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

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(Proceedings commence at 4:09 p.m.)

THE COURT: Good afternoon.

MR. LEON: Good afternoon, Your Honor.

THE COURT: All right. We are here this afternoon for the purpose of reading a bench decision in the estimation trial that we had earlier this month.

And I will apologize for subjecting to you all to a lengthy, dramatic reading. As we discussed, my preference probably would have been to prepare a written opinion in a case like this, but timing is sensitive in this case; I want to get the parties a decision quickly.

Let me just make sure everybody who's on the phone can hear me. I suppose that most folks are listen-only, but I'm particularly concerned with Hilton’s counsel, Mr. Neff.

MR. NEFF: (Via telephone) Yes, Judge. This is Mr. Neff. I can hear you well. Thank you.

THE COURT: All right. This matter comes before the Court on the April 24, 2012 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, which I'm going to refer to as "the motion."

In the motion, the debtors seek estimation of the damages Hilton would sustain if the debtors reject three management agreements.

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

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

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

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

For a variety of reasons that were discussed on and off at the trial, Hilton did not receive the incentive fee stream it anticipated. It has not, in fact, received any incentive fees under these management agreements since 2007. It does not seek the payment of incentive fees as part of the damages sought in this proceeding.

Hilton's 2005 valuation was based on the full thirty-year term, including the seven years from 2006 to 2012, for which it has already received payment; and to date, it's received $79 million in fees under the management agreements.

Turning to the three management agreements here, they contemplate certain payments to the hotel manager. For purposes of the Court's inquiry, these provisions regarding payment are the same for the three agreements.

The first category of payments under the management agreements is the management fee, set forth in Article 5.1 of the management agreements. Under Article 5.1, the management fee includes a base fee and an incentive fee that we've already discussed. The management agreement defines the "base fee" for management services as:

"An amount equal to two percent (2%) of gross revenues."

The incentive fee, as mentioned earlier, is triggered only if Hilton satisfies certain performance thresholds, which are not at issue in this proceeding.

The second category of payments contemplated by the management agreements is something called the "corporate overhead fee." Pursuant to Article 5.3 of the agreements, a manager will receive a corporate overhead fee for corporate overhead expenses that it incurs in connection with managing the resorts. In the words of Article 5.3, the manager is “reimbursed” for corporate overhead in the amounts equal to one percent of gross revenues.

The third category of payments contemplated by the management agreements is the so-called "group services expense." Article 5.2 of the management agreements provides for the manager to receive reimbursement for group services expense in the amount of up to two percent for each of the resorts' revenues. Group services expense is used to fund marketing, advertising, reservations, and other promotional services that the manager provides in managing the resorts.

Several other provisions of the management agreements are relevant to this dispute, although they are not payments that Hilton seeks as part of the proceedings.

The first of these is the Article 6 provision for capital expenditures. Under that provision, the debtors -– that is, the owners –- are obligated to contribute four percent of gross resort revenue to fund necessary capital expenditures at each resort. To the extent the manager believes funding of additional capital expenditures is required beyond the four percent, the management agreements require the manager to seek approval from the debtors. If there is a disagreement over the amount of capital expenditures needed, the manager may pursue that dispute by putting the debtors on formal notice of a contractual conflict and pursue a dispute resolution procedure to resolve the matter.

Other relevant provisions in the management agreements include a provision regarding the terms of the agreements, with the term to run through 2024, with a ten-year option out to 2034.

The management agreements also have a provision addressing termination. In that provision, the debtors have the right to terminate the agreements without the payment of any additional fee or premium if the manager fails to satisfy certain performance requirements. Specifically, the debtors may terminate the management agreements without penalty if, after 2010 and for two consecutive operating years:

“(i) the GOP (gross operating profits) achieved by the Hotel for each Operating Year is less than ninety percent (90%) of the GOP set forth in the approved Annual Operating Plan for such Operating Year.” And this has been referred to as the gross operating profit test."

“(ii) the Annualized RevPAR (revenue per available room) for the Hotel for each of such Operating Years is less than ninety-five percent of the Annualized RevPAR of the

Competitive Set for each respective Operating Year.” And that's been referred to as the "RevPAR performance test."

If the manager, here Hilton, fails to satisfy the performance tests, and thus faces termination, it can make a cure payment to the debtors to avoid termination and continue managing the resorts.

The final provision that is relevant in the management agreements for our purposes is a liquidated damages provision. And that provides that if, after 2024, the debtors sell the resorts and terminate Hilton as manager, Hilton is entitled to a specified termination fee in the amount equal to the product of the total management fee paid or payable by the manager for the twelve-month period prior to the effective date of termination, multiplied by a specified multiplier that varies under the circumstances, and which we don't need to address in this proceeding.

Turning now to the governing legal standard for this dispute, the Court observes that each of the management agreements is governed by the laws of the state in which the subject resort is located. Accordingly, the laws of Arizona, California, and Hawaii will govern the calculation of damages to which Hilton will be entitled upon the rejection of each respective management agreement.

These three states generally agree that, in a breach of contract action, a plaintiff may recover the amount of damages necessary to place it in the same position it would have occupied had the breach not occurred. The usual recovery for the breach of a contract is the contract price or the lost profits therefrom.

