

MEMORANDUM OF LAW

DATE: May 18, 1995

TO: Jack Krasovich, Deputy Director, Park and Recreation
Department, Central Division

FROM: City Attorney

SUBJECT: San Diego Civic Light Opera Association

QUESTION PRESENTED

This memo is in response to a question you posed about the San Diego Civic Light Opera Association, Inc. ("Starlight"), which currently has a 25-year lease ("Agreement") with The City for the use of Starlight Bowl in Balboa Park, and supplements a memo to you dated April 7, 1995. You informed us that Starlight is considering a number of options to deal with their current financial situation. Your memo references a letter from the president of Starlight which said, "Starlight is considering filing Chapter 7, reorganizing sic, and operating under the name, Starlight Musical Theatre." Starlight's main concern appears to be whether it would still be able to operate under the present agreement if it filed for Chapter 11 protection under the Bankruptcy Code (11 USC Sections 1 - 1330).

SHORT ANSWER

Starlight may be able to operate under the existing lease, if certain requirements of the Bankruptcy Code (referred to herein as "BC" or "Code") are met.

DISCUSSION

A. General Bankruptcy Principles

First, it is important that we clarify an apparent misconception Starlight has and provide some information about bankruptcy. Chapter 7 of the Code provides a statutory means for an orderly liquidation and equitable distribution of an individual debtor's assets. In re the Great American Pyramid Joint Venture, 144 B.R. 780 (Bankr. W.D. Tenn. 1992). BC section 727 (in Chapter 7) provides for the discharge of a debtor -- the individual debtor is discharged from all debts (with a few exceptions) that arose before the filing of the bankruptcy petition.

Procedures for reorganization of a business are contained in Chapter 11 of the Code. "The American bankruptcy laws have been designed to give a failing business a breathing spell while it attempts to work out its financial problems. citation omitted . . . `the fundamental purpose of reorganization is to prevent a debtor from going

into liquidation, with an attendant loss of jobs and possible misuse of economic resources." *American Pyramid*, 144 B.R. at 788, quoting *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984). Creditors are prohibited from taking any action against the debtor or the debtor's property by the automatic stay provision of BC section 362. The debtor then has the opportunity to prepare a reorganization plan.

A business may not file Chapter 11 merely to put off creditors where the business has deteriorated to the point where there is no hope of reorganization or repayment of debts. A Chapter 11 petition must be filed in good faith. "An implicit prerequisite to the right to file is 'good faith' on the part of the debtor . . ." *In re Roland*, 77 B.R. 265, 267 (Bankr. D. Mont. 1987). The court will look to see "if there is an ongoing business to reorganize, and whether there was a reasonable probability of a plan being proposed and confirmed." *Id.* Starlight will thus not be afforded Chapter 11 protection if there is no possibility that reorganization would enable it to continue operations.

Chapter 11 allows the court to appoint a trustee if that would be in the best interest of the creditors and the estate (i.e., if there is an indication of mismanagement or fraud by the debtor). BC Section 1104. Appointment of a trustee is not automatic, however. *In re Stein & Day, Inc.*, 87 B.R. 290 (Bankr. S.D.N.Y. 1988). Chapter 11 also delineates the duties of a trustee, who is a fiduciary charged with protecting the interest of the creditors, the debtor, and the estate. BC Section 1106. Finally, BC Section 1108 specifically authorizes a trustee to operate the debtor's business.

If no trustee is appointed, a Chapter 11 debtor acts as trustee pursuant to BC sections 1106 and 1107, with the same duties and responsibilities as a trustee. "A debtor in possession is a fiduciary holding the estate's assets and operating its business for the benefit of the creditors and under the supervision of the court." *In re Waldvogel*, 125 B.R. 13, 15 (Bankr. E.D. Wis. 1991). If a court finds that Starlight is being properly managed, it may not appoint a trustee.

B. Possible Consequences of Starlight Bankruptcy

If Starlight files a Chapter 11 petition, the Agreement may be rejected.F

"Rejection" as used here, is a term employed by the Code which means that the agreement in question is terminated by the trustee, or debtor if no trustee is appointed.

The Agreement is an "unexpired lease," also known as an "executory contract," that is, a contract under which some further performance is due. BC Section 365. The trustee, or debtor if there is no trustee, is authorized by BC section 365(a) to either assume or reject an executory contract, subject to the court's approval.F

"Assume" as used here, means that the debtor accepts the agreement and performance continues.

