

## **Purchase and Sale of Intellectual Property In Bankruptcy Cases**

### **The Association of the Bar of the City of New York Committee on Bankruptcy and Corporate Reorganization**

This report addresses the purchase and sale of intellectual property in a bankruptcy case from the perspective of the potential purchaser. A hypothetical set of facts has been created to highlight many of the hurdles and potential pitfalls that parties may face in attempting to purchase and sell such assets in a bankruptcy case. The report also poses the question as to whether Section 365(c) of the Bankruptcy Code should be amended to eliminate uncertainty for parties generated by inconsistent court rulings with respect to assumption of a nonexclusive license by a debtor licensee.

#### **Introduction**

When purchasing intellectual property from a bankruptcy estate, a purchaser needs to know what it is acquiring. Intellectual property such as trademarks, trade names, patents, copyrights and domain names may be treated differently in a bankruptcy case and the debtor may not have unfettered authority to sell certain types of intellectual property. Further, a purchaser needs to know whether the intellectual property to be acquired is owned by the debtor or is licensed to the debtor and, if licensed, whether the license is exclusive or nonexclusive.<sup>1</sup>

#### **Intellectual Property Defined**

What is intellectual property? Intellectual property is a legally protected interest in a concept that is reflected in restrictions on the exploitation of the creation. Intellectual property rights are generally transferable either by assignment or license. There are several categories of intellectual property, which include patents, copyrights, trademarks, trade secrecy and domain names.

Section 101(35A) of the Bankruptcy Code defines intellectual property as (A) trade secret; (B) invention, process, design or plant under title 35 (patent); (C) patent application; (D) plant variety; (E) work of authorship protected under title 17 (copyright); or (F) (semi-conductor chip) mask work protected under chapter 9 of title 17, to the extent protected by applicable nonbankruptcy law. The bankruptcy definition of intellectual property does not include trademarks.<sup>2</sup>

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<sup>1</sup> While an intellectual property license may be identified as an “exclusive” license, because there are many facets to the rights covered by a particular copyright or patent, the actual terms of the license should be carefully reviewed to determine whether the licensee has been granted all of the rights under the particular copyright or patent. For example, a licensee may be granted an exclusive license to exploit a patent to make, use or sell a particular device, but if the patent covers other devices, the licensor may have retained rights such that the licensee does not have the right to utilize all of the possible rights available.

<sup>2</sup> Trademarks were likely excluded from the definition of intellectual property because trademarks require continuing quality control by the licensor in order to retain its continued rights, unlike copyrights and patents where there is no continuing quality control obligation. Hence, imposing such quality control on a debtor trademark licensor under Section 365(n) of the Bankruptcy Code is arguably contrary to one of the fundamental aspects of rejecting executory contracts (*i.e.*, to relieve a debtor from burdensome ongoing obligations). *See*, Steven M.

## **Patent**

A patent is a legal monopoly on the exploitation of an invention, granted by the government for a limited period of time in exchange for public disclosure and eventual unrestricted public use of the invention. During the term of the patent, the owner may prevent others from making, using or selling the invention. The subject matter of patents may include (i) a new and non-obvious process, machine, manufactured item or composition of matter (utility patent), (ii) a new and non-obvious ornamental design for a manufactured article (design patent), or (iii) a new and distinct variety of plant which is invented or discovered and asexually reproduced (plant patent).

Patent rights are territorial and granted by a national government in response to an application by the individual inventor(s) or, in some countries but not the U.S., by the company employing the inventor(s). The application must be filed before the invention is publicly disclosed or (in the U.S. but not all other countries) within a limited time after public disclosure. Foreign applications based on an application in the inventor's home country must be filed within one year of the home country filing date to claim the benefit of the home country filing date.

Patent rights do not exist until an application has been approved and granted. The use of the phrase "patent pending" means only that an application has been filed (somewhere). Unless and until the patent application is granted, the invention may be copied without liability, but if the copying continues after the patent issues, the copier would be liable for patent infringement. The term of utility patents applied for since June 8, 1995, is 20 years from the date of application. (Previously, the term was 17 years from the date of issue.) The term of design patents is 14 years from the date of issue.

## **Copyright**

A copyright is the right to control the copying of original creative works or derivations thereof. The subject matter of a copyright may include the original and creative expression of an idea in tangible form (writing, photograph, recording, film, musical notation, source code, art, sculpture, and so forth). A copyright, however, does not protect the idea itself. Others are free to paraphrase the idea or to create their own expressions of the idea.