To calculate lost profits, expenses are subtracted from revenue. Only net profits, not gross profits, are recoverable for breach of contract. These depend on the particular transaction at issue, which dictates what expenses need to be deducted from the gross profits to determine the appropriate figure.

Arizona Courts have recognized that compensatory contract damages will be awarded for the net amount of losses caused and gains prevented. See Biltmore Evaluation & Treatment Services v. RTS NOW, LLC, 2009 WL 223293, at *2 (Ariz. Ct. App. Jan. 29, 2009). Similarly, California Courts have observed that damages are based on net profits, which they have consistently defined as gains made after deducting the value of labor, materials, rents, and all expenses, together with the interest of the capital employed. See Electronic Funds Solutions v. Murphy, 36 Cal. Rptr. 3d 663, 676 (Cal Ct. App. 2005). Finally, Hawaii has recognized that a non-breaching party may recover damages that arise naturally from the breach, or that were in the contemplation of the parties at the time of contracting. See Jones v. Johnson, 41 Haw. 389, 1956 WL 10315, at *3 (Haw. 1956).

The Court notes that the parties do not disagree about what the applicable law is, although they strongly disagree with how it should be applied in this case. Applying the applicable law and relevant provisions of the management agreements, the parties reach very different conclusions about the proper measure of damages.

The Court notes that both parties use an expert to provide a breakdown of the respective numbers on damages, as well as an explanation of how each component is calculated. Hilton's expert for this purpose was Roger Cline, and the debtors' expert for this purpose was Thomas Morone.

On the one hand, Hilton contends it is entitled to $334 million for rejection of these three management agreements. Hilton's requested $334 million is broken into four general categories:

First, it seeks damages of some $165 million for fees under the three management agreements. These fees include a base fee and the corporate overhead fee but do not, as previously mentioned, include any damages for an incentive fee.

A large difference between the parties' calculation of damages results from their use of different discount rates to provide a current valuation for the worth of the payments that Hilton would receive in the future. Hilton uses an eight percent discount rate.

The second component of damages that Hilton seeks is for group services expenses of approximately $38.9 million.

Third, Hilton seeks damages of approximately $120 million for so-called "brand damages." It describes "brand damages" as the impact of the rejection of these three management agreements on its Waldorf=Astoria brand.

Fourth and finally, Hilton seeks approximately $9.8 million in damages for losses relating to what it alleged to be debtors' plan to expand the Grand Wailea Resort by some 300 rooms in the near future, thus purportedly expanding the profits that Hilton would receive under that particular management agreement.

Debtors, on the other hand, see things far differently. They argue that Hilton is only entitled to approximately $46 million in damages. Of the three categories of damages sought by Hilton, debtors claim that Hilton is entitled only to the first, the management fee, and that the management fee should consist solely of the base fee. Thus, in debtors' view, Hilton should get no damages for the corporate overhead fee, group services expense, brand damages, and the Grand Wailea expansion.

Moreover, debtors arrive at their figure of $46 million only after subtracting certain money for cure payments that debtors contend Hilton will have to make for failing to meet the performance test in the future at the Grand Wailea Resort.

I turn first to the issue of the management fees. And in looking in that, the Court must first project the fees per year that Hilton would earn under the management agreements and reduce these profits by the expenses that Hilton would incur to arrive at a profit margin. In doing that, one looks to the total projected revenues at the Resorts as these revenues are used to calculate the fees.

Mr. Morone and Mr. Cline's projections for the resorts as, one witness put it, "quite close." Roger Cline, Hilton's expert, projects approximately $14.6 billion in revenue. Thomas Morone, an expert for the debtors, opines that the projected revenue for purposes of the management agreements is approximately $13 billion.

There are only two real differences between these two different predictions of revenue. The first is the inflation rate, where Mr. Cline uses three percent and Mr. Morone uses 2.5.

The Court concludes that the appropriate inflation rate is 2.5. The Court finds that Mr. Morone reasonably relied on historical data from the Bureau of Labor and Statistics. That data shows the inflation rate for the past ten years at 2.4 percent. And he adjusted upwards to account for the slightly higher twenty-year historical average of 2.6 percent, resulting in his inflation rate of 2.5.

The Court rejects Mr. Cline's figure, which he has adopted from an appraisal firm HVS, which is a standard inflation rate that they use for hotel appraisals. Mr. Cline also relies on a website called "forecastchart.com" to conclude the appropriate rate is three percent. But he has not submitted any evidence that forecastchart.com is a reliable industry standard website. In any event, his reliance on inflation rate used by another company without proffering any evidence as to how it was determined or why it is appropriate is insufficient to refute Mr. Morone's proposed inflation rate based on historical data.

The second difference between the parties' predictions is the level of capital expenditures to be made by the debtors in the resorts. Mr. Cline assumes an eight percent contribution by the debtors. In support of this number, Diane Jaskulske, Hilton's witness, testified that Hilton averages eight to ten percent of revenue annually for properties similar in size and complexity as the resort. Matthew Bailey, Managing Director of Grand Wailea, testified that four percent is simply too low to maintain the operating standards under Hilton's management agreement.

On the other hand, Mr. Morone utilizes a four percent capital expenditure assumption, as per Article 6 of the management agreements. Article 6 obligates the debtors to contribute four percent of resort revenue to fund necessary capital expenditures. Debtors argue that they have never agreed to anything beyond the four percent, and that Hilton has never formally requested any increase.

