Executory Contracts in Bankruptcy: How Can We Get Through This Together (or Not)

Lacey Bryan
Markus Williams Young & Hunsicker LLC
Denver, Colorado

Larissa Gotguelf
FTI Consulting, Inc.
Los Angeles, California

Natasha MacParland
Davies Ward Phillips & Vineberg
Toronto, Ontario

Amalia Sax-Bolder
Brownstein Hyatt Farber Schreck LLP
Denver, Colorado

Genevieve Weiner
Sidley Austin LLP
Los Angeles, California

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1. <u>General Introduction/Background</u>

Section 365 of the Bankruptcy Code permits a trustee or debtor-in-possession to assume or reject executory contracts and unexpired leases. This provision of the Code allows the trustee to take best advantage of the rights and assets of the estate by allowing a debtor to retain beneficial contracts and discard nonbeneficial contracts to enable an effective restructuring. The provisions of section 365 attempt to balance the interests of the estate with other parties' rights to receive the benefit of their bargain and the Code provides some protection to the countervailing interests held by other parties.

a. What is "executory"?

i. The Bankruptcy Code does not define the term "executory contract."

ii. The legislative history to section 365 observes that the term executory contract "generally includes contracts on which performance remains due to some extent on both sides." H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 58 (1978).

iii. Most circuit courts use the "Countryman" definition of executory contracts, including the Third, Fourth, Fifth, Seventh, Eighth, Ninth, and Tenth Circuits. Professor Vern Countryman defines an executory contract as:

> [A] contract under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.

Vern Countryman, *Executory Contracts in Bankruptcy, Part I*, Minn. L. Rev. 439, 460 (1973).

iv. The Bankruptcy Code does not provide a date for determining whether a contract is executory either. *Penn Traffic Co. v. COR Route 5 Co., LLC (In re Penn Traffic Co.)*, 2005 U.S. Dist. LEXIS 20407, at *13–14 (S.D.N.Y. Sep. 16, 2005); *see also COR Route 5 Co., LLC v. Penn Traffic Co. (In re Penn Traffic Co.)*, 524 F.3d 373, 381 (2d Cir. 2008) (noting some courts have denied debtors' postpetition attempts to assume or reject contracts that were executory as of the petition date in light of postpetition events affecting those contracts).

v. An executory contract represents both an asset (the debtor's right to the counterparty's future performance) and a liability (the debtor's own obligation to perform).

vi. Examples of contracts that are generally found to be executory:

1. Service contracts

2. Employment contracts
3. Real property and equipment leases
4. Settlement agreements
5. Real estate sales contracts
6. Intellectual property licenses
7. Development contracts

vii. Examples of contracts that are generally found to be non-executory:

1. Mortgages
2. Promissory notes
3. Contracts where the only remaining obligation is payment by one side
4. Contracts where the debtor's performance is completely optional
5. Perpetual, royalty free licenses

b. Ability to assume, assign, or reject

i. When material performance is due on both sides on the petition date, the Bankruptcy Code gives the option to the trustee to honor the contractual relationship (assumption) or repudiate it (rejection). An executory contract must be assumed or rejected in its entirety. But a contract may not be assumed if it has already expired according to its terms or otherwise ceases to exist after the petition date. *Ctys. Contracting & Constr. Co. v. Constitution Life Ins. Co.*, 855 F.2d 1054, 1061 (3d Cir. 1988); *Texscan Corp. v. Com. Union Ins. Cos. (In re Texscan Corp.)*, 107 B.R. 227, 230 (B.A.P. 9th Cir. 1989).

ii. If the trustee chooses to keep the relationship in existence, then the estate will assume the contract and adopt it so that it becomes the estate's contract. The estate is then entitled to receive the other party's performance and is liable for the obligations undertaken by the debtor. The trustee must "cure and assure" and follow the mandates of section 365(b)(1).

iii. If the trustee chooses to reject the contract, then that constitutes a prepetition breach of contract under section 365(g)(1). Upon rejection, the other party to the contract becomes a creditor whose claim is classed by section 502(g) as a general unsecured claim.

iv. If the estate first assumes a contract and then later rejects it, the rejection is the estate's breach and the other party's damages are treated as an administrative expense under section 365(g)(2).

v. The chapter 7 trustee must assume or reject contracts within 60 days of the order of relief in in such extended period as the court may allow under section 365(d)(1), otherwise the contracts are deemed to have been rejected. In cases under other chapters, the trustee may make the decision to assume or reject at any time up to plan confirmation.

vi. The bankruptcy court must grant the motion for rejection or assumption of an executory contract of the debtor under section 365. The bankruptcy court applies the business judgment rule to evaluate a debtor's assumption or rejection decision.

vii. To assign a contract, the estate must first assume it. Then the trustee must provide adequate assurance of future performance by the assignee. Upon assignment of the contract, the assignee acquires all the estate's rights under the contract and assumes all duties of future performance. Section 365(k) relieves the estate of all liability for post-assignment breaches.

c. What does rejection mean?

i. *Tempnology*

1. Rejection only relieves the debtor from any future performance under the contract. *Mission Prod. Holdings v. Tempnology, LLC*, 139 S. Ct. 1652, 1662 (2019)). After rejection, "[t]he debtor can stop performing its remaining obligations under the agreement." *Id.* at 1662.

2. "[A] rejection has the same consequence as a contract breach outside bankruptcy: It gives the counterparty a claim for damages, while leaving intact the rights the counterparty has received under the contract." *Id.* at 1661; *see* 11 U.S.C. §§ 365(g)(1), 502(g) (providing the consequences of rejection as a breach and that such breach is deemed to have occurred prepetition).

3. Rejection of an executory contract does *not* terminate the contract; rather, rejection is considered a breach. *See Tempnology*, 139 S. Ct. at 1661–62. In other words, rejection is not the same as recission of the contract. Even though the rejection is a breach that gives rise to the other party's claim for damages and a discharge of any future performance obligation by the other party, the contract is not reversed *ab initio*.

ii. Discussion of rights under state law for breach of contract

4. A breach stemming from rejection of an executory contract in bankruptcy court is generally considered material. *See In re Blair*, 534 B.R. 787, 790 (Bankr. D.N.M. 2015) (collecting cases).

5. As an example, under Colorado law, the counterparty to a contract is excused from performance if the other party materially breached the contract. *See Blood v. Qwest Svcs. Corp.*, 224 P.3d 301, 324 (Colo. App. 2009); *see also Kaiser v. Market Square Disc. Liquors, Inc.*, 992 P.2d 636, 640 (Colo. App. 1999) (noting that, in the context of a multiparty dispute, a material breach of contract excuses further performance). Thus, if a debtor rejects the executory contract, the counterparty will no longer need to perform under Colorado law because the debtor materially breached the contract.

6. The case *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984) involved rejection of a collective bargaining agreement in a chapter 11 bankruptcy. The *Bildisco* court explained that "[i]f the debtor-in-possession elects to continue to receive benefits from the other party to an executory contract pending a decision to reject or assume the contract, the debtor-in-possession is obligated to pay for the reasonable value of those services, which, depending on the circumstances, may be what is specified in the contract." 465 U.S. at 531 (citation omitted). Accordingly, the Supreme Court has recognized that the price specified by a pre-bankruptcy contract may constitute the reasonable value of the goods or services provided postpetition. *See also Peters v. Pikes Peak Musicians Ass'n*, 462 F.3d 1265, 1274 (10th Cir. 2006) (affirming the bankruptcy court's ruling that the orchestra musicians' administrative claims for unpaid wages under the terms of their collective bargaining agreement during the pendency of the case were computed from the terms of the agreement).

d. *Nunc pro tunc* relief

i. Rejection under section 365(a) does not take effect until judicial approval is secured, but the bankruptcy court has the equitable power to order a rejection operate retroactively to the motion filing date.

ii. The Supreme Court's decision in *Roman Catholic Archdiocese of San Juan v. Acevedo Feliciano*, 140 S. Ct. 696, 206 L. Ed. 2d 1 (2020) (per curiam) has led some bankruptcy courts to believe that there is a shift in the law of *nunc pro tunc* relief in bankruptcy. *Acevedo Feliciano*, however, has not changed the existing law on *nunc pro tunc* approval of a rejection of an executory contract. *See, e.g.*, *In re Player's Poker Club, Inc.*, 636 B.R. 811, 828 (Bankr. C.D. Cal. 2022).

11 U.S.C. § 365(c)(1) and Prevention of Assumption *or* Assignment in Franchise Agreements

Generally provisions in an executory contract which restrict a debtor's ability to assign are rendered unenforceable by 11 U.S.C. § 365(f)(1) ("[N]otwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection . . . ."). However, in the case of a franchise agreement where there is a license of protected intellectual property, depending on the inclination of the franchisor and/or the court in which the bankruptcy case is pending, a franchisor may be able to prevent a debtor from assuming or assigning the franchise agreement. In the case of a franchisee that seeks to reorganize, this could be incredibly problematic to the debtor's go-forward plan.

This question turns largely on the interpretation and application of 11 U.S.C. § 365(c)(1), which provides:

> (c) The trustee [or debtor-in-possession] may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—
>
> (1) (A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment . . .

Consider, for example, a franchisor who for one reason or another, has determined it no longer wishes to do business with a franchisee who happens to be a debtor-in-possession. The debtor-in-possession does not move to assign the franchise agreement at issue, but merely to assume it. Nonetheless, in its opposition to the assumption, the franchisor asserts that the

franchisee-debtor may not assume the franchise agreement because 1) the franchisor does not consent to the assumption and 2) federal trademark law, including the Lanham Act, excuses the franchisor from accepting performance under the franchise agreement from a third party without their consent.

But the franchisor isn't being asked to accept performance under the franchise agreement from a third party here; instead, the debtor-in-possession seeks only to assume the agreement. Can federal trademark law prevent the assumption without assignment?

Because the wording of 11 U.S.C. § 365(c)(1) is "assume or assign" (emphasis added), in some jurisdictions the franchisor can prevent the assumption of a franchise agreement when applicable law – *i.e.*, federal trademark law - excuses the franchisor from accepting performance under the franchise agreement from anyone other than the debtor, even when the debtor is *not* seeking to assign the contract. This is called the "hypothetical test" and is principally based on what some courts call a "plain" reading of the literal language of 11 U.S.C. § 365(c)(1). This has been adopted by the Third Circuit (*In re West Electronics*, 852 F.2d 79 (3rd Cir. 1988)), Fourth Circuit (*RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004)), the Ninth Circuit (*Perlman v. Catapult Entertainment (In re Catapult Entertainment)*, 165 F.3d 747 (9th Cir. 1998)), the Eleventh Circuit (*City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners*, 27 F.3d 534 (11th Cir. 1994)).

Conversely, there is a contrary line of cases which have adopted the "actual test," which disallows assumption of an executory contract under 11 U.S.C. § 365(c)(1) and applicable law *only* where there is an actual proposed assignment of the contract. This test has been adopted by the First Circuit (*Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997)) and the Fifth

Circuit (*Bonneville Power Admin. V. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238 (5th Cir. 2006)). As noted by *Collier on Bankruptcy*, "As a matter of policy, a refusal to permit debtors in possession to assume otherwise nonassignable contracts would present problems for debtors whenever the debtor's business is one in which major contracts are nonassignable under nonbankruptcy law. Such debtors will not, as a practical matter, be able to avail themselves of the benefits of chapter 11 because they will not be able to perform their prebankruptcy contracts without permission from the nondebtor parties to the contracts." 3 Collier on Bankruptcy P 365.07.

This is still an open issue in multiple circuits, and in 2009 the Supreme Court denied certiorari. *N.C.P. Mktg. Group, Inc. v. BG Star Prods.*, 556 U.S. 1145 (2009). Notably, in the denial of the petition for writ of certiorari, Justice Kennedy (joined by Justice Breyer), stated "The division in the courts over the meaning of § 365(c)(1) is an important one to resolve for bankruptcy courts and for businesses that seek reorganization. This petition for certiorari, however, is not the most suitable case for our resolution of the conflict. Addressing the issue here might first require us to resolve issues that may turn on the correct interpretation of antecedent questions under state law and trademark-protection principles. For those and other reasons, I reluctantly agree with the Court's decision to deny certiorari. In a different case the Court should consider granting certiorari on this significant question."

In re: MSR Resort Golf Course, LLC, et al, Debtors
Case No. 11-10372 (SHL)

Hotel Management Agreement Rejection – Estimating Damages

Item	Hilton Position	Debtors Position	Judge's Ruling
Management Fees – Projected Revenue Calculation – Inflation Rate	Hilton utilized a standard inflation rate used for hotel appraisals by hotel valuation firm HVS, as well as data from "forecastchart.com," arriving at a 3% annual inflation rate.	Debtors utilized historical data from the Bureau of Labor and Statistics which showed a 2.4% inflation rate for the past ten years and 2.6% average for the past twenty years, arriving at 2.5%.	The Court concluded that Hilton has not shown evidence that the site they used was a reliable source of industry information. Hilton's data evidence was insufficient compared to debtors' use of official historical data. The appropriate inflation rate was determined to be 2.5%.
Management Fees – Projected Revenue Calculation – Funding of CapEx	Hilton assumed 8% capital expenditure contribution by the debtors. This was supported by testimony that Hilton averaged 8 – 10% for other properties that were similar in size and complexity. A testimony by a director at Grand Wailea stated that 4% was too low to maintain operating standards under the management agreement.	Debtors assumed 4% capital expenditure contribution based on the management agreement that required the debtors to provide at least 4% of resort revenue for capital expenditures.	The Court found 6% to be an appropriate figure. This was directly derived from debtors' expert's testimony that the debtors had consistently spent 6% on capital expenditures. Hilton's 8% was too high given the fact that an agreement provision required Hilton to follow specific procedures to receive additional capital expenditure funding beyond the minimum 4%. Further evidence that the 8% is too high came from testimony that the resorts were in better shape at the time of the hearing than at the time of purchase, despite Hilton's 2005 memo stating that the resorts were in excellent condition.
Management Fees – Corporate Overhead Fee	Hilton included the full 1% of the corporate overhead fee within their lost profits calculation, with no corresponding expense incurred by Hilton. Hilton argued that the term 'corporate overhead fee' was inherited from the resorts' previous manager when Hilton acquired their management agreements. Additionally, a Hilton witness claimed that the corporate	Debtors deducted the corporate overhead fee from their calculations, arguing that it was considered a reimbursement expense (per the agreement, the corporate overhead fee was a reimbursement to the manager) rather than a profit. The debtors also noted that, the management fee was stated to include	The Court concluded that Hilton was entitled to the 1% corporate overhead fee, given that appropriate deductions are made for expenses. The Court believed that although the corporate overhead fee was not explicitly stated within the management fee, there was no dispute that the fee would have been earned by Hilton had the debtors not rejected the management agreements. Furthermore, the agreement did not state that the corporate overhead fee was reimbursable or subject to a cap, the management agreement only stated that Hilton was to receive 1% of gross revenues. The Court countered the debtors argument that the corporate overhead fee was not part of liquidated damages, as per the termination

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	overhead fee was essentially the same as the two percent base within the management fee.	only the base and incentive fees. In the same section, the debtors argued that the corporate overhead fee was never stated as a consideration for Hilton's performance under the management agreements and that the liquidated damages and termination provisions do not account for corporate overhead fees as part of liquidated damages in the event of termination.	provisions, stating that liquidated damages are not necessarily a proximation of actual damages suffered. In regards to corporate overhead expenses, based on Hilton's 2006 10-K form, the Court found evidence that Hilton incurred additional annual overhead expenses when adding new properties to their portfolio. Using Hilton's own estimate of its overhead expenses from its 2005 internal memorandum (prepared before purchasing the management agreements in this dispute), the Court found Hilton's expected cost of managing the resorts at 0.25% revenues or 8.33% of a three percent base management fee. The Court rejected the estimate of Hilton's corporate overhead prepared by Hilton's treasurer solely for this litigation as self-serving.
Discount Rate Calculation	Hilton applied an 8.1% discount rate, arguing that the risk of the management agreements at the time they acquired them was minimal. In addition, they claimed 8.1% was the industry standard and was also used by Hilton to value its own management fee contracts. The base management fee in these agreements was paid first from hotel revenue, making it less risky than fees paid as a function of profitability. A Hilton expert testified that the proper discount rate should be 7.5% based on factors such as mortgage rates for full service hotels and the rate generally used for hotel	The debtors' expert witness applied a 13.6% discount rate for the Arizona Biltmore and the La Quinta and a 14.6% rate for the Grand Wailea. The debtors' expert calculated Hilton's overall WACC for beginning of 2006 to be 10.6% and adjusted upwards to take into account risk for each resort's unique situation. The debtors utilized a 1.29 beta – a risk variable within the WACC calculation. The expert noted Grand Wailea to be particularly volatile due to its remote location and subsequent dependency on	The Court began by adopting the debtors' 10.6% WACC calculated at the time Hilton entered into the management agreements. The Court found Hilton's 8.1% calculation inaccurate, as the Hilton expert utilized data from Bear Stearns that was published almost a year after Hilton's acquisition of the agreements. In addition, the Hilton Bloomberg WACC calculation utilized a beta of 1, which is speculated to be the Bloomberg default beta. Since no party was able to explain the basis for using the default beta of 1, the Court relied on the 1.29 beta, for which the debtors have provided an expert testimony. On one hand, Hilton failed to show that the management agreements lacked risk and that the 8% discount rate was sufficient to discount future fees especially in light of evidence of unique risks these resorts might face. Evidence of risk in these resorts supported an upwards adjustment of the WACC. On the other hand, the debtors failed to persuade the Court that the risks are as high as the their proposed discount rate suggested. Therefore, the Court adjusted the WACC for

Hotel Management Agreement Rejection – Estimating Damages

	investments as of April 2006. In his report, the expert referenced Hilton's 8.1% WACC published in December 2006 by a Bear Stearns report. Another consideration was Bloomberg's calculation of 8.7% at the end of 2005 and 8.2% in the first quarter of 2006. The Hilton expert adjusted downwards to 7.5% in consideration of Hilton's reliable income stream.	group travelers and natural conditions. The beta of 1.29 was supported by the affidavit of another witness who provided a technical analysis of beta.	the Arizona Biltmore and the La Quinta to 11.6%, while the WACC for the Grand Wailea was adjusted to 12.6%.
Cure Payments		Debtors deducted about $7 million in cure payments, claiming that Hilton would fail performance tests on two occasions in the future. The first occasion would be in 2013 and 2014 when Hilton would need to make a cure payment of $6 million to avoid contract termination. In the second occasion, based on the "Monte Carlo Analysis", the debtors believed Hilton would fail a performance test in 2031 for the Grand Wailea – which would incur an estimated cure payment of around $1 million.	The Court rejected the debtors' arguments as unduly speculative for several reasons. First, the Court agreed there was a risk that the Grand Wailea would fail the performance test, but the potential failure was not shown with enough certainty to allow for cure payments for it. This risk of failure should already be accounted for within the established discount rate. The Court also noted that the Monte Carlo Analysis was unduly speculative as well. The debtors conceded that they were not aware of its use in projecting future failure in hotel management contracts. In addition, the debtors' expert previously suggested that predictions after 10 years are not sufficiently reliable – and the Monte Carlo Analysis attempted to predict well over a decade into the future.
Group Services	Hilton argued the net present value of lost group services	The debtors argued that group services expenses	The Court concluded that Hilton was entitled to some amount of group services expenses. Hilton's $17 million request was

Hotel Management Agreement Rejection – Estimating Damages

Expenses – Net Present Value of Group Services Expenses	expense was about $17 million. They claimed that group services expense was provided for in the management agreements, so related damages were foreseeable. Hilton stated that they will have to self-fund amounts formerly contributed by the resorts, which a Hilton expert noted would take at least 5 years.	should be reduced to the amounts actually expended. They claimed that Hilton was not entitled to $17 million in group services expense damage because the management agreements did not permit recovery of this type of expense. In addition, they argued that Hilton would replace any lost group services by 2014.	described as having been discounted to net present value. This number was then adjusted accordingly with the Court's prior ruling on the discount rate.
Group Services Expenses – "Key Money"	Hilton sought to recover over $21 million in "key money", which were supposed to be payments it would need to make in order to obtain additional management agreements to replace the ones that it would lose.	The debtors argued there was simply no basis for Hilton's $21 million in key money.	The Court rejected Hilton's request for key money on the basis that the management agreements have no mention of it. It was too hard to say if the key money was contemplated by all parties during the contract formation. In addition, any evidence at trial was insufficient in supporting Hilton's claim for key money damages. The Court noted that Hilton itself concedes that whatever management agreements it one day acquires could also be management agreements that they would seek to acquire regardless if these agreements are rejected.
Brand Damages	Hilton sought $120 million in brand damages from alleged damage to their Waldorf-Astoria brand. Hilton argued that such damages were contemplated when they acquired the agreements in 2006. Hilton continued to argue that the loss of the resorts would contribute to tension among other Waldorf-Astoria owners who have been		The Court rejected Hilton's claim for brand damages, citing that it was not specified on the management agreements. The claim of protecting and growing the Hilton brand was covered under the group services expenses that had been previously granted by the Court. The Court found a lack of evidence provided by Hilton to support their claims. Other than the opinion of one Hilton expert witness, there had been no hard evidence showing damages to Hilton's business or potential opportunities. In addition, a Hilton witness even testified that no hotel owner made any indication that they would pull their property from Hilton if the agreements were rejected.

