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IT IS SO ORDERED.

Dated: July 10, 2024



  
Mina Nami Khorrami  
United States Bankruptcy Judge

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UNITED STATES BANKRUPTCY COURT  
SOUTHERN DISTRICT OF OHIO  
EASTERN DIVISION

In re:	*	Case No. 2:23-bk-53043
WELCOME GROUP 2, LLC <i>et al.</i> , <sup>1</sup>	*	Chapter 11
	*	Judge Mina Nami Khorrami
Debtors.	*	Jointly Administered

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MEMORANDUM OPINION AND ORDER DENYING IN PART HILTON  
FRANCHISE HOLDING LLC'S MOTION FOR RELIEF FROM AUTOMATIC STAY  
REGARDING HILLIARD HOTELS, LLC (DOC. #166)

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Before the Court is *Hilton Franchise Holding LLC's Motion for Relief from Automatic Stay Regarding Hilliard Hotels, LLC* (Doc. #166) (the "Motion") filed on February 28, 2024, the *Objection of Hilliard Hotels, LLC to Hilton Franchise Holding LLC's Motion for Relief from Automatic Stay* (Doc. #191) filed on March 25, 2024, the *Brief of Hilton Franchise Holding LLC Regarding Application of the Hypothetical Test to the Assumption of Franchise Agreements* (Doc.

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<sup>1</sup> The Debtors and the last four digits of their federal tax identification numbers are as follows: Welcome Group 2, LLC (6795), Hilliard Hotels, LLC (6063), and Dayton Hotels, LLC (1123). The Debtors' headquarters are located at 5955 E. Dublin Granville Road, New Albany, Ohio 45305.

#226), and the *Supplemental Memorandum in Support of Debtor's Objection to the Hilton Franchise Holding LLC Motion for Relief from Automatic Stay Regarding Hilliard Hotels, LLC* (Doc. #227) both of which were filed on May 13, 2024.

On March 27, 2024, the Court held a preliminary hearing (the "Hearing") on the Motion at which Caitlin Conklin appeared on behalf of Hilton Franchise Holding LLC ("Hilton") and Ira Thomsen and Denis Blasius appeared on behalf of Hilliard Hotels, LLC (the "Debtor"). The single issue before the Court at this time is whether 11 U.S.C. § 365(c)(1) as a matter of law prohibits the Debtor from assuming a franchise agreement with Hilton even though the Debtor has not yet sought to assume the agreement and has no intention of assigning the agreement to a nondebtor entity. For the reasons stated below, the Court concludes that the Debtor is not precluded, as a matter of law, from assuming the franchise agreement with Hilton and that 11 U.S.C. § 365(c)(1) should be interpreted to apply the "actual test," as application of the "actual test" is consistent with the plain meaning of the statute and promotes the objectives of chapter 11 relief and the Bankruptcy Code when a debtor intends to assume an executory contract but not assign it.

## **I. Jurisdiction**

The Court has jurisdiction over this matter pursuant to 28 U.S.C. § 1334 and the Amended General Order 05-02 entered by the United States District Court for the Southern District of Ohio, referring all bankruptcy matters to this Court. This matter is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A), (G), and (O). Venue is properly before this Court pursuant to 28 U.S.C. §§ 1408 and 1409.

## **II. Findings of Facts and Procedural Background**

The Debtor and Hilton (collectively the "Parties") entered into a franchise agreement on or about June 30, 2017 (the "Franchise Agreement"). The Franchise Agreement authorizes the

Debtor to operate a 94-room hotel as a Hampton Inn by Hilton which is located at 1600 Hampton Court, Sidney, Ohio (the “Hampton Inn”), and as a result the Debtor is operating under the Hampton Inn brand. The Franchise Agreement authorizes the Debtor to use trademarks and operational systems owned by Hilton, and as such is a valuable asset to the Debtor and its bankruptcy estate. Consequently, the Debtor intends on assuming the Franchise Agreement and does not intend on assigning it.