The

purpose of allowing the assumption or rejection of an executory contract is to enable the debtor to assume a contract that will benefit the estate, or to relieve the estate of a burdensome contract by rejecting it. In re Norquist, 43 B.R. 224 (Bankr. E.D. Wash. 1984). The court, surprisingly, considers only the effect on the estate if the contract were to be rejected. "A bankruptcy court . . . need determine only whether . . . disaffirmance would be advantageous to the debtor (citations omitted). The burden or hardship which rejection of the executory contract would impose on other parties to such a contract is not a factor to be weighed by the bankruptcy court in ruling on the debtor's application." *Botman's, Inc. v. Allied Supermarkets, Inc.*, 706 F.2d 187, 189 (6th Cir.), certiorari denied, 464 U.S. 908 (1983). Therefore, if Starlight, as debtor in possession, were to reject the Agreement, it would not be required to perform, but the City would then not be required to provide the Starlight Bowl and perform other responsibilities under the Agreement.

BC section 365 also authorizes the debtor to assume an executory contract, if to do so would be to the debtor's benefit. For example, a lease may be assumed where continuation of a lease is essential to continued operation of the debtor's business and the debtor would suffer substantial loss if it were forced to relocate. In re Central Florida Fuels, Inc., 89 B.R. 242 (Bankr. M.D. Fla. 1988). However, a Chapter 11 debtor is also required to assume the burdens, as well as the benefits, of a lease agreement or contract. In re Mushroom Transp. Co., 78 B.R. 754 (Bankr. E.D. Pa. 1987). If Starlight, while in the process of reorganizing, were to assume the Agreement, Starlight would still be required to fulfill all its obligations under the Agreement, and the City would be required to comply with its responsibilities as well.

The Code also allows the assignment of an executory agreement or executory contract. "Notwithstanding 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 a contract or lease, the trustee may assign such contract or lease" BC Section 365(f)(1). Assignment is authorized, however, only if: "(A) the trustee assumes such contract or lease . . . ; and (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether there has been a default in such a contract or lease." BC Section 365(f)(2). In addition, the assignment relieves the trustee and the estate from any liability for breach occurring after such assignment. BC Section 365(k).F

B.C. section 265(c) contains an exception to the assignment authority of a trustee for executory contracts such as loan commitments or letters of credit, not applicable here.

In re New Town Mall, 17 B.R. 326 (Bankr. D. S.D. 1982).

The debtor's or trustee's only duties prior to assignment of an unexpired lease are to first assume the lease, cure any outstanding

defaults, and then give adequate assurance of the assignee's future ability to perform. In re Office Products of America, Inc., 140 B.R. 407 (Bankr. W.D. Tex. 1992). The Code specifically permits the bankruptcy court to approve the assignment of an executory contract even if the other party to the contract objects to the assignment. In re Wills Motors, Inc., 133 B.R. 297 (Bankr. S.D.N.Y. 1991). Therefore, if the debtor or trustee were to assign the Agreement to another party, the City would have no say in that assignment, regardless of the language in the Agreement requiring otherwise.

CONCLUSION

We have provided an extensive discussion regarding rejection, assumption, and assignment of executory contracts in order that you may better understand some of the possible consequences if Starlight files a Chapter 11 bankruptcy petition. With this explanation in mind, we now proceed to answer your questions.

- 1) Could Starlight continue operating the Starlight Bowl under the current lease agreement?

Answer: If Starlight, as debtor in possession, assumes the Agreement, per Code requirements, Starlight may continue operating under the Agreement.

- 2) Would the current agreement have to be amended to allow continued operation under the current lease agreement?

Answer: Again, assuming the Code requirements are met, the Agreement with City would not have to be amended. However, if the Agreement were assigned, we would suggest that the assignee be named when the Agreement is renegotiated.

- 3) Would the current lease agreement have to be rescinded and a new lease agreement authorized by Council?

Answer: The current Agreement would not have to be rescinded and a new agreement authorized by Council at this time, if Code requirements have been met. (Of course, the Agreement may be sent to Council in order to inform Council of the status of the Agreement.) Again, we suggest any necessary amendments be made when the Agreement is renegotiated.

This is a more complete response than our earlier memo to you. If there are any further questions on this matter, we will be glad to assist you further.

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By

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cc Marcia McLatchy,

Park & Recreation Director
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