The Court finds that six percent is the appropriate figure to use. The six percent, in fact, is derived from Mr. Morone's testimony that the debtors have consistently spent six percent, on average, on capital expenditures. The Court rejects Hilton's eight percent as too high, given that Hilton must follow certain procedures outlined in Article 6, in order to receive additional capital expenditures funding beyond the four percent reserve fund. And Hilton has never commenced the dispute resolution procedure set forth in that article.

Hilton's position about the need for eight percent is further undercut by the fact that Hilton, in its 2005 memo, viewed the resorts to be in excellent shape before purchasing these management contracts. And Mr. Bailey testified that, in his view, the resort was in better shape today than it was at the time of the purchase.

Moving on to the second component of damages, we turn to the corporate overhead fee. The debtors' expert Mr. Morone deducted the corporate overhead fee as a reimbursed expense, while Hilton's expert Mr. Cline included the full one percent of the corporate overhead fee in his calculation of lost profits and deducted no expense incurred by Hilton in managing the resorts.

In contending that the corporate overhead fee is a reimbursement, rather than profit, debtors rely, among other things, upon the language in Article 5.1 of the management agreement, which expressly states that the corporate overhead fee is to be reimbursed to the manager. They also note that Section 1 of the management agreement states that the management fee includes only the base and incentive fees, and that the corporate overhead fee is never described as "consideration" for Hilton's performance under the management agreements. Debtors finally note that the liquidated damages and termination provisions do not contemplate corporate overhead fees being incorporated as liquidated damages in the event of termination.

For Hilton's part, its expert Mr. Cline assumed no expense for corporate overhead and payment of the full one percent of profit. His conclusions were echoed by Hilton's witness Diane Jaskulske, who testified that she was ninety-nine percent certain that losing the resorts will not change "one iota of what [is done in the] corporate office." Hilton's corporate offices, she said, rarely assist directly in providing services to the resort.

Instead, Hilton views corporate overhead fee as merely a term that Hilton inherited when it acquired the management agreements from the resorts' former manager KSL. As Hilton's witness Ted Middleton explained, the corporate overhead fee is simply viewed by Hilton to be analogous -- that is, the same --

as the two percent base fee.

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

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

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

However, the Court finds that Hilton's 2006 10-K form is persuasive in suggesting that Hilton does incur additional annual overhead expenses when adding new properties to the portfolio. Indeed, the Court rejects as incredible the testimony of various witnesses that there is no corporate overhead associated with these resorts, which all parties describe as "iconic," and indisputably far more complex than a typical hotel managed by Hilton.

As to the exact measure of these corporate overhead expenses, the Court will use Hilton's own estimate of such expenses in its 2005 internal memorandum, which was prepared before purchasing these management agreements. That memorandum calculates its expected cost of managing the resorts at .25 of revenues, or 8.33 percent of a three percent base management fee.

The Court rejects as self-serving the only other evidence of the actual amount of corporate overhead, which was an estimate prepared by Hilton's treasurer solely for the purpose of this litigation.

The Court now turns to the applicable discount rate. A discount rate must be applied to calculate the present value of future payments owed to Hilton under the management agreements, to account for the time value of money and the financial risk of the fee stream. See In re Chemtura Corp., 448 B.R. 635, 673 (Bankr. S.D.N.Y. 2011).

In Chemtura, Judge Gerber noted that the discount rate should be calculated at the time the contract was entered into. Chemtura, at 677.

"Existing case law and common sense require that the discounting to fix the damages award must reflect the same payment risk insofar as the Court can accomplish that as the original contract did."

Id. at 673.

The choice of an appropriate rate does not need to be exact. See Jones & Laughlin Steel Corp. v. Pfeifer, 462 U.S. 523, 552-553 (1983), where the Court notes:

"We do not suggest that a trial judge should embark on the search for delusive exactness."

The Court may choose a discount rate not proposed by the parties. See In re 785 Partners, LLC, 2012 WL 959364, at *5 (Bankr. S.D.N.Y. Mar. 20, 2012), holding that, since the experts did not thoroughly explain their determinations of the discount rate, the Court treated their opinions as the range and selected an intermediate rate.

Although the weighted average cost of capital -- which we'll discuss a bit more in a moment -- or the "WACC," is a reasonable starting point in determining the proper discount rate, the WACC must be adjusted to account for risk. See In re M Waikiki, LLC, 2012 WL 2062421, at *4 (Bankr. D. Haw. June 7, 2012).

Here, Hilton argues for an eight percent discount rate. It contends that the risk of the management agreements at the time they acquired them were de minimis. It contends that eight percent is the industry standard, and it's what Hilton uses to value its own management fees contracts. It notes that the base management fee here is less risky than other revenue streams because it is paid first from the hotel revenue and, thus, far less risky than fees that are a function of hotel profitability.

One Hilton expert, Mr. Hennessey, testified that the proper discount rate was 7.5 percent, based among a variety of things, including: mortgage rates for full service hotels as of April 2006; and the rate generally utilized for hotel investments as of April 2006. He also considered the WACC at the time Hilton acquired the resorts and adjusted it downward to, in his view, achieves a discount rate applicable to the hotel company's reliable income stream derived from base management fees. In his report, he referenced a report by Bear Stearns, which gave Hilton's WACC at 8.1 percent. He also testified he looked at Bloomberg, which reported Hilton's WACC at 8.7 percent as of December 31st, 2005, and 8.2 percent in the first quarter of 2006.

