge Bye found that IBC did as well: "[a]s the purpose of the integrated agreement was to transfer IBC's bread business in the specified territories to comply with the antitrust Final Judgment, it cannot seriously be argued IBC would not materially breach the integrated agreement if it breached its duty to forbear from using the trademarks in those territories." Because each party had ongoing obligations that would result in a material breach if not performed, the integrated agreement was executory under the Countryman test.

The Bottom Line

Defining which agreements constitute the contract at issue is key to determining whether the contract may be assumed or rejected by a debtor in bankruptcy. In *In re Physiotherapy Holdings, Inc.*, No. 13-12965 (Bankr. D. Del. Mar. 19, 2014) (see WilmerHale Client Alert, April 11, 2014), the bankruptcy court allowed a debtor to assume a license agreement while simultaneously rejecting other related agreements with the licensor because the court found that the license agreement was an agreement separate and distinct from the other related agreements between the parties. And in *Interstate Bakeries*, by finding the License Agreement and Asset Purchase Agreement to be one integrated agreement, the majority essentially "diluted" the materiality of the outstanding obligations in the License Agreement and, as a result, found the integrated agreement to be non-executory. The rights of the licensee were therefore protected from the effects of potential rejection—for example, the potential termination of the licensee's rights to use the trademarks.

When parties entering into a transaction governed by multiple agreements fail to clearly express their intent on whether the various agreements constitute a single integrated contract for purposes of rejection or assumption under section 365 of the Bankruptcy Code, courts may resolve the issue by relying on clauses many attorneys consider to be boilerplate—e.g., severability and integration clauses. In *Interstate Bakeries*, for example, the court relied in part on the boilerplate integration language in both the License Agreement and Asset Purchase Agreement to conclude that they were one agreement. And while in *Physiotherapy Holdings* the court rejected the argument that the integration clause provided evidence that one of the agreements at issue was a mere component of another—explaining that "the integration clause simply means all of the Agreements between the parties are reflected in the Agreements as written, thereby eliminating parol evidence"—it did rely on (a) language providing which of the agreements would govern in the event of contradiction between the two and (b) the fact that indemnity provisions in the two agreements differed in scope as evidence that the agreements should not be considered a single contract. The contractual clauses relied on by the courts in these cases are typically included in agreements for other purposes and without a view to section 365.

In sum, courts may differ in which clauses they find relevant and how they interpret the clauses for section 365 purposes. Parties entering into multi-agreement transactions—including asset purchase and other acquisition transactions—should consider carefully whether the agreements are to be read as an integrated contract or distinct agreements for purposes of section 365 of the Bankruptcy Code, and should draft contracts clearly to leave no ambiguity on the issue. Even transactions like these among seemingly healthy companies could otherwise create unexpected results if one of the parties later becomes financially distressed.

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[1] In so concluding, the court relied in part on the Third Circuit's decision in *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010).

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