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Hotel Management Agreement Rejection – Estimating Damages

	pressuring Hilton to expand the brand – noting that these resorts collectively accounted for 25% of the rooms that were part of this brand. The $120 million in brand damages was decided through two different analyses focused on the time period between 2012 to 2034. The first analysis accounted for losses to existing Waldorf-Astoria properties and any impact to the brand's future development program, resulting in damages totaling $112 million. The second analysis estimated the overall value of the Waldorf-Astoria brand and found that the brand would lose 56.5% of its value, resulting in damages totaling $128 million. In taking the midpoint between the two figures, Hilton sought brand damages of $120 million.		Nowhere in the agreements was there a provision that allowed a hotel owner to terminate their own contract on the basis that the subject agreements were rejected. The Court required real-world evidence of brand damage – particularly noting that the amount Hilton sought in brand damages was more than 35% of the total damages requested in this case. There was an additional lack of concrete evidence from Hilton's fact witnesses when it came to assumptions underlying brand damages calculations. For example, the valuation of the Waldorf-Astoria brand was $2.265 billion, but this value was contradicted by some of Hilton's own documents and public filings. A different calculation for lost opportunities damages was found to be based on particularly aggressive assumptions as well as assumptions that were undercut by opposing evidence. The Court noted that the States of Arizona, California, and Hawaii recognize that damages must be proven with reasonable certainty.
Damages Relating to the Potential Expansion of the Grand Wailea	Hilton argued it would incur a loss of $9.8 million from not being able to reap the benefits from the proposed expansion of the Grand Wailea if the management agreement was rejected by the debtors. Hilton argued that this expansion would add ~$255 million value to the resort. Hilton used a 13%	The debtors' expert witness testified that any potential expansion of the Grand Wailea must be viewed in the context of future performance, and the then-performance of the resort was a real concern.	The Court rejected Hilton's claim for damages relating to lost fees from the potential expansion of the Grand Wailea. The debtors had a right to expand the resort, but had no obligation to undertake the specified expansion and, at the time, had no plans to do so. The Court found the Hilton expert witness's damages calculation defective as it did not take into account how the disruption from the expansion could negatively impact the resort. The debtors estimated such adverse effects could impact earnings for as long as two years.

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	discount rate to find the net present value of foregone base fees and corporate overhead fees.		

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

	. Chapter 11
IN RE:	.
	. Case No. 11-10372 (SHL)
MSR RESORT GOLF COURSE, LLC, et al,	. New York, New York
	. Tuesday, July 31, 2012
Debtors.	. 4:09 p.m.

. . . .

BENCH RULING RE: TRIAL ON MOTION OF MSR RESORT GOLF COURSE, LLC, ET AL, FOR ENTRY OF AN ORDER ESTIMATING DAMAGES RESULTING FROM REJECTION OF THE HILTON MANAGEMENT AGREEMENTS AND AN ORDER AUTHORIZING REJECTION OF THE HILTON MANAGEMENT AGREEMENTS

BEFORE THE HONORABLE SEAN H. LANE
UNITED STATES BANKRUPTCY JUDGE

APPEARANCES:

For the Debtors:

Chad J. Husnick, Esq.
KIRKLAND & ELLIS, LLP
300 North LaSalle
Chicago, Illinois 60654

Atif Khawaja, Esq.
Eric F. Leon, Esq.
KIRKLAND & ELLIS, LLP
601 Lexington Avenue
New York, New York 10022

(Appearances Continued)

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APPEARANCES: (Continued)

For GIC RE:	Brian E. Greer, Esq. DECHERT, LLP 1095 Avenue of the Americas New York, New York 10036
Also Appearing:	Michelle J. Vladimirsky, Esq. KASOWITZ, BENSON, TORRES & FRIEDMAN, LLP 1633 Broadway New York, New York 10019

APPEARANCES VIA TELEPHONE:

For Waldorf=Astoria Management, LLC:	David M. Neff, Esq. Brian Audette, Esq. PERKINS COIE, LLP 131 S. Dearborn Street, Suite 1700 Chicago, Illinois 60603

1 (Proceedings commence at 4:09 p.m.)
2 THE COURT: Good afternoon.
3 MR. LEON: Good afternoon, Your Honor.
4 THE COURT: All right. We are here this afternoon for
5 the purpose of reading a bench decision in the estimation trial
6 that we had earlier this month.
7 And I will apologize for subjecting to you all to a
8 lengthy, dramatic reading. As we discussed, my preference
9 probably would have been to prepare a written opinion in a case
10 like this, but timing is sensitive in this case; I want to get
11 the parties a decision quickly.
12 Let me just make sure everybody who's on the phone can
13 hear me. I suppose that most folks are listen-only, but I'm
14 particularly concerned with Hilton's counsel, Mr. Neff.
15 MR. NEFF: (Via telephone) Yes, Judge. This is Mr.
16 Neff. I can hear you well. Thank you.
17 THE COURT: All right. This matter comes before the
18 Court on the April 24, 2012 motion of MSR Resort Golf Course,
19 LLC, et al., for entry of an order estimating damages resulting
20 from rejection of the Hilton Management Agreements, and an
21 order authorizing rejection of the Hilton Management
22 Agreements, which I'm going to refer to as "the motion."
23 In the motion, the debtors seek estimation of the
24 damages Hilton would sustain if the debtors reject three
25 management agreements.

1 The management agreements relate to three properties:
2 one, the Arizona Biltmore Resort & Spa in Phoenix, Arizona;
3 two, the La Quinta Resort and Club PGA West in La Quinta,
4 California; and three, the Grand Wailea Resort Hotel & Spa in
5 Maui, Hawaii.

6 The Court conducted a trial on this matter over the
7 course of five days: June 27th, 29th, July 2nd, 3rd, and July
8 13th. The Court at trial heard from five fact witnesses and two
9 experts on behalf of Hilton and one fact witness and one expert
10 witness on behalf of the debtors, in addition to materials
11 submitted by the debtors as part of their motion.

12 In connection with acquiring these three management
13 agreements, Hilton prepared a November 2005 investment
14 memorandum. That memorandum contained Hilton's then present
15 value of the future revenues from the three agreements at
16 roughly $260 million. That valuation of the three management
17 agreements was "predicated on realizing incentive fees," fees
18 that are provided for under certain circumstances in the three
19 management agreements.

20 Hilton assumed it would achieve incentive fees
21 starting in 2006, and would achieve the maximum contractual
22 incentive fee starting in 2010. At that time, in 2005, it
23 further assumed it would continue to receive the three percent
24 maximum incentive fee stream until the end of the contractual
25 term.

1 For a variety of reasons that were discussed on and
2 off at the trial, Hilton did not receive the incentive fee
3 stream it anticipated. It has not, in fact, received any
4 incentive fees under these management agreements since 2007.
5 It does not seek the payment of incentive fees as part of the
6 damages sought in this proceeding.
7 Hilton's 2005 valuation was based on the full thirty-
8 year term, including the seven years from 2006 to 2012, for
9 which it has already received payment; and to date, it's
10 received $79 million in fees under the management agreements.
11 Turning to the three management agreements here, they
12 contemplate certain payments to the hotel manager. For
13 purposes of the Court's inquiry, these provisions regarding
14 payment are the same for the three agreements.
15 The first category of payments under the management
16 agreements is the management fee, set forth in Article 5.1 of
17 the management agreements. Under Article 5.1, the management
18 fee includes a base fee and an incentive fee that we've already
19 discussed. The management agreement defines the "base fee" for
20 management services as:
21 "An amount equal to two percent (2%) of gross
22 revenues."
23 The incentive fee, as mentioned earlier, is triggered
24 only if Hilton satisfies certain performance thresholds, which
25 are not at issue in this proceeding.

1 The second category of payments contemplated by the
2 management agreements is something called the "corporate
3 overhead fee." Pursuant to Article 5.3 of the agreements, a
4 manager will receive a corporate overhead fee for corporate
5 overhead expenses that it incurs in connection with managing
6 the resorts. In the words of Article 5.3, the manager is
7 "reimbursed" for corporate overhead in the amounts equal to one
8 percent of gross revenues.
9 The third category of payments contemplated by the
10 management agreements is the so-called "group services
11 expense." Article 5.2 of the management agreements provides
12 for the manager to receive reimbursement for group services
13 expense in the amount of up to two percent for each of the
14 resorts' revenues. Group services expense is used to fund
15 marketing, advertising, reservations, and other promotional
16 services that the manager provides in managing the resorts.
17 Several other provisions of the management agreements
18 are relevant to this dispute, although they are not payments
19 that Hilton seeks as part of the proceedings.
20 The first of these is the Article 6 provision for
21 capital expenditures. Under that provision, the debtors --
22 that is, the owners -- are obligated to contribute four percent
23 of gross resort revenue to fund necessary capital expenditures
24 at each resort. To the extent the manager believes funding of
25 additional capital expenditures is required beyond the four

1 percent, the management agreements require the manager to seek
2 approval from the debtors. If there is a disagreement over the
3 amount of capital expenditures needed, the manager may pursue
4 that dispute by putting the debtors on formal notice of a
5 contractual conflict and pursue a dispute resolution procedure
6 to resolve the matter.
7 Other relevant provisions in the management agreements
8 include a provision regarding the terms of the agreements, with
9 the term to run through 2024, with a ten-year option out to
10 2034.
11 The management agreements also have a provision
12 addressing termination. In that provision, the debtors have
13 the right to terminate the agreements without the payment of
14 any additional fee or premium if the manager fails to satisfy
15 certain performance requirements. Specifically, the debtors
16 may terminate the management agreements without penalty if,
17 after 2010 and for two consecutive operating years:
18 "(i) the GOP (gross operating profits) achieved by the
19 Hotel for each Operating Year is less than ninety percent (90%)
20 of the GOP set forth in the approved Annual Operating Plan for
21 such Operating Year." And this has been referred to as the
22 gross operating profit test."
23 "(ii) the Annualized RevPAR (revenue per available
24 room) for the Hotel for each of such Operating Years is less
25 than ninety-five percent of the Annualized RevPAR of the

1 Competitive Set for each respective Operating Year." And
2 that's been referred to as the "RevPAR performance test."
3 If the manager, here Hilton, fails to satisfy the
4 performance tests, and thus faces termination, it can make a
5 cure payment to the debtors to avoid termination and continue
6 managing the resorts.
7 The final provision that is relevant in the management
8 agreements for our purposes is a liquidated damages provision.
9 And that provides that if, after 2024, the debtors sell the
10 resorts and terminate Hilton as manager, Hilton is entitled to
11 a specified termination fee in the amount equal to the product
12 of the total management fee paid or payable by the manager for
13 the twelve-month period prior to the effective date of
14 termination, multiplied by a specified multiplier that varies
15 under the circumstances, and which we don't need to address in
16 this proceeding.
17 Turning now to the governing legal standard for this
18 dispute, the Court observes that each of the management
19 agreements is governed by the laws of the state in which the
20 subject resort is located. Accordingly, the laws of Arizona,
21 California, and Hawaii will govern the calculation of damages
22 to which Hilton will be entitled upon the rejection of each
23 respective management agreement.
24 These three states generally agree that, in a breach
25 of contract action, a plaintiff may recover the amount of

1 damages necessary to place it in the same position it would
2 have occupied had the breach not occurred. The usual recovery
3 for the breach of a contract is the contract price or the lost
4 profits therefrom.
5 To calculate lost profits, expenses are subtracted
6 from revenue. Only net profits, not gross profits, are
7 recoverable for breach of contract. These depend on the
8 particular transaction at issue, which dictates what expenses
9 need to be deducted from the gross profits to determine the
10 appropriate figure.
11 Arizona Courts have recognized that compensatory
12 contract damages will be awarded for the net amount of losses
13 caused and gains prevented. See Biltmore Evaluation &
14 Treatment Services v. RTS NOW, LLC, 2009 WL 223293, at *2
15 (Ariz. Ct. App. Jan. 29, 2009). Similarly, California Courts
16 have observed that damages are based on net profits, which they
17 have consistently defined as gains made after deducting the
18 value of labor, materials, rents, and all expenses, together
19 with the interest of the capital employed. See Electronic
20 Funds Solutions v. Murphy, 36 Cal. Rptr. 3d 663, 676 (Cal Ct.
21 App. 2005). Finally, Hawaii has recognized that a non-
22 breaching party may recover damages that arise naturally from
23 the breach, or that were in the contemplation of the parties at
24 the time of contracting. See Jones v. Johnson, 41 Haw. 389,
25 1956 WL 10315, at *3 (Haw. 1956).

1 The Court notes that the parties do not disagree about
2 what the applicable law is, although they strongly disagree
3 with how it should be applied in this case. Applying the
4 applicable law and relevant provisions of the management
5 agreements, the parties reach very different conclusions about
6 the proper measure of damages.
7 The Court notes that both parties use an expert to
8 provide a breakdown of the respective numbers on damages, as
9 well as an explanation of how each component is calculated.
10 Hilton's expert for this purpose was Roger Cline, and the
11 debtors' expert for this purpose was Thomas Morone.
12 On the one hand, Hilton contends it is entitled to
13 $334 million for rejection of these three management
14 agreements. Hilton's requested $334 million is broken into
15 four general categories:
16 First, it seeks damages of some $165 million for fees
17 under the three management agreements. These fees include a
18 base fee and the corporate overhead fee but do not, as
19 previously mentioned, include any damages for an incentive fee.
20 A large difference between the parties' calculation of
21 damages results from their use of different discount rates to
22 provide a current valuation for the worth of the payments that
23 Hilton would receive in the future. Hilton uses an eight
24 percent discount rate.
25 The second component of damages that Hilton seeks is

1 for group services expenses of approximately $38.9 million.
2 Third, Hilton seeks damages of approximately $120
3 million for so-called "brand damages." It describes "brand
4 damages" as the impact of the rejection of these three
5 management agreements on its Waldorf=Astoria brand.
6 Fourth and finally, Hilton seeks approximately $9.8
7 million in damages for losses relating to what it alleged to be
8 debtors' plan to expand the Grand Wailea Resort by some 300
9 rooms in the near future, thus purportedly expanding the
10 profits that Hilton would receive under that particular
11 management agreement.
12 Debtors, on the other hand, see things far
13 differently. They argue that Hilton is only entitled to
14 approximately $46 million in damages. Of the three categories
15 of damages sought by Hilton, debtors claim that Hilton is
16 entitled only to the first, the management fee, and that the
17 management fee should consist solely of the base fee. Thus, in
18 debtors' view, Hilton should get no damages for the corporate
19 overhead fee, group services expense, brand damages, and the
20 Grand Wailea expansion.
21 Moreover, debtors arrive at their figure of $46
22 million only after subtracting certain money for cure payments
23 that debtors contend Hilton will have to make for failing to
24 meet the performance test in the future at the Grand Wailea
25 Resort.

1 I turn first to the issue of the management fees. And
2 in looking in that, the Court must first project the fees per
3 year that Hilton would earn under the management agreements and
4 reduce these profits by the expenses that Hilton would incur to
5 arrive at a profit margin. In doing that, one looks to the
6 total projected revenues at the Resorts as these revenues are
7 used to calculate the fees.
8 Mr. Morone and Mr. Cline's projections for the resorts
9 as, one witness put it, "quite close." Roger Cline, Hilton's
10 expert, projects approximately $14.6 billion in revenue.
11 Thomas Morone, an expert for the debtors, opines that the
12 projected revenue for purposes of the management agreements is
13 approximately $13 billion.
14 There are only two real differences between these two
15 different predictions of revenue. The first is the inflation
16 rate, where Mr. Cline uses three percent and Mr. Morone uses
17 2.5.
18 The Court concludes that the appropriate inflation
19 rate is 2.5. The Court finds that Mr. Morone reasonably relied
20 on historical data from the Bureau of Labor and Statistics.
21 That data shows the inflation rate for the past ten years at
22 2.4 percent. And he adjusted upwards to account for the
23 slightly higher twenty-year historical average of 2.6 percent,
24 resulting in his inflation rate of 2.5.
25 The Court rejects Mr. Cline's figure, which he has

1 adopted from an appraisal firm HVS, which is a standard
2 inflation rate that they use for hotel appraisals. Mr. Cline
3 also relies on a website called "forecastchart.com" to conclude
4 the appropriate rate is three percent. But he has not
5 submitted any evidence that forecastchart.com is a reliable
6 industry standard website. In any event, his reliance on
7 inflation rate used by another company without proffering any
8 evidence as to how it was determined or why it is appropriate
9 is insufficient to refute Mr. Morone's proposed inflation rate
10 based on historical data.
11 The second difference between the parties' predictions
12 is the level of capital expenditures to be made by the debtors
13 in the resorts. Mr. Cline assumes an eight percent
14 contribution by the debtors. In support of this number, Diane
15 Jaskulske, Hilton's witness, testified that Hilton averages
16 eight to ten percent of revenue annually for properties similar
17 in size and complexity as the resort. Matthew Bailey, Managing
18 Director of Grand Wailea, testified that four percent is simply
19 too low to maintain the operating standards under Hilton's
20 management agreement.
21 On the other hand, Mr. Morone utilizes a four percent
22 capital expenditure assumption, as per Article 6 of the
23 management agreements. Article 6 obligates the debtors to
24 contribute four percent of resort revenue to fund necessary
25 capital expenditures. Debtors argue that they have never

1 agreed to anything beyond the four percent, and that Hilton has
2 never formally requested any increase.
3 The Court finds that six percent is the appropriate
4 figure to use. The six percent, in fact, is derived from Mr.
5 Morone's testimony that the debtors have consistently spent six
6 percent, on average, on capital expenditures. The Court
7 rejects Hilton's eight percent as too high, given that Hilton
8 must follow certain procedures outlined in Article 6, in order
9 to receive additional capital expenditures funding beyond the
10 four percent reserve fund. And Hilton has never commenced the
11 dispute resolution procedure set forth in that article.
12 Hilton's position about the need for eight percent is
13 further undercut by the fact that Hilton, in its 2005 memo,
14 viewed the resorts to be in excellent shape before purchasing
15 these management contracts. And Mr. Bailey testified that, in
16 his view, the resort was in better shape today than it was at
17 the time of the purchase.
18 Moving on to the second component of damages, we turn
19 to the corporate overhead fee. The debtors' expert Mr. Morone
20 deducted the corporate overhead fee as a reimbursed expense,
21 while Hilton's expert Mr. Cline included the full one percent
22 of the corporate overhead fee in his calculation of lost
23 profits and deducted no expense incurred by Hilton in managing
24 the resorts.
25 In contending that the corporate overhead fee is a

1 reimbursement, rather than profit, debtors rely, among other
2 things, upon the language in Article 5.1 of the management
3 agreement, which expressly states that the corporate overhead
4 fee is to be reimbursed to the manager. They also note that
5 Section 1 of the management agreement states that the
6 management fee includes only the base and incentive fees, and
7 that the corporate overhead fee is never described as
8 "consideration" for Hilton's performance under the management
9 agreements. Debtors finally note that the liquidated damages
10 and termination provisions do not contemplate corporate
11 overhead fees being incorporated as liquidated damages in the
12 event of termination.
13 For Hilton's part, its expert Mr. Cline assumed no
14 expense for corporate overhead and payment of the full one
15 percent of profit. His conclusions were echoed by Hilton's
16 witness Diane Jaskulske, who testified that she was ninety-nine
17 percent certain that losing the resorts will not change "one
18 iota of what [is done in the] corporate office." Hilton's
19 corporate offices, she said, rarely assist directly in
20 providing services to the resort.
21 Instead, Hilton views corporate overhead fee as merely
22 a term that Hilton inherited when it acquired the management
23 agreements from the resorts' former manager KSL. As Hilton's
24 witness Ted Middleton explained, the corporate overhead fee is
25 simply viewed by Hilton to be analogous -- that is, the same --

1 as the two percent base fee.