A copyright comes into effect automatically upon creation of a copyrightable work. The Berne Copyright Convention, to which the U.S. is a party, provides protection of copyright in nearly every country. No registration, publication or formal notice is required to create the copyright, but copyright owners should routinely include a copyright notice, *e.g.*, © 2001 by [Owner], to avail themselves of important procedural rights against potential infringers. U.S. copyright owners must register their copyrights as a prerequisite to filing suit for infringement.

The owner of a copyright is generally the individual(s) who created the work but, in the U.S., rights in a copyrightable work created by an employee in the scope of employment belong automatically to the employer, under the work-for-hire doctrine. Work-for-hire does not apply to independent contractors, who often must assign or license the rights to the contracting party.

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Abramowitz, *Protecting Intellectual Property Assets in Bankruptcy, Issues Relating to Bankruptcy of Licensor and Licensee*, ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, June 4, 2002.

The term of copyright for works created after January 1, 1978 is the life of the author plus 70 years. If under the work-for-hire doctrine, the author is a corporation or other legal entity, the term is the shorter of 95 years from the date of publication or 125 years from the date of creation.

### **Trademark**

A trademark is sometimes called “industrial property” and is a right to keep others from appropriating a distinctive commercial identity. The subject matter of a trademark may include a distinctive symbol (word, name, symbol, logo, slogan, sound, smell, trade dress, product shape) used to associate goods or services with a particular source. Trademark rights do not grant anyone an absolute monopoly on a particular word or logo, just the right to keep others from using the same or a very similar mark on or in association with the same or closely related goods or services, or from otherwise misleading customers into thinking that there is a commercial relationship with the trademark owner.

In the U.S. and other English law countries, common law rights in trademarks arise when the mark is used to identify and distinguish goods of one vendor from those of another. It is use of the mark that creates the recognition and the right to keep others from appropriating the mark for themselves.

The common law basis of trademarks in the U.S. is still evident in the requirement that U.S. applicants must use the mark before a federal registration will be issued. Countries outside the English law system typically base trademark rights on the filing for registration and, by treaty, non-U.S. applicants may obtain a U.S. registration without proving that the mark is in commercial use in the U.S. The term of a federal registration is 10 years, but it can be renewed indefinitely as long as the mark remains in use.

The owner of a trademark is presumed to control the quality of the goods or services sold under the mark. This can either be the company that manufactures and sells the goods or a company that licenses another to manufacture or sell the goods. The owner must exercise quality control as part of a license agreement or by ownership of the licensee/manufacturer.

### **Trade Secrecy**

Trade secrecy is a right to prevent disclosure of secret (non-public) business information. The subject matter of trade secrecy includes information that is secret and that is used in business for competitive advantage. As defined in the Uniform Trade Secrets Act, trade secrecy consists of information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

If a formula, idea or invention is not patented it can only be protected from exploitation by others through the owner’s efforts to keep it secret. If the secret is revealed, the owner may have a cause of action against a contractual partner or fiduciary who disclosed the secret without authorization, but, once disclosed, a trade secret is gone.

## **Domain Names**

A domain name is an electronic url address such as www.uscourts.org. Domain names are obtained by registering with the applicable domain authority (a registrar). Domain names are not licensed, even though they are obtained through a contract from one of many domain name registrars. As a general matter, domain names could be treated as “owned” intellectual property, similar to a trademark or copyright registration or a patent. Often, a domain name incorporates a trademark or trade name of the domain name registrant. In such cases, trademark issues may rise.

## **Executory Contract Defined**

Before a court will permit a debtor to assume, assign or reject an intellectual property agreement, it must first determine that the agreement is executory in nature. Bankruptcy courts must examine the practical effect of the agreement to determine if any of the “essential rights” in the underlying intellectual property have transferred an ownership interest, thus rendering the agreement non-executory.

One author has postulated that, in determining if the licensee has acquired a property interest, courts look for the three “bundles of rights”: (1) the right of exclusivity; (2) the right to transfer; and (3) the right to sue infringers. If these three rights have been transferred, then it is likely that the licensee will be imputed to have “title” to the intellectual property and the license agreement is generally outside the scope of Section 365 of the Bankruptcy Code. If less than all three rights have been transferred, courts generally find the rights to be merely contractual, and thus executory. Joshua M. Marks, *Protecting Your Intellectual Property License in Bankruptcy*, Arter & Hadden LLP, June 2001, available at: <http://library.lp.findlaw.com>.

