UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

Not for Publication

In re:	:	Chapter 11
ENRON CORP., *et al*.,	:	Case No. 01 B 16034 (AJG)
Debtors.	:	

OPINION CONCERNING DEBTORS' OBJECTION
TO PROOFS OF CLAIM OF METROMEDIA FIBER NETWORK, INC.

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ARTHUR J. GONZALEZ
United States Bankruptcy Judge.

Commencing on December 2, 2001, and from time to time continuing thereafter, Enron Corp.

(the "Debtor") and certain of its affiliated entities, including Enron Broadband Services, Inc. ("EBS") (collectively, the "Debtors"), filed voluntary petitions for relief under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"). On July 15, 2004, the Court entered an Order confirming the Debtors' Supplemental Modified Fifth Amended Joint Plan of Affiliated Debtors (the "Plan") in these cases. The Plan became effective on November 17, 2004.

On May 20, 2002, Metromedia Fiber Network, Inc. and its affiliated entities filed voluntary petitions for relief under the Bankruptcy Code and by order, dated August 21, 2003, their Second Amended Plan of Reorganization (the "Metromedia Plan") was confirmed. Metromedia Fiber Network, Inc. is now known as AboveNet, Inc. ("Metromedia" or the "Claimant"). Metromedia's Plan became effective on September 8, 2003.

Prior to both of their filings for bankruptcy protection, Metromedia and EBS had entered into an arrangement whereby EBS provided Metromedia with, among other things, use of portions of the EBS fiber-optic communications system (the "System") in return for payments by Metromedia. The terms of the parties agreement were set forth in three writings (i) a Lease Agreement dated June 30, 1999 (the "Master Lease"); (ii) a Collocation Agreement dated June 30, 1999 (the "Collocation Agreement"), as amended; and (iii) an Indefeasible Right to Use Agreement dated November 15, 2000 (the "IRU Agreement", together with the Master Agreement and the Collection Agreement, the "EBS Agreements"). Pursuant to their terms, the Master Lease and the Collocation agreements are governed by the laws of Oregon, and the IRU Agreement is governed by the laws of Texas.

Also prior to both sides filing for bankruptcy protection, in addition to entering into the EBS Agreements, EBS and Metromedia had entered into a Lease and Service Agreement and Co-location

Agreement (the "Lease and Service Agreements"), pursuant to which Metromedia provided EBS with access to Metromedia's fiber-optic cables and internet connectivity and permitted EBS to operate telecommunications equipment at Metromedia's co-location spaces in return for monthly payment of service and lease fees and related charges. Thus, the combined effect of the EBS Agreements and the Lease and Service Agreements was to provide EBS and Metromedia with the ability to use certain of each other's fiber-optic network and location sites, with the parties trading roles, depending upon the relevant agreement, as provider and recipient.

Currently at issue are two proofs of claim that Metromedia filed in the EBS chapter 11 case related to the Lease and Service Agreements. In the first proof of claim, dated October 14, 2002, and assigned claim number 20363 ("Metromedia's Unsecured Performance Claim"), the Claimant asserts a general unsecured claim against EBS in the amount of $799,930.43 premised on obligations that allegedly remained due and owing by EBS under the Lease and Service Agreements. The second proof of claim, dated October 28, 2002, and assigned claim number 21357 ("Metromedia's Unsecured Rejection Claim" and together with the Unsecured Performance Claim, "Metromedia's Unsecured Claims"), is filed as a general unsecured claim against EBS in the amount of $23,911,695.00 based upon rejection damages allegedly arising out of EBS' rejection of the Lease and Service Agreements. Metromedia's Unsecured Claims total $24,711,625.43.

Enron and EBS filed an objection, dated April 29, 2004 (the "Objection"), pursuant to sections 502 and 553 of the Bankruptcy Code, to Metromedia's Unsecured Performance Claim and Metromedia's Unsecured Rejection Claim seeking to expunge these unsecured claims.