Pursuant to the Franchise Agreement, the Hampton Inn must comply with and satisfy certain brand standards (the “Brand Standards”) so that hotel guests can expect to have a uniform experience when staying at a hotel that is operating under a similar franchise agreement with Hilton. The Debtor’s right to continue operating the Hampton Inn as a branded hotel is conditioned upon compliance with the Brand Standards. At some point prior to the bankruptcy filing, Hilton informed the Debtor that certain repairs and improvements to the Hampton Inn were required for it to satisfy the Brand Standards. Consequently, the Debtor agreed to a property improvement plan (the “PIP”) that required the Debtor to make certain renovations to the Hampton Inn within a specified time. To date, the Debtor has spent over \$1.5 million to comply with the PIP. According to Hilton, however, the Debtor failed to make the necessary repairs and improvements to the Hampton Inn within the timeline provided in the PIP and is in violation of the Franchise Agreement as a result. Hilton then filed the Motion requesting relief from the automatic stay pursuant to 11 U.S.C. § 362(d)(1) to terminate the Franchise Agreement.

Hilton asserts that the following bases constitute cause in support of its request for relief from the automatic stay: (1) the Debtor’s failure to complete the PIP is an incurable default under the Franchise Agreement; (2) 11 U.S.C. § 365(c)(1) precludes the Debtor, as a matter of law, from assuming the Franchise Agreement; (3) the failure of the Debtor to comply with the Brand

Standards while operating the Hampton Inn results in a lack of adequate protection for Hilton; and (4) the Debtor is in default of its post-petition monetary obligations for the monthly fees associated with the Franchise Agreement.

The Parties agree that the Franchise Agreement is an executory contract that is subject to assumption or rejection under 11 U.S.C. § 365. The Parties further agree that the issue of whether 11 U.S.C. § 365(c)(1) precludes the Debtor from assuming the Franchise Agreement is pivotal to the determination of whether relief from the automatic stay is warranted in this case. At the Hearing, the Parties requested time to brief this single issue for the Court prior to the Court making a final determination on the request for relief from the automatic stay based on Hilton's other alleged bases for cause — lack of adequate protection and incurable default. Therefore, the Court will only address the narrow issue of whether the statutory language contained in 11 U.S.C. § 365(c)(1) prohibits the Debtor from assuming the Franchise Agreement as a matter of law. All other issues presented in the Motion will be determined after a final hearing is held.<sup>2</sup>

### **III. Positions of the Parties**

Hilton's position in support of its Motion is that, as a matter of law, the Franchise Agreement cannot be assumed by the Debtor pursuant to 11 U.S.C. § 365(c)(1). Hilton contends that the plain language of 11 U.S.C. § 365(c)(1) requires the Court to apply a "hypothetical test" to determine whether the Franchise Agreement can be assumed absent consent from Hilton if applicable law prohibits the assignment of the contract, even if the Debtor has no intention of assigning the Franchise Agreement. Hilton argues that the Franchise Agreement cannot be assumed by the Debtor because applicable nonbankruptcy law (i.e., The Lanham Act, 15 U.S.C.

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<sup>2</sup> At the Hearing, the Parties consented to the final hearing on the Motion being held beyond the 30-day period required by 11 U.S.C. § 362(e)(1) and the automatic stay continuing in effect pending the conclusion of that final hearing.

§§ 1051-1141n) prohibits the assignability of the Franchise Agreement and Hilton does not consent to the Franchise Agreement being assumed. Hilton urges this Court to interpret 11 U.S.C. § 365(c)(1) in such a way that it must conclude that the Debtor is precluded from assuming the Franchise Agreement as a matter of law even though the Debtor has no intention of assigning the Franchise Agreement.

In contrast, the Debtor submits that the Court should apply an “actual test” to determine whether an executory contract can be assumed under 11 U.S.C. § 365(c)(1). Under the “actual test” the Court makes a determination on a case-by-case basis as to whether a debtor actually intends to assign the executory contract. If a debtor has no intention of assigning the executory contract, then a debtor can assume it. According to the Debtor in this case, it will suffer a significant financial burden if it is not able to continue operating the Hampton Inn pursuant to the Franchise Agreement, and thus, the Debtor does not intend to assign the Franchise Agreement. Therefore, in applying the “actual test” under 11 U.S.C. § 365(c)(1), the Debtor maintains that it can assume the Franchise Agreement because it has no *actual* intent to assign it.