2 Based on all the evidence before the Court and the
3 applicable law, the Court concludes that Hilton is entitled to
4 the corporate overhead fee, provided that appropriate
5 deductions are made for expenses. Even though the management
6 agreements do not include the corporate overhead fee as part of
7 the management fee, there is no dispute that the fee would have
8 been earned had the debtors not rejected the Hilton Management
9 Agreements.

10 Further, Section 5.3 does not state that the corporate
11 overhead fee is reimbursable or subject to a cap like
12 reimbursable expenses. The management agreements only provide
13 that Hilton is to receive one percent of gross revenues.

14 While the debtors argue that the termination provision
15 is persuasive, the termination provision reflects an agreement
16 between the parties as to the amount that the debtors would
17 have to pay at a much later date to terminate the agreements,
18 as opposed to proof of actual damages. And those items are not
19 necessarily the same. See, e.g., Vrgora v. Los Angeles Unified
20 School Dist., 200 Cal. Rptr. 130, 135 (Cal. Ct. App. 1984),
21 explaining that liquidated damages are not necessarily a
22 proximation of actual damages suffered. See also Pima Sav. and
23 Loan. Ass'n v. Rampello, 812 P.2d 1115, 1118 (Ariz. Ct. App.
24 1991), explaining liquidated damages need not approximate
25 actual loss.

1 However, the Court finds that Hilton's 2006 10-K form
2 is persuasive in suggesting that Hilton does incur additional
3 annual overhead expenses when adding new properties to the
4 portfolio. Indeed, the Court rejects as incredible the
5 testimony of various witnesses that there is no corporate
6 overhead associated with these resorts, which all parties
7 describe as "iconic," and indisputably far more complex than a
8 typical hotel managed by Hilton.
9 As to the exact measure of these corporate overhead
10 expenses, the Court will use Hilton's own estimate of such
11 expenses in its 2005 internal memorandum, which was prepared
12 before purchasing these management agreements. That memorandum
13 calculates its expected cost of managing the resorts at .25 of
14 revenues, or 8.33 percent of a three percent base management
15 fee.
16 The Court rejects as self-serving the only other
17 evidence of the actual amount of corporate overhead, which was
18 an estimate prepared by Hilton's treasurer solely for the
19 purpose of this litigation.
20 The Court now turns to the applicable discount rate.
21 A discount rate must be applied to calculate the present value
22 of future payments owed to Hilton under the management
23 agreements, to account for the time value of money and the
24 financial risk of the fee stream. See In re Chemtura Corp.,
25 448 B.R. 635, 673 (Bankr. S.D.N.Y. 2011).

1 In Chemtura, Judge Gerber noted that the discount rate
2 should be calculated at the time the contract was entered into.
3 Chemtura, at 677.
4 "Existing case law and common sense require that the
5 discounting to fix the damages award must reflect the
6 same payment risk insofar as the Court can accomplish
7 that as the original contract did."
8 Id. at 673.
9 The choice of an appropriate rate does not need to be
10 exact. See Jones & Laughlin Steel Corp. v. Pfeifer, 462 U.S.
11 523, 552-553 (1983), where the Court notes:
12 "We do not suggest that a trial judge should embark on
13 the search for delusive exactness."
14 The Court may choose a discount rate not proposed by
15 the parties. See In re 785 Partners, LLC, 2012 WL 959364, at
16 *5 (Bankr. S.D.N.Y. Mar. 20, 2012), holding that, since the
17 experts did not thoroughly explain their determinations of the
18 discount rate, the Court treated their opinions as the range
19 and selected an intermediate rate.
20 Although the weighted average cost of capital -- which
21 we'll discuss a bit more in a moment -- or the "WACC," is a
22 reasonable starting point in determining the proper discount
23 rate, the WACC must be adjusted to account for risk. See In re
24 M Waikiki, LLC, 2012 WL 2062421, at *4 (Bankr. D. Haw. June 7,
25 2012).

1 Here, Hilton argues for an eight percent discount
2 rate. It contends that the risk of the management agreements
3 at the time they acquired them were de minimis. It contends
4 that eight percent is the industry standard, and it's what
5 Hilton uses to value its own management fees contracts. It
6 notes that the base management fee here is less risky than
7 other revenue streams because it is paid first from the hotel
8 revenue and, thus, far less risky than fees that are a function
9 of hotel profitability.
10 One Hilton expert, Mr. Hennessey, testified that the
11 proper discount rate was 7.5 percent, based among a variety of
12 things, including: mortgage rates for full service hotels as of
13 April 2006; and the rate generally utilized for hotel
14 investments as of April 2006. He also considered the WACC at
15 the time Hilton acquired the resorts and adjusted it downward
16 to, in his view, achieves a discount rate applicable to the
17 hotel company's reliable income stream derived from base
18 management fees. In his report, he referenced a report by Bear
19 Stearns, which gave Hilton's WACC at 8.1 percent. He also
20 testified he looked at Bloomberg, which reported Hilton's WACC
21 at 8.7 percent as of December 31st, 2005, and 8.2 percent in
22 the first quarter of 2006.
23 Debtors again have a different view. Their expert,
24 Mr. Morone, applied a 13.6 percent discount rate to the Arizona
25 Biltmore and the hotel in California, and a 14.6 percent

1 discount rate to the Grand Wailea. He calculated Hilton's
2 overall weighted average cost of capital; the WACC, as of the
3 beginning of 2006, to be 10.6 percent. He noted that Mr.
4 Hennessey testified that Bloomberg's reported WACC of 8.7
5 percent relied on what's called a "beta" that was a default of
6 one percent; or, as Mr. Morone used, a beta of 1.29.
7 Beta is one of the components in calculating the WACC
8 for any company and measures that company risk in relation to
9 the rest of the market. Mr. Morone testified that the 1.29
10 beta is appropriate because Hilton stock was riskier than the
11 market as a whole, and for that he cited debtors' expert Derek
12 Pitts, who submitted an affidavit with the debtors' motion.
13 Mr. Morone adjusted Hilton's WACC to account for
14 property-specific risks, as the WACC reflects aggregate risk of
15 Hilton's entire diversified portfolio of management agreements,
16 relying on something called the "Ibbotson's Size-Risk Premium,"
17 Mr. Morone adjusted the WACC to reflect specific risks, such as
18 the size of the resorts, the brand, and the volatility as to
19 the Grand Wailea. He noted the Grand Wailea's additional risk,
20 in his view, included the remote location, the dependency on
21 air travel, the dependency on group travelers, and natural
22 conditions.
23 Based on the credible evidence and the applicable law,
24 the Court starts off by adopting the WACC used by Mr. Morone.
25 The difference between Bloomberg's WACC of 8.7 percent

1 and Mr. Morone's determination is that Mr. Morone used a beta
2 of 1.29, as opposed to a beta of one. The affidavit of
3 debtors' expert Derek Pitts provides support for the assertion
4 of using a beta of 1.29; and in fact, Mr. Pitts' affidavit
5 provides the only real analysis of beta in this case.
6 Using that beta and information from Hilton's own 10-
7 K, I reach the conclusion that Hilton's WACC at the time of
8 entering these management agreements was 10.6.
9 Mr. Hennessey opined that Hilton's WACC was 8.1, but
10 based his finding upon an internal Bear Stearns estimate
11 published in December 2006, almost a year after Hilton acquired
12 the resorts.
13 I also note that Hilton's expert makes reference to
14 Bloomberg's WACC. There was discussion at trial that Bloomberg
15 apparently uses a default beta of one. It was unclear from the
16 testimony -- indeed, no one seemed to know -- if that default
17 of one was used by Bloomberg in all instances for Hilton or
18 even in all instances for all companies. And as no party has
19 provided any explanation of the basis for using that default of
20 one here, the Court instead relies on the 1.29 beta, for which
21 analysis has been provided by Mr. Pitts.
22 On the one hand, Hilton has failed to establish that
23 the management agreements lack any risk, and that its eight
24 percent rate that it applies to all acquired management
25 agreements is sufficient to discount its future fees upon

1 rejection. Indeed, credible evidence has been presented
2 showing that these iconic resorts are exposed to unique risks
3 that make their revenue streams more volatile than a typical
4 Hilton property, supporting an upward adjustment of the WACC,
5 which represents the riskiness to Hilton's business as a whole.
6 Thus, the Court rejects the notion that the same risks apply to
7 these resorts as apply to the operation of one of Hilton's
8 Hampton Inns.
9 On the other hand, the debtors have failed to persuade
10 the Court that the attendant risks are as high as they claim.
11 There is credible evidence that the management fees here, taken
12 from gross revenues, rather than profits, are a less risky
13 source of revenue for Hilton than many of Hilton's other
14 revenue streams and other revenue streams at the resort.
15 For all these reasons, the Court will adjust the WACC
16 for the Arizona Biltmore and the La Quinta upward by one
17 percent, to arrive at a discount rate of 11.6. And this is to
18 account for the attendant risks identified by Mr. Morone and
19 discussed by Mr. Pitts.
20 The Court will adjust the WACC for the Grand Wailea by
21 two percent upwards, rather than one percent, to reach a
22 discount rate of 12.6, based on the aforementioned attendant
23 risks, plus additional risks unique to the Grand Wailea that
24 were discussed at the trial, and that have been mentioned
25 previously, including its location.

1 The one additional percent increase is also
2 appropriate to account for the possibility that the Grand
3 Wailea may fail the performance tests over the life of these
4 agreements. The credible evidence was that there have been
5 real economic struggles in the recent performance of the Grand
6 Wailea, which is perhaps the most iconic, and thus most unique
7 of these three resorts. These struggles have been evidenced by
8 various metrics that Hilton itself prepared, rating performance
9 at the resort. These difficulties no doubt have been
10 influenced by the current economic downturn and Grand Wailea's
11 location and unusual dependence on group bookings for success,
12 bookings that are incredibly sensitive to the economy.
13 Such an adjustment for risk of termination has been
14 recognized by the courts. See M Waikiki, 2012 WL 2062421, at
15 *4-5, adjusting the WACC upwards to account for performance-
16 based termination risk. See also Pet Food Express Ltd. v.
17 Royal Canin USA, Inc., 2011 WL 1464874, at *12 (N.D. Cal.
18 2011), noting that the failure to reduce damages due to
19 uncertainty of lost profits towards the end of an agreement
20 ignores the contingency in the agreement that would have
21 allowed a defendant to terminate the agreement prior to the end
22 of the term for plaintiff's failure to perform its contractual
23 duties and obligations.
24 The Court now turns to the related issue of cure
25 payments. Debtors' expert Mr. Morone deducted some $7 million

1 in cure payments because he contends that Hilton will fail the
2 performance test and will need to make cure payments on two
3 occasions. First, in his view, it will fail in 2013 and '14,
4 and because the debtors can terminate the contract, Hilton will
5 need to make a cure payment of some $6 million. As to the
6 second instance, based on a so-called "Monte Carlo Analysis,"
7 Mr. Morone concludes that Hilton will again fail the
8 performance test as to the Grand Wailea in 2031, prompting a
9 second cure payment of almost a million.
10 Mr. Morone believes that both these cure payments
11 should be deducted from Hilton's profits.
12 The Court rejects the debtors' arguments as unduly
13 speculative for several reasons. First, while the Court agrees
14 there is a risk that Hilton will fail the performance test at
15 the Grand Wailea, that failure has not been shown to the degree
16 of certainty so as to make it appropriate to deduct cure
17 payments from Hilton's profits. As already discussed, this
18 risk of failure should instead be accounted for in application
19 of the discount rate for the Grand Wailea.
20 Indeed, in reaching that conclusion, the Court notes
21 that the performance test here has been described as fairly
22 easy to satisfy by some observers. And while I won't go that
23 far, I do note that Hilton's operating requirements are based
24 in part on Hilton Resorts' annual operating plan that it itself
25 prepares.

1 Additionally, the Court notes that the Monte Carlo
2 Analysis is unduly speculative. Mr. Morone himself conceded
3 that he was unaware of its use in projecting future failure in
4 hotel management contracts. Indeed, the Court notes that the
5 prediction that Hilton will fail in 2031 seems to be at odds
6 with Mr. Morone's approach of only estimating revenues out for
7 ten years because he found predictions after ten years not to
8 be sufficiently reliable. I turn next to group services
9 expenses. Hilton seeks some $38 million, almost $39 million,
10 in damages stemming from lost group services expenses in the
11 event the management agreements are rejected. This figure is
12 comprised of two components. The first is some $17 million in
13 the net present value of lost group services expense, and the
14 second is some $21.7 million in so-called "key money."
15 The management agreements define group services
16 expenses as each hotel's:
17 "cost for participation in the group services
18 (including reasonable corporate overhead related
19 thereto) as determined in accordance with Section 5.2,
20 excluding reimbursable expenses which shall be charged
21 separately."
22 Group services includes services and facilities
23 relating to advertising, marketing, promotion, publicity,
24 public relations, and group sales services, for all
25 Waldorf=Astoria Hotels and Resorts, as well as any additional

1 program or group benefit such as the Hilton HHonors program,
2 that are provided to all managed hotels. Group services
3 expense are capped at two percent of resort revenue and are
4 distinct from the corporate overhead fee.
5 Hilton argues that the group services expense was
6 expressly provided for in the management agreements; and thus,
7 damages relating to them were foreseeable at the time of
8 contracting. Hilton states that the brand fund that
9 Waldorf=Astoria is currently operating operates at a loss, and
10 that Hilton subsidizes it already, and that Hilton would have
11 to self-fund the amounts formerly contributed to maintain the
12 same level of brand support and marketing for the
13 Waldorf=Astoria brand. Hilton believes that this funding will
14 have to continue until Hilton completely replaces the amount of
15 group services expenses previously contributed by the Hilton
16 Resorts, which its primary expert estimates will take at least
17 five years.
18 In addition to the group services expense itself,
19 Hilton seeks to recover over $21 million in so-called "key
20 money," which it alleges are payments that it will need to make
21 to obtain additional management agreements to replace the ones
22 that it would lose and therefore, to replace the lost group
23 services expense. Key money represents funds that a management
24 company may be required to pay a hotel owner to obtain those
25 management rights.

1 For their part, the debtors argue that the group
2 services expenses exceed the cap established in the management
3 agreements, and accordingly should be reduced to the amount
4 actually expended, so that Hilton is no longer subsidizing the
5 difference. The debtors further argue that Hilton is also not
6 entitled to the approximately $17 million in group services
7 expense damages because the management agreements don't permit
8 recovery of such expenses, and that Hilton will replace any
9 lost group services by 2014, and that Hilton can simply elect
10 to avoid incurring any such damages. Finally, the debtors
11 assert there is no basis for Hilton's request for the $21
12 million in key money.
13 Given the facts and applicable law, the Court grants
14 in part and denies in part Hilton's request for damages in
15 connection with group services expense. The language of the
16 management agreements contemplates the payment of group
17 services expenses for the costs incurred in providing group
18 services to the Waldorf=Astoria brand generally.
19 The evidence established that Hilton has used such
20 funds for their intended purpose. The mere fact that Hilton
21 may spend more than is required for that purpose for its own
22 business reasons is irrelevant. All that matters is that
23 Hilton seeks only to recover the fee provided for under the
24 management agreements, not any extra costs beyond that.
25 Moreover, there was no evidence at trial that Hilton intended

1 in the future to spend less on group services for the
2 Waldorf=Astoria brand than is contemplated by the management
3 agreements.
4 Relatedly, the Court concludes that Hilton's request
5 for payments of these fees for a five-year period represents an
6 appropriate exercise of its duty to mitigate its damages. See,
7 e.g., Shaffer v. Debbas, 21 Cal. Rptr. 2d 110, 114 (Cal. Ct.
8 App. 1993), as well as Shahata v. W Steak Waikiki, LLC, 721
9 F.Supp. 2d 968, 988 (D. Haw. 2010).
10 The Court notes that Hilton has sought some $17
11 million in group services expense, a number that has been
12 described to me as having been discounted to net present value.
13 While the Court awards group services expense, it notes that
14 the correct number may be different than the $17 million.
15 While the parties do not address this issue, the Court's prior
16 ruling on the discount rate presumably applies to this
17 component of damages; therefore, this number presumably should
18 be adjusted accordingly consistent with this Court’s earlier
19 ruling on the discount rate.
20 Moving on to the second aspect of Hilton's group
21 services claim, the Court rejects Hilton's request for the
22 payment of so-called "key money" for several reasons.
23 As an initial matter, the provision to pay key money
24 is nowhere mentioned in the management agreements, in stark
25 contrast to the group services expense itself. So it is very

1 hard to say the key money was within the parties' contemplation
2 at the time of contract formation as an appropriate measure of
3 damages, and these requested damages are particularly troubling
4 given that the amount of key money sought is in fact greater
5 than the amount of damages actually sought for group services
6 expense under the contract itself.
7 In any event, the evidence at trial was insufficient
8 to support Hilton's claim for key money damages. Hilton cannot
9 identify which hotel agreements this key money will be used to
10 acquire. Instead, Hilton's claim for recovery of key money is
11 not grounded on any specific facts, but rather on Mr. Cline's
12 professional judgment.
13 But Mr. Cline based his analysis, specifically the
14 twenty-five percent ratio assumption he used for calculating
15 key money, upon conversations with Ted Middleton, Hilton's Vice
16 President of Development. Middleton, however, later testified
17 that he had done no analysis of the amount of key money that
18 Hilton would be required to pay to replace the group services
19 expense payments, and was not aware of anyone else at Hilton
20 who performed such analysis.
21 Finally, the Court notes that Hilton itself concedes
22 that whatever management agreements it may one day acquire
23 could very well be management agreements that Hilton would seek
24 to acquire regardless of whether these management agreements
25 are actually rejected.

1 So for all those reasons and the lack of evidence
2 supporting the necessity of key money payments, the Court
3 rejects that component of damages.
4 I now turn to Hilton's request for so-called "brand
5 damages." Hilton seeks approximately $120 million in damages
6 stemming from its alleged damage to Hilton's Waldorf=Astoria
7 brand. These damages purport to stem from the debtors'
8 termination of the management agreements and flow from the
9 theory that these properties are "iconic and irreplaceable,"
10 which is a phrase that has been used often in this trial and
11 seems not to be in dispute.
12 Hilton argues that such damages were contemplated by
13 the parties when Hilton acquired the agreements in 2006, as
14 part of an effort to launch the Waldorf=Astoria brand. Hilton
15 believed the acquisition of these management agreements for
16 these three resorts would enable Hilton to generate additional
17 business, as well as credibility among investors and within the
18 real estate development community.
19 Hilton further alleges that the loss of the resorts
20 would contribute to tension among other Waldorf=Astoria owners
21 who have already been pressuring Hilton to expand and grow the
22 brand, particularly given that the resorts collectively account
23 for some twenty-five percent of the rooms comprising that
24 brand.
25 Hilton's determination of the amount in brand damages

1 is based on two separate analyses that focus on the time period
2 spanning from 2012 to 2034. The first estimate provides for
3 losses to the existing pipeline of Waldorf=Astoria properties
4 and any impact to the brand's future development program.
5 Utilizing this approach, Hilton estimates brand damages
6 totaling a hundred-and-twelve-some-odd million dollars. The
7 second methodology estimates the overall value of the
8 Waldorf=Astoria brand and determines that the brand will lose
9 56.5 percent of its value. Under that analysis, Hilton
10 estimates damages in the total amount of $128 million. Taking
11 the midpoint between these two figures, Hilton seeks damages
12 for brand loss in the total amount of $120 million.
13 The Court denies Hilton's request for brand damages.
14 Like the request for key money, the notion for brand damages is
15 nowhere contained in the management agreements. Instead, the
16 notion of protecting and growing the brand is covered by the
17 management agreements' group services expense, which are
18 damages that have been requested by Hilton and granted by the
19 Court.
20 Moreover, Hilton's request for brand damages is
21 fatally undercut by lack of evidence. Hilton's expert Roger
22 Cline set forth his proposed calculation of damages, presuming
23 that there will be damage to the Waldorf=Astoria name. But
24 other than Mr. Cline’s opinion, Hilton has offered no hard
25 evidence of damage to its business or business opportunities,

1 including growth and expansion.

2 For example, Hilton has not provided evidence that a

3 current hotel owner, potential hotel owner, or Hilton HHonors

4 client has presented any concerns about the impact of rejection

5 on the brand. Thus, there is no evidence that any current or

6 future owner would refuse to engage in business with Hilton,

7 would back out of a deal, or would even seek to receive reduced

8 rates.

