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Feature

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SC SJ: One Take on Harmonizing the Bankruptcy Code and FAA

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The longstanding tension between the Federal Arbitration Act (FAA) and the Bankruptcy Code recently resulted in an interesting harmonization of the two regimes by the U.S. Bankruptcy Court for the District of Delaware. In a pair of jointly administered bankruptcies,[1] the debtors, the owner and lessee, respectively, of the former Fairmont San Jose (the hotel) filed chapter 11 petitions after COVID-related losses led to financial distress, as well as disputes with the hotel's operator, Accor Management US Inc. When Accor sought to lift the stay in response to the debtors' motion to estimate (and effectively cap) Accor's claims, the bankruptcy court ultimately permitted both arbitration — initially, on a conditional basis — and estimation, the latter ultimately only for feasibility purposes.

Background

Prior to the bankruptcy, Accor operated the hotel as a Fairmont-branded property. Accor operated the property pursuant to a hotel-management agreement (HMA) between Accor and FMT SJ, which leased the hotel from owner SC SJ.[2] The three parties also entered into a separate owners' agreement, which addressed SC SJ's rights and obligations in relation to the HMA.[3] The HMA contained an arbitration provision that applied to "any Dispute arising out of or relating to this Agreement."[4]

The COVID-19 pandemic left the debtors unable to fill the hotel, which triggered significant financial distress beginning in 2020. Following discussions with Accor, the debtors closed the hotel on March 5, 2021. The closure breached the HMA.[5] The debtors blamed the closure on the need to find a new management company and new financing, which Accor declined to provide.[6] Shortly before the bankruptcy, Accor requested arbitration under the HMA, seeking damages and to enjoin the hotel's closure.[7] Among other things, the parties disputed the appropriate-damages calculation.

The debtors sought to cap Accor's claim based on the HMA's liquidated-damages clause. That clause measured damages based on the prior year's earnings and would have capped damages at approximately $2 million.[8] Accor valued its damages at more than $22 million, arguing that the liquidated-damages formula should not apply in light of the pandemic, and Accor's claim for breach of the implied covenant of good faith and fair dealing was not covered by the liquidated-damages clause.[9]

The debtors filed their chapter 11 petitions in early March 2021 before injunctive relief could enter, and they filed a motion seeking estimation soon thereafter.[10] In addition, the debtors quickly filed their disclosure statement and proposed plan, which had the support of their secured lender and was premised on the entry into a management agreement with a new hotel operator and new financing.[11]

1 *In re SC SJ Holdings LLC*, Case No. 21-10549 *(SC SJ)*; *In re FMT SJ LLC*, Case No. 21-10521 *(FMT SJ)*. All docket indices refer to the SC SJ docket unless otherwise indicated.
2 Declaration of Neil Demchick in Support of Chapter 11 Petitions and First-Day Pleading (First-Day Decl.), ¶¶ 7-8 and Ex. D (HMA) [D.I. 11].
3 First Day Decl. Ex. E (Owners' Agreement).
4 HMA § 1.10. A "Dispute" includes, subject to carve-outs in the HMA, "all disputes, controversies, claims or disagreements arising out of or relating to this Agreement." *Id.* at § 1.9.
5 First Day Decl. ¶ 19.
6 *Id.* at ¶¶ 18-19.
7 Accor Management (U.S.) Inc.'s Preliminary Objection to Debtors' Motion to Estimate Maximum Amount of Fairmont Hotel & Resorts (U.S.) Inc.'s Contingent and Unliquidated Claim [D.I. 107], ¶¶ 14-20.
8 *See* Amended Disclosure Statement with Respect to Joint Chapter 11 Plan of Reorganization at 36 [D.I. 391].
9 Notice of Filing of Unredacted Version of Accor Management (U.S.) Inc.'s Additional Supplemental Opposition to Debtors' Motion to Estimate Maximum Amount of Accor's Claim (Estimation Objection), Ex. 1 [D.I. 466].
10 Motion of Debtors for Order Under Bankruptcy Code Section 502(c) and Bankruptcy Rule 3018 Estimating Maximum Amount of Contingent and Unliquidated Claim of Fairmont Hotels & Resorts (U.S.) [D.I. 71].
11 Joint Chapter 11 Plan of Reorganization [D.I. 88] and Disclosure Statement with Respect to Joint Chapter 11 Plan of Reorganization [D.I. 89] (both of which were later amended).

