

UNITED STATES BANKRUPTCY COURT  
DISTRICT OF MINNESOTA  
THIRD DIVISION

In Re: CHAPTER 11  
Restaurant Ventures I,  
Debtor. Bky. 3-91-6945

ORDER

This matter is before the Court on motion of the Debtor to modify the terms of an earlier order entered on April 21, 1992, regarding obligations of the Debtor under a Lease with Capital City Investments (CCI). Evidence was heard and received, beginning on May 13, 1992, continuing thereafter pursuant to adjournment, and ending on May 26, 1992. The Court, having considered the evidence heard and received, having considered the written and oral arguments of counsel, and now being fully advised in the matter, makes this ORDER pursuant to the Federal and Local Rules of Bankruptcy Procedure.

I.

STATEMENT OF FACTS

RELATIONSHIP OF THE PARTIES.

CCI owns the Golden Hills Shopping Center located on I-394, in on the north side of Highway I-394 at the intersection of Turner's Crossroad, just west of Highway 100. Debtor is a tenant at Golden Hills where it operates two restaurants and a night club known as the American Cafe, CocoLezzone and Rupperts, respectively. CCI and Debtor entered into a Lease dated June 9, 1983 ("Original Lease") of approximately 12,855 square feet of space in Golden Hills (Debtor's Exhibit 2). Under the Original Lease, Debtor is obligated to pay base rent of approximately \$12,319.36 per month, a percentage of gross receipts, and Debtor's pro rata share of real estate taxes, utilities and certain maintenance costs.

The Original Lease was subsequently amended by an Amendment to Lease Agreement dated December 10, 1984, ("First Amendment") (Debtor's Exhibit 3). The First Amendment provided for an increase in rental space with appropriate rental increases and extended the term of the Original Lease for a period of one year. It also recognized that:

(a) under the provisions of paragraph 7 of the Original Lease, Debtor, at its own cost and expense, was obligated to pay for all

costs, work and installations necessary for tenants' use and occupancy of the leased premises located in Golden Hills; and

(b) notwithstanding the provisions of paragraph 7 of the Original Lease, CCI agreed to pay for \$884,500 of tenant improvements to the leased premises occupied by Debtor in Golden Hills. Under the First Amendment, Debtor agreed to pay additional rent of \$12,500 to CCI, in recognition of CCI's payment of tenant improvements, commencing on January 1, 1985, and continuing on the first day of each month thereafter during the lease term through December 1, 1999. CCI paid for the tenant improvements referenced in the First Amendment (Debtor's Exhibit 5).

The Original Lease, as amended, was subsequently amended by a Second Amendment to Lease Agreement ("Second Amendment") (Debtor's Exhibit 1), which modified the initial term of the Original Lease, as amended, for four additional years, with expiration on December 31, 2003.

The Original Lease, as amended, was amended a third time by a Third Amendment to Lease Agreement ("Third Amendment") dated August 5, 1988, (Debtor's Exhibit 4). The Third Amendment recognized the Debtor's request that CCI pay for additional leasehold improvements to the tenant improvements already paid for by CCI under the First Amendment, and, it modified the \$12,500 per month additional rental obligation required by the First Amendment to conform with the refinancing of CCI's obligation to a third party lender in connection with that transaction.(FN1)

Additionally, contemporaneous with the execution of the Third Amendment, CCI advanced Debtor \$1,520,000 to pay for more tenant improvements, either directly or by paying an existing obligation to First Bank. The money loaned by First Bank had been used by Debtor for the payment of tenant improvements to the leased premises at Golden Hills. These advances were memorialized by a

(FN1) CCI originally borrowed the money used to finance the \$884,500 improvements, and refinanced the existing balance of \$500,000 in connection with its financing of the second improvements in 1988.

5, 1988, from Debtor to CCI. Debtor acknowledged in the Third Amendment that, for purposes of the Original Lease, as amended, payments pursuant to the Lessor Note are "deemed to be rent." (Debtor's Exhibit 4 at 5). Debtor further acknowledged and agreed that a default in the payment of any amount due under the Third Amendment constituted a default under the Original Lease, as amended (Debtor's Exhibit 4 at Paragraph 6).