Debtors again have a different view. Their expert, Mr. Morone, applied a 13.6 percent discount rate to the Arizona Biltmore and the hotel in California, and a 14.6 percent discount rate to the Grand Wailea. He calculated Hilton's overall weighted average cost of capital; the WACC, as of the beginning of 2006, to be 10.6 percent. He noted that Mr. Hennessey testified that Bloomberg's reported WACC of 8.7 percent relied on what's called a "beta" that was a default of one percent; or, as Mr. Morone used, a beta of 1.29.

Beta is one of the components in calculating the WACC for any company and measures that company risk in relation to the rest of the market. Mr. Morone testified that the 1.29 beta is appropriate because Hilton stock was riskier than the market as a whole, and for that he cited debtors' expert Derek Pitts, who submitted an affidavit with the debtors' motion.

Mr. Morone adjusted Hilton's WACC to account for property-specific risks, as the WACC reflects aggregate risk of Hilton's entire diversified portfolio of management agreements, relying on something called the "Ibbotson's Size-Risk Premium," Mr. Morone adjusted the WACC to reflect specific risks, such as the size of the resorts, the brand, and the volatility as to the Grand Wailea. He noted the Grand Wailea's additional risk, in his view, included the remote location, the dependency on air travel, the dependency on group travelers, and natural conditions.

Based on the credible evidence and the applicable law, the Court starts off by adopting the WACC used by Mr. Morone.

The difference between Bloomberg's WACC of 8.7 percent and Mr. Morone's determination is that Mr. Morone used a beta of 1.29, as opposed to a beta of one. The affidavit of debtors' expert Derek Pitts provides support for the assertion of using a beta of 1.29; and in fact, Mr. Pitts' affidavit provides the only real analysis of beta in this case.

Using that beta and information from Hilton's own 10-K, I reach the conclusion that Hilton's WACC at the time of entering these management agreements was 10.6.

Mr. Hennessey opined that Hilton's WACC was 8.1, but based his finding upon an internal Bear Stearns estimate published in December 2006, almost a year after Hilton acquired the resorts.

I also note that Hilton's expert makes reference to Bloomberg's WACC. There was discussion at trial that Bloomberg apparently uses a default beta of one. It was unclear from the testimony -- indeed, no one seemed to know -- if that default of one was used by Bloomberg in all instances for Hilton or even in all instances for all companies. And as no party has provided any explanation of the basis for using that default of one here, the Court instead relies on the 1.29 beta, for which analysis has been provided by Mr. Pitts.

On the one hand, Hilton has failed to establish that the management agreements lack any risk, and that its eight percent rate that it applies to all acquired management agreements is sufficient to discount its future fees upon rejection. Indeed, credible evidence has been presented showing that these iconic resorts are exposed to unique risks that make their revenue streams more volatile than a typical Hilton property, supporting an upward adjustment of the WACC, which represents the riskiness to Hilton's business as a whole. Thus, the Court rejects the notion that the same risks apply to these resorts as apply to the operation of one of Hilton's Hampton Inns.

On the other hand, the debtors have failed to persuade the Court that the attendant risks are as high as they claim. There is credible evidence that the management fees here, taken from gross revenues, rather than profits, are a less risky source of revenue for Hilton than many of Hilton's other revenue streams and other revenue streams at the resort.

For all these reasons, the Court will adjust the WACC for the Arizona Biltmore and the La Quinta upward by one percent, to arrive at a discount rate of 11.6. And this is to account for the attendant risks identified by Mr. Morone and discussed by Mr. Pitts.

The Court will adjust the WACC for the Grand Wailea by two percent upwards, rather than one percent, to reach a discount rate of 12.6, based on the aforementioned attendant risks, plus additional risks unique to the Grand Wailea that were discussed at the trial, and that have been mentioned previously, including its location.

The one additional percent increase is also appropriate to account for the possibility that the Grand Wailea may fail the performance tests over the life of these agreements. The credible evidence was that there have been real economic struggles in the recent performance of the Grand Wailea, which is perhaps the most iconic, and thus most unique of these three resorts. These struggles have been evidenced by various metrics that Hilton itself prepared, rating performance at the resort. These difficulties no doubt have been influenced by the current economic downturn and Grand Wailea's location and unusual dependence on group bookings for success, bookings that are incredibly sensitive to the economy.

Such an adjustment for risk of termination has been recognized by the courts. See M Waikiki, 2012 WL 2062421, at *4-5, adjusting the WACC upwards to account for performance-based termination risk. See also Pet Food Express Ltd. v. Royal Canin USA, Inc., 2011 WL 1464874, at *12 (N.D. Cal. 2011), noting that the failure to reduce damages due to uncertainty of lost profits towards the end of an agreement ignores the contingency in the agreement that would have allowed a defendant to terminate the agreement prior to the end of the term for plaintiff's failure to perform its contractual duties and obligations.

The Court now turns to the related issue of cure payments. Debtors' expert Mr. Morone deducted some $7 million in cure payments because he contends that Hilton will fail the performance test and will need to make cure payments on two occasions. First, in his view, it will fail in 2013 and '14, and because the debtors can terminate the contract, Hilton will need to make a cure payment of some $6 million. As to the second instance, based on a so-called "Monte Carlo Analysis," Mr. Morone concludes that Hilton will again fail the performance test as to the Grand Wailea in 2031, prompting a second cure payment of almost a million.