Accor asked the court to modify the stay and to enforce the HMA's arbitration provisions.[12]

Relevant Statutory Provisions

The FAA codifies the U.S.'s "liberal federal policy favoring arbitration."[13] Courts are required to "rigorously enforce agreements to arbitrate,"[14] absent limited circumstances, such as "a contrary congressional command."[15] A contrary intent may be evidenced by "an inherent conflict between arbitration and the [applicable] statute's underlying purposes."[16]

Section 2 of the FAA "makes arbitration agreements 'valid, irrevocable, and enforceable' as written ... and § 4 requires courts to compel arbitration 'in accordance with the terms of the agreement.'"[17] Thus, a court generally will compel arbitration in accordance with the parties' intent to arbitrate. Courts determine intent by reference to the underlying agreement, applying a rebuttable presumption to ambiguities in scope in favor of arbitration.[18] A court "may submit to arbitration 'only those disputes ... that the parties have agreed to submit.'"[19]

A longstanding theory suggests that the FAA and Bankruptcy Code must "inevitably clash," creating inherent conflicts that would obviate the obligation to arbitrate.[20] Bankruptcy throws a curve into an ordinary arbitration analysis, as the circumstances of a particular case may require an abbreviated path to resolution.[21]

To that end, § 502(c) of the Bankruptcy Code permits estimation of "(1) any contingent or unliquidated claim, the fixing or liquidation of which ... would unduly delay the administration of the case; or (2) any right to payment arising from a right to an equitable remedy for breach of performance." A party seeking estimation under § 502(c) must prove, among other things, that proceedings to fully liquidate the claim would unduly delay the bankruptcy process.[22]

"Undue delay" is undefined, which places its determination in the hands of bankruptcy judges. Most courts agree that the undue delay must be something "excessive,"[23] "fatal to moving the ... Chapter 11 cases" forward,[24] creating a "void in the Debtors' plan formulation"[25] or causing a situation where "no meaningful plan could be proposed."[26] In other words, "it is clear that estimation does not become mandatory merely because liquidation may take longer and thereby delay administration of the case. Liquidation of a claim ... will almost always be more time consuming than estimation."[27] Thus, "[a]bsent a finding of undue delay," it is within a court's "sound discretion and not [its] obligation" to estimate a claim.[28] Faced with seemingly competing motions, the *SC SJ* court approached the requested relief in stages, holding three separate hearings: (1) a hearing on Accor's stay motion; (2) a hearing on whether to permit estimation to proceed; and (3) an evidentiary hearing on estimation.

First Hearing: Enforceability of the Arbitration Provision

At a hearing in early April 2021, the *SC SJ* court heard Accor's lift-stay motion. Accor's pleadings argued for the broad applicability of the HMA's arbitration provision, as well as public policy favoring arbitration.[29] The debtors countered that arbitration should be halted while the bankruptcy proceeded, as the HMA's arbitration provision was not mandatory and, even if it was, the HMA was not binding on both debtors.[30] In addition, the debtors relied heavily on their pending estimation motion, scheduled for a hearing later that month, as evidence of a contrary congressional intent rendering arbitration non-mandatory.[31]

The court rejected the arguments that the HMA's arbitration clause was inapplicable. It found that the clause was the parties' exclusive contractual remedy.[32] In addition, the court rejected preliminary arguments that estimation and arbitration were in conflict, finding that "estimation and liquidation of a claim are not mutually exclusive," and it modified the stay to permit arbitration to proceed in accordance with the HMA on an abbreviated schedule.[33] However, the court decided to proceed with the hearing on the debtor's estimation motion later that month and ordered the parties to submit supplemental briefings to address the scope, if any, of estimation under § 502(c).[34]