As previously noted, the EBS Agreements are comprised of three separate agreements.

Pursuant to the Master Lease, EBS leased to Metromedia certain fibers in the System that are routed from a location in Utah to a location in Texas and EBS provided or arranged for certain of Metromedia's maintenance and repair requirements, governmental approvals, as well as various other authorizations and agreements necessary for installation and use of the System. The fiber-optic route was delivered in two segments, with annual payments payable to EBS for the first segment, representing a portion of the route leased for use to Metromedia, in the amount of $2,014,836.42, and for the second segment, representing the balance of the route leased for use to Metromedia, in the amount of $762,306.58.

Pursuant to the related Collocation Agreement, EBS provided Metromedia with the right and license to, among other things, locate, install, maintain and operate equipment in EBS' collocation facilities at regeneration space sites, where the physical equipment necessary for operation was located, along the route from the originating point of the fiber-optic cable system in Utah to its termination point in Texas. Metromedia was obligated to pay $78,956.00 to EBS monthly in consideration for its agreement to use all of the collocation facilities.

Pursuant to the IRU Agreement, EBS provided Metromedia with an indefeasible right to use certain fiber-optic cables located in Utah and in Colorado. Metromedia was obligated to pay $2,500.00 per month to EBS in consideration for the use of the fiber-optic cable located in Utah, and $5,000.00 per month to EBS in consideration for the use of the fiber-optic cable located in Denver, with a total monthly obligation of $7,500.00.

Previously, each side had sought payment for administrative claims asserted against the other, owing on the agreement for which the respective claimant was the provider of a service. On October

7, 2002, EBS filed a motion (the "EBS Motion") in the Metromedia bankruptcy cases in which EBS sought an order pursuant to sections 503(a) and (b)(1) and 365(d)(10) of the Bankruptcy Code allowing and compelling immediate payment of an administrative expense claim in the aggregate amount of $3,122,967.00 for services provided to Metromedia under the EBS Agreements subsequent to Metromedia having filed for bankruptcy protection, (the "EBS Administrative Claim"). The total of $3,122,967.00 represented the sum of: (a) $2,777,143.00 owing under the Master Lease; (b) $315,824.00 owing under the Collocation Agreement; and (c) $30,000.00 owing under the IRU Agreement.

Metromedia filed an application, dated October 25, 2002, in the EBS Chapter 11 case (the "Metromedia Administrative Claim Application") pursuant to which Metromedia sought allowance and payment of an administrative claim against EBS in the amount of $1,964,996.00 (the "Metromedia Administrative Claim") for amounts allegedly due to Metromedia under the Lease and Service Agreements subsequent to EBS having filed for bankruptcy protection.

Ultimately, EBS and Metromedia entered into a settlement agreement resolving the issues raised in the EBS Motion and the Metromedia Administrative Claim Application. The terms of the settlement agreement were set forth in a Stipulation and Agreed Order Resolving Disputes and Settling Respective Administrative Expense Claims of Both EBS and Metromedia (the "Stipulation"). The Effective Date of the Stipulation was set as the date that it was approved by both debtors' bankruptcy courts. The Stipulation was approved by the Bankruptcy Court overseeing the Metromedia filings on January 30, 2003 and by this Court on February 6, 2003 and, therefore, the Effective Date of the Stipulation is February 6, 2003. Pursuant to the terms of the Stipulation, Metromedia was obligated to

pay $545,509.00 to EBS, which payment was deemed to extinguish both the EBS Administrative Claim and the Metromedia Administrative Claim. The parties, however, expressly preserved their respective rights and defenses regarding pre-petition claims against the others' estates. In addition, pursuant to the Stipulation, Metromedia was obligated to cease using the System and remove all equipment from the System. The Stipulation further provided that the EBS Agreements and any and all other agreements, whether written or oral, by and between EBS and Metromedia were deemed rejected and terminated pursuant to section 365 of the Bankruptcy Code.[1] Metromedia paid its obligation to EBS on account of the EBS Administrative Claim pursuant to the terms of the Stipulation.