#### **IV. Legal Analysis**

Upon the filing of a bankruptcy petition, the automatic stay prohibits entities from obtaining possession of or control over property of the estate. *See* 11 U.S.C. § 362(a)(3). The automatic stay under 11 U.S.C. § 362(a) is “one of the fundamental debtor protections provided by the [B]ankruptcy [Code].” *Berman v. Diamond Sav. & Loan Co. (In re Berman)*, 1993 U.S. App. LEXIS 29504, at \*4 (6th Cir. Nov. 10, 1993) (citing *Federal Land Bank of Louisville v. Glenn (In re Glenn)*, 760 F.2d 1428, 1436 (6th Cir. 1985)). Unless a franchise agreement is terminated prior to the bankruptcy case being filed, a debtor continues to have a property interest in that agreement post-petition, and that property interest becomes property of the bankruptcy

estate pursuant to 11 U.S.C. § 541. *See In re Tornado Pizza, LLC*, 431 B.R. 503, 510 (Bankr. D. Kan. 2010). The automatic stay applies to a debtor’s interest in a nonterminated franchise agreement, and a franchisor must request relief from the automatic stay before it can terminate the franchise agreement. *See Elder-Beerman Stores Corp. v. Thomasville Furniture Indus. (In re Elder-Beerman Stores Corp.)*, 195 B.R. 1019, 1024 (Bankr. S.D. Ohio 1996) (“[W]hile parties may otherwise be permitted to terminate an agreement under state contract law, in bankruptcy such a termination would be in violation of the stay, and the parties must seek permission of the court to act.”) (citation omitted); *Comput. Commc’ns, Inc. v. Codex Corp. (In re Comput. Commc’ns, Inc.)*, 824 F.2d 725, 731 (9th Cir. 1987) (holding that an entity violated the automatic stay by unilaterally terminating the contract).

If the Debtor is prohibited from assuming the Franchise Agreement as a matter of law, as Hilton urges this Court to find, then Hilton will be entitled to relief from the automatic stay to terminate that agreement. 11 U.S.C. § 365(a) governs assumption and provides in pertinent part that “the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.” 11 U.S.C. § 365(a). A debtor in possession possesses the same rights and powers as a trustee subject to certain exceptions not applicable here. *See* 11 U.S.C. § 1107(a). Thus, a debtor in possession may assume or “reject any executory contract—meaning a contract that neither party has finished performing” pursuant to § 365(a). *Mission Prod. Holdings v. Tempnology, LLC*, 587 U.S. 370, 372, 139 S. Ct. 1652, 203 L. Ed. 2d 876 (2019) (internal quotation marks and citation omitted).

The ability to assume an executory contract, however, is subject to certain requirements and restrictions. One such restriction can be found in § 365(c)(1).

11 U.S.C. § 365(c)(1) provides as follows:

(c) The trustee 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[.]

11 U.S.C. § 365. “[Section] 365(c)(1)(A) acts to balance the rights of third parties who contracted with the debtor and whose rights may be prejudiced by having the contract or lease performed by an entity with which they did not enter into the agreement.” *In re Lil' Things*, 220 B.R. 583, 591 (Bankr. N.D. Texas 1998). Courts are divided on how to apply 11 U.S.C. § 365(c)(1) when a debtor in possession wants to assume an executory contract and has no intention of assigning it to a nondebtor entity. Two main approaches have emerged from courts interpreting the statutory language in § 365(c)(1). One approach is referred to as the “hypothetical test.” The other approach is the so called “actual test,” although the underlying reasoning and basis for the application of the “actual test” varies in the courts that apply such test.<sup>3</sup>

### **A. Hypothetical Test**

The majority of the circuit courts of appeals that have decided this issue have adopted what is referred to as the “hypothetical test” when applying 11 U.S.C. § 365(c)(1), meaning that if applicable law prevents the assignment of the executory contract, both assumption and assignment are prohibited even if the debtor does not intend on assigning the contract. *See RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2003); *Perlman v. Catapult Ent.*,

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<sup>3</sup> The Sixth Circuit has not opined on the application of either test in situations where a debtor is attempting to assume but not assign an executory contract. *But cf. Rieser v. The Dayton Country Club Co. (In re Magness)*, 972 F.2d 689, 693 (6th Cir. 1992) (holding that a chapter 7 trustee was not permitted under § 365 to assign the debtor’s golf membership as an executory contract of the debtor). The *Magness* case is inapplicable to the case at bar because it did not deal with the right of a debtor to assume an executory contract but instead it dealt with the right of a chapter 7 trustee to assign an executory contract. *Magness*, 972 F.2d at 694.