Whether a contract is executory will depend on the terms of the particular contract and the degree to which the parties performed their respective duties as of the bankruptcy petition date. Affirmative covenants will generally render a contract executory. *See, e.g., Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985) (technology licensor’s duty to defend intellectual property rights, indemnify licensee and maintain confidentiality). Likewise, negative covenants have been determined to be sufficient to make a contract executory. *See, e.g., In re Rovine Corp.*, 5 B.R. 402 (Bankr. W.D. Tenn. 1980) (covenant not to compete); *In re Select-A-Seat Corp.*, 625 F.2d 290 (9th Cir. 1980) (exclusive licensor’s duty not to further license held sufficient).

Further, certain contracts that may facially appear to be executory may indeed not be executory. *See, e.g., In re Robert L. Helms Constr. & Development Co., Inc.*, 139 F.3d 702 (9th Cir. 1998) (unexercised option insufficient to make a contract executory because optionee has no duty to exercise option); *In re Bergt*, 241 B.R. 17 (Bankr. D. Alaska 1999) (right of first refusal not an executory contract when no sale was pending at the time of bankruptcy filing).

Finally, an executory contract on the date of filing of a bankruptcy petition that becomes non-executory post-petition may be rendered unassumable. *See, e.g., In re Government*

*Securities Corporation*, 101 B.R. 343, 349 (Bankr. S.D. Fla. 1989), *aff'd* 972 F.2d 328 (11th Cir. 1992).

Most licenses of intellectual property are considered “executory contracts” for purposes of bankruptcy law.<sup>3</sup> Patent licenses are deemed executory because the licensor commonly has an ongoing duty to defend infringement claims and to notify the licensee of any infringement proceeding. *In re Access Beyond Technologies, Inc.*, 237 B.R. 32 (Bankr. D. Del. 1999) (patent license is executory because there is “material duty” not to sue each other for infringement covered under the license); *Everex Systems, Inc. v. Cadtrax Corp. (In re CFLC, Inc.)*, 89 F.3d 673 (9th Cir. 1996) (patent license is an executory contract). Other business terms, like “most favoured nation” clauses (under which the licensor agrees to adjust fees downward if it gives a better rate to another licensee) or exclusivity terms, will likewise result in a finding that the contract is executory.

Copyright licenses are deemed executory if the licensor has ongoing obligations under the licensing agreement. *In re Qintex Entertainment, Inc.*, 950 F.2d 1492 (9th Cir. 1991); *In re Select-A-Seat Corp.*, at 290 (licensor’s obligation under exclusive software licensing agreement to refrain from suing for infringement).<sup>4</sup>

Trademark licenses are usually deemed executory because the licensor has ongoing obligation of quality control and the licensee has a payment obligation and continuing contractual duties under the license. *In re Blackstone Potato Chip Co., Inc.*, 109 B.R. 557, 560 (Bankr. D.R.I. 1990); *In re Chipwich, Inc.*, 54 B.R. 427 (Bankr. S.D.N.Y. 1985).

### **Applicable Bankruptcy Statutes and Rules**

The purchase and sale of intellectual property in a bankruptcy case is generally governed by Sections 363 and 365 of the Bankruptcy Code and Rules 2002, 4001, 6004 and 6006 of the Federal Rules of Bankruptcy Procedure.

Sections 363(b) and (f) of the Bankruptcy Code provide that a debtor may sell intellectual property free and clear of any interest in such property outside the ordinary course of business after notice and a hearing; *provided, however*, that

- (i) applicable nonbankruptcy law permits the sale,
- (ii) an entity holding an interest in the property consents to the sale,
- (iii) if the interest held by the entity is a lien that the price at which the property is to be sold is greater than the aggregate value of all liens on such property,

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<sup>3</sup> *RCC Tech. Corp. v. Sunterra Corp.*, 287 B.R. 864, 865 (D. Md. 2003), *rev'd on other grounds and remanded*, 361 F.3d 257 (4<sup>th</sup> Cir. 2004) (“intellectual property licensing agreements ... are executory contracts”); *In re Golden Books Family Entertainment, Inc.*, 269 B.R. 300, 314 (D. Del. 2000) (courts usually hold intellectual property license as executory contracts, citing *In re Access Beyond*, 237 B.R. 32 (Bankr. D. Del. 1999)).

<sup>4</sup> One author has suggested that cases such as *In re Stein and Day Inc.*, 81 B.R. 263 (Bankr. S.D.N.Y. 1988), and *In re Learning Publication, Inc.*, 94 B.R. 963 (Bankr. M.D. Fla. 1988), holding that a copyright license is not an executory contract if all the licensor does is collect royalties, are probably no longer good law. See Stuart M. Riback, *Intellectual Property Licenses: The Impact of Bankruptcy*, 722 PLI/PAT 203 (2003).