EBS contends that by the express terms of the Stipulation, the settlement of the respective administrative expense claims and the rejection of the Agreements "did not constitute a waiver or release of the parties' respective rights to file or assert claims against each other for pre-petition amounts due under the Agreements or for damages arising out of the rejection of the agreements or to otherwise assert such rights or claims for any purposes."

EBS further argues that the rejection of the Agreements by Metromedia resulted in damages in favor of EBS in the amount of $54,166,748.40 (the "EBS Rejection Damage Claim"). EBS did not file

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[1]According to the parties, the Lease and Service Agreements previously were rejected by the Debtors on September 27, 2002. On that date, Enron sent notice to Metromedia that it was rejecting the Lease and Service Agreements, pursuant to this Court's Amended Order, dated April 11, 2002, establishing the procedures by which the Debtors were permitted to reject their executory contracts and unexpired leases. Indeed, Metromedia treated the Lease and Service Agreements as having been rejected effective as of September 27, 2002 because less than one month later, it filed the Metromedia Administrative Claim Application in which it sought payment of an administrative claim concerning the Lease and Service Agreements "from the date that EBS filed for bankruptcy protection through the date of the Notice of Rejection, effective September 27, 2002."

a proof of claim in the Metromedia's bankruptcy cases for the EBS Rejection Damage Claim, however, it did file a proof of claim for obligations totaling $3,749,983.29 ("EBS's Performance Claim")[2] allegedly owing to EBS under the Agreements for periods prior to Metromedia filing for bankruptcy protection.

EBS objects to Metromedia's Unsecured Claims and seek to expunge them in their entirety based upon EBS's right to set off the EBS Unsecured Claims, in the amount of $54,166,748.00, against Metromedia's Unsecured Claims totaling $24,711,625.43. As the EBS Unsecured Claims exceed the total of the Metromedia Unsecured Claims, EBS argues that the EBS Unsecured Claims fully offset and extinguish the Metromedia Unsecured Claims.

Discussion

Section 553 of the Bankruptcy Code permits the setoff of mutual debts that arose before the commencement of the case. *In re Bennett Funding Group, Inc.*, 146 F.3d 136, 138-39 (2d Cir. 1998). The section preserves whatever rights of setoff a party has under applicable non-bankruptcy law. *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18, 116 S.Ct. 286, 289, 133 L. Ed. 2d 258 (1995). A setoff concerns a defendant reducing a plaintiff's claim against it by its claim against the plaintiff which arises out of a different transaction than the one upon which the plaintiff basis its claim. *Holford v. Powers (In re Holford)*, 896 F.2d 176, 178 (5th Cir.1990). The debts are considered mutual when the debtor and creditor each incurred its debt to the other in the same right or capacity.

[2]By this Court's Order, dated December 18, 2003, approving a motion filed by EBS, EBS sold EBS's Performance Claim to Liquidity Solutions, Inc., pursuant to section 363 of the Bankruptcy Code for $487,497.81.

Bennett Funding, 146 F.3d at 139; *Westinghouse Credit Corp.*, 278 F.3d at 149.

Pursuant to section 365(a) of the Bankruptcy Code, and subject to court approval, a trustee[3] "may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). In determining whether to approve a trustee's decision to reject such lease or contract, a court applies the "business judgment" test which is met if the rejection is beneficial to the estate. *In re Klein Sleep*, 78 F.3d at 25.(citations omitted). The rejection of the lease or contract is deemed a breach of the lease or contract as of the date immediately preceding the bankruptcy filing. 1 U.S.C. 365(g)(1).[4] *Nostas Assocs. V. Costich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18, 26 (2d Cir. 1996). The counter-party to that lease or contract is left with a pre-petition claim against the debtor's estate for that breach. *Id*. Rejection, while treated as a breach, does not terminate the lease or contract.[5] *Medical Malpractice Ins. Ass'n v. Hirsch (In re Lavigne)*, 114 F.3d 379, 387 (2d Cir. 1997).