*Inc. (In re Catapult Ent., Inc.)*, 165 F.3d 747 (9th Cir. 1998); *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 534 (11th Cir. 1994); *In re West Elecs., Inc.*, 852 F.2d 79 (3rd Cir. 1988).

Courts that have applied the “hypothetical test” focus on what they assert is the plain meaning of the statute. *See Perlman v. Catapult Ent., Inc. (In re Catapult Ent., Inc.)*, 165 F.3d 747, 751 (9th Cir. 1998); *In re West Elecs., Inc.*, 852 F.2d 79, 83 (3rd Cir. 1988); *City of Jamestown, Tenn. v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 534, 536 (11th Cir. 1994). As described by the *Catapult* court, “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.” *Catapult*, 165 F.3d at 750 (citations omitted).

Under the “hypothetical test,” the actual intent of the debtor is irrelevant to the court’s analysis and will have no impact on whether the debtor is permitted to assume an executory contract. *See Ohio Skill Games Inc. v. Pace-O-Matic, Inc. (In re Ohio Skill Games Inc.)*, 2010 Bankr. LEXIS 2220, at \*11 (Bankr. N.D. Ohio July 8, 2010). The courts applying the “hypothetical test” focus on the statutory language being written in the disjunctive—assume *or* assign—and conclude that allowing a debtor to assume an executory contract when applicable law bars the assignment of same essentially reads the “or” out of the statute and replaces it with an “and.” *See RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 269 (4th Cir. 2004); *Perlman v. Catapult Ent., Inc. (In re Catapult Ent., Inc.)*, 165 F.3d 747, 754 (9th Cir. 1998); *United States v. Techdyn Sys. Corp. (In re Techdyn Sys. Corp.)*, 235 B.R. 857, 861-62 (Bankr. E.D. Va. 1999). Further, having determined that the statutory language is clear, courts applying the “hypothetical test” admonish the use of policy arguments to justify a statutory interpretation that

disregards the plain language of the statute. *See Catapult*, 165 F.3d at 754; *Sunterra*, 361 F.3d at 269; *Techdyn*, 235 B.R. at 864.

The other approach to interpreting § 365(c)(1) is the so called “actual test.”

## **B. Actual Test**

### **(i) Actual Test - Policy Analysis**

A minority of circuit courts of appeals and the great majority of the bankruptcy courts have applied what is referred to as the “actual test” when interpreting 11 U.S.C. § 365(c)(1), whereby the court performs an ad hoc analysis as to whether the debtor intends to assign the executory contract to an entity other than the debtor. *See Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997); *cf. Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238 (5th Cir. 2006) (adopting the “actual test” with respect to § 365(e)(2)(A)); *In re Footstar, Inc.*, 323 B.R. 566, 569 (Bankr. S.D.N.Y. 2005) (“[T]he great majority of lower courts have taken the view that the courts should apply an ‘actual test’ in construing the statutory language so as to permit assumption where the debtor in possession in fact does not intend to assign the contract.” (listing cases)).

Courts that employ the “actual test” perform a case-by-case analysis as to whether the nondebtor party to the executory contract is actually being forced to accept performance from a party other than the debtor. *See Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997). In essence, the actual intent of the debtor with respect to whether it plans to assign the executory contract is material to the determination by the court; if assignment is not actually contemplated by the debtor, the applicable law cannot prohibit the assumption of the contract. *See Ohio Skill Games Inc. v. Pace-O-Matic, Inc. (In re Ohio Skill Games Inc.)*, 2010 Bankr. LEXIS 2220, at \*11 (Bankr. N.D. Ohio July 8, 2010). “Under the actual test, assumption is prohibited

only where the debtor expresses an actual intent to assign the contract to a party to whom the nondebtor could refuse performance.” *In re Edison Mission Energy*, 2013 Bankr. LEXIS 3872, at \*28 (Bankr. N.D. Ill. Sept. 16, 2013).