(iv) the interest is in *bona fide* dispute, or

(v) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Section 365 of the Bankruptcy Code provides that a debtor may assume or reject an executory contract<sup>5</sup> such as an intellectual property license, subject to various statutory conditions and exceptions as will be more fully discussed in this article. The purpose of Section 365 of the Bankruptcy Code is to “benefit the estate” by allowing the debtor to assume “beneficial” executory contracts and reject “burdensome ones.” *Schachter v. Lefrak (In re Lefrak)*, 223 B.R. 431, 434 (Bankr. S.D.N.Y. 1998). Unless otherwise directed by the court, the debtor must perform its duties under an executory contract during the bankruptcy proceeding. If the debtor does not perform its duties, the non-debtor party may file a motion compelling performance or seek relief from the automatic stay to terminate the contract.

In a Chapter 11 case, the debtor can assume, reject or assign an executory contract until the date of plan confirmation. In a Chapter 7 case, an executory contract is “deemed rejected” unless it is assumed within 60 days after the order for relief, or within the additional time as the court extends for cause before expiration of the sixty-day period. 11 U.S.C. § 365(d)(1). If there has been a default in an executory contract or unexpired lease, the debtor may not assume such contract unless, at the time of assumption of such contract, the debtor cures the default, compensates the other party for actual pecuniary loss, and provides adequate assurance of future performance under such contract.

A debtor, however, has no ability to assume a contract that was terminated under state law prior to commencement of the bankruptcy case.<sup>6</sup> *Emplexx Software Corp. v. AGI Software, Inc. (In re AGI Software, Inc)*, 199 B.R. 850 (Bankr. D.N.D. 1995) (software license terminated pre-bankruptcy); *In re Texscan Corp.*, 107 B.R. 227 (9th Cir. BAP 1989) (contract expired under own terms), *aff’d on other grounds*, 976 F.2d 1269 (9th Cir. 1992). Whether a contract or lease has terminated pre-petition is a question of state law. See 11 U.S.C. § 541(b)(2) (nonresidential real property lease that is terminated or expires pre-petition is not property of the estate). *But*

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<sup>5</sup> The Bankruptcy Code does not define an executory contract. However, a majority of bankruptcy courts apply the Countryman definition of an executory contract which states that a contract is executory where both the debtor and the non-debtor party have unperformed obligations such that failure of either to complete performance would constitute a material breach excusing the performance of the other. Vern Countryman, *Executory Contracts and Bankruptcy*, 57 MINN. L. REV. 439 (1973). See *In re Texscan*, 976 F.2d 1269 (9th Cir. 1992); *In re Select-A-Seat Corp.*, 625 F.2d 290 (9th Cir. 1980); *In re Coast Trading Company, Inc.*, 744 F.2d 686, 692 (9th Cir. 1984); *In re Sundial Asphalt Co., Inc. v. V.P.C. Investors Corp. (In re Sundial Asphalt Co., Inc.)*, 147 B.R. 72, 79 (E.D.N.Y. 1992) (referencing the Countryman definition in an action permitting re-consideration of a debtor’s motion to reject an executory contract); *South Chicago Disposal, Inc. v. LTV Steel Co., Inc. (In re Chateaugay Corp.)*, 130 B.R. 162, 164 (S.D.N.Y. 1991) (applying Countryman in determining that an executory contract did not exist where performance on one side had been fully rendered); *In re Telegent, Inc.*, 268 B.R. 723, 729-730 (Bankr. S.D.N.Y. 2001) (adopting the Countryman definition in finding a merger agreement with various on-going obligations was an executory contract). Whether sufficient performance remains due on both sides in order for the contract to be executory must be analyzed on a case-by-case basis.

<sup>6</sup> However, pre-petition termination of an executory contract or lease which has value to the bankruptcy estate may constitute an avoidable transfer. See e.g., *In re Edward Harvey Co., Inc.*, 68 B.R. 851 (Bankr. D. Mass. 1987); see generally Robert E. Goodman, Jr., *Avoidance of Lease Terminations as Fraudulent Transfers*, 43 BUS. LAW. 807 (1988).

*see, e.g., In re Waterkist Corp.*, 775 F.2d 1089 (9th Cir. 1985) (possession of leasehold premises coupled with state anti-forfeiture laws may allow debtor to assume purportedly terminated lease); *Bell v. Alden Owners, Inc.*, 199 B.R. 451, 458 (S.D.N.Y. 1996) (turning to state law in determining whether a pre-petition lease is terminated); *EBG Midtown South Corp. v. McLaren/Hart Environmental Engineering Corp. (In re Sanshoe Worldwide Corp.)*, 139 B.R. 585, 594 (E.D.N.Y. 1992) (same), *aff'd*, 993 F.2d 300 (2d Cir. 1993); *In re Reinhardt*, 209 B.R. 183, 187 (Bankr S.D.N.Y. 1997) (possession of residential leasehold premises during period in which state court extended time to cure default constituted an interest in property belonging to the lessee/debtor's estate).