Debtor was represented by Winthrop & Weinstine with respect to all negotiations involving the Original Lease and all amendments. The Original Lease, First Amendment, Second Amendment and Third Amendment were drafted by Winthrop & Weinstine. Inclusion of paragraph 5 in the Third Amendment deeming the Lessor Note payments to be rent, was at the instruction of CCI. No note or security agreement was executed by the parties regarding the obligation arising out of the first improvements, and payments were at all times received and applied by CCI as rent. Payments regarding the second improvements under the Lessor Note were at all times

received and applied by CCI as interest and return of principal.

Debtor filed for Chapter 11 relief on December 20, 1991, and thereafter ceased making any additional payments arising from the improvements to CCI until January 17, 1992. In the interim, Debtor only paid what it denoted as base rent under the Original Lease. On February 10, 1992, Debtor commenced Adversary Proceeding No. 3-92-0032, seeking: declaratory judgment severing from the lease the additional payment obligations arising from both the first and second improvements; and, seeking abatement of rent pursuant to paragraph 18 of the Original Lease.

#### THE CONDEMNATION.

Golden Hills became the subject of condemnation proceedings in connection with the expansion of Highway 12 into I-394. Through this process, Golden Hills lost a strip of land along its southeastern edge as well as part of the northerly portion of the property, both of which were formerly providing parking spaces for Debtor and six other retail/restaurant tenants of Golden Hills. (CCI Exhibit) 1. Prior to the taking, which occurred on March 1, 1989, there were 389 on-site parking spaces (plus approximately 14 parking spaces on state owned right-of-way property) to service Debtor and the 6 other tenants at Golden Hills. Of the 389 on-site parking spaces, 182 spaces were located in the lot directly behind Golden Hills and 207 parking spaces were in the parking lot adjacent to I-394. During the construction phase of I-394, approximately 94 on-site parking spaces were lost on a temporary basis. Pursuant to an agreement between CCI and the State of Minnesota, the State of Minnesota made available to Golden Hills

the land adjacent to the east for temporary replacement parking. The temporary lot provides 150 usable parking spaces for Golden Hills. After completion of I-394, Golden Hills will lose 71 on-site parking spaces on a permanent basis, leaving 318 on-site parking spaces, if the temporary lot is not included as part of a permanent resolution of the parking arrangements for the property. (FN2)

This will result in a 18.25% reduction in on-site parking after completion of I-394.

CCI, the Debtor, and others are parties to a pending condemnation suit in Hennepin County district court in connection with the I-394 development and the property. (3) CCI entered into an Agreement with Debtor dated May 4, 1990, ("Settlement Agreement") (CCI Exhibit K). The Settlement Agreement addresses numerous issues between the parties arising from the condemnation including: the division of condemnation proceeds; the dismissal, with prejudice, of a pending declaratory judgment suit commenced by CCI against Debtor; and, procedures, methods and rights of the parties regarding rent abatement provided for under paragraph 18 of the Original Lease in the event of condemnation.

## II.

### PROCEDURAL POSTURE

(FN2) CCI entered into negotiations with the State of Minnesota prior to the condemnation for a land exchange, whereby CCI would

obtain from the State approximately five acres of land laying to the east of Golden Hills in exchange for the land lost to construction of I-394. These negotiations resulted in a tentative agreement for the land exchange. However, final agreement was not consummated. CCI and the Debtor entered an agreement (described later and referred to as the "Settlement Agreement") that requires the Debtor's consent before CCI can enter into further discussions with the Department of Transportation about the possibility of obtaining perpetual parking on the land east of Golden Hills. Mr. Webb, president of the Debtor, testified that he has not, and does not intend to, consent to CCI's request.