Mr. Morone believes that both these cure payments should be deducted from Hilton's profits.

The Court rejects the debtors' arguments as unduly speculative for several reasons. First, while the Court agrees there is a risk that Hilton will fail the performance test at the Grand Wailea, that failure has not been shown to the degree of certainty so as to make it appropriate to deduct cure payments from Hilton's profits. As already discussed, this risk of failure should instead be accounted for in application of the discount rate for the Grand Wailea.

Indeed, in reaching that conclusion, the Court notes that the performance test here has been described as fairly easy to satisfy by some observers. And while I won't go that far, I do note that Hilton's operating requirements are based in part on Hilton Resorts' annual operating plan that it itself prepares.

Additionally, the Court notes that the Monte Carlo Analysis is unduly speculative. Mr. Morone himself conceded that he was unaware of its use in projecting future failure in hotel management contracts. Indeed, the Court notes that the prediction that Hilton will fail in 2031 seems to be at odds with Mr. Morone's approach of only estimating revenues out for ten years because he found predictions after ten years not to be sufficiently reliable. I turn next to group services expenses. Hilton seeks some $38 million, almost $39 million, in damages stemming from lost group services expenses in the event the management agreements are rejected. This figure is comprised of two components. The first is some $17 million in the net present value of lost group services expense, and the second is some $21.7 million in so-called "key money."

The management agreements define group services expenses as each hotel's:

> "cost for participation in the group services (including reasonable corporate overhead related thereto) as determined in accordance with Section 5.2, excluding reimbursable expenses which shall be charged separately."

Group services includes services and facilities relating to advertising, marketing, promotion, publicity, public relations, and group sales services, for all Waldorf=Astoria Hotels and Resorts, as well as any additional program or group benefit such as the Hilton HHonors program, that are provided to all managed hotels. Group services expense are capped at two percent of resort revenue and are distinct from the corporate overhead fee.

Hilton argues that the group services expense was expressly provided for in the management agreements; and thus, damages relating to them were foreseeable at the time of contracting. Hilton states that the brand fund that Waldorf=Astoria is currently operating operates at a loss, and that Hilton subsidizes it already, and that Hilton would have to self-fund the amounts formerly contributed to maintain the same level of brand support and marketing for the Waldorf=Astoria brand. Hilton believes that this funding will have to continue until Hilton completely replaces the amount of group services expenses previously contributed by the Hilton Resorts, which its primary expert estimates will take at least five years.

In addition to the group services expense itself, Hilton seeks to recover over $21 million in so-called "key money," which it alleges are payments that it will need to make to obtain additional management agreements to replace the ones that it would lose and therefore, to replace the lost group services expense. Key money represents funds that a management company may be required to pay a hotel owner to obtain those management rights.

For their part, the debtors argue that the group services expenses exceed the cap established in the management agreements, and accordingly should be reduced to the amount actually expended, so that Hilton is no longer subsidizing the difference. The debtors further argue that Hilton is also not entitled to the approximately $17 million in group services expense damages because the management agreements don't permit recovery of such expenses, and that Hilton will replace any lost group services by 2014, and that Hilton can simply elect to avoid incurring any such damages. Finally, the debtors assert there is no basis for Hilton's request for the $21 million in key money.

Given the facts and applicable law, the Court grants in part and denies in part Hilton's request for damages in connection with group services expense. The language of the management agreements contemplates the payment of group services expenses for the costs incurred in providing group services to the Waldorf=Astoria brand generally.

The evidence established that Hilton has used such funds for their intended purpose. The mere fact that Hilton may spend more than is required for that purpose for its own business reasons is irrelevant. All that matters is that Hilton seeks only to recover the fee provided for under the management agreements, not any extra costs beyond that. Moreover, there was no evidence at trial that Hilton intended in the future to spend less on group services for the Waldorf=Astoria brand than is contemplated by the management agreements.

Relatedly, the Court concludes that Hilton's request for payments of these fees for a five-year period represents an appropriate exercise of its duty to mitigate its damages. See, e.g., Shaffer v. Debbas, 21 Cal. Rptr. 2d 110, 114 (Cal. Ct. App. 1993), as well as Shahata v. W Steak Waikiki, LLC, 721 F.Supp. 2d 968, 988 (D. Haw. 2010).

The Court notes that Hilton has sought some $17 million in group services expense, a number that has been described to me as having been discounted to net present value. While the Court awards group services expense, it notes that the correct number may be different than the $17 million. While the parties do not address this issue, the Court's prior ruling on the discount rate presumably applies to this component of damages; therefore, this number presumably should be adjusted accordingly consistent with this Court’s earlier ruling on the discount rate.

Moving on to the second aspect of Hilton's group services claim, the Court rejects Hilton's request for the payment of so-called "key money" for several reasons.

As an initial matter, the provision to pay key money is nowhere mentioned in the management agreements, in stark contrast to the group services expense itself. So it is very hard to say the key money was within the parties' contemplation at the time of contract formation as an appropriate measure of damages, and these requested damages are particularly troubling given that the amount of key money sought is in fact greater than the amount of damages actually sought for group services expense under the contract itself.