Upon assumption, the Chapter 11 debtor is obligated to continue to perform all duties under the executory contract. A breach of the contract by the debtor after assumption results in a post-petition claim entitled to priority as an administrative claim under 11 U.S.C. §§ 507(a)(1) and 503. *Nostas Associates v. Bernard W. Costich (In re Klein Sleep Prods.)*, 78 F.3d 18, 30 (2d Cir. 1996).

### **The Hypothetical**

New Acquisition Corp. ("New Corp.") is interested in purchasing certain assets from the bankruptcy estate of Widget IP Corp. ("WIPC"), including WIPC's intellectual property assets. WIPC operates a research and design facility and develops, manufactures and markets widgets on a worldwide basis. The bankruptcy court has approved procedures for WIPC to conduct a sale of its assets pursuant to Sections 363 and 365 of the Bankruptcy Code. Among the assets to be sold are patents, trademarks, tradenames, copyrights and the domain name used by WIPC to develop, manufacture and market its widgets.

In addition to owning various patents, trademarks, copyrights and its domain name, WIPC also licenses certain intellectual properties from third parties. One of these licensors is New Corp.'s competitor, Mega IP Corp. ("Mega Corp"). Mega Corp. has indicated to WIPC that it would object to any of its licenses falling into the hands of New Corp.<sup>7</sup> Furthermore, WIPC recently sold to Mega Corp. a portion of the royalty stream to the copyright of I-Widge, one of its more successful software programs. New Corp. insists that the I-Widge copyright be included as part of the sale. New Corp. is interested in acquiring WIPC's assets, including the intellectual property, but is concerned that it be able to acquire all of the intellectual property that is necessary to continue to develop, manufacture and market widgets on a worldwide basis as WIPC had done.

As bankruptcy and intellectual property counsel to the Purchaser, New Corp., your law firm needs to advise New Corp. as to whether or not it will be able to acquire all of WIPC's intellectual property assets that it will need to develop, manufacture and market widgets.

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<sup>7</sup> The Mega Corp. license contains conditional assignment rights which include the right to assign the license to affiliates or to unrelated third parties with Mega Corp.'s consent, which consent shall not be unreasonably withheld.

## **The Intellectual Property Audit**

One of the first tasks that New Corp. should perform is to identify all of WIPC's intellectual property interests and then to review all relevant documentation and public filings to confirm the nature and extent of the WIPC's interests in its intellectual property. There are many variations of intellectual property audits, the simplest being a review of a list of intellectual property rights as may be provided by the debtor. More comprehensive intellectual property audits may include: (i) reviewing physical files of the debtor; (ii) reviewing products and marketing materials of the debtor to identify intellectual property rights which may have been used by the debtor; (iii) conducting searches of the government or other public databases and records for issued, registered or pending rights; and (iv) title and lien searches. One practical note is that license rights are not always recorded, and the debtor's files of such licenses may be difficult to identify.

## **Legal Analysis of Intellectual Property Rights**

Once the intellectual property audit is complete and New Corp. is satisfied that WIPC either owns or licenses all the intellectual property that it wants to acquire, an analysis of the legal interests of various parties with respect to the intellectual property and how their respective rights will be treated in WIPC's bankruptcy case must be performed.

### **Assumption of Intellectual Property Licenses Pursuant to Section 365 of the Bankruptcy Code**

WIPC's ability to assume any nonexclusive patent or copyright licenses involving intellectual property that it licenses from third parties such as Mega Corp. or others is controlled by Section 365(c)(1) of the Bankruptcy Code which provides:

The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if

(1) (A) applicable law excuses a party, other than the debtor, to such contract from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment.

Section 365(c)(1) of the Bankruptcy Code provides that a debtor may not assume an executory contract without the non-debtor's consent if applicable law precludes assignment of the contract to a third party. Courts, however, interpret this section differently. Compare *In re Catapult Entm't, Inc.*, 165 F.3d 747, 749-50 (9th Cir.), *cert. dismissed*, 528 U.S. 924 (1999), with *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir.), *cert. denied*, 521 U.S. 1120 (1997).