Treating rejection as a pre-petition breach affords the non-debtor party a claim against the bankruptcy estate; however, state law must be consulted to determine the parties' rights concerning the contract and its breach. *Id*. Thus, if the relevant jurisdiction requires mitigation of damages, then the calculation of the total damages would have to take account of that fact prior to application of any

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[3]This includes a chapter 11 debtor in possession who, pursuant to 11 U.S.C. § 1107, has the rights and powers and can perform all of the functions and duties of a trustee.

[4]11 U.S.C. § 365(g)(1) provides, in relevant part, that the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease-

> (1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition.

[5]Except in certain limited situations that would not be applicable to any rejection by Metromedia, as a lessee, of the EBS Agreements. *See* 11 U.S.C. §§ 365(h) & (i).

relevant cap on the damage award. *See In re Fifth Avenue Jewelers*, 203 B.R. 372, 381 (Bankr. W.D. Pa. 1996).

Parties' Contentions

As previously noted, the Debtors object to Metromedia's Unsecured Claims asserting that because the EBS Rejection Damage Claim is greater, it can setoff the competing claims which extinguishes Metromedia's Unsecured Claims. EBS maintains that any rejection damage claim it has against Metromedia is a pre-petition damage that is incurred in the same capacity as Metromedia's pre-petition rejection damage claim against EBS and the debts would be considered mutual and subject to setoff.

The Claimant argues that EBS's objection is barred by the Stipulation. The Claimant contends that the terms of the Stipulation, including the carefully drafted recitals, establish that it was EBS, and not Metromedia, that rejected the contract. Specifically, the Claimant directs the Court's attention to the recital clause in the Stipulation that provides that "EBS seeks to reject the EBS Agreements and any and all other agreements, whether written or oral by and between EBS and Metromedia effective as of January 31, 2003." The Claimant asserts that there was no indication that Metromedia was seeking to reject any agreements between the parties. The Claimant argues that it was EBS that had a strong interest in rejecting the EBS Agreements based upon its business judgment. The Claimant further asserts that EBS wanted to finalize the rejection "without any ability to revisit the issue" and for that purpose, the Stipulation provided that "Metromedia hereby waives any right to seek any extension or reinstatement of the EBS Agreements." The Claimant maintains that it merely consented to EBS's decision to reject the EBS Agreements and agreed to this term of the Stipulation presumably to allow

EBS to reject the EBS Agreements in the context of Metromedia's bankruptcy filing. According to the Claimant, because EBS sought to reject the EBS Agreements, it cannot claim that it was damaged by its own election to reject them. In addition, the Claimant contends that by electing to reject the EBS Agreements, EBS is estopped or has waived its right to seek damages based on that rejection. The Claimant argues that the rejection was precisely what EBS sought and it cannot now claim the right to damages for that rejection.

EBS argues that, pursuant to the Stipulation, EBS and Metromedia each rejected the EBS Agreements simultaneously. Therefore, EBS argues that it seeks rejection damages for Metromedia's rejection from Metromedia's estate and Metromedia seeks rejection damages for EBS's rejection from EBS's bankruptcy estate. EBS further argues that because the EBS Rejection Damage Claim is greater, it can be offset against Metromedia's Unsecured Claims. To support this view, EBS also references the Stipulation, specifically, the decretal paragraph wherein the parties expressly preserved their respective rights and defenses regarding pre-petition claims against the others' estates.