Second Hearing: The Need for Estimation

On April 29, 2021, the *SC SJ* court considered whether it would estimate Accor's claim value.[35] The debtors argued that waiting for arbitration to conclude would place at risk their ability to secure mezzanine financing and contract with a new management company, both of which were required to effectuate the proposed reorganization.[36] The debtors further argued that estimation should fully adjudicate the claim for all purposes.[37]

Accor argued that the HMA's timing constraints would force a prompt conclusion to arbitration and would not delay the debtors' negotiations.[38] In addition, Accor argued in the alternative that if the court were to estimate its claim

12 Motion to (i) Modify the Automatic Stay to Permit Arbitration of Disputes; and (ii) Enforce Arbitration Clause Compelling Arbitration of Disputes (Arbitration Motion) [D.I. 92].
13 *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 339 (2011) (quoting *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983)).
14 *Shearson/Am. Exp. Inc. v. McMahon*, 482 U.S. 220, 226 (1987) (quoting *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 221(1985)).
15 *Id.*
16 *Id.* at 227.
17 *AT&T*, 563 U.S. at 344.
18 *Granite Rock Co. v. Int'l Bhd. of Teamsters*, 561 U.S. 287, 301 (2010).
19 *Id.* at 302 (quoting *First Options of Chicago Inc. v. Kaplan*, 514 U.S. 938, 943 (1995)).
20 Patrick M. Birney, "Reawakening Section 1334: Resolving the Conflict Between Bankruptcy and Arbitration through an Abstention Analysis," 16 *ABI L. Rev.* 619, 657 (2008), *available at* abi.org/members/member-resources/law-review.
21 *See, e.g., In re Interco Inc.*, 137 B.R. 993, 998 (Bankr. E.D. Mo. 1992) ("[A] lengthy arbitration proceeding will adversely affect [the] Debtors' ability to formulate and implement a plan of reorganization."); *White Mountain Mining Co. LLC*, 403 F.3d 164, 166 (4th Cir. 2005) (affirming denial of motion to compel where arbitration "would have seriously interfered with the debtor's efforts to reorganize").
22 11 U.S.C. § 502(c).
23 *In re John Q. Hammons Fall 2006 LLC*, No. 16-21142, 2017 WL 4638439, at *4 (Bankr. D. Kan. Oct. 13, 2017).
24 *Id.*
25 *Interco*, 137 B.R. at 998.
26 *In re CF. Smith & Assocs. Inc.*, 235 B.R. 153, 158 (Bankr. D. Mass. 1999).
27 *In re Dow Corning Corp.*, 211 B.R. 545, 563 (Bankr. E.D. Mich. 1997).
28 *In re RNI Wind Down Corp.*, 369 B.R. 174, 191 (Bankr. D. Del. 2007) (internal quotations omitted).
29 Arbitration Motion at 11, 13.
30 Debtors' Memorandum and Points of Authority in Opposition to Fairmont's Motion to (I) Modify the Automatic Stay to Permit Arbitration of Disputes; and (II) Enforce Arbitration Clause Compelling Arbitration of Disputes at 13, 15 [D.I. 108].
31 Hearing Transcript (April 7 Hr'g) at 72:1-20, 77:2-7, 79:3-85:18 (Bankr. D. Del. April 7, 2021) [D.I. 184].
32 *Id.* at 109:20-110:2.
33 *Id.* at 110:10-11.
34 *Id.* at 111:5-22.
35 Hearing Transcript (April 29 Hr'g) at 82:19-83:10 (Bankr. D. Del. April 29, 2021) [D.I. 273].
36 Debtors' Memorandum of Points and Authorities in Support of Debtors' Motion to Estimate Maximum Amount of Fairmont Hotel & Resorts (U.S.) Inc.'s Contingent and Unliquidated Claim at 13 [D.I. 226].
37 *Id.* at 19-21.
38 Estimation Objection at 3-4.