9 In fact, Hilton's own witnesses testified that no

10 owner has made any indication to Hilton that they would pull

11 their property from Hilton if these three resorts were lost;

12 nor could Hilton's witnesses identify any perspective

13 Waldorf=Astoria properties that would refuse to join the brand

14 as a result of rejection of these management agreements, or any

15 co-branding opportunities that will be lost. Indeed, none of

16 the hotel management agreements contain provisions that would

17 enable a hotel owner a right to terminate its own agreement

18 with Hilton by virtue of the loss of these three management

19 agreements, or at least no witness was aware of any such

20 provision. Hilton has not offered any evidence establishing

21 that any new hotel will elect not to join the Waldorf=Astoria

22 brand because of the management agreement rejections.

23 Accordingly, the Court concludes that Hilton has not

24 shown such brand damage will occur with the reasonable

25 certainty required for being awarded by this Court.

1 The Court recognizes that rejection here has not yet
2 occurred; and thus, this case is different than a normal breach
3 of contract case, where the parties can look back historically
4 at events. This inevitably may mean that it is harder for
5 Hilton to provide evidence of brand damages.
6 But the Court notes that this bankruptcy and rejection
7 proceeding have been the subject of media coverage, and the
8 debtors have made it very clear from the beginning of this case
9 more than a year ago that rejection of these management
10 agreements was a real possibility, and evaluating the
11 management agreements in this case for rejection was one of the
12 three cornerstones of the debtors' restructuring efforts.
13 Given the well publicized nature of these proceedings, the
14 Court cannot grant the very substantial brand damages sought by
15 Hilton without some real-world evidence of damage to the brand.
16 And relatedly, the Court notes that the brand damages sought
17 are more than thirty-five percent of the total damages
18 requested in this case.
19 In addition to the lack of concrete evidence from
20 Hilton's fact witnesses, there are difficulties with some of
21 the assumptions underlying the brand damages calculation. For
22 example, the brand damages sought assume a valuation of the
23 Waldorf=Astoria brand at some 2.265 billion, but that value is
24 contradicted by some of Hilton's own documents and public
25 filings, which set forth a different valuation.

1 Furthermore, Mr. Cline's lost opportunities damages
2 calculation is based on an estimation that, notwithstanding the
3 rejection, Waldorf=Astoria will increase its number of hotels
4 by twenty-two in the near future, an aggressive assumption that
5 appears fundamentally at odds with Hilton's claim that the
6 Waldorf=Astoria brand would be harmed by rejection. And
7 indeed, his projection as to the brand's performance going
8 forward is similarly aggressive into the future, undercutting
9 the argument of brand damage.
10 Finally, Mr. Cline's measure of calculating damages is
11 premised upon the notion that the measure of damages is
12 directly correlated to the number of rooms lost. But that
13 notion is undercut by evidence at trial that there will be
14 times when a brand might lose a hotel from its group, and that
15 loss may not inflict any damage whatsoever to the brand. Mr.
16 Cline did not offer any limiting principle regarding his theory
17 of brand damages to reflect this fact.
18 The rejection of Hilton's brand damage claim is
19 consistent with the applicable case law. Applicable state law
20 generally holds that speculative contract damages cannot serve
21 as a proper legal basis for recovery. See Scott v. Pacific Gas
22 & Electric Company, 904 P.2d 834, 845 (Cal. 1995); that case
23 noting that it was a fundamental principle of contract law that
24 speculative, remote, imaginary, contingent, or merely possible
25 contract damages cannot serve as a legal basis for recovery,

1 and absent any definable loss, a party is entitled only to
2 nominal damages. See also McDevitt v. Guenther, 522 F.Supp. 2d
3 1272, 1287 (D. Haw. 2007); that case highlighting that, under
4 Hawaiian law, speculative damages are not recoverable on
5 actions arising under contract or in tort. See also Southern
6 Union Co. v. Southwest Gas Corp., 180 F.Supp 2d 1021 (D. Ariz.
7 2002); that case holding that a party cannot recover for lost
8 profit damages on the grounds it is too speculative to support
9 recovery.

10 Moreover, the Court notes that the States of Arizona,
11 California, and Hawaii recognize that damages must be proven
12 with reasonable certainty. Walter v. Simmons, 818 P.2d 214
13 (Ariz. Ct. App. 1991); that case putting the burden on the
14 plaintiff to prove damages stemming from a breach of contract
15 with reasonable certainty. See also Maggio, Inc. v. United
16 Farm Workers of America, 278 Cal. Rptr. 250, 264 (Cal. Ct. App.
17 1991); that case noting that damages for loss of profits may be
18 denied as "unestablished" or as being too uncertain or
19 speculative if they cannot be calculated with reasonable
20 certainty. See also Omura v. American River Investors, 894
21 P.2d 113, 116 (Haw. Ct. App. 1995), stating that the extent of
22 loss must be shown with reasonable certainty and cannot be
23 based on mere speculation or guesswork.

24 These principles about certainty are applicable to
25 situations where parties assert claims for lost profits

1 resulting from damage to plaintiff's reputation, and case law
2 from all three states reflect this. See, e.g., Dong Ah Tire &
3 Rubber Co., Ltd. v. Glasforms, Inc., 2010 WL 1691869, at *5
4 (N.D. Cal. 2010); that case holding that there was insufficient
5 evidence to support any award of damages for lost profits or
6 reputation restoration, and that lost profits must be proven to
7 be certain as to their occurrence and their extent. See also
8 Hi-Pac Ltd. v. Avoset Corp., 26 F.Supp. 2d 1230, 1237 (D. Haw.
9 1997); that case holding that plaintiffs cannot recover on a
10 claim that a defendant's breach of contract damaged the
11 plaintiff's reputation, and thereby resulting in lost profits,
12 because the plaintiffs were unable to identify or reasonably
13 calculate any specific lost sales or profits, and accordingly
14 failed to meet their burden.
15 Also instructive are this jurisdiction's decisions
16 relating to claims on reputation damages. Generally, the
17 standard to show loss of good will or reputation damages is
18 high. In ESPN, Inc. v. Office of Comm’r of Baseball, 76
19 F.Supp. 2d 416 (S.D.N.Y. 1999), for example, the Court held
20 that under New York law, in order to recover damages for loss
21 of good will, business reputation, or future profits, the
22 claimant must prove the fact of loss with certainty, and the
23 loss must be reasonably certain in amount.
24 The Second Circuit in Toltec Fabrics, Inc. v. August,
25 Inc., 29 F.3d 778, 781 (2d Cir. 1994), presented a three-part

1 test for recovery:

2 The first being that the claimant must show that there

3 was in fact a loss of good will that must be proved with

4 reasonable certainty.

5 The second being that claimant must present objective

6 proof of that loss.

7 And third, that the claimant must show that the loss

8 was caused by the opposing party's breach.

9 These two cases, while outside the jurisdictions at

10 issue in this proceeding, are instructive in how to value and

11 approach the issue of brand damages here.

12 Hilton relies particularly on two cases in support of

13 its contention that it is entitled to brand damage, but neither

14 case supports its position.

15 In Woolley v. Embassy Suites, Inc., 278 Cal. Rptr. 719

16 (Cal. Ct. App. 1991), the Court considered a request by a hotel

17 branding and management company for a preliminary injunction to

18 prevent a hotel owner from terminating the hotel management

19 agreements. The Court there declined to grant the injunction,

20 noting that computation of a damage award for the loss to

21 Embassy's reputation as a result of wrongful termination could

22 be adequately addressed through expert testimony.

23 Nothing in this case mandates or counsels the award of

24 brand damages here, however.

25 Second, Hilton cites to In re M Waikiki, LLC, 2012 WL

1 2062421 (Bankr. D. Haw. June 7, 2012). In that case, the Court
2 denied Marriott's request for damages to its reputation and
3 good will associated with the hotel owner's alleged breach of
4 Marriott's management agreement. The Court's holding was based
5 on its finding that Marriott presented no evidence of any
6 damage to the brand reputation.
7 Hilton argues that this case supports its position
8 because the Hawaiian Court stated that its holding was without
9 prejudice to the ultimate allowance of Marriott's claims.
10 However, this case does nothing more than support the Court's
11 conclusion that Hilton cannot recover such damages without
12 proof.
13 Finally, I turn to the last item of damages sought,
14 those relating to the potential expansion of the Grand Wailea.
15 Hilton argues that it will incur losses in the amount of some
16 $9 million in connection with the proposed expansion at the
17 Grand Wailea in the event the debtors reject the management
18 agreement.
19 In April 2012, the County of Maui granted approval of
20 a two-hundred-and-fifty-million-dollar expansion at the Grand
21 Wailea, which would add approximately 310 additional rooms and
22 increase the size of the resort from 780 to 1,090 rooms. Such
23 expansion has been contemplated as far back as 2005.
24 Hilton argues that this expansion, which could be
25 completed by 2017, would add tremendous value to the resort,

1 with Hilton estimating such value at over $255 million.
2 Specifically, Hilton believes that expansion will result in a
3 significant increase in gross revenues; and accordingly, base
4 management fee income to Hilton, once expansion is completed.
5 Termination of the management agreements would prevent Hilton
6 from reaping the benefits of expansion in the form of increased
7 fees. Hilton opines that, using a thirteen percent discount
8 rate, the net present value of Hilton's foregone base fees and
9 corporate overhead fees total some $9.8 million.
10 But the Court rejects Hilton's claim for damages
11 associated with a possible expansion of the Grand Wailea.
12 While the debtors have the right to expand the Grand Wailea,
13 the debtors presented testimony at trial that they have no
14 obligation, contractual or otherwise, to undertake the
15 expansion; they also assert that they presently have no plans
16 to expand the Grand Wailea; and third, that they have made no
17 commitment to do so. None of these assertions can credibly be
18 disputed.
19 I parenthetically note that one of Hilton's witnesses
20 briefly suggested that the debtors were contractually obliged
21 to maximize operations at the resort, and that this meant the
22 debtors were obligated somehow to move forward with this
23 possible expansion. That position, I conclude, is a wild over-
24 reach, based on the contract language at issue.
25 But in any event, turning back to the debtors'

1 position here, it's not surprising, given the facts. As
2 previously discussed, the trial was full of evidence regarding
3 the poor performance of the Grand Wailea. The debtors' witness
4 Thomas Shumaker described the approval here obtained by the
5 debtors as a right to expand and conceded that this right was
6 enormously valuable. But he credibly testified that any
7 potential expansion of the Grand Wailea must be viewed in the
8 context of the future performance of the resort, and that the
9 current performance of the resort was a real concern. He also
10 credibly testified that the approval here could be extended
11 out, so as to preserve the debtors' options and this valuable
12 right, while not committing to going forward with any
13 expansion. He and other witnesses noted that the debtors have
14 actually had a right to expand a smaller number of rooms on the
15 same property for some time and have not proceeded to go
16 forward with that expansion.
17 In sum, the debtors' mere consideration of expansion
18 is insufficient to entitle Hilton to damages here. See, e.g.,
19 Greenwich S.F., LLC v. Wong, 118 Cal. Rptr. 3d 531, 553 (Cal.
20 Ct. App. 2010); that case concluding that:
21 "The existence of plans for development does not
22 supply substantial evidence that the development is
23 reasonably certain to be built, much less that it is
24 reasonably certain to produce profits."
25 And that any reliance on a real estate project that

1 may not occur in order to claim lost profits is "inherently
2 uncertain, contingent, unforeseeable, and speculative."
3 See also Vestar Development II, LLC v. General
4 Dynamics Corp., 249 F.3d 958, 962 (9th Cir. 2001); that case
5 holding that there is no way to evaluate, other than through
6 speculation, the profits of a prospective land purchaser on a
7 shopping center it would have built, had the purchaser been
8 permitted to purchase the parcel of land.
9 The Court also notes that Mr. Cline's damages
10 calculation as to the Grand Wailea expansion is somewhat
11 defective because it fails to account for the fact that such
12 expansion would negatively impact the Grand Wailea's
13 performance. It would do so by causing considerable disruption
14 to the resort for the period during which construction was
15 underway, and could result in potential lost business, required
16 discounting, and loss of good will among affected guests. The
17 debtors anticipate that the adverse effect on revenue and
18 earnings could last as long as two years.
19 Relatedly, the Court notes the evidence at trial that
20 group bookings typically have a provision that permits them to
21 cancel their reservation if there's ongoing construction, and
22 that such group bookings are crucial to the Grand Wailea's
23 economic success.
24 That concludes the Court's rulings on the motion to
25 estimate damages from rejection of these three management

1 agreements. Again, as I noted earlier, it's my normal
2 preference to provide a written decision to the parties, but
3 debtors explained the need for a quick resolution of this
4 dispute and requested a decision, if at all possible, by August
5 1st, 2012, which is tomorrow. The need for such an expedited
6 decision relates to the existing deadlines for an exit strategy
7 in this Chapter 11 case, either by plan or sale or some
8 combination of both. And those deadlines for an exit strategy
9 were the result of hotly contested hearings on exclusivity in
10 this case, a dispute that was resolved by agreement of the
11 parties on the timing for an exit strategy. And so I
12 understand the quandary faced by the debtors; and therefore
13 prepared this bench ruling.
14 However, this being a bench ruling and transcription
15 being what it is, I plan to review the transcript to ensure
16 that it accurately reflects my ruling; and therefore reserve
17 the right to amend it accordingly. So I'd ask the debtors to
18 order the transcript on an expedited basis, and I'll take a
19 look at it. And I also request that the debtors prepare an
20 order memorializing my ruling, and obviously consult with
21 Hilton's counsel on the appropriate language to do so.
22 So that didn't take quite an hour and a half; it was a
23 little shorter than my estimate, but that concludes my business
24 for the day.
25 Is there anything that any party needs to raise?

1 MR. LEON: No. I just wanted to take the opportunity
2 to once again thank Your Honor and your staff for accommodating
3 the parties, our schedule, and in particular the debtors' short
4 time constraints. It's very much appreciated on all sides.
5 And we also appreciate Your Honor's attention to this matter.
6 THE COURT: Absolutely.
7 Mr. Neff, is there anything you need to raise at this
8 time?
9 MR. NEFF: Your Honor, did you want the parties to
10 attempt to come up and try to quantify what the amount is?
11 THE COURT: Well, that actually was going to be the
12 next thing I was going to mention. If you noted, there is no
13 ultimate bottom-line quantification. That's because there are
14 many components to this that I was trying to get right, and I
15 was going to leave you all to do the math, particularly as to
16 the discount rate.
17 So yes, I think, it would be the appropriate subject
18 of discussion among the parties, in terms of memorializing the
19 ruling in an order.
20 MR. NEFF: Very good.
21 THE COURT: All right. Thank you.
22 Anything else? All right.
23 MR. LEON: Nothing for debtors.
24 THE COURT: Thank you. Have a good evening.
25 MR. LEON: Thank you, Your Honor. You, too.

1 MR. NEFF: Thank you, Judge.

2 (Proceedings concluded at 5:15 p.m.)

3 *****

4

1 CERTIFICATION

2 I certify that the foregoing is a correct transcript

3 from the electronic sound recording of the proceedings in the

4 above-entitled matter.

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8 S/ Coleen Rand August 1, 2012

9 Coleen Rand, AAERT Cert. No. 341 DATE

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11 Certified Court Transcriptionist

12

13 AudioEdge Transcription, LLC

Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)

United States Court of Appeals for the Fifth Circuit

February 13, 2006, Filed

No. 04-11264

Reporter

440 F.3d 238 *; 2006 U.S. App. LEXIS 3438 **; Bankr. L. Rep. (CCH) P80,453; 55 Collier Bankr. Cas. 2d (MB) 1050; 46 Bankr. Ct. Dec. 13

IN THE MATTER OF: MIRANT CORPORATION, Debtor, BONNEVILLE POWER ADMINISTRATION, Appellant, VERSUS MIRANT CORPORATION, Appellee.

Prior History: **[**1]** Appeal from the United States District Court For the Northern District of Texas.

Counsel: For BONNEVILLE POWER ADMINISTRATION, Appellant: Jeffrey A. Clair, William Kanter, US Department of Justice Civil Division, Washington, DC.

For MIRANT CORPORATION, Appellee: Robin E. Phelan, Amy M. Walters, Frances A. Smith, Haynes & Boone, Dallas, TX; Thomas E. Lauria, White & Case, Miami, FL.

Judges: Before GARWOOD, SMITH, and DeMOSS, Circuit Judges.

Opinion by: DeMOSS

Opinion

[*240] DeMOSS, Circuit Judge:

Bonneville Power Administration ("BPA") appeals the district court's affirmance of two orders entered by the bankruptcy court. Debtor Mirant Corporation and related entities filed a petition under Chapter 11 of the Bankruptcy Code, triggering a dispute between the parties regarding the ability of BPA to terminate an executory contract for the future purchase of electric power. On the one hand, the Bankruptcy Code's automatic stay, effective upon the filing of a Chapter 11 petition, precludes any act to obtain possession of or exercise control over property of the estate. *See* 11 U.S.C. § 362(a). On the other hand, in an executory contract related to the future call of energy purchase **[**2]** by BPA, *see generally* § 365, the parties agreed to an ipso facto clause that provided for default and a termination payment in the event of a bankruptcy filing, *see* § 365(e). [1] BPA argues that the Bankruptcy Code (or the "Code") permits it to terminate the executory contract pursuant to the contract's ipso facto clause. *See* § 365(e)(2)(A). The parties now dispute the priority of the two Chapter 11 provisions: the automatic stay and the termination arguably permitted by the combined effect of the ipso facto clause and § 365(e)(2)(A).

[*241] This appeal requires us to address the intersection of three relevant statutory provisions: 11 U.S.C. § 362(a) (the automatic bankruptcy stay); 11 U.S.C. § 365(e)(2)(A) (permitting a nondebtor party to an executory contract to terminate or modify such contract **[**3]** when applicable law excuses the nondebtor from accepting or rendering performance to the trustee or an assignee); and the Anti-Assignment Act (or "the Act"), 41 U.S.C. § 15 (prohibiting transfer of contracts to which the United States is a party).

Concluding that the bankruptcy stay precedes any termination permitted by either the Anti-Assignment Act or the agreement of the parties, we affirm the district court's order declaring BPA to have violated the automatic stay. Finding no abuse of discretion in the court's determination that cause was not shown where the Anti-Assignment Act is not an applicable law under § 365(e)(2)(A), we affirm also the denial of BPA's motion to lift or modify the stay.

I. Background

A. Factual Background

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[1] *See* BLACK'S LAW DICTIONARY 847 (8th ed. 2004) (defining *ipso facto* clause as a "contract clause that specifies the consequences of a party's bankruptcy").

Mirant Corporation is an international energy company that produces and sells electricity in the United States and abroad. Appellee Mirant Americas Energy Marketing, L.P. ("Mirant") is a subsidiary of Mirant Corporation and engages in asset risk management, including commodities, energy, and financial product trading. Mirant is responsible for procuring fuel and selling power for Mirant Corporation's operating **[**4]** facilities.

BPA is a federal power marketing agency within the United States Department of Energy. BPA was created in 1937 by Congress to market low-cost hydroelectric power generated by a series of federal dams along the Columbia River in the Pacific Northwest. *See generally* Bonneville Project Act of 1937, 16 U.S.C. § 832. Originally, BPA marketed the energy produced for the benefit of the public, particularly domestic and rural customers, giving preference and priority to public bodies and cooperatives. *See* § 832c(a). For some time, surplus in energy production meant BPA could market freely to all who desired to purchase in the area. In 1980, increasing demands upon the supply triggered, in part, Congress's enactment of the Pacific Northwest Electric Power Planning and Conservation Act, 16 U.S.C. §§ 839-839h, which required BPA to offer new contracts to its customers. *See Aluminum Co. of Am. v. Cent. Lincoln Peoples' Util. Dist.*, 467 U.S. 380, 382, 104 S. Ct. 2472, 81 L. Ed. 2d 301 (1984). Thereafter, BPA was authorized to acquire additional resources in order to increase the supply of federal power. *See* 16 U.S.C. § 839d(a)(2). **[**5]** Accordingly, BPA entered certain contracts related to the marketing of federal power. *See* § 832a(f).

BPA and Mirant are parties to the Western Systems Power Pool Agreement (the "WSPPA"), a contract the parties agree is standard for electric power sales. The WSPPA is an umbrella agreement governing electric power transactions. Subject to the WSPPA, BPA and Mirant's predecessor in interest (Southern Company Energy Marketing, L.P.)[2] entered two agreements: (1) the Agreement to Enable Future Purchases, Sales, and Exchanges of Power and Other Services No. 99PB-10588 (the "Enabling Agreement") and (2) an option contract though which BPA purchased a one-time call option for the future **[*242]** purchase of a set amount of firm power from Mirant over a three-year period commencing in 2004 (the "Confirmation Agreement").