(FN3) In addition to condemnation damages due to loss of parking, the Debtor claims compensable condemnation losses from changed access, and loss of site visibility from the highway due to design changes made to the roadway in the development of I-394.

Pursuant to an order of this Court dated February 21, 1992, the time within to assume or reject the Original Lease, as amended, was extended through April 20, 1992. By motion dated April 3, 1992, Debtor requested an expedited hearing seeking an order for extension of time to assume or reject the Original Lease, as amended, and authority to provide adequate protection. CCI filed an objection to Debtor's April 3, 1992, motion. The hearing on Debtor's motion was held on April 10, 1992.

After hearing arguments of counsel, the Court found that cause existed to extend the time to assume or reject the Original Lease, as amended, conditioned upon the Debtor:

- a. making all prospective payments under the Original Lease, as amended, as they become due; and
- b. filing a Plan and Disclosure Statement within the exclusivity period provided by Section 1121(b) of the Bankruptcy Code.

The Court further directed that lease payments presently undisputed, which include base rent, Debtor's share of real estate taxes and assessments, and common area maintenance charges, be paid directly to CCI as they became due during the Chapter 11 case. The Court's order further directed that the "disputed" rents which are the subject of the adversary proceeding (File No. 3-92-0032) be deposited into a separate and distinct interest-bearing debtor-in-possession account for the benefit of CCI, pending further order of the Court. The Court entered its written Order on April 21, 1992.

On or about April 28, 1992, Debtor filed a motion claiming that the Court issued its April 21, 1992, Order based upon a mistake of fact and a mistake of the application of the law and sought relief under Bankruptcy Rule 9024 which incorporates Rule 60 of the Federal Rules of Civil Procedure. In its motion, Debtor claimed an inability to deposit into escrow all of the payments due under the Original Lease, as amended. The hearing on Debtor's motion to amend was held on May 13, 1992. At that hearing, the Court determined that Section 365(d)(3) of the Bankruptcy Code required Debtor to perform all obligations arising under the Original Lease, as amended, from and after the order for relief, until the Debtor decided to assume or reject said lease.

However, the Court determined that it could provide Debtor temporary financial relief if the Debtor could demonstrate that there is a substantial likelihood that it will prevail on the merits of the Adversary Proceeding on the severance issue, or on entitlement to a pro rata adjustment in rent under paragraph 18 of the Original Lease.

### III.

#### ISSUES

1. Has the Debtor shown an entitlement to rent abatement under paragraph 18 of the Original Lease, as amended?

2. Has the Debtor shown a substantial likelihood that it will prevail on its attempt to sever the two improvement obligations from the Original Lease, as amended?

### IV.

#### DISCUSSION

##### RENT ABATEMENT.

Paragraph 18 of the Original Lease provides in pertinent part:

In the event that the Lessor or Tenant shall fail to exercise such option to terminate this Lease, then and in such event, the Lessor shall, with reasonable promptness, make necessary repairs to and alterations of the improvementso on the Premises, or the parking area serving the Premises, as the case may be, for the purpose of restoring the same to an economic architectural unit, susceptible to the same use as that which was in effect immediately prior to such taking, to the extent that may have been necessary for such condemnation subject to a pro rata adjustment in the rental hereunder.

Lessor and Tenant shall each have the right to compensation or damages for and on account of any loss, injury, damage or taking of any right, interest or estate of the party making the claim.

Pursuant to this paragraph, The Debtor claims entitlement to a pro rata adjustment in the rent due to loss of parking, visibility, and access resulting from the construction of I-394. The Debtor does not suggest a specific abatement amount. The record does not support an abatement of rent under paragraph 18 for at least three reasons.