at all, it should be for the limited purpose of determining plan feasibility.[39]

The *SC SJ* court saw merit in both arguments: An estimation, whether final or not, would advance the cases, and the arbitration, if it was expedited, would not unduly delay the bankruptcy.[40] Therefore, the court elected to move down both paths simultaneously, scheduling an evidentiary hearing on estimation in June 2021 while allowing 60 days for the arbitration to progress — roughly the amount of time that Accor stated that arbitration would take to conclude. The court reserved for the third hearing the scope of applicability of estimation. However, the court warned that it would not permit arbitration to delay case progress: "If it looks by June 11th that the arbitration isn't going to be completed for another 30 or 60 days, then it's highly likely ... I'm going to estimate for all purposes, because I can't let this debtor sit in bankruptcy, shuttered for months, without the ability to reopen and start making reservations for new guests."[41]

Third Hearing: Limited Estimation

At a three-day evidentiary hearing in June 2021, the parties presented the *SC SJ* court with cross arguments on undue-delay and damages-claim valuations.[42] The debtors pressed their argument for estimation, arguing that the arbitration process would make it impossible for the debtors to meet plan milestones, pointing to delays in arbitration arising from the selection of arbitration neutrals.[43] Accor countered that the debtors had already completed much of the process of locating a new management company/mezzanine lender[44] and suggested, as an alternative, an estimation limited to feasibility for plan purposes.[45]

In its oral ruling on June 29, 2021, the court declined to order estimation for claims-liquidation purposes. The court found that the debtors had preliminary offers in place, rendering the "bulk of their fears ... unsubstantiated."[46] In addition, the court found that the debtors had sufficient equity backing and a personal guarantee from the debtors' ultimate owner, making it unlikely that the offers would be rescinded before the arbitration concluded.[47]

However, the court determined that estimation was appropriate for plan purposes, noting that "the Plan itself is contingent on assigning a value to Accor's claim in order to establish feasibility."[48] Thus, the court permitted arbitration to continue and, because estimation was limited, constrained its consideration of the merits of Accor's claims, and expressly held that no findings would be binding on an arbitrator.[49] Ultimately, applying "prudence," the court estimated Accor's claim at $22.24 million, the "highest value [that Accor] could reasonably receive" if it prevailed on its claim — *i.e.*, "the amount of lost profits over the term of the remaining time of the contract, without applying the liquidated-damages provision."[50]

Conclusion

A dispute within the scope of an enforceable arbitration clause does not necessarily preclude any relief in the bankruptcy court. Situations where the enforcement of arbitration provisions might lead to undue delay or otherwise threaten the progress of a reorganization may be ripe for alternative relief, including estimation in the bankruptyc court.[51] Nevertheless, as the bankruptcy court reminded the parties to the SC SJ/Accor dispute, "bankruptcy law's general rule is to liquidate, not to estimate."[52] Ultimately, as the proceedings in *SC SJ* showed, the harmonizing of the two regimes might not result in an either/or decision. abi

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39 *Id.* at 1.
40 April 29 Hr'g at 82:16-83:16.
41 *Id.* at 83:11-16.
42 The parties met in May 2021 for several days of mediation, which proved unsuccessful.
43 Hearing Transcript at 32:10-33:1 (Bankr. D. Del. June 10, 2021) [D.I. 441].
44 Hearing Transcript at 54:24-25:10; 76:21–77:2 (Bankr. D. Del. June 17, 2021) [D.I. 472].
45 *Id.* at 77:3-17.
46 Hearing Transcript (June 29, 2022, Hr'g) 11:7-8 (Bankr. D. Del. June 29, 2021) [D.I. 509].
47 *Id.* at 11:5-21.
48 *Id.* at 13:25-14:3.
49 *Id.* at 14:8-15.
50 *Id.* at 21:12-13; 14-16.
51 *Supra* n.21.
52 June 29 Hr'g at 10:12-13 (quoting *Dow Corning*, 211 B.R. at 563).