Finally, even if EBS has a valid rejection damage claim, the Claimant contends that EBS has not met its burden to establish the amount of the claim. The Claimant argues that EBS's calculation of the EBS Rejection Damage Claim is based on the amount that Metromedia would have paid the Debtor under the remaining term of the EBS Agreements. The Claimant contends that by utilizing the expected revenue under the EBS Agreements as the basis of its claim, EBS ignores any potential expenses and obligations that might reduce the value of its claims, including an obligation to mitigate damages, the uncertainty of how subsequent events and circumstances could impact on its claim, present valuation considerations, and any other defenses available to the Claimant. The Claimant argues that the mere

assertion of an unadjudicated claim cannot serve as a basis to establish that such claim offsets and extinguishes the adversary's claim. Rather, the Claimant urges that to exercise a right to setoff, the party seeking it must prove the validity of the claim upon which it basis its purported right to setoff. Here, the Claimant contends that EBS has not submitted any evidence establishing the validity of the EBS Rejection Damage Claim.

EBS argues that it has met it burden to establish the amount of the claim and has calculated it pursuant to section 502(b)(6) of the Bankruptcy Code.

Analysis

The Court has considered the terms of the Stipulation and concludes that the Stipulation does not reflect a simultaneous rejection by EBS and Metromedia. There is no specific reference in the Stipulation to a rejection by Metromedia of the EBS Agreements. The Stipulation specifically references that EBS was seeking to reject the EBS Agreements. In addition to the specific language in the Stipulation, EBS's counsel advised the Court that it was rejecting these contracts. However, other than EBS's argument that you can infer from the Stipulation that Metromedia rejected the relevant contracts, there is no allegation that either party advised the Metromedia bankruptcy court that Metromedia was rejecting such contracts. Metromedia argues that it merely acquiesced to EBS's decision to reject the EBS Agreements in the EBS bankruptcy cases. Further, the Stipulation not only authorized the rejection of the EBS Agreements by EBS, it also authorized their termination. As the terms of the Stipulation only reference EBS as electing to reject the EBS Agreements, the Court concludes that only EBS rejected the EBS Agreements.

A party to a contract would only have a rejection damage claim if the other party to the

executory contract or unexpired lease were under bankruptcy protection and rejected such lease or contract. Inasmuch as Metromedia did not reject the EBS Agreements, EBS does not have a rejection damage claim that it can assert against the Metromedia bankruptcy estate stemming from the EBS Agreements.

Moreover, the parties' actions after entering into the Stipulation support this interpretation. While Metromedia filed Metromedia's Unsecured Rejection Claim in the EBS case, EBS did not file a proof of claim in Metromedia's case for the putative EBS Rejection Damage Claim. EBS argues that it may assert a viable rejection damage claim against Metromedia defensively as a setoff even if it may not affirmatively collect upon such claim against Metromedia's estate because it failed to timely file such claim. Even if this interpretation accurately reflects the law,[6] it does not explain why EBS would not file a claim in the Metromedia case and would, thereby, forgo the excess value of its claim. It is simply not plausible that if EBS had a claim in an amount in excess of $54 million, it would choose not to file a proof of claim against Metromedia but use it only as a defense to Metromedia's Unsecured Claims valued at under $25 million. It is not credible that if it were confident that it had such a claim, it would forfeit the right to assert the balance of the claim of in excess of $29 million dollars against the Metromedia estate. Thus, the parties' action after entering into the Stipulation further support the Court's conclusion that, pursuant to the terms of the Stipulation, EBS rejected the EBS Agreements in its case but Metromedia did not reject it in the Metromedia case.

Further, under the facts of this case, even if the Stipulation were intended to effectuate a

[6]As subsequently noted in footnote 8, the Court does not reach this issue.

simultaneous rejection by both debtors, EBS could not establish a rejection damage claim against Metromedia for Metromedia's rejection of the EBS Agreements under such Stipulation. As previously noted, the rejection of a contract is only relevant when a party seeking to cease performing under the contract is in bankruptcy. Therefore, if there were a simultaneous rejection by counter-parties who were both debtors, each debtor would be considered a non-rejecting party in the other's bankruptcy with respect to that debtor's rejection.[7] In the context of each case, the non-rejecting party would assert a rejection damage claim in the other's case.