Firstly, paragraph 9 of the Settlement Agreement entered by the parties in May of 1990 (CCI Exhibit K) constitutes an amendment to paragraph 18 of the Original Lease, and sets forth in detail the circumstances and procedures applicable to the abatement rights and responsibilities of the parties recognized in paragraph 18 of the Original Lease. Paragraph 9 of the Settlement Agreement provides:

RV1 and Webb GV will agree to continue to operate their businesses under the present lease agreements covering the property in question subject to the following

understanding:

- a. for the six month periods ending on December 31st and June 30th during the lease term or any extension thereof, the combined gross sales of the businesses operated by RV1 and Webb GV on the leased premises will be compared with the combined gross sales of said businesses for the same six-month period during the immediately preceding year. If such combined gross sales have decreased by 10 percent or more during the current six month period as compared to the preceding six-month period, RV1 and Webb GV shall have sixty (60) days after the end of such six-month period within which to notify CCI in writing that they wish to renegotiate the rental of said lease premises.
- b. The parties shall then in good faith proceed to negotiate an adjustment in the rental to then be paid under the lease agreements.
- c. If the parties are not able to agree upon an adjustment in the rental within a period of ninety (90) days after the giving of such written notice, RV1 and Webb GV, at their option, shall have the right to terminate the lease agreements by giving written notice to that effect to CCI within ten (10) days after the expiration of said ninety-day period.

The Debtor has not shown that the circumstances and procedures set out in paragraph 9 exist and have been complied with.

The Debtor argues that paragraph 9 of the Settlement Agreement is somehow a separate and additional right to terminate the Lease, as amended, unassociated with the abatement provision in paragraph 18 of the Original Lease. The provision, however, quite clearly deals with the circumstances and procedures regarding rent adjustment based on the occurrence of declining revenues; or, in other words, rent abatement. Rent reduction for declining revenues recognizes the right to rent abatement for unrestored losses covered under paragraph 18 of the Original Lease. The stated circumstances and procedures provide the necessary detail for exercise of the right.

Secondly, the Debtor has not shown that it has suffered business losses related to the condemnation. Debtor's income statement for the first quarter of 1992 indicates that first quarter sales have increased by approximately \$72,742 over the same period last year.(FN4) Overall, the Debtor's annual gross receipts have remained fairly constant, at approximately \$8,000,000, since its first full year of operations. The Debtor's main argument seems to be that the condemnation has stunted its growth; but no evidence has been offered that would tend to show that growth would otherwise likely have occurred during the period absent the condemnation, or by what measure.(5)

Thirdly, a substantial portion of the unquantified loss claimed by the Debtor is based on damage that it alleges will result from permanent change of access, and loss of visibility

from the highway due to change in grade of the roadway itself. Legal entitlement to reimbursement for this type of loss in condemnation proceedings in Minnesota is presently uncertain, where the alleged loss results solely from use or changed use of property away from the allegedly damaged property.(6) Presumably, rent abatement entitlement under paragraph 18 of the Original Lease is for compensable damages or loss resulting from a condemnation. Compensable loss to the Debtor through loss of visibility from the highway due to change in road grade, and loss due to change in access, is presently speculative.

#### SEVERANCE OF IMPROVEMENT OBLIGATIONS.

Generally, 11 U.S.C. Section 365 requires that a debtor must assume or reject an unexpired lease of nonresidential real property in full and may not pick and choose among the terms in an agreement to retain the beneficial aspects of the lease while rejecting the burdensome provisions. In re Miller, 103 B.R. 353 (Bankr. D. Col. 1989) (when trustee seeks to enjoy continued benefits of lease, trustee is required to comply with its burdens as well, and like rules should apply to debtor); In re David Orgell, 177 B.R. 574 (Bankr. C.D. Cal. 1990) (debtor may not assume only favorable portions of executory lease, and reject or avoid unfavorable portions); In re Mitchell, 108 B.R. 166 (Bankr. S.D. Ohio 1989) (debtor, when assuming either executory contracts or unexpired

(FN4) The Debtor operates three entertainment facilities on the property. Two are upscale facilities, Rupperts Nightclub and CocoLezzone Restaurant, and one a more moderate facility, American Cafe. According to the Debtor, the American Cafe increased its business by 28% from its inception through 1991, while CocoLezzone and Rupperts business fell by 8% and 18% respectively during the same period. The Debtor's theory is that the Rupperts and CocoLezzone losses are directly related to loss of parking proximate to the front entries of those establishments. The theory was supported, in part, by the Debtor's expert testimony. However, it was conceded that other factors might account for the losses as well, particularly the Gulf War during the winter of 1991, and the downturn in the economy following the War. A highly competitive entertainment and restaurant industry was also cited as a potential factor. The Debtor argues that a decline in net operating profit from 7% for the first year of operation to a negative percent in 1991 is evidence of loss due to the condemnation, but does not support the argument with any specific facts.