Many of the courts applying the “actual test” find that a literal interpretation of § 365(c)(1) often defeats the policy considerations and underlying purposes of the Bankruptcy Code. *See Edison*, 2013 Bankr. LEXIS 3872, at \*30-31 (“The Court also finds that the actual test is more congruous with fundamental bankruptcy policy: the maximization of the value of the debtor’s estate.” (citation omitted)); *In re Mirant Corp.*, 303 B.R. 319, 334 (Bankr. N.D. Texas 2003) (holding that § 365(c)(1) is “not meant to aid creditors in penalizing an estate”); *In re Cumberland Corral, LLC*, 2014 Bankr. LEXIS 936, at \*25 (Bankr. M.D. Tenn. March 11, 2014) (finding that a literal interpretation of § 365(c)(1) would produce an “outcome [that is] contrary to the purposes of the Bankruptcy Code”).

**(ii) Actual Test - Plain Meaning Analysis**

The *Footstar* court arrives at the same result as the courts that apply the “actual test” though it reaches its conclusion under a different analysis. *See In re Footstar, Inc.*, 323 B.R. 566 (Bankr. S.D.N.Y. 2005). The reasoning employed by the *Footstar* court furthers the objective of the statute and the overall purpose of chapter 11 relief without doing violence to the plain language of the statute. *Footstar*, 323 B.R. at 570. In doing so, the court construed the phrase “assume or assign” as it is written and did not substitute “and” for the word “or” which is akin to the analysis used by courts that apply the “hypothetical test.” *Id.* Courts that apply the “actual test” endorse a statutory interpretation that promotes the overall objectives of and policies behind the Bankruptcy Code. In similar fashion, the *Footstar* court maintains that its interpretation of § 365(c)(1) furthers the objective of the limitation contained in § 365(c)(1) (i.e., the right of a counterparty to refuse to

accept performance from or render performance to an entity other than the debtor or the debtor in possession) and the overall purpose of chapter 11 by fostering, not frustrating, the reorganization efforts of the debtor. *Footstar*, 323 B.R. at 573-74.

According to the bankruptcy court in *Footstar*, courts that apply the “hypothetical test” incorrectly limit their focus on the introductory language in the statute—“the trustee may not assume or assign”—to the exclusion of the conditional language that follows. *Footstar*, 323 B.R. at 576. The prohibition regarding assumption or assignment applies only “if applicable law excuses a [counterparty] from accepting performance from or rendering performance to *an entity other than* the debtor or debtor in possession . . . .” 11 U.S.C. § 365(c)(1)(A) (emphasis added).

The *Footstar* court concluded that:

[T]he limitation prescribed in Section 365(c)(1) exists only "if" a counter party to a contract is excused by applicable law from accepting performance from or rendering performance to "an entity *other than* the debtor or the debtor in possession." Thus, through Section 1107(a), Section 365(c)(1) does indeed apply so as to bar a debtor in possession from assuming in order to assign its contract to another entity. But this limitation cannot by its express terms be construed to bar the right of a debtor in possession to assume without assignment, since without assignment there is no "entity other than the debtor in possession" involved with the contract. To hold otherwise would conflict with both the plain meaning and the intent of the statute as written by Congress.

*Footstar*, 323 B.R. at 576-577. Accordingly, the court ultimately determined that “[a]pplicable law does not excuse a [counterparty] from performance with a debtor who assumes but does not assign.” *Id.* at 576.