Together, the WSPPA, the Enabling Agreement, and the Confirmation Agreement (collectively, the **[**6]** "Agreement") form the sum of the parties' contractual rights and obligations. [3] Under the terms of the Agreement, BPA owed no obligation to exercise its option, and if it did not do so, the option expired on the strike date provided, December 23, 2003. The parties agree, and the lower courts noted, that BPA did not exercise and, in practical terms, would not have exercised its option because the option price bargained for in the Agreement exceeded the market price of energy during the relevant period of the Agreement.

The Agreement includes a default provision, or ipso facto clause, that authorizes BPA to terminate **[**7]** the contract and claim liquidated damages if Mirant petitioned for bankruptcy before the option period expired. The Agreement provides that default by the institution of a bankruptcy proceeding triggers the non-defaulting party's "right to terminate all transactions between the Parties under this Agreement upon written notice" and the non-defaulting party's right to a termination payment. Upon termination, the non-defaulting party may liquidate all transactions with the debtor and demand a termination payment equal to the market-based cost of replacing the option contract. [4] The Agreement also provides that all transactions under the agreement are forward contracts and that the parties are forward contract merchants as defined by the Bankruptcy Code. *See* 11 U.S.C. § 556.

[8]** On July 1, 2003, BPA wrote to Mirant requesting, pursuant to the Agreement, adequate assurances of Mirant's ability to perform. Mirant responded by letter on July 3, stating its willingness to wire assurance but disputing the reasonable estimate of the amount of

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[2] Mirant Corporation was originally a wholly owned subsidiary of Southern Company Energy Marketing.

[3] Although the parties below disputed the integration of the contracts, some of which were executory in nature and others of which were not, the bankruptcy court assumed without deciding that the Confirmation Agreement was an executory contract and that the three contracts formed a single agreement. In their briefings to this Court, both parties treat the three contracts as an integrated agreement.

[4] As a practical matter, the bankruptcy court noted that the peculiar facts of this case mean the primary dispute between the parties is the termination payment. Because market prices were lower than the option price of the Agreement during the relevant period, both parties acknowledged that the Agreement would never have been performed. According to the bankruptcy court, BPA seeks to declare Mirant's default and thereby obtain a claim against Mirant in bankruptcy proceedings for the amount of the termination payment.

assurance. On July 7, Mirant wired to BPA $ 523,389 as adequate assurance of its ability to perform.

B. Procedural Background

On July 14, 2003, Mirant Corporation and 82 of its direct and indirect subsidiaries, including Mirant, filed voluntary Chapter 11 bankruptcy petitions. That day, the court held a hearing and entered an interim order authorizing the Debtors to comply with the terms of prepetition trading contracts and to enter into postpetition trading contracts in the normal course of business and setting a final hearing for the entry of a final order of authorization. The bankruptcy court also approved the joint administration of the Debtors' cases. [5]

[9]** Under the Code, Mirant as a debtor remains in possession of its estate. *See* 11 U.S.C. § 1101. [6] **[*243]** Mirant continues to conduct its business in the ordinary course. On July 16, 2003, the bankruptcy court ordered the parties, specifically including all governmental units, to comply with the Code's automatic stay provision, § 362, and its provision regarding executory contracts and unexpired leases, § 365 (the "Order to Comply"). [7] The Order to Comply enjoined BPA from multiple acts affecting Mirant or the debtor estate, including interference in any way with any and all of the property of any of the Debtors. The Order to Comply expressed that it had no effect upon any exceptions to the automatic stay, based upon any section of the Bankruptcy Code, or upon the right of any party to seek relief from the automatic stay according to § 362(d).

[10]** BPA terminated its Confirmation Agreement with Mirant shortly thereafter, and Mirant characterizes this termination as a violation of the bankruptcy court's order and stay. On July 30, 2003, BPA notified Mirant in writing that the Chapter 11 petition constituted default under the parties' Agreement and that accordingly, BPA terminated all transactions with Mirant. BPA stated that under the terms of the Agreement, both parties were forward contract merchants and that the Agreement was a forward contract for purposes of 11 U.S.C. § 556. BPA also demanded a termination payment from Mirant under the Agreement of $ 1,085,040 [8] and set forth terms for the payment of that amount in light of the assurance Mirant had already provided and the amount BPA yet owed Mirant under the Agreement. BPA requested payment of the remaining amount allegedly owed by Mirant, $ 533,026, within three days of receipt of the July 30 letter. [9]

[11]** In response to BPA's termination letter and termination payment demand, Mirant wrote to BPA on August 7, 2003, challenging BPA's status as a forward contract merchant under the Code, describing BPA's purported termination of the Agreement as a violation of §§ 362 and 365 of Chapter 11, and demanding that BPA immediately withdraw its purported termination of the Agreement and perform. BPA later responded by letter, notifying Mirant of BPA's refusal to withdraw the termination letter.

On August 27, 2003, the bankruptcy court entered its final authorization order to Debtors, permitting compliance with prepetition trading contracts and entrance into post-petition trading contracts in the ordinary course of business, providing credit support for trading contracts, and authorizing assumption of prepetition trading contracts. This final authorization order contemplated the possible future event of a creditor, such as BPA, demanding acceptance or rejection of a trading option contract.

[*244] Before the bankruptcy court, on October 17, 2003, Mirant filed a motion to enforce the automatic stay and for contempt, arguing (1) that the transmission of BPA's July 30 termination letter violated the **[**12]** automatic stay, 11 U.S.C. § 362(a), because the act

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[5] The United States Trustee for the Northern District of Texas appointed three official committees in the jointly administered cases.

[6] A debtor in possession "means debtor except when a person that has qualified under section 322 of this title is serving as trustee in the case." 11 U.S.C. § 1101.

[7] Section 362 provides for automatic stay of, among other actions, "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate," 11 U.S.C. § 362(a)(3), and provides exceptions to the automatic entry of stay, § 362(b).

Section 365 provides for the administration of contracts, such as the one at issue here, including the debtor's assumption or rejection of such a contract. 11 U.S.C. § 365(a).

[8] BPA calculated the termination payment based upon market quotes for replacement transactions on July 30, 2003.

[9] By its own description, the July 30 letter constituted a contracting officer's final decision under 41 U.S.C. § 605, permitting Mirant to appeal the decision to either the Department of Energy Contract Board of Appeals or the United States Court of Federal Claims.

constituted an attempt to obtain possession of property of the estate and to exercise control over the estate; and (2) that BPA, as an entity of a government agency, cannot be a forward contract merchant under the Code's definition (the "Motion to Enforce"). BPA responded that under the Code, it was a forward contract merchant and that the Anti-Assignment Act, 41 U.S.C. § 15, bars any assignment of the Agreement, thus permitting BPA's termination of the Agreement consistent with 11 U.S.C. § 365(e)(2)(A). The bankruptcy court heard argument on November 12, 2003, [10] ruled that BPA had violated the stay, and offered BPA an option either to rescind its termination or to return for a continued hearing on the motion for contempt related to that violation. [11]

[13]** On November 17, 2003, the court entered an order, to which the parties had agreed in the interim, declaring that BPA had violated the automatic stay, denying the relief sought by BPA, ordering BPA to rescind its termination of the Confirmation Agreement, and returning the parties to the status quo that existed immediately prior to the delivery of the Termination Letter (the "Stay Violation Order"). [12] BPA appealed the Stay Violation Order to the district court. During this period, other creditors, aside from BPA, filed motions for modification of the stay and motions to require Mirant's assumption and assignment or rejection of various trading contracts, and they received bankruptcy court rulings on those motions.

[14]** On December 5, 2003, BPA filed a motion to modify the automatic stay retroactively to permit termination of the Confirmation Agreement (the "Motion to Modify Stay"). At that time, the option of the Confirmation Agreement was soon to expire on December 23. The bankruptcy court held a December 17 hearing on the motion and responses, and the court subsequently denied the Motion to Modify Stay. In its memorandum opinion, the bankruptcy court cited the Ninth Circuit in holding that (1) the stay applies to prevent unilateral termination even if a contract is unassumable and contains a valid ipso facto **[*245]** clause and (2) the stay must be modified before the ipso facto clause may be invoked. *See In re Computer Communs.*, 824 F.2d 725, 729-30 (9th Cir. 1987); 3 COLLIER ON BANKRUPTCY P 365.06[1][f] (15th ed. rev. 2005). The bankruptcy court clarified that its refusal to modify the stay stemmed from BPA's failure to make a sufficient showing of cause as required by § 362(d)(1). BPA could not, according to the court's holding, show cause in the absence of Mirant's default and even if the ipso facto clause **[**15]** could be enforced to trigger default, BPA failed to demonstrate cause for relief where BPA would suffer no harm by the continued enforcement of the stay.

BPA appealed the order denying the Motion to Modify Stay, and the district court consolidated BPA's appeals of the two bankruptcy court orders. The district court affirmed the bankruptcy court's Stay Violation Order and denial of BPA's Motion to Modify Stay on August 13, 2004. BPA timely appealed to this Court.

II. Discussion

A. Standard of Review

We review questions of law, including the interpretation of statutory language, *de novo*. *See*, *e.g.*, *Fed. Trade Comm'n v. Nat'l Bus. Consultants, Inc.*, 376 F.3d 317, 319 (5th Cir. 2004); *United States v. Bridges*, 894 F.2d 108, 111 (5th Cir. 1990). Our review of a bankruptcy court's findings of fact is for clear error. *Zer-Ilan v. Frankford* (*In re CPDC, Inc.*), 337 F.3d 436, 440-41 (5th

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[10] During the hearing, BPA represented that the only basis for Mirant's default under the Agreement was the filing of a bankruptcy petition.

[11] The bankruptcy court also ruled BPA was not a forward contract merchant. A forward contract merchant must be a person under the plain text of the Code. 11 U.S.C. § 101(26). The bankruptcy court reasoned that because a governmental entity is not a person under the code, *see* §§ 101(26), 101(41), BPA could not be a forward contract merchant. As such, the court concluded, BPA is not authorized by the Code to enjoy the exceptions to automatic stay provided to forward contract merchants under §§ 362(b)(6) and 556. BPA waived its challenge to the bankruptcy court's interpretation of "forward contract merchant" on appeal to this Court.

[12] BPA subsequently wrote to counsel for Mirant, withdrawing its Termination Letter and reinstating the Confirmation Agreement. BPA noticed its retention of rights under the Agreement and applicable law and expressed that its compliance with the Stay Violation Order did not constitute waiver of those rights. The issue of waiver -- whether BPA waived its challenge to the Stay Violation Order by agreeing to withdraw its termination -- was presented to the district court, which concluded that BPA did not waive its challenge to the Stay Violation Order because the bankruptcy court had already ruled that BPA violated the stay when the court presented BPA the option of either rescission of the termination letter or continuation on the motion for contempt. Mirant does not argue BPA waived its ability to challenge the Stay Violation Order on appeal to this Court.

Cir. 2003). "This Court may affirm if there are any grounds in the record to support the judgment, even if those grounds were not relied upon by the courts below." *Bustamante v. Cueva (In re Cueva)*, 371 F.3d 232, 236 (5th Cir. 2004) **[**16]** (internal quotation marks omitted).

The bankruptcy court's denial of a motion for modification of a stay is reviewed for abuse of discretion. *See*, *e.g.*, *Chunn v. Chunn (In re Chunn)*, 106 F.3d 1239, 1242 (5th Cir. 1997).

B. The Parties' Arguments

The parties agree that the Confirmation Agreement here is an executory contract under the Bankruptcy Code and that therefore the Code's provision for executory contracts applies. *See* 11 U.S.C. § 365. [13] Generally, § 365(e) of the Code bars the enforcement of ipso facto clauses in executory contracts, such as the ipso facto clause in the Agreement here. § 365(e)(1). [14] However, an exception to **[*246]** this general rule appears in subsection (e)(2)(A),

> (2) Paragraph (1) of this subsection does *not* apply to an executory contract . . ., if --
>
> (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease *from accepting performance from or rendering performance to the trustee or to an assignee* of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (ii) **[**17]** such party does not consent to such assumption or assignment . . . .

§ 365(e)(2)(A) (emphasis added).

[18]** BPA argues that the subsection (e)(2)(A) exception applies to this case, permitting the Agreement's ipso facto clause to have effect, terminating the Agreement as of Mirant's Chapter 11 filing, and precluding any review by the bankruptcy court. According to BPA, the exception applies because the Anti-Assignment Act is an "applicable law" under the text of § 365(e)(2)(A) that excuses BPA "from accepting performance from or rendering performance to the trustee or to an assignee" of the Agreement. § 365(e)(2)(A).

The Anti-Assignment Act provides,

> No contract or order, or any interest therein, shall be transferred by the party to whom such contract or order is given to any other party, and any such transfer shall cause the annulment of the contract or order transferred, so far as the United States is concerned.

41 U.S.C. § 15(a).

BPA explains the Act's application to this Agreement as follows. BPA argues that § 365(e)(2)(A) carves out a class of executory contracts whose ipso facto clauses may be given effect when nonbankruptcy, applicable law renders the contract unassignable (in the abstract as opposed to upon a factual showing) to "the **[**19]** trustee or an assignee" without consent of the nondebtor party. This Agreement is such an executory contract, according to BPA, because the Anti-Assignment Act excuses the United States from accepting performance from an assignee. In this vein, BPA asks this Court to join other circuits that have held that § 365(e)(2)(A) creates a hypothetical test, under which a debtor is precluded from assuming or assigning an executory contract even if the applicable law would not bar assignment in the actual circumstances before the court but does bar assignment to a hypothetical third party, "*i.e.*, under the applicable law, could the government refuse performance from [an assignee]." *See* *In re West Elecs., Inc.*, 852 F.2d 79, 83 (3d Cir. 1988); *see also* *Perlman v. Catapult Entertainment (In re Catapult Entertainment)*, 165 F.3d 747, 750 (9th Cir.

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[13] "The legislative history of § 365(a) indicates that Congress intended the term [executory contract] to mean a contract 'on which performance remains due to some extent on both sides.'" *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984)(quoting H.R. Rep. No. 95-595, at 347 (1977)), *superseded by statute on other grounds*, 11 U.S.C. § 1113 (1984). We accept the parties' characterization of the Agreement and assume, without addressing the issue, that the Agreement is an executory contract under Chapter 11.

[14] Section 365(e)(1) provides the general rule,

> (1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract that is conditioned on --
>
> . . .
>
> (B) the commencement of a case under this title . . . .

§ 365(e)(1).

1999). [15]

[20]** BPA asks this Court to hold that under a hypothetical test, § 365(e)(2) permits automatic termination of the Agreement prior to judicial review and prior to the entry of automatic stay, or in the alternative, **[*247]** that § 365(e)(2) requires a bankruptcy court to lift the automatic stay in order for the ipso facto clause to be enforced. Accordingly, BPA challenges both the bankruptcy court's entry of automatic stay and denial of a modification to the stay because the ipso facto clause and the Anti-Assignment Act permit BPA to terminate the Agreement automatically upon Mirant's Chapter 11 filing prior to any review by or approval of the bankruptcy court under § 365(e)(2)(A).

Mirant responds that the automatic stay provision, § 362(a), is violated by BPA's termination of the Agreement, that is, BPA's attempt to exercise control of property of the estate without the oversight of the bankruptcy court. Mirant argues the bankruptcy court did not abuse its discretion in entering the stay because the stay is automatic and either the Anti-Assignment Act does not apply because there was no transfer or, even if the Act does apply, the stay's automatic entry precedes any termination permitted **[**21]** by the combined effect of the Act, § 365(e)(2)(A), and the ipso facto clause of the Agreement. Mirant also argues the bankruptcy court did not err in denying BPA's motion to modify the stay because BPA failed to show the cause required under § 362(d)(1). In support, Mirant urges this Court to adopt an actual, or as-applied, analysis to determine whether the Anti-Assignment Act applies to this case and to conclude that it does not (thereby foreclosing termination via the ipso facto clause) because no assignment occurred here.

C. Analysis

1. Hypothetical vs. Actual Test

We begin by addressing the question that affects each of the issues raised by BPA, that is, whether this Circuit adopts the actual or hypothetical approach to the text of § 365(e)(2)(A). The hypothetical test was first announced and adopted in the sole circuit opinion to address the conjunctive effect of § 365 and the Anti-Assignment Act. *West*, 852 F.2d at 82. In *West*, a divided panel addressed similar facts and held the bankruptcy court abused its discretion in denying a lift of the Chapter 11 stay, which had the effect of preventing the government from terminating an executory **[**22]** contract under the two statutes. 852 F.2d at 82. Addressing § 365(c), [16] as opposed to § 365(e)(2) at issue here, the *West* majority created a hypothetical test for the determination of whether the Anti-Assignment Act was an "applicable law" such that the government could refuse performance under the Act. The *West* majority rejected an as-applied determination of whether assignment had occurred under the Act. *Id.* Concluding that hypothetically speaking the Anti-Assignment Act was an "applicable law" because it made the contract generally unassignable, the majority in *West* held that § 365(c)(1) foreclosed the debtor's ability to assume the contract. *Id.* at 83. The majority reasoned:

> We think that by including the words "or the debtor in possession" in 11 U.S.C. § 365(c)(1) Congress anticipated an argument like the one here made and wanted that section to reflect its **[*248]** judgment that in the context of the assumption and assignment of executory contracts, a solvent contractor and an insolvent debtor in possession going through bankruptcy are materially distinct entities. While the relevant case law is very sparse, **[**23]** it supports our understanding of the

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[15] BPA secondarily argues that if the Act must be applied to the facts, rather than in the abstract, then the assignment here occurs as a result of Mirant's change in status from prepetition entity to debtor in possession. But before the bankruptcy court, BPA conceded there was no assignment on this record from Mirant prepetition to Mirant as debtor in possession. BPA argued instead that subsection (e)(2)(A)'s text contemplates a hypothetical, rather than actual, test of assignment.

> THE COURT: "[A] debtor is not an assignee when property passes to an estate, not for tax purposes, not for anything. In fact, there is no assignee here? Who's the assignee?"
>
> COUNSEL FOR BPA: "Your Honor, there isn't one. But that's what (a)(2) contemplates. It's a hypothetical test."

[16] Section 365(c) precludes a trustee from assuming or assigning an executory contract if "(1)(A) applicable law excuses a [nondebtor] party . . . to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession . . . and (B) such party does not consent to such assumption or assignment." 11 U.S.C. § 365(c)(1). Although the language of subsections (c)(1) and (e)(2) of § 365 are similar, they are by no means parallel overall or identical in effect. The two are not sufficiently similar that caselaw interpreting the one should be given any more than informative weight in interpreting the other.

> interplay between . . . § 365(c)(1) and 41 U.S.C. § 15.

Id. (footnote omitted).

In other words, under the Third Circuit's hypothetical approach, which rested on language in § 365(c)(1) that does not appear in § 365(e)(2)(A), a court must ask **[**24]** whether BPA could refuse to accept performance of the Agreement from *any* assignee because the Anti-Assignment Act makes the Agreement unassignable as a matter of law. If so, then irrelevant is the fact that the debtor did not actually assign, intend to assign, or attempt to assign the contract, and consequently the executory contract is terminable by its ipso facto provision under § 365(c). *See id.*; *see also RCI Tech. Corp. v. Sunterra Corp.* (*In re Sunterra Corp.*), 361 F.3d 257 (4th Cir. 2004) (addressing § 365(c) and copyright law); *Catapult*, 165 F.3d at 747 (addressing § 365(c) and federal patent law); *City of Jamestown v. James Cable Partners, L.P.* (*In re James Cable Partners*, *L.P.)*, 27 F.3d 534, 537 (11th Cir. 1994) (addressing § 365(c) and a municipal ordinance regarding franchise rights).

In contrast, the *West* dissent believed that Congress did not intend for "a 'solvent contractor and an insolvent debtor in possession going through bankruptcy' [to be] different entities for the purposes of the [Anti-Assignment Act]." *West*, 852 F.2d at 84 (Higginbotham, J., dissenting in part) **[**25]** (citation omitted). Likewise, those courts that have rejected *West*'s hypothetical analysis adopt an actual test to determine a law's applicability under § 365. *See Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 613 (1st Cir. 1995); *see also Cajun Elec. Members Comm. v. Mabey* (*In re Cajun Elec. Power Coop., Inc.*), 230 B.R. 693, 705 (Bankr. M.D. La. 1999); *In re Lil' Things, Inc.*, 220 B.R. 583, 587 (Bankr. N.D. Tex. 1998); *Texaco Inc. v. La. Land & Exploration Co.*, 136 B.R. 658, 669 (Bankr. M.D. La. 1992) (concluding the *West* hypothetical test is incorrect for three primary reasons); *In re Hartec Enters., Inc.*, 117 B.R. 865, 871 (Bankr. W.D. Tex. 1990) (stating that the *West* hypothetical test "does not fulfill the purposes of the non-assignment statutes it seeks to enforce, creates inherent inconsistencies in the language of . . . the Code, and fails to adequately account for" amendments to the Code), *vacated by settlement*, 130 B.R. 929 (W.D. Tex. 1991).

