Professional Perspective

Diamond Sports Illustrates Evolving Issues of Bankruptcy Law & Sports Broadcasting Rights

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Like all good Shakespearean dramas, the recently filed bankruptcy cases of Diamond Sports Group, LLC and certain affiliated entities in the US Bankruptcy Court for the Southern District of Texas started off with a swordfight. In this case the blood was spilled not from sabers but from the tips of attorneys' tongues, as Major League Baseball (MLB) and the debtors—owners and operators of 19 regional sports broadcasting networks—traded blows over the latter's refusal to make post-petition payments at the contract rate—or initially, any payments at all—under their Telecast Rights Agreements with a group of four MLB teams.

The dispute, which certain of the debtors' secured creditors fretted would turn into a "morass of litigation," raises unique legal issues concerning the fundamental process by which a debtor may go about deciding to assume or reject executory contracts under Bankruptcy Code Section 365, as well as unique business ones concerning the balance that sports leagues now seek to strike between licensing their rights to third party broadcasters, and broadcasting or selling the rights directly to consumers themselves.

Pay to Play: Contract Price or Something Else?

The ability to assume or reject unexpired leases executory contracts—a contract on which material performance remains due on both sides—is a cornerstone of the bankruptcy process that facilitates the overall goal of reorganizing or otherwise maximizing value of a debtor's business. The power of a Chapter 11 debtor to assume or reject executory contracts allows it to keep the contracts that are necessary and/or advantageous to its business—or assign them to third-parties—or shed itself of unnecessary or burdensome contracts, provided there is no non-bankruptcy law prohibition on any such assumption or assignment.

However, Congress in enacting Bankruptcy Code Section 365 struck a balance between the debtor's rights and the non-debtor counterparty's rights under executory contracts. If the debtor opts to assume or keep an executory contract, then under Bankruptcy Code Section 365(b)(1) the debtor must cure all monetary defaults under the contract—including the payment of any arrearages at the contract price—and provide "adequate assurance" that the debtor or assignee, as the case may be, will perform under the contract in the future. If the debtor rejects the contract, then under Bankruptcy Code Section 365(g) the non-debtor counterparty will have a breach of contract damages claim that will be deemed pre-petition.

At issue in the Diamond Sports case is what the parties' rights are while the bankrupt debtor decides whether to assume or reject the contract. A debtor that does not make required post-petition payments due on an executory contract does so at its peril, as failure to make such payments could lead to, among other things, a motion for relief from stay to terminate the contract under Bankruptcy Code Section 363(d)(1), or a motion to compel the debtor to make a prompt decision on whether to assume or reject under Bankruptcy Code Section 365(d)(2).

Further, the Supreme Court has endorsed the position that "[i]f a debtor-in-possession elects to continue to receive benefits from the other party to an executory contract pending a decision to reject or assume the contract, the debtor-in-possession is obligated to pay for the reasonable value of those services, which, depending on the circumstances of a particular contract, may be what is specified in the contract." See *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984). So, on that basis, counterparties to executory contracts with a bankrupt debtor may seek an administrative priority claim under Bankruptcy Code Section 503(b) for the value of the services provided post-petition and regular payments of such claim as adequate protection under Bankruptcy Code Section 363(e), essentially requiring payment of all post-petition obligations.

In Diamond Sports, MLB and the affected teams at issue requested precisely such an administrative claim and adequate protection payments for the value of the broadcast rights provided to the debtors post-petition under their Telecast Rights Agreements, arguing that the claim and payments should be in the amounts specified in the parties' contracts. The debtors, which at the time the motions were filed had not made any such payments to the affected MLB teams post-petition, argued that the contract rate is only the presumptive value to be used in setting such an administrative claim, and that the debtors should be able to pay only the "reasonable value of the rights for which the Debtors are obligated to pay" during the

pendency of the Chapter 11 case, which the debtors assert to be a lower amount that will be established by expert testimony.

At the April 13, 2023, preliminary hearing on the matter, the debtors asserted that while the Telecast Rights Agreements are the "lifeblood of their business," the contract price is "unreasonable," and the debtors intend to depose officials at MLB and introduce their own expert testimony in order to establish the "real value" of the rights at issue. The debtors argue that the contract rate is only the presumptive value provided to a debtor by a counterparty to an executory contract, and the debtors should be able to present evidence rebutting that presumption.

MLB seemingly conceded that the contract price is only the presumptive value for the purposes of this analysis, but highlighted that the league's broadcast rights are "unique, exclusive, and valuable IP" and noted that once the games are played, "we don't get those games back. We cannot rebroadcast [them]." The league further emphasized that "on a daily basis, the IP is being used and nothing is being paid," giving the debtors a "free ride." In other words, MLB emphasized the fact that intellectual property is unique, suggesting that deference be given to the contracting parties in assigning its value, and also emphasized the fact that games being broadcast are transitory and cannot be restored to the league, suggesting that the teams would be prejudiced by not receiving the contract price.

The parties have not yet fully briefed the issues, and an evidentiary hearing was set for May 31, 2023, to decide them. Pending that hearing, the Bankruptcy Court subsequently ordered the debtors to pay 50% of the contract price to the MLB teams in question, and to place funds equal to the remaining 50% in a segregated account.