(FN5) Much of the Debtor's claimed loss from the condemnation is unliquidated anticipated future damage. For instance, the Debtor's expert, John Melaniphy, testified that the access and visibility changes will be reflected in changing frequency of use patterns over time, and that the most important variables regarding the success of a restaurant/entertainment complex are those site factors that affect frequency patterns. Therefore, the full effects of the changes in access and visibility will not be felt immediately. He testified that customers will decrease the frequency of their visits to the complex until the business cannot be supported.

(FN6) The only cited Minnesota case allowing compensable damages for these types of losses in condemnation cases is State of Minn v. Strom-Sponsel, Court File Nos. CD 1983 and CD 1984 (Order and

Memorandum filed August 19, 1991). That case is presently on appeal to the Minnesota Court of Appeals.

lease, must accept both benefits and burdens of contract or lease). However, courts have found executory contracts to be severable from related agreements contained in the same document, and have allowed the debtor to assume the executory contract without complying with the terms of the related agreement. See: *Byrd v. Gardinier* (In re *Gardinier*), 831 F.2d 974 (11th Cir. 1987), cert. denied, 488 U.S. 853 (1988); *In re Cutters*, 104 B.R. 886 (Bankr. M.D. Tenn. 1989).

Bankruptcy cases and the Original Lease provide that Minnesota law governs disputes over its interpretation. (Debtor's Exhibit 2 at Paragraph 34); *In re Continental Airlines*, 932 F.2d 282, 294 (3rd Cir. 1991) (State law determines characterization of agreement as lease); *In re Huff*, 81 B.R. 531, 534 (Bankr. D. Minn. 1988). To determine whether an agreement is divisible, the Court must apply applicable state law. *In re Ritchey*, 84 B.R. 474 (Bankr. N.D. Ohio 1988).

In Minnesota "[w]hether the contract is entire or severable turns on the intent of the parties as objectively manifested by them." *Schultz v. Stiernagle*, 270 N.W.2d 269, 271 (Minn. 1978). Intention of the parties is to be determined by considering the language used, the subject matter of the contract and how the parties themselves treated it. *Anderson v. Kammeier*, 262 N.W.2d 366, 370 (Minn. 1977).

The contract is to be interpreted to give effect to the mutual intention of the parties of the time of contracting, and in so doing, the language used governs if it is clear and does not involve ambiguity. *Carl Bolander & Sons v. United Stockyards Corp.*, 215 N.W.2d 473 (Minn. 1974). However, in the bankruptcy context, a particular obligation cannot be both a secured claim based on a promissory note and security agreement, and a leasehold obligation for rent.(FN7)

There are inconsistent bankruptcy benefits and burdens associated with leases and secured claims. A secured creditor is entitled to a secured claim in bankruptcy to the extent of the value of its collateral. 11 U.S.C. Section 506(a). The creditor is entitled to an unsecured claim for the balance, even if the creditor would not have had recourse against the Debtor outside of bankruptcy. 11 U.S.C. Section 1111(a). Alternatively, the creditor can elect to have a fully secured claim, but with different payment rights. 11 U.S.C. Sections 1111(b)(2) and 1129(b)(2)(A)(i)(II). The rights of the secured creditor, however, are subject to being modified in certain ways without the creditor's consent. See 11 U.S.C. Section 1129(b)(2)(A).