Thus, a debtor, subject to the approval of the bankruptcy court, may assume any executory contract of the debtor.<sup>8</sup> The threshold question presented in our hypothetical, therefore, is whether WIPC can assume the intellectual property licenses it plans to assign, transfer and sell to New Corp. free and clear of any interests. As noted, WIPC's ability to assume any intellectual property license (assuming it is an executory contract) is governed by Section 365 of the Bankruptcy Code.

Pursuant to Section 365, a debtor may assume and assign an executory contract so long as the debtor (1) cures outstanding defaults under the contract or provides adequate assurance of prompt cure; (2) compensates or provides adequate assurance to a party who had suffered actual pecuniary loss due to the default; and (3) provides adequate assurance of future performance under the contract. 11 U.S.C. § 365(b)(1)(A)-(C).<sup>9</sup> And, in the event that the debtor wishes to assign the contract to a third party, adequate assurance of performance by the proposed assignee must be demonstrated. 11 U.S.C. § 365(f)(2)(B).

In determining whether adequate assurance of future performance has been provided, courts consider the extent and history of the debtor's past defaults, whether the debtor's financial data demonstrates an ability to generate an income stream sufficient to meet the contract obligations, the general economic outlook in the debtor's industry, and the presence of a guarantee or other security. Generally, the debtor may assign such contract despite a contractual provision prohibiting or limiting assignment. 11 U.S.C. § 365 (e)(1).

These requirements, however, do not apply to "defaults that are a breach of a provision relating to" (1) the "insolvency or financial condition of the debtor"; (2) the "commencement" of a bankruptcy case; (3) the "appointment of or taking possession" by a trustee or a custodian; or (4) "the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract." 11 U.S.C. § 365(b)(2).

However, even if the contract lacks an anti-assignment clause, the debtor may not assume or assign the contract if (1) "applicable law excuses a party, other than the debtor to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or debtor-in-possession, whether or not such contract or lease prohibits or

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<sup>8</sup> Courts generally view the decision to assume, reject, or assign an executory contract an issue of the debtor's business judgment. *NLRB v. Bildisco & Bildisco*, 104 S. Ct. at 1195; *In re TWA*, 261 B.R. 103, 120 (Bankr. D. Del. 2001) ("A debtor's determination to reject an executory contract is governed by the business judgment test"); *In re Klein Sleep*, 78 F.3d at 30 (the "judicial finding" must be made in determining whether the debtor's assumption of a certain lease was in the "best interest" of the estate); *In re Market Square Inn, Inc.*, 978 F.2d 116, 121 (3d Cir. 1992) (assumption or rejection of an executory contract is a matter of business judgment.) However, even under the business judgment test, courts balance equity between the parties to executory contracts. 11 U.S.C. §365(b). *Info Systems Technology v. Logical Software*, 1987 U.S. Dist. LEXIS 6285, at \*3 (the test is whether the party whose contract is to be rejected will be damaged disproportionately to any potential benefit to the debtor or its estate); *In re Petur USA Instrument Co.*, 35 B.R. 561 (Bankr. W.D. Wash. 1983) (rejection of patent agreement would drive the nondebtor out of business); *In re Midwest Polychem, Ltd.*, 61 B.R. 559 (Bankr. N.D. Ill. 1986) (resulting large claim for rejection eliminates any business rationale).

<sup>9</sup> The assumption of an executory contract transforms the contract into a post-petition obligation giving rise to an administrative expense claim against the estate. *In re Klein Sleep Products, Inc.*, 78 F.3d at 21 (holding that "damages arising from future rent under an assumed lease must be treated as an administrative expense").

restricts assignment of rights or delegation of duties” and (2) “[the nondebtor] party does not consent to such assumption or assignment.” 11 U.S.C. § 365(c). Thus, the debtor’s right to assume or assign is not absolute. *In re Supernatural Foods*, 268 B.R. 759 (Bankr. M.D. La. 2001).

### **Assumption of Nonexclusive Patent Licenses**

#### **The “Hypothetical Test” Under *Catapult***

The treatment of *nonexclusive* patent licenses under the Bankruptcy Code has been addressed by a number of courts. Patent license agreements commonly include anti-assignability clauses limiting the licensee’s ability to transfer rights without the licensor’s consent. Nonexclusive patent licenses are executory contracts that generally may be assumed or rejected, because each party to the contracts owes material continuing performance to the other. *See Everex Sys. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 677 (Bankr. S.D.N.Y. 1997). Nevertheless, a debtor may not assign a nonexclusive patent license to a third party, absent consent of the licensor, because federal patent law precludes the holder of a nonexclusive license from assigning it.<sup>10</sup> *CFLC*, 89 F.3d at 679.