Since *Footstar* was published in 2005, most of the courts that have reviewed this issue have agreed with its approach. In particular, in *In re Adelpia Comms. Corp.*, 359 B.R. 65, 72 (Bankr. S.D.N.Y. 2007), the court indicated its full agreement with *Footstar*. The *Adelpia* court stressed that it was following *Footstar* not only as a matter of intra-district consistency, but also because it believed that *Footstar* was “plainly correct.” *Adelpia*, 359 B.R. at 72 n.13 Likewise, in *In re*

*Aerobox Composite Structures, LLC*, 373 B.R. 135, 141-42 (Bankr. D.N.M. 2007), the court endorsed *Footstar* and its reasoning that construing § 365(c)(1) to prohibit assumption by the debtor in possession who wants to assume but not assign would render it an oxymoron – because it would make no sense to prohibit assumption by the debtor in possession in order to protect the counterparty from being forced to accept performance by someone other than the debtor in possession.<sup>4</sup>

Whether applying the “hypothetical test” approach or the “actual test” approach, each is susceptible to criticism. Justice Kennedy, in a statement with whom Justice Breyer joined regarding the denial of a petition for writ of certiorari to consider this issue, noted the potential inequities created by applying the “hypothetical test” and the challenges presented with applying the “actual test.”

The hypothetical test is not, however, without its detractors. One arguable criticism of the hypothetical approach is that it purchases fidelity to the Bankruptcy Code's text by sacrificing sound bankruptcy policy. For one thing, the hypothetical test may prevent debtors-in-possession from continuing to exercise their rights under nonassignable contracts, such as patent and copyright licenses. Without these contracts, some debtors-in-possession may be unable to effect the successful reorganization that Chapter 11 was designed to promote. For another thing, the hypothetical test provides a windfall to nondebtor parties to valuable executory contracts: If the debtor is outside of bankruptcy, then the nondebtor does not have the option to renege on its agreement; but if the debtor seeks bankruptcy protection, then the nondebtor obtains the power to reclaim -- and resell at the prevailing, potentially higher market rate -- the rights it sold to the debtor.

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<sup>4</sup> The Court notes that there are two courts that have refused to follow *Footstar*. In *Moe's Franchisor, LLC v. Taylor Inv. Partners II, LLC* (*In re Taylor Inv. Partners II, LLC*), 533 B.R. 837 (Bankr. N.D. Ga. 2015), the court acknowledged that the *Footstar* approach “certainly has appeal” but ultimately held that it was bound by the Eleventh Circuit’s decision adopting the hypothetical test. *Taylor*, 533 B.R. at 841 (citing *City of Jamestown, Tenn. v. James Cable Partners, L.P.* (*In re James Cable Partners, L.P.*), 27 F.3d 534 (11th Cir. 1994)). The court in *In re Kazi Foods of Mich., Inc.*, 473 B.R. 887, 890 (Bankr. E.D. Mich. 2011), listed *Footstar* among various decisions that favor the “actual test” before ultimately adopting the hypothetical test.

Of course, the actual test may present problems of its own. It may be argued, for instance, that the actual test aligns § 365(c) with sound bankruptcy policy only at the cost of departing from at least one interpretation of the plain text of the law.

*N.C.P. Mktg. Grp., Inc. v. BG Star Prods.*, 556 U.S. 1145, 1146-1147, 129 S. Ct. 1577, 173 L. Ed. 2d 1028 (2009) (citation omitted).

Moreover, the leading commentator on bankruptcy considers the “hypothetical test” approach to be “troubling, as it may prevent a debtor in possession from being able to reorganize under circumstances that do not adversely affect the other party to the contract.” COLLIER ON BANKRUPTCY ¶ 365.07 (Richard Levin & Henry J. Sommer eds., 16th ed.) (citation omitted). Additionally, the commentator notes that the application of the “hypothetical test” contravenes the overall objectives and relief provided by chapter 11.

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.

COLLIER ON BANKRUPTCY ¶ 365.07 (Richard Levin & Henry J. Sommer eds., 16th ed.).

## **V. Application of Law**

In the current case, the Parties do not dispute the applicability of § 365(c)(1) or that the Franchise Agreement is an executory contract. For the purpose of obtaining a determination from this Court as to whether the “hypothetical test” or “actual test” applies in this case, the Parties do not contest that the Lanham Act, 15 U.S.C. §§ 1051-1141n, constitutes “applicable law” that prohibits the nonconsensual assignment of the Franchise Agreement, and thus, would excuse Hilton from accepting performance from or rendering performance to an entity other than the

Debtor.<sup>5</sup> The only remaining issue, then, is whether the nonassignability of the Franchise Agreement is a bar to the Debtor assuming it pursuant to § 365(c)(1).