Obligations under leases are treated in an entirely different way. If the lease is assumed by the debtor, the debtor must cure any defaults, compensate the lessor for any damage, and give adequate assurance of future performance. 11 U.S.C. Section 365(b)(1). Obligations under an assumed lease are not subject to modification under a plan of reorganization. 11 U.S.C.



(FN7) Obligations under a Lease can be secured without changing their nature as leasehold obligations. For instance, a tenant's obligation to pay rent under a lease can be secured through a security agreement covering particular collateral. However, the same obligation cannot exist both as a secured claim pursuant to a separate note and security agreement, and as rent pursuant to a lease.

Section 1129(a)(9)(A). On the other hand, if the lease is rejected, the lessor's claim for damages is strictly limited by the Bankruptcy Code. See 11 U.S.C. Section 502(b)(6).

With these general observations in mind, the obligation arising from the first improvements, originally \$884,500, is rent under the Lease. The First, Second and Third Amendments to the Original Lease are, in fact, true lease amendments. With respect to the obligation arising out of the first improvements, the parties could look to nothing other than the lease documents and landlord/tenant law to define their rights and responsibilities. Certainly, neither the First nor the Third Amendment can be interpreted as a note, or any other evidence of debt outside the context of a lease. While it is true that paragraph 4 of the Third Amendment provides that the obligations "shall survive in all respects the termination of the Original Lease by either party," that alone is insufficient to turn the obligation into something other than rent under the Lease.(FN8) Clearly, the parties intended to, and at all times did, treat the obligation as rent. See Exhibits 16 and 17.

The same cannot be said, however, for the obligation arising from the second improvements. Instruments executed at the same time for the same purpose and in the course of the same transaction, are legally one instrument and will be read and construed together unless the parties stipulate otherwise. See In

(FN8) The purported scope of liability in paragraph 4 is questionable under landlord/tenant law.

re Holtorf's Estate, 28 N.W.2d 155, 157. The Lessor Note and Security Agreement were executed contemporaneously with the Third Amendment to the Original Lease. The Note and Security Agreement define and articulate the transaction. Paragraphs 5 and 6 of the Third Amendment merely memorialize CCI's intent to have the additional right to leasehold remedies upon default of a secured claim that is based on the Note. That, however, does not change the nature of the transaction as a secured transaction. In fact, the transaction was at all times treated as a secured obligation by CCI under the Lessor Note and Security Agreement. All payments on the Lessor Note were received and applied as interest and return of principal. See: Exhibits 16 and 17.

Since the obligation cannot be both a secured claim based on a promisory note and security agreement, and a leasehold obligation for rent, and since the documents and historical treatment concerning the second improvements transaction evidence a secured debt, the obligation should be severed from the Third Amendment to the Original Lease, as amended, for purposes of the Debtor's bankruptcy case. The obligation is a separate secured transaction

distinct from the Lease. It does not arise under the Lease, as amended, within the meaning of 11 U.S.C. Section 365(d)(3), but is a separate claim within the meaning of 11 U.S.C. Section 506. Furthermore, to the extent that paragraph 6 of the Third Amendment makes default on the claim a default under the Lease, as amended, the default under paragraph 6 of the Third Amendment may be cured under 11 U.S.C. Section 365(b)(1)(A) by successfully restructuring the claim upon which the Lessor Note is based, pursuant to 11 U.S.C. Section 1129.

V.

DISPOSITION

Based on the foregoing, IT IS HEREBY ORDERED:

1. Restaurant Ventures I is not presently entitled to abatement of rent under paragraph 18 of the Original Lease, as amended, with CCI.

2. Obligations of Restaurant Ventures under paragraph 2 of the Third Amendment to the Original lease are rent obligations under the Original lease, as amended.

3. Obligations of Restaurant Ventures under the Lessor Note and Security Agreement are obligations pursuant to a secured transaction, which is severable from the Original Lease, as amended by the Third Amendment.

Dated: June 12, 1992.

By The Court:

DENNIS. D. O'BRIEN

U.S. BANKRUPTCY JUDGE