In *CFLC*, the debtor-licensee moved to assume a nonexclusive patent license and assign it to a buyer unrelated to the debtor. The licensor objected on the basis that Section 365(c) of the Bankruptcy Code prevented the assignment because applicable federal common law precludes the assignment of nonexclusive patent licenses. The Circuit Court agreed with the licensor that federal patent law was “applicable law” under Section 365(c) of the Code and that, under federal patent law, nonexclusive licensees may not assign patent licenses without the licensor’s consent.<sup>11</sup> *CFLC*, 89 F.3d at 679.

In addition to the proscription on a debtor-licensee’s ability to assign a nonexclusive patent license, a debtor licensee may face the threat of the loss of its patent license altogether. In *In re Catapult Entm’t, Inc.*, 165 F.3d at 749-50, *Catapult*, the debtor-in-possession, sought court approval to assume two nonexclusive patent licenses. The licensor objected.

*Catapult* argued that Section 365(f)(1) of the Bankruptcy Code “provides that executory contracts, once assumed, may be assigned notwithstanding any contrary provisions contained in the contract or applicable law.” *Catapult* posited that Section 365(c)(1) should not be read to prohibit assumption because that would result in Section 365(f)(1) having no meaning. The Ninth Circuit, however, disagreed stating that the “applicable law” referenced in Section 365(c)(1) to determine whether a contract can be assumed is the law relating to whether a licensor is excused from accepting performance from another licensee, while the “applicable law” referenced in Section 365(f)(1) relates to whether a contract can be “assigned,” notwithstanding the identity of the proposed assignee.

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<sup>10</sup> These issues may not arise in connection with an *exclusive* patent license. In such a case, the assignee may distinguish between non-exclusive license and exclusive license for a particular field of business or market (latter may not be considered exclusive license such that it constitutes an assignment) and exclude others from using the patented technology. In effect, the assignee does not need to assume the right; the assignee already owns it. *See In re Access*, 237 B.R. at 44 (*dicta*). However, one court has held that an exclusive patent license is assignable despite the objection of the licensor under Section 365(c)(1). *In re Supernatural*, 268 B.R. at 779.

<sup>11</sup> Similar principles appear to apply in the case of nonexclusive copyright licenses. *See In re Patient Educ. Media, Inc.*, 210 B.R. 237, at 242-243 (Bankr. S.D.N.Y.) (following *CFLC*’s rule for nonexclusive copyright licenses).

Catapult further argued that Section 365(c)(1) is internally inconsistent when read to prohibit assumption of an executory contract by a debtor. This argument was similarly overruled by the Ninth Circuit. The Court found that Section 365(c)(1) requires a determination as to whether “applicable law” permits assumption and assignment (i) where the debtor wants to assume and even if the licensor has consented to assumption by the debtor or (ii) if the debtor wants to assign the executory contract.

The Ninth Circuit further rejected Catapult’s argument that, since the types of contracts described in Section 365(c)(2) are nonassignable under state law, Section 365(c)(2) was necessary because subsection (c)(1) would permit nonassignable contracts to be assumed notwithstanding applicable law. The Ninth Circuit dismissed this argument saying that the uniformity of state law limiting assignability of the types of contracts described in subsection (c)(2) was the reason for the apparent internal inconsistency.

The Ninth Circuit applied what has become known as the “hypothetical test” and found that, if, under applicable law, a debtor is not allowed to assign an executory contract to a third party without the non-debtor party’s consent, then the debtor-in-possession cannot assume the contract even though the debtor-in-possession may have no intention of assigning it to a third party. *Id.* at 750.

The Ninth Circuit found that federal patent law constituted applicable law under which nonexclusive patent licenses are “personal and assignable only with the consent of the licensor” (quoting *CFLC*, 89 F.3d at 680) and held that a debtor-in-possession’s inability to assign a nonexclusive patent license precludes that debtor-in-possession from assuming the license as well.

In addition to the *Catapult* decision, three other federal appellate courts and a number of lower courts have also interpreted Section 365(c)(1) as creating a “hypothetical test” pursuant to which a debtor-in-possession is precluded from assuming an executory contract without the non-debtor’s consent if a hypothetical assignment would be prohibited under applicable law. *See Cinicola v. Sharffenberger*, 248 F.3d 110, 127 (3d Cir. 2001) (acknowledging its previous holding that “365(c)(1) created hypothetical test”); *In re James Cable, L.P.*, 27 F.3d 534 (11th Cir. 1994) (same); *In re Sunterra Corporation*, 361 F.3d 257 (4<sup>th</sup> Cir. 2004) (debtor must “obtain the nondebtor’s consent to assume the contract, and it must thereafter obtain the nondebtor’s consent to assign the contract”); *In re Access Beyond Technologies, Inc.*, 237 B.R. at 45 (debtor-in-possession may not assume or assign nonexclusive patent license without licensor’s consent); *In re West Elec.*, 852 F.2d 79 (3d Cir. 1988); *In re Catron*, 158 B.R. 629, 638 (E.D. Va. 1993) (same), *aff’d without opinion*, 25 F.3d 1038 (4th Cir. 1994).