In any event, the evidence at trial was insufficient to support Hilton's claim for key money damages. Hilton cannot identify which hotel agreements this key money will be used to acquire. Instead, Hilton's claim for recovery of key money is not grounded on any specific facts, but rather on Mr. Cline's professional judgment.

But Mr. Cline based his analysis, specifically the twenty-five percent ratio assumption he used for calculating key money, upon conversations with Ted Middleton, Hilton's Vice President of Development. Middleton, however, later testified that he had done no analysis of the amount of key money that Hilton would be required to pay to replace the group services expense payments, and was not aware of anyone else at Hilton who performed such analysis.

Finally, the Court notes that Hilton itself concedes that whatever management agreements it may one day acquire could very well be management agreements that Hilton would seek to acquire regardless of whether these management agreements are actually rejected.

So for all those reasons and the lack of evidence supporting the necessity of key money payments, the Court rejects that component of damages.

I now turn to Hilton's request for so-called "brand damages." Hilton seeks approximately $120 million in damages stemming from its alleged damage to Hilton's Waldorf=Astoria brand. These damages purport to stem from the debtors' termination of the management agreements and flow from the theory that these properties are "iconic and irreplaceable," which is a phrase that has been used often in this trial and seems not to be in dispute.

Hilton argues that such damages were contemplated by the parties when Hilton acquired the agreements in 2006, as part of an effort to launch the Waldorf=Astoria brand. Hilton believed the acquisition of these management agreements for these three resorts would enable Hilton to generate additional business, as well as credibility among investors and within the real estate development community.

Hilton further alleges that the loss of the resorts would contribute to tension among other Waldorf=Astoria owners who have already been pressuring Hilton to expand and grow the brand, particularly given that the resorts collectively account for some twenty-five percent of the rooms comprising that brand.

Hilton's determination of the amount in brand damages is based on two separate analyses that focus on the time period spanning from 2012 to 2034. The first estimate provides for losses to the existing pipeline of Waldorf=Astoria properties and any impact to the brand's future development program. Utilizing this approach, Hilton estimates brand damages totaling a hundred-and-twelve-some-odd million dollars. The second methodology estimates the overall value of the Waldorf=Astoria brand and determines that the brand will lose 56.5 percent of its value. Under that analysis, Hilton estimates damages in the total amount of $128 million. Taking the midpoint between these two figures, Hilton seeks damages for brand loss in the total amount of $120 million.

The Court denies Hilton's request for brand damages. Like the request for key money, the notion for brand damages is nowhere contained in the management agreements. Instead, the notion of protecting and growing the brand is covered by the management agreements' group services expense, which are damages that have been requested by Hilton and granted by the Court.

Moreover, Hilton's request for brand damages is fatally undercut by lack of evidence. Hilton's expert Roger Cline set forth his proposed calculation of damages, presuming that there will be damage to the Waldorf=Astoria name. But other than Mr. Cline’s opinion, Hilton has offered no hard evidence of damage to its business or business opportunities, including growth and expansion.

For example, Hilton has not provided evidence that a current hotel owner, potential hotel owner, or Hilton HHonors client has presented any concerns about the impact of rejection on the brand. Thus, there is no evidence that any current or future owner would refuse to engage in business with Hilton, would back out of a deal, or would even seek to receive reduced rates.

In fact, Hilton's own witnesses testified that no owner has made any indication to Hilton that they would pull their property from Hilton if these three resorts were lost; nor could Hilton's witnesses identify any perspective Waldorf=Astoria properties that would refuse to join the brand as a result of rejection of these management agreements, or any co-branding opportunities that will be lost. Indeed, none of the hotel management agreements contain provisions that would enable a hotel owner a right to terminate its own agreement with Hilton by virtue of the loss of these three management agreements, or at least no witness was aware of any such provision. Hilton has not offered any evidence establishing that any new hotel will elect not to join the Waldorf=Astoria brand because of the management agreement rejections.

Accordingly, the Court concludes that Hilton has not shown such brand damage will occur with the reasonable certainty required for being awarded by this Court.

The Court recognizes that rejection here has not yet occurred; and thus, this case is different than a normal breach of contract case, where the parties can look back historically at events. This inevitably may mean that it is harder for Hilton to provide evidence of brand damages.

But the Court notes that this bankruptcy and rejection proceeding have been the subject of media coverage, and the debtors have made it very clear from the beginning of this case more than a year ago that rejection of these management agreements was a real possibility, and evaluating the management agreements in this case for rejection was one of the three cornerstones of the debtors' restructuring efforts. Given the well publicized nature of these proceedings, the Court cannot grant the very substantial brand damages sought by Hilton without some real-world evidence of damage to the brand. And relatedly, the Court notes that the brand damages sought are more than thirty-five percent of the total damages requested in this case.

In addition to the lack of concrete evidence from Hilton's fact witnesses, there are difficulties with some of the assumptions underlying the brand damages calculation. For example, the brand damages sought assume a valuation of the Waldorf=Astoria brand at some 2.265 billion, but that value is contradicted by some of Hilton's own documents and public filings, which set forth a different valuation.

Furthermore, Mr. Cline's lost opportunities damages calculation is based on an estimation that, notwithstanding the rejection, Waldorf=Astoria will increase its number of hotels by twenty-two in the near future, an aggressive assumption that appears fundamentally at odds with Hilton's claim that the Waldorf=Astoria brand would be harmed by rejection. And indeed, his projection as to the brand's performance going forward is similarly aggressive into the future, undercutting the argument of brand damage.