The Debtor here has no intention of assigning the Franchise Agreement, but Hilton does not consent to the Debtor assuming or assigning the Franchise Agreement. The Franchise Agreement is the vehicle through which the Debtor is authorized to operate its hotel as a Hampton Inn. If the Debtor is not able to assume the Franchise Agreement, it will be forced to expend funds to remove Hilton's trademarks and operational systems and the value of the Debtor's estate will arguably decrease resulting in less income being available to fund a plan of reorganization. This decrease in the value of the Debtor's estate not only impacts the Debtor but also the entire creditor body. Clearly, the Franchise Agreement is a valuable asset to the Debtor in this case, and the ability to assume the Franchise Agreement will significantly impact the ability of the Debtor to reorganize. Denying the Debtor an opportunity to assume the Franchise Agreement when the Debtor has no intention of assigning it will stymie any efforts by the Debtor to reorganize. And it is contrary to some of the most fundamental objectives of chapter 11 relief—maximizing the value of the bankruptcy estate for the benefit of creditors and the successful reorganization of the debtor.

In evaluating these approaches, the Court finds that the “actual test” as articulated by *Footstar*, *Adelphia*, and *Aerobox*, is the most faithful interpretation of the language in § 365(c)(1). It also preserves the evident purpose of § 365(c)(1), which is to protect a counterparty from being forced to do business with someone other than the debtor. To be clear, though, the Court does not

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<sup>5</sup> The Debtor did not explicitly concede on this point but instead stated that “[e]ven assuming *arguendo* that [Hilton's] interpretation of the prohibitions in the Lanham Act apply herein, that in and of itself does not prohibit the assumption of the Franchise Agreement by the Debtor.” Suppl. Mem. Supp. Debtor's Obj. 3, ECF No. 227. As is more fully addressed in the Court's opinion, whether “applicable law” prohibits the assignment of the Franchise Agreement is not determinative of the Court's analysis in this case because the Debtor in fact does not intend to assign the contract.

adopt the “actual test” because it believes that to be the better policy. Rather, the Court believes it is also the most faithful interpretation of the statutory language. The Court also notes that *Footstar* answers the primary criticism leveled at the “actual test” by Justice Kennedy and the courts adopting the “hypothetical test.” *Footstar* demonstrates that the charge that the “actual test” rewrites the statute is not accurate. And it further demonstrates that the plain meaning analysis of the “hypothetical test” is itself flawed and leads to a contradictory, if not an oxymoronic, result.

The courts applying the “hypothetical test” overemphasize the introductory language of 11 U.S.C. § 365(c)(1) – “the trustee may not assume or assign” and overlook the conditional language that follows which states: “if 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 . . . .*” See *Footstar*, 323 B.R. at 576. To illustrate, and as was discussed by the court in *Footstar*, if the names of the Parties are inserted into the statutory language, it shows how applying the “hypothetical test” when interpreting § 365(c)(1) “render[s] the provision a virtual oxymoron.” *Footstar*, 323 B.R. at 573.

(c) [Hilliard Hotels, LLC] may not assume or assign any executory contract or unexpired lease of [Hilliard Hotels, LLC], whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, *if—*

(1)

(A) applicable law excuses [Hilton Franchise Holding LLC] from accepting performance from or rendering performance *to an entity other than* [Hilliard Hotels, LLC], 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[.]

11 U.S.C. § 365(c)(1) (emphasis added). The operative clause here is “if applicable law excuses [Hilton Franchise Holding LLC] from accepting performance from or rendering performance to an entity other than [Hilliard Hotels, LLC].” Without assignment of the contract by the Debtor,

there can be no entity other than the Debtor that will be accepting performance or rendering performance under the Franchise Agreement. It is a legal impossibility unless the executory contract is assigned. Based on the plain language of § 365(c)(1), the statutory condition that the creditor must be forced to accept performance from or render performance to an entity other than the debtor can only be triggered and thus make the limitation in § 365(c)(1) applicable if the debtor assigns the contract, because the debtor can never be an entity other than itself. Therefore, based on the plain language of the statute, a debtor is not prohibited from assuming an executory contract if it does not intend on assigning it. Interpreting § 365(c)(1) in this manner not only comports with the plain language of the statute, but it also is consistent with the overall objectives of chapter 11 relief and the purposes of the Bankruptcy Code.