It is worth noting that if the Telecast Rights Agreements are assumed, it is black letter law that any arrearages would need to be cured at the contract rate and the existing contract terms will need to be assumed—a debtor cannot "cherry pick" terms that it likes of an executory contract. So, if the debtors are successful in establishing some lower rate to be paid post-petition while they decide to assume or reject, there would be an ever-growing deficit between those payments and the contract price, making the cost of curing and assuming the contracts ever more cost prohibitive with each passing day, and thus, theoretically, ever more unlikely.

To DTC or Not DTC? That is the Question

In addition to raising unique issues of bankruptcy law, the dispute between MLB and the debtors in the Diamond Sports provides insight into the current state of the sports broadcasting business more broadly, in particular with respect to the bargaining positions of sports leagues and broadcasters as the business model of sports broadcasting evolves to one that is increasingly focused on direct-to-consumer (DTC) programming.

According to the filings in the case, the Telecast Rights Agreements at issue grant the debtors the exclusive right to broadcast the games of the MLB teams in question in their specified territories. MLB emphasized at the April 13, 2023, hearing the fact that the games of these teams "have to be broadcast" for the fans of said teams. Since the debtors have the infrastructure up and running to do these broadcasts, one might think this would give them significant bargaining power with MLB and the teams at issue.

Indeed, it is a common feature of many business bankruptcies that a debtor will separate its executory contracts and unexpired leases into roughly three groups: ones that the debtor will definitely assume—or assume and assign; ones that the debtor will definitely reject; and ones that the debtor might assume if the counterparty agrees to modifications of them in some way.

With that in mind, it is notable that in Diamond Sports, the debtors are only trying to reduce post-petition payments to four of the 16 MLB teams for which it has entered into Telecast Rights Agreements, meaning that presumably the other 12 teams are being paid post-petition at the contract rate. Further, the debtors offered at the April 13, 2023, hearing to escrow payments at the contract rate, but made that initial offer only with respect to two of the teams at issue.

In response, MLB noted at the April 13, 2023, hearing that it has set up a local media department to broadcast the games themselves in the event it becomes necessary to do so, asserting this to be necessary in order to maintain the league's relationship with its fans. This calls to mind not only the balancing act that sports leagues must now undertake between licensing broadcasting rights to third party broadcasters and broadcasting directly to consumers themselves, but also the fact that parties that once operated largely symbiotically—here, the regional broadcaster and the sports league—may find themselves to less in a symbiotic relationship and more in a competitive one as the business model evolves.

As the debtors noted in their first day declaration in the Diamond Sports case, their business is one that is "in transition" due to consumers cutting the cord. As a result, in addition to shifting from arrangements with multi-channel linear distributors—cable and satellite companies—to multi-channel streaming distributors—DirecTV Stream and FuboTV—the debtors are increasingly focused on their own direct-to-consumer programming on Bally Sports+.

Of course, MLB has its own direct-to-consumer service, MLB.TV, having been among the early adopters of that model. The debtors argued at the April 13, 2023, hearing that a "large part" of the reason why they assert the post-petition administrative claims to be lower than the contract price with the MLB teams in question is because the league has not approved the granting of DTC rights by the teams to the debtors. The debtors have fleshed this out in further briefing, arguing that "the Telecast Rights Fees are not 'reasonable' given the Debtors' inability to use the DTC rights," and that "MLB wants the rights back so it can 'nationalize' baseball's digital broadcasts."

The debtors argue that such approval is contemplated in the debtors' Telecast Rights Agreements with the teams, subject only to the approval of MLB, the league has withheld for over two years. The debtors in their April 28, 2023, brief filed in the case argue that the league is withholding approval of the DTC rights because "MLB wants to nationalize the DTC rights and monetize them for the sole benefit of MLB's thirty ownership groups." Hand in hand with the increased importance of the DTC rights, the debtors also argue that "the value of the traditional linear rights granted under the contracts have materially decreased" since the Telecast Rights Agreements with the four MLB teams were negotiated between 2010 and 2015.

The view in the other dugout is decidedly to the contrary. MLB and the four teams argue that the debtors are attempting to "rewrite" the Telecast Rights Agreements by refusing to pay the contract price and seeking to establish a lower value to be paid during bankruptcy. One team argued that the debtors "are forcing [the MLB teams] to fund their business" by using the teams' intellectual property, the value of which cannot be recaptured after the games are played, and not paying the contract rate for it.

The same team argued that "the entire risk of this bankruptcy not working" is being put on the MLB teams by forcing them to continue performing post-petition without compensation. Another team argued that the "Debtors are using the threat of non-payment to try to extract direct-to-consumer concessions from MLB and the teams." MLB and the four teams also requested relief from the automatic stay in order to terminate the Telecast Rights Agreements at issue.

Perhaps as a result of these shifting bargaining positions, the parties at the April 13, 2023, hearing could not even agree on whether to mediate. As happens so often in sports, this leaves the matter to the discretion of the umpire—in this case, Bankruptcy Judge Christopher Lopez.