Finally, Mr. Cline's measure of calculating damages is premised upon the notion that the measure of damages is directly correlated to the number of rooms lost. But that notion is undercut by evidence at trial that there will be times when a brand might lose a hotel from its group, and that loss may not inflict any damage whatsoever to the brand. Mr. Cline did not offer any limiting principle regarding his theory of brand damages to reflect this fact.

The rejection of Hilton's brand damage claim is consistent with the applicable case law. Applicable state law generally holds that speculative contract damages cannot serve as a proper legal basis for recovery. See Scott v. Pacific Gas & Electric Company, 904 P.2d 834, 845 (Cal. 1995); that case noting that it was a fundamental principle of contract law that speculative, remote, imaginary, contingent, or merely possible contract damages cannot serve as a legal basis for recovery, and absent any definable loss, a party is entitled only to nominal damages. See also McDevitt v. Guenther, 522 F.Supp. 2d 1272, 1287 (D. Haw. 2007); that case highlighting that, under Hawaiian law, speculative damages are not recoverable on actions arising under contract or in tort. See also Southern Union Co. v. Southwest Gas Corp., 180 F.Supp 2d 1021 (D. Ariz. 2002); that case holding that a party cannot recover for lost profit damages on the grounds it is too speculative to support recovery.

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

These principles about certainty are applicable to situations where parties assert claims for lost profits resulting from damage to plaintiff's reputation, and case law from all three states reflect this. See, e.g., Dong Ah Tire & Rubber Co., Ltd. v. Glasforms, Inc., 2010 WL 1691869, at *5 (N.D. Cal. 2010); that case holding that there was insufficient evidence to support any award of damages for lost profits or reputation restoration, and that lost profits must be proven to be certain as to their occurrence and their extent. See also Hi-Pac Ltd. v. Avoset Corp., 26 F.Supp. 2d 1230, 1237 (D. Haw. 1997); that case holding that plaintiffs cannot recover on a claim that a defendant's breach of contract damaged the plaintiff's reputation, and thereby resulting in lost profits, because the plaintiffs were unable to identify or reasonably calculate any specific lost sales or profits, and accordingly failed to meet their burden.

Also instructive are this jurisdiction's decisions relating to claims on reputation damages. Generally, the standard to show loss of good will or reputation damages is high. In ESPN, Inc. v. Office of Comm’r of Baseball, 76 F.Supp. 2d 416 (S.D.N.Y. 1999), for example, the Court held that under New York law, in order to recover damages for loss of good will, business reputation, or future profits, the claimant must prove the fact of loss with certainty, and the loss must be reasonably certain in amount.

The Second Circuit in Toltec Fabrics, Inc. v. August, Inc., 29 F.3d 778, 781 (2d Cir. 1994), presented a three-part test for recovery:

The first being that the claimant must show that there was in fact a loss of good will that must be proved with reasonable certainty.

The second being that claimant must present objective proof of that loss.

And third, that the claimant must show that the loss was caused by the opposing party's breach.

These two cases, while outside the jurisdictions at issue in this proceeding, are instructive in how to value and approach the issue of brand damages here.

Hilton relies particularly on two cases in support of its contention that it is entitled to brand damage, but neither case supports its position.

In Woolley v. Embassy Suites, Inc., 278 Cal. Rptr. 719 (Cal. Ct. App. 1991), the Court considered a request by a hotel branding and management company for a preliminary injunction to prevent a hotel owner from terminating the hotel management agreements. The Court there declined to grant the injunction, noting that computation of a damage award for the loss to Embassy's reputation as a result of wrongful termination could be adequately addressed through expert testimony.

Nothing in this case mandates or counsels the award of brand damages here, however.

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

2062421 (Bankr. D. Haw. June 7, 2012). In that case, the Court denied Marriott's request for damages to its reputation and good will associated with the hotel owner's alleged breach of Marriott's management agreement. The Court's holding was based on its finding that Marriott presented no evidence of any damage to the brand reputation.

Hilton argues that this case supports its position because the Hawaiian Court stated that its holding was without prejudice to the ultimate allowance of Marriott's claims. However, this case does nothing more than support the Court's conclusion that Hilton cannot recover such damages without proof.

Finally, I turn to the last item of damages sought, those relating to the potential expansion of the Grand Wailea. Hilton argues that it will incur losses in the amount of some $9 million in connection with the proposed expansion at the Grand Wailea in the event the debtors reject the management agreement.

In April 2012, the County of Maui granted approval of a two-hundred-and-fifty-million-dollar expansion at the Grand Wailea, which would add approximately 310 additional rooms and increase the size of the resort from 780 to 1,090 rooms. Such expansion has been contemplated as far back as 2005.

Hilton argues that this expansion, which could be completed by 2017, would add tremendous value to the resort, with Hilton estimating such value at over $255 million. Specifically, Hilton believes that expansion will result in a significant increase in gross revenues; and accordingly, base management fee income to Hilton, once expansion is completed. Termination of the management agreements would prevent Hilton from reaping the benefits of expansion in the form of increased fees. Hilton opines that, using a thirteen percent discount rate, the net present value of Hilton's foregone base fees and corporate overhead fees total some $9.8 million.