The actual or as-applied determination of whether a law is "applicable" under § 365(c) and (e)(2)(A) was first **[**26]** adopted by the First Circuit. *Summit Inv.*, 69 F.3d at 613. The actual test requires on a case-by-case basis a showing that the nondebtor party's contract will actually be assigned or that the nondebtor party will in fact be asked to accept performance from or render performance to a party -- including the trustee -- other than the party with whom it originally contracted. *Id.* at 612. The actual test contemplates that in a case where no assignment has taken place, § 365(e)(2)(A)'s exception is not available and, as such, an ipso facto clause is invalidated. *See id.*; *see also Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997), *abrogated on other grounds by Hardemon v. City of Boston*, 144 F.3d 24 (1st Cir. 1998); *In re Cardinal Indus. Inc.*, 116 B.R. 964, 982 (Bankr. S.D. Ohio 1990).

Although this Circuit has addressed § 365(c)(1), we have yet to address § 365(e) or to name the test we apply to the determination of whether a nonbankruptcy **[*249]** law applies under either § 365(c)(1) or § 365(e)(2)(A). *See Stumpf v. McGee* (*In re O'Connor*), 258 F.3d 392, 402 (5th Cir. 2001); **[**27]** *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935, 943 (5th Cir. 1983). Review of this Circuit's law, however, reveals that our adoption today of the actual test, in resolving the availability of § 365(e)(2)(A)'s exception, is consistent with prior caselaw. In *O'Connor*, a panel of this Court determined that a Louisiana statute regarding partnership was an applicable law under § 365(c) and engaged in an as-applied analysis to determine whether an exception to the general rule applied to the case at hand to permit the assumption of the executory contract. 258 F.3d at 403-04 (concluding that the exception was not applicable and declaring the contract unassumable). In *Braniff*, a nondebtor objected to the district court's order that authorized the debtor in possession to assign its lease agreements with the United States for use of space at Washington National Airport to a different airline under the version of § 365 (c) that existed prior to the 1984 amendment. 700 F.2d at 942. Reversing the district court and prohibiting the assignment of the lease, the panel concluded that the broad **[**28]** language of § 365(c) was not limited in application solely to personal service contracts. *Id.* at 943. The *Braniff* court held that the Code of the District of Columbia and a federal regulation enacted pursuant to that Code were "applicable law" under § 365(c), which prevented the lease's assignment because, in fact, the assignment had been attempted and ordered by the district court and the assignee airline had not been approved to perform by the agency vested with the authority for such approval. *Id.* at 942-43. *Braniff* did not

address the hypothetical approach; indeed, the split between actual and hypothetical approaches had not yet emerged nor had any court yet approved a hypothetical approach to the determination of whether a law is applicable. Instead, *Braniff* addressed the language of § 365(c) prior to its amendment in 1984. However, the pre-amendment language of § 365(c) more closely tracks the current language of § 365(e)(2)(A) than it does the current form of § 365(c). [17] Thus, the approach taken in *Braniff* informs our approach to § 365(e)(2)(A) on this record, even in light of the statutory amendment to § 365(c) and **[**29]** the post-amendment development of a split between the hypothetical and actual tests.

[30]** The plain text of § 365(e)(2)(A) requires an actual test for determining whether a law is "applicable" under the exception, permitting enforcement of an ipso facto clause. According to the statute's plain language, an executory contract's ipso facto clause may be enforced if "applicable law excuses a [nondebtor] party . . . from accepting performance from or rendering performance . . . to an assignee of such contract" and that non-debtor party does not consent to "such assumption or assignment." **[*250]** 11 U.S.C. § 365(e)(2)(A). Congress might have chosen the exception to apply if any law prohibited the assignment, but instead Congress tethered the exception to "applicable" law that "excuses a party." It is axiomatic that an applicable law must apply to a set of circumstances; BPA creates smoke and erects mirrors when it argues that a contract not assignable as a matter of law, even if no such assignment existed in fact and no excuse existed in fact for the nondebtor party to refuse acceptance or performance in a particular situation, satisfies the language chosen by Congress in drafting the § 365(e)(2)(A) exception. The law that releases a nondebtor from the general **[**31]** rule foreclosing the enforcement of an ipso facto clause must apply to something and must excuse the nondebtor from some specific performance or acceptance, *see* § 365(e)(2)(A); thus, if the debtor demonstrates that no application exists or that no excuse obtains on a given record, then the congressional language announces such a circumstance is material, making the § 365(e)(2)(A) exception unavailable. The applicability of the law under § 365(e)(2)(A) is determined not in the abstract but on the record at hand. *See Cajun Elec.*, 230 B.R. at 705; *Lil' Things*, 220 B.R. at 587; *Texaco*, 136 B.R. at 669; *Cardinal Indus.*, 116 B.R. at 974-75.

That applicability is determined based upon the case is supported also by the congressional choice to structure the exception as a two-part test, the second portion of which requires a fact-based showing. *See* 11 U.S.C. § 365(e)(2)(A)(i)-(ii). Subsection (ii) provides that the § 365(e)(2)(A) exception lies only where "such [nondebtor] party does not consent to such assumption or assignment." § 365(e)(2)(A)(ii). The combination of the plain text **[**32]** and the overall structure of the test that must be met in order for the exception to arise communicates that Congress intended § 365(e)(2)(A) to apply to a given factual situation rather than to a class of executory contracts as BPA urges.

BPA argues that the use of the adjective "such" merely refers to the assumption and assignment provided in the preceding subsection and does not demand that Congress intended an actual test would determine the exception's availability. We are not persuaded that standing alone, Congress's use of the adjective "such" to modify "assignment" in § 365(e)(2)(A)(ii) mandates the use of an actual test. The modifier "such" references the assignments provided in the preceding subsection and does not, on its own, require an as-applied approach to the determination of whether a law applies to permit an ipso facto clause's enforcement. However, in combination with the other factors that demand a case-by-case inquiry into whether a nonbankruptcy law applies to permit termination by ipso facto clause, we cannot agree with so broad an analysis as permitted by the entirely theoretical approach countenanced by those courts adopting the hypothetical approach.

[33]** Finally, the plain text of the law proffered by BPA as applicable here, the Anti-Assignment Act, cuts against the broad application advanced by BPA. In theory, a law of such general applicability might exist to

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[17] "Before the 1984 amendment, the pivotal language in section § 365(c) read precisely like the current version of section 365(e)(2); that is, it adverted to the 'applicable law excusing a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance *to the trustee or to an assignee* of such contract or lease . . . .'" *Summit Inv.*, 69 F.3d at 613 (alteration in original). In 1984, Congress made no change to the statute we address today, § 365(e)(2)(A), and with respect to § 365(c), it replaced the phrase "to the trustee or to an assignee of such contract or lease" that still appears in § 365(e)(2)(A) with the phrase "to an entity other than the debtor or debtor in possession." *See* Leasehold Management Bankruptcy Amendments Act of 1983, Pub. L. No. 98-353, § 362, 98 Stat. 333, 361 (July 10, 1984); *see also Summit Inv.*, 69 F.3d at 613.

merit application in most if not all circumstances under § 365(e)(2)(A), but the Anti-Assignment Act is, by its own terms, not so broadly applicable. Subsection (a) of the Act provides a general rule for annulment of a public contract upon a transfer by a party other than the United States. 41 U.S.C. § 15(a). Subsection (b), though, limits the application of the general rule, and the limitation applies on the basis of specific facts. "The provisions of subsection (a) of this section *shall not apply* in any *case in which* the moneys due or to become due from the United States **[*251]** . . . under a contract providing for payments aggregating $ 1,000 or more, are assigned to a bank, trust company, or other financing institution" given other fact-based circumstances. § 15(b) (emphasis added). Both the text of the Anti-Assignment Act and the text of § 365(e)(2)(A) require a case-by-case inquiry into the application of the Act to the executory contract or lease **[**34]** at issue in the bankruptcy proceeding. As such, we hold that with respect to § 365(e)(2)(A) and the Anti-Assignment Act, the actual test must be used to determine the Act's applicability to a given case. [18] When the law to be applied to a § 365(e)(2)(A) determination cannot apply to the case and the record before the bankruptcy court in fact or law, then § 365(e)(2)(A)'s exception cannot give effect to an ipso facto clause.

[**35] 2. Automatic Stay

Given that the actual test applies based upon the plain language of § 365(e)(2)(A), we next conclude that the automatic stay must precede any enforcement of an ipso facto clause ultimately permitted by a bankruptcy court under § 365(e)(2)(A).

Section 362 provides for an automatic but not permanent stay against "any act to obtain possession of property of the estate" from which a party may seek relief "for cause, including the lack of adequate protection of an interest in property." 11 U.S.C. § 362(a)(3), (d)(1); *Cueva*, 371 F.3d at 236; *see also Computer Commc'ns*, 824 F.2d at 729. The Code itself requires that the stay's effect be automatically triggered upon the filing of a petition for bankruptcy. *See* § 362(a); *Cueva*, 371 F.3d at 236. Section 541(c)(1) provides that a debtor's estate includes the debtor's interest in property that becomes property of the estate "notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law" that is conditioned upon the commencement of a bankruptcy case. § 541(c)(1). Recently, Chief Judge Jones explained **[**36]** the principle at issue,

> Sweeping all of the debtor's property into the bankruptcy estate created at filing is the means by which the Code achieves effective and equitable bankruptcy administration. Only through a comprehensive administration of the debtor's property, wherever located and by whomever controlled, can the court shield the property from creditors' unauthorized grasp; prevent harassment of debtors; and ultimately ensure equal distribution among creditors.

Burgess v. Sikes (In re Burgess), 438 F.3d 493, 2006 U.S. App. LEXIS 2056, 2006 WL 205043, at *15, No. 04-31089 (5th Cir. Jan. 27, 2006) (Jones, C.J., dissenting).

Furthermore, this Court has recognized the automatic stay's broad application and noted that such breadth reflects a congressional intent that courts will presume protection of property when faced with uncertainty or ambiguity. *Brown v. Chesnut (In re Chesnut)*, 422 F.3d 298, 303 (5th Cir. 2005). Likewise, the bankruptcy court's discretion to grant a modification **[*252]** or lift of the automatic stay is broad. *Cueva*, 371 F.3d at 236.

Here, Mirant's interest in the Agreement, even if it were ultimately terminable, became **[**37]** property of the estate upon Mirant's filing on July 14, 2003. Accordingly, the Agreement was subject to review by the bankruptcy court, and a party with an interest in an executory contract or lease must come before the bankruptcy court to move for a modification or lift of the stay under § 362(d) in order to effect the terms of an ipso facto clause under § 365(e)(2)(A).

The Bankruptcy Code, which must be read and must function as a whole, demands this conclusion. The Ninth Circuit has noted three compelling reasons to read the Code in this manner. *See Computer Commc'ns*, 824

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[18] Although we join the First Circuit in requiring an actual test to determine whether a law applies under § 365(e)(2)(A), we do not entirely join its reasoning. *See Summit Inv.*, 69 F.3d at 612-14. Interpreting § 365(e)(2)(A), the First Circuit found that the statute's plain text permitted both the actual and hypothetical tests and adopted the actual test on the basis of legislative history and a determination that no assignment existed when prepetition debtors became debtors in possession under the Bankruptcy Code. *Id.* at 612-13. Instead, Congress's choice to trigger § 365(e)(2)(A)'s exception upon the application of a law to a particular case dictates that an abstract approach should not be read into the statute.

F.2d at 730 (citing *Wegner Farms Co. v. Merchants Bonding Co.* (*In re Wegner Farms Co.)*, 49 B.R. 440, 444 (Bankr. N.D. Iowa 1985)). First, § 362(b) provides particular exceptions to the entry of automatic stay, but no exception is provided in the case of executory contracts. *Id.*; *see also* 11 U.S.C. § 362(b). Second, "elsewhere in the [Bankruptcy Code], Congress expressly overrode the stay provision but did not do so in § 365; and finally . . . not exempting this brand of executory contracts is consistent with the purposes and policies underlying **[**38]** the staying of actions against a debtor postpetition." *Computer Commc'ns*, 824 F.2d at 730-31 (internal quotation marks omitted).

Moreover, on this record, the interplay of the Bankruptcy Code and the Anti-Assignment Act in particular comports with the conclusion that the automatic stay must precede any termination permitted by an ipso facto clause and § 365(e)(2)(A). While the Bankruptcy Code and this Court's caselaw interpreting it require that the initiation of the broad automatic stay is immediate upon filing, such automatic triggering is absent from the text of the Anti-Assignment Act and caselaw interpreting the Act. According to BPA, the termination permitted by § 365(e)(2)(A) and the ipso facto clause of the Agreement here is automatic upon Mirant's filing for relief under the Bankruptcy Code and precedes the entry of automatic stay. We disagree. The Anti-Assignment Act, instead, provides the government with an option to rescind its contracts upon transfer. The Anti-Assignment Act permits the United States to elect its response to the transfer of a contract to which it is a party. The United States may either waive its rights under the Act and continue performance, **[**39]** or it may terminate the contract. *See Tuftco Corp. v. United States*, 222 Ct. Cl. 277, 614 F.2d 740, 744 (Ct. Cl. 1980) (permitting the United States to waive the Anti-Assignment Act's prohibition of transfer where the government was aware of, assented in writing to, and recognized the assignment); *see also NRG Co. v. United States*, 31 Fed. Cl. 659, 661 (1994). Thus, the Act does not provide for automatic recision of the public contract upon transfer; annulment of the contract at issue requires a response by the United States. The Anti-Assignment Act, and its effect on a given executory contract, may be raised by the government after the entry of a bankruptcy court's automatic stay under, at a minimum, the provision for stay modification. *See* 11 U.S.C. § 362(d).

Accordingly, the automatic stay prohibited BPA from terminating the Agreement. Even when § 365(e)(2)(A) will ultimately permit a nondebtor party to terminate an executory contract by virtue of the combined effect of § 365(e)(2)(A), applicable law, and an ipso facto clause, the nondebtor party must seek relief from the stay before the bankruptcy court under **[*253]** § 362(d). **[**40]** Therefore, we affirm the bankruptcy court's Stay Violation Order.

3. The Denial of Modification to Stay

We next address BPA's contention that the lower courts erred in failing to lift or modify the stay under § 362(d)(1). Based upon our conclusion that the Anti-Assignment Act has no application on this record, we cannot say the bankruptcy court abused its discretion in denying BPA's Motion to Modify Stay. The bankruptcy court denied BPA's motion because the court concluded that BPA failed to show cause for relief from stay under § 362(d)(1), although a portion of the court's conclusion also necessarily rested upon the legal determination that the Anti-Assignment Act is not an applicable law under § 365(c)(1) or (e)(2)(A).

The Bankruptcy Code does not precisely define "cause" under § 362(d)(1), and in the past we have noted that this lack of definition affords "flexibility to the bankruptcy courts." *Little Creek Dev. Co. v. Commonwealth Mortgage Corp.* (*In re Little Creek Dev. Co.*), 779 F.2d 1068, 1072 (5th Cir. 1986) (explaining that lack of good faith is sufficient for "cause" and discussing the inherent balancing required for the court's determination **[**41]** of whether a stay should be lifted under § 362(d)). Mirant argues that a contractual right to terminate does not constitute sufficient cause to grant relief from the automatic stay. *See Elder-Beerman Stores Corp. v. Thomasville Furniture Indus. Inc. (In re Elder-Beerman Stores Corp.*), 195 B.R. 1019, 1023 (Bankr. S.D. Ohio 1996). The exception provided by § 365(e)(2)(A) discredits such a broad understanding of the limits on a potential relief from stay, and a bankruptcy court's discretion is not so broad as Mirant argues. Although the district court did not abuse its discretion here to deny the stay's modification, on a record differing in fact, procedure, or both, a bankruptcy court's discretion is limited by the text of § 365(e)(2)(A), that is, in the case in which a law proffered as applicable under § 365(e)(2)(A) is determined to apply to the case, then the stay must be lifted or modified in such a way that permits the entitled nondebtor party to exercise its termination option accordingly.

Here, BPA has not demonstrated cause because the Anti-Assignment Act is not an applicable law on this record because here there has been no transfer. In

order for the Act **[**42]** to apply to this case, it must be said that the Agreement was "transferred" within the meaning of the Act. *See* 41 U.S.C. § 15. The caselaw, however, does not support BPA's reading of transfer under the Act. On this record, the Anti-Assignment Act cannot apply because no assignment, which would be prohibited by the Act, occurred between prepetition debtor and debtor in possession for three salient reasons. First, Mirant never affirmatively assumed or rejected the Agreement. *See* 11 U.S.C. § 365(a). [19] According to § 365(f)(2)(A), assumption must precede assignment. *See* § 365(f)(2)(A); *see also* *Cinicola v. Scharffenberger*, 248 F.3d 110, 120 (3d Cir. 2001). Here, Mirant did not assume the Agreement. Second, BPA might have moved under § 365(d)(2) [20] for the court to order **[*254]** Mirant to determine, within time constraints, whether it would assume or reject the Agreement. But BPA never so moved the court, nor did it make any effort apparent on the record (other than the letter, sent to Mirant, unilaterally terminating the Agreement) to either the bankruptcy court or with opposing counsel to resolve the question of assumption **[**43]** or rejection. Finally, BPA conceded to the bankruptcy court that there was no assignee in fact. On such a record, no transfer - prohibited by the Anti-Assignment Act - has occurred or even been attempted, and therefore the Act is not an applicable law.

[44]** The parties dispute whether, as a matter of law, a transfer or assignment occurs as a result of the change in status from prepetition debtor to debtor in possession. If the change in the status produces a transfer of the executory contract, then according to BPA, the Anti-Assignment Act applies. If the change in status is nominal only and there is no transfer or assignment as a matter of law, then, as Mirant argues, the Anti-Assignment Act may have no applicability in the absence of a transfer. *See* 41 U.S.C. § 15 (providing that "any such transfer shall cause the annulment of the contract or order transferred, so far as the United States is concerned"). We need not, on this record, resolve this res nova question. [21] We hold only what this record permits, that is, no transfer occurs under the Anti-Assignment Act where the debtor neither assumes nor attempts to assume the executory contract, the nondebtor concedes there is no assignment in fact, and the nondebtor, seeking to invoke the combined effect of the Anti-Assignment Act and § 365(e)(2)(A), fails to move for assumption or rejection under § 365(d)(2). In such a circumstance, where no party has moved **[**45]** to assume the executory contract before the bankruptcy court, no assignment occurs between prepetition debtor and debtor in possession with respect to the Anti-Assignment Act and § 365(e)(2)(A).

[**46] III. Conclusion

For the foregoing reasons, the bankruptcy court correctly determined that a Chapter 11 automatic stay must precede the enforcement of any eventual right a nondebtor may have to terminate an executory contract under § 365(e)(2)(A). Accordingly, we affirm the bankruptcy **[*255]** court's Stay Violation Order. Also, the bankruptcy court did not abuse its discretion to deny modification or lift of stay where no assignment or

[19] We have previously recognized that in Chapter 11 proceedings, an executory contract might be neither assumed, rejected, nor assigned and that in such a circumstance, the contract would ride through the proceedings, leaving the nondebtor's claim to survive the bankruptcy. *Century Indem. Co. v. NGC Settlement Trust* (*In re Nat'l Gypsum Co.*), 208 F.3d 498, 504 n.4 (5th Cir. 2000).

[20] Section 365(d)(2) vested BPA with the procedure to demand Mirant's action with respect to the Agreement. "The court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease." § 365(d)(2). This statutory provision, as the bankruptcy court noted, offered BPA the means to obtain the information it needed, whether Mirant would assume or reject the Agreement after filing for bankruptcy, and in the time in which BPA urged that an answer was needed.