Moreover, as the court in *Adelphia* points out, the application of the “hypothetical test” renders 11 U.S.C. § 365(f)(1) superfluous. 11 U.S.C. § 365(f)(1) provides that the terms in an executory contract that prohibit the assignment of the executory contract are unenforceable. *See In re Adelphia Comms. Corp.*, 359 B.R. 65, 72 n.17 (Bankr. S.D.N.Y. 2007); *see also* COLLIER ON BANKRUPTCY ¶ 365.09 (Richard Levin & Henry J. Sommer eds., 16th ed.). An executory contract must first be assumed as a precondition to assignment under § 365(f)(2). If § 365(c)(1) made it impossible to even assume the contract to be assigned, there would be no reason for having a § 365(c)(1) exception in § 365(f). “Similarly, if § 365(c)(1) made it impossible for a debtor in possession to assume an unassignable contract, the purpose of including ‘or debtor in possession’ in § 365(c)(1) would be difficult to explain.” *Adelphia*, 359 B.R. at 72 n.17.

As noted previously, the justification for the limitation contained in § 365(c)(1) is to preserve the right of a counterparty to refuse to accept performance from or render performance to an entity other than the debtor. In this case, the Debtor has no intention of assigning the Franchise

Agreement to a third party but instead intends to assume it and perform pursuant to its terms. Assumption of the Franchise Agreement by the Debtor would maintain the Parties' relationship as it existed prior to the bankruptcy, thereby allowing the Parties to enjoy both the benefits and burdens of their contract. More importantly, applying the plain language of § 365(c)(1) illustrates exactly why that provision in effect only applies to a trustee and not a debtor who has no intention of assigning its contract.

Furthermore, if the Debtor is barred from assuming the Franchise Agreement in this case, Hilton arguably would obtain a windfall because it would be relieved of its obligations under the Franchise Agreement simply by withholding its consent, as opposed to complying with the terms and conditions for termination of the Franchise Agreement which Hilton would be required to do if the Debtor had not filed for bankruptcy protection. Such a situation essentially provides Hilton with veto power over the Debtor's ability to reorganize. Section 365(c)(1) is designed to protect a creditor from being forced into a contractual relationship with an unknown third party. In this instance, Hilton does not need this protection because the Debtor does not intend on assigning the Franchise Agreement. Thus, assumption by the Debtor in this case poses no risk to Hilton of having to accept performance from or provide performance to an unknown third party. Interpreting § 365(c)(1) in such a way that allows the creditor to benefit from the protections provided therein when in fact there is no assignment contemplated and thus, no protection is warranted, essentially permits that creditor to use § 365(c)(1) as a sword instead of a shield. This Court is not inclined to endorse an interpretation of § 365(c)(1) that results in such an imbalance of the Parties' rights and obligations.

Accordingly, having considered the facts of this case and the relevant caselaw, this Court rejects the "hypothetical test" and finds that the "actual test" and the reasoning of *Footstar*,

including the cases that follow it, are the better approach to applying § 365(c)(1) when a debtor wants to assume an executory contract with no intention of assigning it to a nondebtor entity.

#### **V. Conclusion**

For all these reasons, the Court finds that the “actual test” should be used to determine whether the Debtor can assume the Franchise Agreement pursuant to 11 U.S.C. § 365(c)(1).

Therefore, **IT IS ORDERED** that the request for relief from automatic stay to terminate the Franchise Agreement on the basis that 11 U.S.C. § 365(c)(1) prohibits the Debtor from assuming the Franchise Agreement as a matter of law is DENIED. It is further,

**ORDERED** that the automatic stay imposed by 11 U.S.C. §362(a) is hereby continued in effect until the final hearing on all remaining matters related to the *Hilton Franchise Holding LLC’s Motion for Relief from Automatic Stay Regarding Hilliard Hotels, LLC* (Doc. #166) is held or the Court orders otherwise.

**IT IS SO ORDERED.**

Service List:

Default List