But the Court rejects Hilton's claim for damages associated with a possible expansion of the Grand Wailea. While the debtors have the right to expand the Grand Wailea, the debtors presented testimony at trial that they have no obligation, contractual or otherwise, to undertake the expansion; they also assert that they presently have no plans to expand the Grand Wailea; and third, that they have made no commitment to do so. None of these assertions can credibly be disputed.

I parenthetically note that one of Hilton's witnesses briefly suggested that the debtors were contractually obliged to maximize operations at the resort, and that this meant the debtors were obligated somehow to move forward with this possible expansion. That position, I conclude, is a wild over-reach, based on the contract language at issue.

But in any event, turning back to the debtors' position here, it's not surprising, given the facts. As previously discussed, the trial was full of evidence regarding the poor performance of the Grand Wailea. The debtors' witness Thomas Shumaker described the approval here obtained by the debtors as a right to expand and conceded that this right was enormously valuable. But he credibly testified that any potential expansion of the Grand Wailea must be viewed in the context of the future performance of the resort, and that the current performance of the resort was a real concern. He also credibly testified that the approval here could be extended out, so as to preserve the debtors' options and this valuable right, while not committing to going forward with any expansion. He and other witnesses noted that the debtors have actually had a right to expand a smaller number of rooms on the same property for some time and have not proceeded to go forward with that expansion.

In sum, the debtors' mere consideration of expansion is insufficient to entitle Hilton to damages here. <u>See, e.g.</u>, <u>Greenwich S.F., LLC v. Wong</u>, 118 Cal. Rptr. 3d 531, 553 (Cal. Ct. App. 2010); that case concluding that:

> "The existence of plans for development does not supply substantial evidence that the development is reasonably certain to be built, much less that it is reasonably certain to produce profits."

And that any reliance on a real estate project that may not occur in order to claim lost profits is "inherently uncertain, contingent, unforeseeable, and speculative."

See also Vestar Development II, LLC v. General Dynamics Corp., 249 F.3d 958, 962 (9th Cir. 2001); that case holding that there is no way to evaluate, other than through speculation, the profits of a prospective land purchaser on a shopping center it would have built, had the purchaser been permitted to purchase the parcel of land.

The Court also notes that Mr. Cline's damages calculation as to the Grand Wailea expansion is somewhat defective because it fails to account for the fact that such expansion would negatively impact the Grand Wailea's performance. It would do so by causing considerable disruption to the resort for the period during which construction was underway, and could result in potential lost business, required discounting, and loss of good will among affected guests. The debtors anticipate that the adverse effect on revenue and earnings could last as long as two years.

Relatedly, the Court notes the evidence at trial that group bookings typically have a provision that permits them to cancel their reservation if there's ongoing construction, and that such group bookings are crucial to the Grand Wailea's economic success.

That concludes the Court's rulings on the motion to estimate damages from rejection of these three management agreements. Again, as I noted earlier, it's my normal preference to provide a written decision to the parties, but debtors explained the need for a quick resolution of this dispute and requested a decision, if at all possible, by August 1st, 2012, which is tomorrow. The need for such an expedited decision relates to the existing deadlines for an exit strategy in this Chapter 11 case, either by plan or sale or some combination of both. And those deadlines for an exit strategy were the result of hotly contested hearings on exclusivity in this case, a dispute that was resolved by agreement of the parties on the timing for an exit strategy. And so I understand the quandary faced by the debtors; and therefore prepared this bench ruling.

However, this being a bench ruling and transcription being what it is, I plan to review the transcript to ensure that it accurately reflects my ruling; and therefore reserve the right to amend it accordingly. So I'd ask the debtors to order the transcript on an expedited basis, and I'll take a look at it. And I also request that the debtors prepare an order memorializing my ruling, and obviously consult with Hilton's counsel on the appropriate language to do so.

So that didn't take quite an hour and a half; it was a little shorter than my estimate, but that concludes my business for the day.

Is there anything that any party needs to raise?

MR. LEON: No. I just wanted to take the opportunity to once again thank Your Honor and your staff for accommodating the parties, our schedule, and in particular the debtors' short time constraints. It's very much appreciated on all sides. And we also appreciate Your Honor's attention to this matter.

THE COURT: Absolutely.

Mr. Neff, is there anything you need to raise at this time?

MR. NEFF: Your Honor, did you want the parties to attempt to come up and try to quantify what the amount is?

THE COURT: Well, that actually was going to be the next thing I was going to mention. If you noted, there is no ultimate bottom-line quantification. That's because there are many components to this that I was trying to get right, and I was going to leave you all to do the math, particularly as to the discount rate.

So yes, I think, it would be the appropriate subject of discussion among the parties, in terms of memorializing the ruling in an order.

MR. NEFF: Very good.

THE COURT: All right. Thank you.

Anything else? All right.

MR. LEON: Nothing for debtors.

THE COURT: Thank you. Have a good evening.

MR. LEON: Thank you, Your Honor. You, too.

MR. NEFF: Thank you, Judge.

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

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CERTIFICATION

I certify that the foregoing is a correct transcript from the electronic sound recording of the proceedings in the above-entitled matter.

S/ Coleen Rand — August 1, 2012

Coleen Rand, AAERT Cert. No. 341 — DATE

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