[21] Though other courts have concluded no assignment exists with respect to an executory contract or lease as a result of the change in status between a prepetition debtor and a debtor in possession, *see* *Summit Inv.*, 69 F.3d at 613-14 (discussing *Bildisco*, 465 U.S. at 528); *United States v. Gerth*, 991 F.2d 1428 (8th Cir. 1993), we cannot agree that the Supreme Court has conclusively resolved this question. Instead, in *Bildisco*, the Court merely stated, "for our purposes, it is sensible to view the debtor-in-possession as the same 'entity' which existed before the filing of the bankruptcy petition, but empowered by virtue of the Bankruptcy Code to deal with its contracts and property in a manner it could not have done absent the bankruptcy filing." 465 U.S. at 528. That "sensible view," necessary only for the purposes of that case, does not support in all cases the proposition that no assignment or transfer occurs as a matter of law between prepetition debtor and debtor in possession. Accordingly, neither the Supreme Court nor this Circuit has resolved the argument presented by BPA that rights obtained in bankruptcy require that a debtor in possession be treated as a distinct legal entity from a prepetition debtor.

transfer had occurred or been attempted. On such a record, the Anti-Assignment Act is not an applicable law under § 365(e)(2)(A).

AFFIRMED.

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RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)

United States Court of Appeals for the Fourth Circuit

December 4, 2003, Argued ; March 18, 2004, Decided

No. 03-1193

Reporter

361 F.3d 257 *; 2004 U.S. App. LEXIS 5131 **; Bankr. L. Rep. (CCH) P80,068; 51 Collier Bankr. Cas. 2d (MB) 1276; 42 Bankr. Ct. Dec. 222

In re: SUNTERRA CORPORATION, Debtor. RCI TECHNOLOGY CORPORATION, formerly known as Resort Computer Corporation, Plaintiff- Appellant, v. SUNTERRA CORPORATION, Defendant-Appellee.

Prior History: [1]** Appeal from the United States District Court for the District of Maryland, at Baltimore. (CA-02-2539). J. Frederick Motz, District Judge.

RCC Tech. Corp. v. Sunterra Corp., 287 B.R. 864, 2003 U.S. Dist. LEXIS 1055 (D. Md., 2003)

Disposition: Reversed and remanded.

Counsel: ARGUED: Jay Alan Shulman, SAUL EWING, L.L.P., Baltimore, Maryland, for Appellant.

Kenneth Oestreicher, WHITEFORD, TAYLOR & PRESTON, L.L.P., Baltimore, Maryland, for Appellee.

ON BRIEF: Irving E. Walker, SAUL EWING, L.L.P., Baltimore, Maryland, for Appellant. John F. Carlton, WHITEFORD, TAYLOR & PRESTON, L.L.P., Baltimore, Maryland, for Appellee.

Judges: Before WIDENER, LUTTIG, and KING, Circuit Judges.

Opinion by: KING

Opinion

[*260] KING, Circuit Judge:

RCI Technology Corporation appeals from an order entered in the District of Maryland affirming the bankruptcy court's ruling in favor of Sunterra Corporation. *RCC Tech. Corp. v. Sunterra Corp.*, 287 B.R. 864 (D. Md. 2003). [1] RCI contends that the district court erred in ruling that Sunterra, as the Chapter 11 debtor in possession, was entitled to assume a nonexclusive license of copyrighted software. [2] On appeal, we are called upon to decide whether, pursuant to 11 U.S.C. § 365(c), such a debtor in possession may assume, over the licensor's **[**2]** objection, a nonexclusive software license. In so deciding, we must resolve the issue of whether the disjunctive term "or," as used in the "assume or assign" language of § 365(c), should be construed in the conjunctive as "and." Because we are unable to so construe § 365(c), Sunterra was precluded from assuming the nonexclusive software license, and we reverse and remand.

I.

A.

At all times material to this appeal, RCI conducted business as a software development company for the resort and hospitality industry. RCI's software products were used by entities in this industry, **[**3]** such as Sunterra, for functions such as recording reservations, managing resort properties, and marketing and financing timeshares. [3] Sunterra owns or controls more than 150 subsidiaries and related entities, constituting one of the world's largest resort management businesses.

In the 1990s, Sunterra launched a program called Club Sunterra. Membership in the Club allowed timeshare

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[1] RCI Technology Corporation was formerly known as Resort Computer Corporation, or RCC.

[2] Pursuant to Chapter 11 of the Bankruptcy Code, a debtor in possession remains in possession of the pre-petition assets and administers them for the benefit of its creditors. *In re Southeast Hotel Prop. Ltd. P'ship*, 99 F.3d 151, 152 n. 1 (4th Cir. 1996) (citing 11 U.S.C. §§ 322, 1101(1), 1104, 1107).

[3] A timeshare has been defined as "a share in a property under a timesharing scheme." *Oxford English Dictionary* 879 (Vol. 4 & Supp. 1986). The term time-sharing has been described as "the ownership or right of a property (esp. as a holiday home) for a fixed limited time each year." *Id.*

owners at Sunterra resorts to trade their timeshare rights for such rights at other Sunterra resorts. Because tens of thousands of timeshare owners and units were involved in the Club, Sunterra needed to develop an integrated computer system to assist its management of the Club. For this purpose, Sunterra decided to acquire RCI's Premier Software **[**4]** [4] and modify it into a unique computer program, the SWORD System.

In 1997, RCI and Sunterra entered into a software license agreement (the "Agreement"), pursuant to which RCI granted Sunterra a nonexclusive license to use Premier Software (the "Software"). Under the Agreement, effective December 31, 1997, RCI was required to provide Sunterra a "non-exclusive, worldwide, perpetual, irrevocable, royalty-free license to …use, copy, modify, and distribute" the Software (the "License"). Agreement § 3.1. Sunterra **[*261]** paid RCI $ 3.5 million for the License. Because the Software, as marketed, did not meet Sunterra's requirements, the Agreement authorized Sunterra to utilize the Software to develop its own software system. Under the Agreement, Sunterra owned any enhancements it made to the Software (the "Sunterra Enhancements"). *Id.* §§ 2.15, 3.6.3. Sunterra, in turn, granted RCI **[**5]** a license to use the Sunterra Enhancements. *Id.* § 3.2.2. Sunterra thereafter invested approximately $ 38 million in developing the SWORD System.

B.

On May 31, 2000, Sunterra filed a Chapter 11 bankruptcy petition in the District of Maryland. Two years later, on June 21, 2002, the bankruptcy court confirmed Sunterra's Plan of Reorganization, effective July 29, 2002. Prior to the Plan's confirmation, on March 28, 2002, RCI filed a motion to have the court deem the Agreement rejected (the "Motion"). RCI claimed that the Agreement was an executory contract and that Sunterra, as debtor in possession, was precluded by 11 U.S.C. § 365(c) (hereinafter " § 365(c)" or the "Statute") from assuming the Agreement without RCI's consent. [5] RCI maintained that, because it had refused to consent to assumption of the Agreement, the court was required by law to deem the Agreement rejected.

[6]** Sunterra opposed the Motion, asserting that the Statute was inapplicable because the Agreement was not an executory contract. [6] Sunterra also maintained that it was not precluded from assuming the Agreement because the Statute should be interpreted as prohibiting a debtor in possession from assuming *and* assigning a contract, and it intended only to assume - not to assign. Finally, Sunterra contended that the Statute did not prohibit assumption of the Agreement because RCI had agreed to permit reasonable assignments thereof.

On June 6, 2002, the bankruptcy court relied on *Lubrizol Enterprises*, *Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), and held, in a bench ruling, that the Statute did not prohibit Sunterra, as debtor in possession, from **[**7]** assuming the Agreement. It decided that the Agreement was not an executory contract and that, if it were, the Statute did not preclude assumption because Sunterra did not intend to assign the Agreement. The court concluded that prohibiting Sunterra from assuming the Agreement was nonsensical because RCI would not be damaged if Sunterra, as debtor in possession, assumed the very contract rights it **[*262]** had possessed prior to bankruptcy. The following day, on June 7, 2002, the court entered an order denying the Motion. *In re Sunterra Corp.*, No. 00-5-6931-JS (Bankr. D. Md.).

On June 14, 2002, RCI appealed the bankruptcy court's decision to the district court, which, on January 10,

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[4] It is uncontested that RCI's Premier Software is a copyrighted computer program registered with the United States Copyright Office.

[5] Section 365(c) of Title 11 provides, in pertinent part:

> (c) *The trustee may not assume or assign any executory contract* …of the debtor, whether or not such contract …prohibits or restricts assignment of rights or delegation of duties, if -
>
> (1)(A) applicable law excuses a party, other than the debtor, to such contract …from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract …prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment ….

11 U.S.C. § 365(c) (emphasis added). The term "trustee," as used in the Statute, includes a Chapter 11 debtor in possession. *See, e. g., Perlman v. Catapult Entertainment (In re Catapult Entertainment)*, 165 F.3d 747, 750 (9th Cir. 1999). And the term "applicable law" means "applicable non-bankruptcy law." *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27, 28 (1st Cir. 1984).

[6] In the context of the Statute, "a contract is executory if performance is due to some extent on both sides." *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985).

2003, affirmed. *RCC Tech. Corp. v. Sunterra Corp.*, 287 B.R. 864 (D. Md. 2003) (the "Opinion"). The district court disagreed with the bankruptcy court's finding that the Agreement was not executory, but concluded that the Statute did not preclude Sunterra, as debtor in possession, from assuming it.

In its Opinion, the district court acknowledged that the Statute, read literally, precluded Sunterra, as debtor in possession, from assuming the Agreement because: (1) copyright law excused **[**8]** RCI from accepting performance from a party other than Sunterra, [7] and (2) RCI did not consent to Sunterra's assumption of the Agreement. *Id.* at 865. In explaining its ruling, the court recognized the existence of a circuit split on the issue of whether the Statute should be applied literally. It acknowledged that at least three circuits, the Third, Ninth, and Eleventh, as well as several bankruptcy courts, have followed a "literal test" (generally called the "hypothetical test") in applying the Statute to the assumption of executory contracts. [8] **[**10]** *See In re West Elecs., Inc.*, 852 F.2d 79, 83 (3d Cir. 1988) (characterizing § 365(c)(1)(A) as posing "a hypothetical question"); *In re Catapult Entm't, Inc.*, 165 F.3d 747, 750 (9th Cir. 1999) (same); *In re James Cable Partners*, 27 F.3d 534, 537 (11th Cir. 1994) (same); *In re Catron*, 158 B.R. 629, 633-38 (E.D. Va. 1993) (same), *aff'd without op.*, 25 F.3d 1038 (4th Cir. 1994). On the other hand, the First Circuit, along with a majority of the bankruptcy courts, have applied the "actual test" in such circumstances. [9] *See Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997) **[**9]** (rejecting the literal test in favor of the actual test); *see also In re Catapult*, 165 F.3d at 749 n. 2 (collecting bankruptcy court decisions adopting actual test).

In its Opinion, the district court recognized that resolution of the dispute turned on which of the two tests applied. If the **[*263]** literal test applied, Sunterra could not assume the Agreement because RCI was excused, pursuant to applicable copyright law, from accepting performance from a *hypothetical* third party. On the other hand, if the actual test applied, Sunterra, as debtor in possession, was entitled to assume the Agreement because it did not intend to assign, and RCI would not *actually* be forced to accept performance from a party other than **[**11]** Sunterra. The court then adopted the actual test, interpreting the disjunctive "or" in the conjunctive as "and," and holding that, because RCI would not, in the circumstances, be forced to accept performance from a party other than Sunterra, the Statute did not preclude it from assuming the Agreement. [10]

[12]** Finally, the district court addressed Sunterra's contention that, because RCI had agreed that it would not unreasonably withhold its consent regarding future

[7] Because the Software is a duly registered copyrighted computer program, copyright law is the applicable nonbankruptcy law that would excuse RCI from accepting performance under the Agreement from an entity other than Sunterra. *See, e. g., Everex Sys. v. Cadtrak Corp. (In re CFLC, Inc),*89 F.3d 673, 679 (9th Cir. 1996); *In re Golden Books Family Entm't, Inc.*, 269 B.R. 300, 309 (Bankr. D. Del. 2001).

[8] The term literal test is derived from a literal interpretation of the Statute, under which the disjunctive "or" in § 365(c) is construed to mean what it says. If § 365(c) is construed literally, "a debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a *hypothetical* third party, even where the debtor in possession has no intention of assigning the contract in question to any such third party." *In re Access Beyond Techs., Inc.*, 237 B.R. 32, 48 (Bankr. D. Del. 1999) (original emphasis omitted and emphasis added) (citing *In re James Cable Partners*, 27 F.3d 534, 537 (11th Cir. 1994); *In re West Elecs., Inc.*, 852 F.2d 79, 83 (3d Cir. 1988)). Although generally called the hypothetical test, the test is premised on a literal interpretation of the Statute, and it is more aptly referred to as the "literal test."

[9] Under the actual test, the disjunctive "or" in § 365(c) is construed as the conjunctive "and." In applying the actual test, therefore, a court must make a case-by-case inquiry into whether the nondebtor party would be compelled to accept performance from someone other than the party with whom it had originally contracted, and a debtor would not be precluded from assuming a contract unless it *actually* intended to assign the contract to a third party. *Summit Invest. & Dev. Corp. v. Leroux*, 69 F.3d 608, 612 (1st Cir. 1995).

[10] As the district court explained, the literal test has the "obvious virtue of being consistent with the dictate of the Supreme Court that the plain meaning of a statute must be enforced when its terms are unambiguous." Opinion at 865 (citing *Patterson v. Shumate*, 504 U.S. 753, 757-59, 119 L. Ed. 2d 519, 112 S. Ct. 2242 (1992)). The court adopted the actual test, however, declaring that, although it "has the weakness of reading the statutory language 'assume *or* assign' to mean 'assume *and* assign,' ….it has the virtue of being consistent with the general goals of Chapter 11 because it allows licensees to benefit from the protections of the bankruptcy law while encouraging the maximization of the economic value of the debtor's estate." *Id.* at 866 (emphasis added) (citing *In re Cardinal Indus., Inc.*, 116 B.R. 964, 981 (Bankr. S.D. Ohio 1990)).

assignments of the License by Sunterra, RCI had impliedly consented for Sunterra, as debtor in possession, to assume the Agreement. The court deemed unpersuasive Sunterra's contention that RCI consented to assumption of the Agreement. It determined, however, that its adoption and application of the actual test rendered the consent issue moot. It thus affirmed the bankruptcy court's ruling that the Statute did not bar Sunterra, as debtor in possession, from assuming the Agreement. RCI has filed a timely appeal, and we possess jurisdiction pursuant to 28 U.S.C. § 158(d).

II.

We review de novo the judgment of a district court sitting in review of a bankruptcy court, "applying the same standards of review that were applied in the district court." *Three Sisters Partners, L.L.C. v. Harden (In re Shangra-La, Inc.),*167 F.3d 843, 847 (4th Cir. 1999). Accordingly, we review de novo the issue of whether the Agreement was an executory contract. *Lubrizol*, 756 F.2d at 1045 (observing that issue of whether contract is executory **[**13]** is one of law); *Bose Corp. v. Consumers Union of the United States, Inc.*, 466 U.S. 485, 80 L. Ed. 2d 502, 104 S. Ct. 1949 (1984) (observing that issues of law are reviewed de novo). We also review de novo an issue of statutory construction. *United States v. Childress*, 104 F.3d 47, 50 (4th Cir. 1996) (observing that issues of statutory construction are reviewed de novo).

III.

In its appeal, RCI contends that we should reverse for several reasons. First, it maintains that, because the plain meaning of the Statute can be applied without producing a result that is patently absurd, the court erred in failing to do so. Second, RCI contends that general bankruptcy policy cannot be relied upon to support the decision not to apply the plain meaning of the Statute. Third, RCI maintains that the Statute is unambiguous and that use of legislative history to construe the Statute was inappropriate. Finally, RCI contends **[*264]** that, if legislative history can be utilized, it does not support the Opinion.

On the other hand, Sunterra maintains that, for multiple reasons, we should affirm. First, it asserts that the Statute applies only to executory contracts, and that the Agreement **[**14]** was not executory. Second, it contends that, if the Agreement was executory, we should affirm because courts need not apply the plain meaning of a statute to produce an absurd result or be inconsistent with clearly established legislative intent. On this point, Sunterra maintains that the literal test - interpreting the disjunctive "or" in the Statute to mean what it says - would have produced an absurd result *and* been inconsistent with legislative intent. Finally, Sunterra contends that the Statute does not preclude assumption of an executory contract if the nondebtor party, i. e., RCI, consents to the assignment, and RCI, in section 5.11 of the Agreement, *impliedly* consented to reasonable assignments. Sunterra asserts that assumption was "automatically reasonable" because it would leave undisturbed the identity of Sunterra as the licensee. Sunterra contends, therefore, that we should affirm because RCI had consented to assumption of the Agreement by Sunterra as debtor in possession. We address these issues in turn.

A.

First, Sunterra contends that the Statute does not prohibit assumption of the Agreement because the Statute applies only to executory contracts and the **[**15]** Agreement was not executory. [11] **[**16]** In assessing whether a contract is executory, we are obliged, under *Lubrizol*, 756 F.2d at 1045, to apply what courts have referred to as the Countryman Test. Under the Countryman Test, a contract is executory if the "' obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other.'" *Gloria Mfg. Corp. v. Int'l Ladies' Garment Workers' Union*, 734 F.2d 1020, 1022 (4th Cir. 1984) (quoting Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973)). Applying the Countryman Test, the Agreement was not executory unless it was executory as to *both* Sunterra and RCI when Sunterra petitioned for bankruptcy. [12] We must therefore assess whether, at the time of the Chapter 11 filing, the obligations of both Sunterra and RCI were so unperformed that the failure of either to complete performance would constitute a material breach of the Agreement.

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[11] If the Agreement was not executory, it was not subject to the Statute, and it would have survived the bankruptcy filing unaffected. *See In re Access*, 237 B.R. at 41.

[12] The date a bankruptcy petition is filed is the critical time for determining whether a contract is executory. *See, e. g., In re Columbia Gas Sys. Inc.*, 50 F.3d 233, 240 (3d Cir. 1995); *In re Access*, 237 B.R. at 41 n. 10.

On this point, we agree with the district court that the Agreement was executory when Sunterra petitioned for bankruptcy. When the bankruptcy petition was filed, each party owed at least one continuing material duty to the other under the Agreement - they each possessed an ongoing obligation to maintain the confidentiality of the source code of the software developed by the other, i. e., the Software and the Sunterra Enhancements. [13] Agreement §§ 3.1.3, 3.2.2, 3.10, 3.11.

[*265] B.

If the Agreement was executory, Sunterra agrees **[**17]** that a straightforward application of the Statute prohibits it from assuming the Agreement without RCI's consent. More specifically, Sunterra acknowledges that § 365(c) is drawn in the disjunctive and, by its plain language, prohibits Sunterra from "assuming *or* assigning," rather than from "assuming *and* assigning," the Agreement. And as a settled principle, "unless there is some ambiguity in the language of a statute, a court's analysis must end with the statute's plain language …." *Hillman v. I.R. S.*, 263 F.3d 338, 342 (4th Cir. 2001) (citing *Caminetti v. United States*, 242 U.S. 470, 485, 61 L. Ed. 442, 37 S. Ct. 192 (1917)) (the "Plain Meaning Rule").

Sunterra maintains that the Plain Meaning Rule has no application here, relying on the two narrow exceptions to application of a statute's plain language. The first such exception, premised on absurdity, exists "when literal application of the statutory language at issue results in an outcome that can truly be characterized as absurd, i. e., that is so gross as to shock the general moral or common sense …." *Id.* (quoting *Sigmon Coal Co. v. Apfel*, 226 F.3d 291, 304) (4th Cir. 2000) **[**18]** (internal quotation marks omitted), *aff'd sub nom. Barnhart v. Sigmon Coal Co.*, 534 U.S. 438, 151 L. Ed. 2d 908, 122 S. Ct. 941 (2002). The second exception is premised on legislative intent, and it exists only "when literal application of the statutory language at issue produces an outcome that is demonstrably at odds with clearly expressed congressional intent …." *Id.* A reviewing court may look beyond the plain language of an unambiguous statute only when one of these exceptions is implicated. *Sigmon Coal*, 226 F.3d at 304. And we have recognized that "the instances in which either of these exceptions to the Plain Meaning Rule apply 'are, and should be, exceptionally rare.'" *Hillman*, 263 F.3d at 342 (quoting *Sigmon Coal*, 226 F.3d at 304).

Sunterra maintains that we should affirm because, although the plain language of the Statute precludes its assumption of the Agreement, application of the literal test produces a result that is *both* absurd and demonstrably at odds with clearly expressed legislative intent. Specifically, Sunterra contends that we should reject the plain meaning of the Statute, and read the disjunctive **[**19]** "or" as the conjunctive "and," for three reasons: (1) the plain meaning of § 365(c) is absurd because it creates internal inconsistencies therein; (2) the plain meaning of § 365(c) is absurd because it is inconsistent with general bankruptcy policy; and (3) the plain meaning of § 365(c) is incompatible with its legislative history. We examine these contentions in turn.