EBS argues that, by entering into the Stipulation, the parties intended to effect a simultaneous rejection of the EBS Agreements. If Metromedia intended for the approval of the Stipulation to constitute its rejection of the EBS Agreements also, then EBS would be a rejecting lessor of the EBS Agreements in the EBS case and Metromedia would be considered a rejecting lessee of the EBS Agreements in the Metromedia case. Further, the EBS Rejection Damage Claim would be a pre-petition claim against Metromedia's estate. Although EBS refers to the term of the EBS Agreements wherein the parties reserved their respective rights to assert pre-petition damage claims, that clause also reserved each parties right to assert any available defense. Therefore, any pre-petition claim asserted by EBS was subject to Metromedia defenses.

As the EBS Rejection Damage Claim is considered a pre-petition damage claim, state law

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[7]The parties have not addressed the impact of the automatic stay or whether relief from it was necessary in the context of a contract or lease where both counter-parties are under bankruptcy protection and each debtor consents to rejection by the other in its case with their respective bankruptcy court's approval. Further, since no party in interest has raised the issue, the Court does not address it.

would have to be consulted to determine the parties' rights concerning the breach. Pursuant to the EBS Agreements, Oregon law governs the Master Lease and the Collocation Agreement, and Texas law governs the IRU Agreement. Metromedia could therefore assert any state law defenses that it had to the EBS Rejection Damage Claim. Under both Oregon and Texas state law, it appears that a party charged with the breach of a contract may assert as a defense that such contract was breached by the other party first and therefore, its further performance was excused. *cf. Wasserburger v. American Scientific Chemical, Inc.*, 267 Or. 77, 82, 514 P.2d 1097 (1973) (noting that, generally, Oregon law requires that "a party seeking to recover damages for an alleged breach of contract must plead *and* prove either substantial performance on his part or a valid excuse for his own failure to perform."); *Compass Bank v. MFP Financial Services, Inc.*, 152 S.W.3d 844 (Tex. App. Dallas 2005) (noting that if a "party to a contract commits a material breach of that contract, the other party is discharged or excused from any obligation to perform.")

While the parties may assert any rejection damage claim in the other's bankruptcy case, the absence of specific terms in the Stipulation waiving each other's state law defense that the rejector's nonperformance was induced by the other results in neither party being able to establish a right to such damages. This is because if the parties intended that the Stipulation would effect a simultaneous rejection of the EBS Agreements and the termination of those agreements, then each party would be estopped from asserting that the other party wrongfully harmed it by terminating performance under the agreements. In fact, each party induced the other party to enter into the Stipulation and thereby gave their assent to the termination of the EBS Agreements and the halting of performance. Moreover, not only did the parties not waive any defenses but they specifically preserved any defenses they each had

to the other's asserted pre-petition claims. Therefore, neither party could establish a rejection damage claim based upon the other's rejection of the EBS Agreements. Metromedia's Unsecured Rejection Claim, however, is not based upon the rejection of the EBS Agreements. Rather, it stems from EBS's rejection of the Lease and Service Agreements.

Inasmuch as EBS does not have a feasible rejection damage claim to assert against Metromedia stemming from EBS Agreements, it cannot seek to set off such claim against Metromedia's Unsecured Claims stemming from the Lease and Service Agreements.[8] Therefore, EBS's Objection to Metromedia's Unsecured Claims is overruled.

Metromedia's counsel is to settle an order consistent with this Court's Opinion.

Dated: New York, New York
March 24, 2006

s/ Arthur J. Gonzalez
UNITED STATES BANKRUPTCY JUDGE

[8]In light of the Court's decision that neither party could establish a rejection damage claim stemming from the rejection of the EBS Agreements, it does not address the issue of whether rejection damage claims are subject to setoff under section 553 of the Bankruptcy Code.