1.

Sunterra maintains that adherence to the Plain Meaning Rule produces an absurd result because it sets § 365(c) at war with itself and its neighboring statutory provisions. Specifically, Sunterra maintains that a literal reading of § 365(c) implicates the absurdity exception because it renders inoperative and superfluous § 365(f)(1), [14] as well as the phrase "or the debtor in possession" found in § 365(c)(1)(A). **[*266]** Sunterra, relying on *Sutherland Statutory Construction*, contends that we should interpret § 365(c) to minimize any discord among the provisions of § 365 and, if possible, construe § 365(c) so that none of § 365 is inoperative or superfluous. 2A Norman J. Singer, *Sutherland Statutory Construction* § 46.06 (5th ed. 1992) (" A statute should be construed so that effect is given to all its **[**20]** provisions, [and] so that no part will be inoperative or superfluous ….").

a.

In support of its inconsistency contention, Sunterra first maintains that it is absurd to read § 365(c)(1) literally because such a reading renders § 365(f)(1) inoperative

[13] The term source code, as used in the Agreement, means the humanreadable form of the Software and the Sunterra Enhancements. Agreement § 2.19.

[14] Subsection 365(f)(1) of the Bankruptcy Code provides, in pertinent part, as follows:

> Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract …of the debtor, or in *applicable law*, that prohibits, restricts, or conditions the assignment of such contract …, the trustee may assign such contract …under paragraph (2) of this subsection ….

11 U.S.C. § 365(f)(1) (emphasis added).

and superfluous. The asserted inconsistency between § 365(c)(1) and § 365(f)(1) arises from use of the term "applicable law" in each provision. *In re Catapult*, 165 F.3d at 751. Subsection (c)(1) bars assumption (absent consent) when "applicable law" would **[**21]** bar an assignment. And subsection (f)(1) provides that, *contrary provisions in applicable law notwithstanding*, executory contracts may be assigned. Of course, the assumption of an executory contract is a necessary prerequisite to its assignment under § 365. *See* 11 U.S.C. § 365(f)(2)(A) (providing that trustee may assign executory contract only if trustee first assumes such contract in accordance with provisions of § 365). A literal reading of § 365(c)(1), therefore, initially appears to render § 365(f)(1) inoperative or superfluous.

The Sixth Circuit, in its decision in *In re Magness*, squarely addressed the issue of whether the seemingly warring provisions of § 365(c)(1) and § 365(f)(1) are reconcilable. *In re Magness*, 972 F.2d 689, 695 (6th Cir. 1992). In so doing, the court acknowledged that "section 365(c), the recognized exception to 365(f), appears at first to resuscitate in full the very anti-assignment 'applicable law' which 365(f) nullifies." *Id.* As the court observed, however, the conflict between § 365(c)(1) and § 365(f)(1) is illusory, because "each subsection recognizes an 'applicable law' of markedly different **[**22]** scope." *Id.*; *accord In re James Cable*, 27 F.3d at 537-38; *In re Lil' Things, Inc.*, 220 B.R. 583, 590-91 (Bankr. N.D. Tex. 1998); *In re Antonelli*, 148 B.R. 443, 448 (D. Md. 1992), *aff'd without op.*, 4 F.3d 984 (4th Cir. 1993). First, § 365(f)(1) lays out the broad rule - "a law that, as a general matter, 'prohibits, restricts, or conditions the assignment' of executory contracts is trumped by the provisions of subsection (f)(1)." *In re Catapult*, 165 F.3d at 752 (citing *In re James Cable*, 27 F.3d at 538; *In re Magness*, 972 F.2d at 695). Section 365(c)(1), in contrast, creates a carefully crafted exception to the broad rule, under which "applicable law does not merely recite a general ban on assignment, but instead more specifically 'excuses a party …from accepting performance from or rendering performance to an entity' different from the one with which the party originally contracted …." *Id.* Therefore, under the broad rule of § 365(f)(1), the "applicable law" is the law prohibiting or restricting assignments as such; whereas the "applicable law" under § **[**23]** 365(c)(1) embraces "legal excuses for refusing to render or accept performance, regardless of the contract's status as 'assignable' …." *In re Magness*, 972 F.2d at 699 (Guy, J., concurring).

In order to determine whether a law is overridden by § 365(f)(1) under the foregoing interpretation of § 365(f)(1) and § 365(c)(1), a court must ask *why* "applicable law" prohibits assignment. *In re Catapult*, 165 F.3d at 752 (citing *In re Magness*, 972 F.2d at 700 (Guy, J., concurring); *In re Antonelli*, 148 B.R. at 448). And only applicable anti-assignment law predicated **[*267]** on the rationale that the identity of the contracting party is material to the agreement is resuscitated by § 365(c)(1). *Id.* Premised on this interpretation, we agree with those Circuits that apply § 365(c)(1) literally - the provisions of § 365(c)(1) are not inevitably set at odds with the provisions of § 365(f)(1). *In re Catapult*, 165 F.3d at 752; *In re James Cable*, 27 F.3d at 538; *In re Magness*, 972 F.2d at 695.

b.

The second pillar of Sunterra's inconsistency contention is that a literal **[**24]** reading of § 365(c)(1) creates a conflict within itself. Specifically, Sunterra contends that § 365(c)(1) cannot be read literally because, when so read, the phrase "or the debtor in possession" found in § 365(c)(1)(A) is rendered inoperative and superfluous. Certain bankruptcy courts have agreed with Sunterra's contention, observing, for example, that, "[i] f the directive of Section 365(c)(1) is to prohibit assumption whenever applicable law excuses performance relative to *any* entity other than the debtor, why add the words 'or debtor in possession?' The [literal] test renders this phrase surplusage." *In re Hartec Enters., Inc.*, 117 B.R. 865, 871-72 (Bankr. W.D. Tex. 1990); *accord In re Fastrax, Inc.*, 129 B.R. 274, 277 (Bankr. M.D. Fla. 1991); *In re Cardinal Indus., Inc.*, 116 B.R. 964, 979 (Bankr. S.D. Ohio 1990). As the Ninth Circuit has recognized, however, this position is untenable because "[a] close reading of § 365(c)(1) …dispels this notion." *In re Catapult*, 165 F.3d at 752.

By its plain language, § 365(c)(1) addresses *both* assumption and assignment. *Id.* An assumption and an assignment **[**25]** are "two conceptually distinct events," and the nondebtor must consent to each independently. *Id.* Under the plain language of § 365(c)(1), therefore, *two independent events* must occur before a Chapter 11 debtor in possession is entitled to assign an executory contract. The debtor in possession must first obtain the nondebtor's consent to assume the contract, and it must thereafter obtain the nondebtor's consent to assign the contract. Therefore, "where a nondebtor consents to the *assumption* of an executory contract, § 365(c)(1) will have to be applied a second time if the debtor in possession wishes to *assign* the contract in question." *Id.* And in the second application

of § 365(c)(1), the issue is whether "applicable law excuses a party from accepting performance from or rendering performance to an entity other than …*the debtor in possession.*" 11 U.S.C. § 365(c)(1)(A) (emphasis added). We agree, therefore, that the phrase "debtor in possession," far from being rendered inoperative or superfluous by a literal reading of subsection (c)(1), dovetails neatly with the disjunctive language therein: "The trustee may not assume *or* assign **[**26]** …." 11 U.S.C. § 365(c) (emphasis added); *see In re Catapult*, 165 F.3d at 752.

In light of the foregoing, Sunterra's inconsistency contention also lacks merit - the Statute may be read literally without creating an irreconcilable conflict within itself or with its neighboring statutory provisions.

2.

Sunterra next maintains that the bankruptcy court and the district court properly declined to read the Statute literally, correctly concluding that to do so would produce a result that is inconsistent with general bankruptcy policy. Those courts declined to adhere to the Plain Meaning Rule because they concluded that a literal reading of the Statute conflicts with general bankruptcy policy, implicating the absurdity **[*268]** and intent exceptions to the Rule. Indeed, the district court decided that the result produced by the plain language of the Statute was "quite unreasonable." Opinion at 866. We turn to Sunterra's contention that the intent and absurdity exceptions apply here.

a.

We first assess whether a conflict between the Statute and general bankruptcy policy implicates the absurdity exception to the Plain Meaning Rule. The district court **[**27]** refused to read § 365(c) literally because it viewed the result produced by such a reading to be "quite unreasonable." In assessing whether a plain reading of a statute implicates the absurdity exception, however, the issue is not whether the result would be "unreasonable," or even "quite unreasonable," but whether the result would be *absurd. See Maryland State Dep't of Educ. v. U.S. Dep't of Veterans Affairs*, 98 F.3d 165, 169 (4th Cir. 1996).

Sunterra maintains that reading § 365(c) literally is absurd because such a reading conflicts with the general bankruptcy policy of fostering a successful reorganization and maximizing the value of the debtor's assets. RCI, on the other hand, asserts that reading § 365(c) literally is not absurd because Congress did not sacrifice every right of a nondebtor party to the reorganization process, and that courts should not assume that "sections of the Bankruptcy Code unfavorable to the debtor were enacted in error." RCI observes that the Bankruptcy Code contains many provisions preserving the rights of nondebtor parties from its general debtor-favorable application (the "Nondebtor Provisions"). *See, e. g.*, 11 U.S.C. §§ 362 **[**28]** (b) (listing exceptions to automatic stay, authorizing nondebtor parties to exercise their nonbankruptcy rights notwithstanding § 362(a)), 555-557, 559, 560 (protecting rights of nondebtor party under securities contracts, commodities contracts, grain storage contracts, repurchase agreements, and swap agreements, from effects of automatic stay, avoidance powers, and provisions of § 365). In response, Sunterra acknowledges that "anyone looking at § 365 appreciates that the Bankruptcy Code balances non-debtor rights with those of a debtorin-possession." Sunterra maintains, however, that most of the Nondebtor Provisions address particular grievances of an identifiable constituency, or were enacted in response to particular court decisions. Sunterra contends, therefore, that the mere existence of such provisions does not make it plausible that, in enacting the Statute, Congress intended to preclude Chapter 11 debtors from assuming executory contracts existing prior to the bankruptcy filing.

To the contrary, the existence of the Nondebtor Provisions makes it plausible that Congress meant what it said in the Statute. And as Judge Traxler observed in *Sigmon Coal*, if it is plausible **[**29]** that Congress intended the result compelled by the Plain Meaning Rule, we must reject an assertion that such an application is absurd. *Sigmon Coal*, 226 F.3d at 308 (holding statute not absurd because, although literal application of statute produced somewhat anomalous result, plausible explanation existed). In these circumstances, application of the Plain Meaning Rule does not produce a result so grossly inconsistent with bankruptcy policy as to be absurd.

b.

We turn next to Sunterra's contention on the intent exception. Affirming the bankruptcy court, the district court decided that the actual test, reading the disjunctive "or" as the conjunctive "and," is "far **[*269]** more harmonious" with bankruptcy policy than the literal test. Opinion at 866. Relying on *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989), the court declined to apply the plain

meaning of the Statute, declaring that, "although the plain meaning of statutes must generally be enforced, there is a competing principle that statutes should not be interpreted to produce results that are *unreasonable in light of the drafters' intentions." Id.* The court **[**30]** then ruled that, because the literal test produced a result that conflicted with the goals of Chapter 11, it need not apply the plain meaning of the Statute. *Id.*

In its *Ron Pair* decision, the Supreme Court held that a statute's "plain meaning should be conclusive except in the 'rare cases [in which] the literal application of [the] statute will produce a result *demonstrably at odds* with the intentions of its drafters.'" 489 U.S. at 242 (quoting *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571, 73 L. Ed. 2d 973, 102 S. Ct. 3245 (1982)) (emphasis added). Under *Ron Pair*, therefore, a court is obliged to apply the Plain Meaning Rule unless the party contending otherwise can *demonstrate* that the result would be contrary to that intended by Congress. Requiring a demonstration that the plain meaning of a statute is at odds with the intentions of its drafters is a more stringent mandate than requiring a showing that the statute's literal application is unreasonable in light of bankruptcy policy.

Some bankruptcy commentators maintain that sound bankruptcy policy supports adoption of the actual test. *See* 3 Lawrence P. King, *Collier on Bankruptcy* **[**31]** § 365.06[1][d][iii] (15th ed. revised). As the Supreme Court has repeatedly emphasized, however, Congress is the policymaker - not the courts. *Hartford Underwriters Ins. Co. v. Union Planters Bank, N. A.*, 530 U.S. 1, 13, 147 L. Ed. 2d 1, 120 S. Ct. 1942 (2000)(citing *Kawaauhau v. Geiger*, 523 U.S. 57, 64, 140 L. Ed. 2d 90, 118 S. Ct. 974 (1998); *United States v. Noland*, 517 U.S. 535, 541-42, n. 3, 134 L. Ed. 2d 748, 116 S. Ct. 1524 (1996); *Union Bank v. Wolas*, 502 U.S. 151, 162, 116 L. Ed. 2d 514, 112 S. Ct. 527 (1991)). And, put simply, the modification of a statutory provision to achieve a preferable policy outcome is a task reserved to Congress. *Id.*

As the Ninth Circuit has recognized, application of the actual test "effectively engrafts a narrow exception onto § 365(c)(1) for debtors in possession, providing that, as to them, the statute only prohibits assumption *and* assignment." *Catapult*, 165 F.3d at 754. Under the actual test, the disjunctive "or" of § 365(c) is read as the conjunctive "and," and the term "assume" is effectively read out of the Statute. No matter how appealing such an interpretation may be from a policy standpoint, "we cannot adopt [such **[**32]** interpretation] as our own without trespassing on a function reserved for the legislative branch …." *Sigmon Coal*, 226 F.3d at 308.

In these circumstances, any perceived conflict between a literal reading of the Statute and general bankruptcy policy fails to implicate the intent exception to the Plain Meaning Rule. As we observed in *Sigmon Coal*, a federal court must "determine the meaning of the statute passed by Congress, not whether wisdom or logic suggests that Congress could have done better …." *Id.* We conclude, therefore, that the intent exception is not implicated here.

3.

Sunterra next maintains that the district court should be affirmed because a literal application of the Statute produces **[*270]** an outcome at odds with legislative history. Importantly, § 365, as it now reads, was added to the Bankruptcy Code in 1984 (the "1984 Act"), and there is no relevant legislative history for the 1984 Act. *In re Cardinal*, 116 B.R. at 978. Sunterra contends, however, that the 1984 amendments had their genesis in a 1980 House amendment to an earlier Senate technical corrections bill. That amendment "was accompanied by 'a relatively obscure **[**33]** committee report,'" *In re Catapult*, 165 F.3d at 754 (quoting 1 David G. Epstein, *et al., Bankruptcy* § 5-15 (1992)), which states:

> This amendment makes it clear that the prohibition against a trustee's power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition had been filed because of the personal nature of the contract.

1195, 96th Cong., 2d Sess. § 27(b) (1980) (the "1980 Report"). The First Circuit relied on the 1980 Report in its adoption of the actual test. *Summit Invest. & Dev. Corp. v. Leroux*, 69 F.3d 608, 613 (1st Cir. 1995). Sunterra contends that a literal reading of the Statute is at odds with the 1980 Report, and that this contradiction supports its position. However, legislative history suggesting an interpretation contrary to a statute's plain meaning is not necessarily sufficient to override the Plain Meaning Rule. In *Sigmon Coal*, for example, we declined to rely on legislative history to displace the plain meaning of the statute, because the history

consisted **[**34]** merely of a statement made by a single member of Congress. 226 F.3d at 306. Although such legislative history was "worthy of consideration, [it was] simply not the sort of conclusive legislative history that would trump contrary language in the statute." *Id.*

For at least three reasons, the 1980 Report is not conclusive on congressional intent concerning the 1984 Act. First, the 1980 Report relates to a 1980 proposal, which was never enacted, rather than to the 1984 Act; and we have held that courts are not free to replace a statute's plain meaning with "unenacted legislative intent." *United States v. Morison*, 844 F.2d 1057, 1064 (4th Cir. 1988). Second, the 1980 Report was prepared several years prior to enactment of the Statute. *In re Catapult*, 165 F.3d at 754. Finally, it reflects the views of only a single House committee. *Id.* For these reasons, we agree with the Ninth Circuit that the 1980 Report is not "the sort of clear indication of contrary intent that would overcome the unambiguous language of subsection (c)(1)." *Id.* We must decline, therefore, to reject the Statute's plain meaning on this basis.

C.

Finally, **[**35]** we turn to Sunterra's contention that, in any event, RCI consented to Sunterra's assumption of the Agreement. Pursuant to the Statute, a debtor in possession may assume or assign an executory contract if the nondebtor party consents thereto. 11 U.S.C. § 365(c)(1)(B). Sunterra maintains that RCI had agreed, in section 5.11 of the Agreement, that it would not prohibit Sunterra from transferring the License to a successor in interest if the transfer included substantially all of Sunterra's assets, and that in so doing, RCI consented to its assumption of the License.

The provision of the Agreement at issue provides that the assignment section of the Agreement shall not preclude the transfer of the License to a successor in interest of substantially all of Sunterra's assets if the assignee agrees in writing to be bound by the License (the "Transfer **[*271]** Provision"). [15] Sunterra maintains that RCI had consented, in the Transfer Provision, to permit transfer of the License to a successor in interest under certain circumstances. RCI contends that any consent it provided to Sunterra in the Transfer Provision is irrelevant because, under the Statute, the issue is whether **[**36]** applicable law prohibited the transfer *irrespective of the provisions of the Agreement*. In support of this proposition, RCI observes that the Statute applies "whether or not such contract …prohibits or restricts assignments of rights …." *Id.* § 365(c)(1)(A).

RCI's reliance on this aspect of the Statute's language is misplaced. The Transfer Provision does not *prohibit* or *restrict* Sunterra from transferring its rights under the Agreement; the Transfer Provision *favors* assignment - it entitles Sunterra to assign the Agreement without RCI's consent so long as the assignment includes substantially all of Sunterra's assets. Rather than being irrelevant, therefore, the issue of contractual **[**37]** consent in the Transfer Provision could be determinative of whether the Statute barred Sunterra's assumption. *See In re Midway Airlines, Inc.*, 6 F.3d 492, 497 (7th Cir. 1993) (finding proassignment contract language determinative of assignment issue under § 365(c)). Accordingly, we must disagree with RCI that the Agreement, in *permitting* Sunterra to transfer the License to a successor in interest, is irrelevant to whether the Statute precluded Sunterra from assuming or assigning the Agreement.

Finally, RCI maintains that, even if it consented to Sunterra's transfer of the License to a successor in interest under certain circumstances, the Transfer Provision applies only to assignments, and not to assumptions. We agree. The Transfer Provision is set forth in the "Assignment" section of the Agreement, and all other provisions of that section apply, by their terms, *exclusively* to assignments. [16]

[38]** In sum, we draw the following conclusions. RCI consented to Sunterra's assignment of the License to a

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[15] The Transfer Provision of the Agreement provides:

> The provisions of this section shall not preclude the transfer of this license to a successor in interest of substantially all of [Sunterra's] assets if the assignee agrees in writing to be bound by this License.

Agreement § 5.11.

[16] In support of the proposition that RCI, by virtue of the Transfer Provision, consented to assumption of the Agreement, Sunterra relies on the Seventh Circuit decision in *In re Midway Airlines*. 6 F.3d 492 (7th Cir. 1993). The agreement at issue there, however, explicitly contemplated assumption and assignment in the bankruptcy context. The Transfer Provision, on the other hand, contemplates neither an assignment in the bankruptcy context nor an assumption.

Sunterra also relies on a Louisiana bankruptcy court decision *In re Supernatural Foods*, 268 B.R. 759 (Bankr. M.D. La. 2001), to support the proposition that RCI, by the Transfer Provision, consented to assumption of the Agreement. We are unpersuaded by that decision, however, and we decline to follow it.

successor in interest under certain circumstances. The Transfer Provision, however, does not apply to an *assumption* of the Agreement by a Chapter 11 debtor in possession. Because the terms assumption and assignment describe "two conceptually distinct events," *In re Catapult*, 165 F.3d at 752, and because the Transfer Provision pertains to an assignment rather than an assumption, RCI did not consent to Sunterra's assumption of the Agreement. Without RCI's consent, Sunterra was precluded from assuming the Agreement. IV. Pursuant to the foregoing, the bankruptcy court erred, and the district court erred **[*272]** in affirming the bankruptcy court. We therefore reverse, and we remand for such other and further proceedings as may be appropriate.

REVERSED AND REMANDED

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