### **The “Actual Test” Under *Institut Pasteur***

The *Catapult* decision, however, has not been uniformly followed. In *In re Institut Pasteur*, 104 F.3d at 489, the First Circuit Court of Appeals held that a debtor may assume a nonexclusive patent license agreement in connection with a transfer of its stock to another entity without the consent of the licensor. The First Circuit rejected the “hypothetical test” adopted by *Catapult* in favor of an “actual test” which involves a case-by-case inquiry into whether the non-debtor party is actually being forced to accept performance from an unrelated third party.

In *Institut Pasteur*, the debtor-in-possession moved to assume a patent license agreement and to confirm a plan that provided for transfer of the debtor's stock to a subsidiary of a direct competitor of the licensor. The licensor objected to the stock transfer because it would cause a *de facto* assignment of the license to a direct competitor. *In re Institut Pasteur*, 104 F.3d at 490-91. The First Circuit overruled the objection and permitted the debtor-in-possession to assume the license agreement and transfer its stock. The Circuit Court found that the fact that federal common law prohibits the assignment of patent licenses to third parties does not preclude a debtor-in-possession from consummating a transaction whereby it assumes the patent license agreement and transfers its stock to a third party. *Id.* at 493-94.

The “actual test” requires the court to conduct a “case-by-case inquiry into whether the nondebtor [is] ‘forced to accept performance under its executory contract from someone other than the debtor party with whom it actually contracted.’” *In re Institut Pasteur*, 104 F.3d at 493. A majority of bankruptcy courts interpret Section 365(c)(1) as containing an “actual test” and find that the language of Section 365(c) requires that it must be read to prevent the specific action (either assumption or assignment) that is prohibited by the applicable law. *In re Supernatural*, 268 B.R. at 773 n.39. *See In re Cajun Elec. Power Coop., Inc.*, 230 B.R. 693, 705 (Bankr. M.D. La. 1999) (rejecting “hypothetical test”); *In re Lil’ Things, Inc.*, 220 B.R. 583, 587 (Bankr. N.D. Texas 1998) (same); *In re GP Express Airlines, Inc.*, 200 B.R. 222, 232 (Bankr. D. Neb. 1996) (same); *In re Ontario Locomotive & Indus. Ry. Supplies (U.S.) Inc.*, 126 B.R. 146, 147-48 (Bankr. W.D.N.Y. 1991) (same) (order subsequently vacated on other grounds); *see generally* Daniel J. Bussell & Edward A. Friedler, *The Limits on Assuming and Assigning Executory Contracts*, 74 AM.BANKR.L.J. 321 (2000) (critiquing “hypothetical test”). The actual test focuses on the debtor's actual intent to assign. *In re TechDyn Sys. Corp.*, 235 B.R. 857, 860-61 (Bankr. E.D. Va. 1999).

### **The “Ride-Through” Approach**

To circumvent the effect of the “*hypothetical test*,” one bankruptcy court has permitted a license to “ride through” a Chapter 11 case without requiring that it either be assumed or rejected. *See In re Hernandez*, 287 B.R. 795 (Bankr. D. Ariz. 2002) (license could “ride through” the Chapter 11 case and be binding on the reorganized debtor). Among the factors considered in *Hernandez* were (1) the damage that other party to contracts would suffer, beyond compensation available under the Bankruptcy Code; (2) the importance of the contracts to the debtor's business and reorganization; (3) whether the debtor has had sufficient time to appraise its financial situation and potential value of its assets in formulating a plan; and (4) whether the exclusivity period has terminated. *Hernandez*, 287 B.R. at 806. There is some support for the “ride through” approach. In *In re National Gypsum Co.*, 208 F.3d 498, 504 (5th Cir. 2000), the Fifth Circuit stated that “[i]f an executory contract is neither assumed or rejected, it will ‘ride through’ the proceedings and be binding on the debtor even after a discharge is granted, thus allowing the non-debtor's claim to survive the bankruptcy.” *Id.* at 504 n.4 (citing *Federal's, Inc. v. Edmonton Inv. Co.*, 555 F.2d 577, 579 (6th Cir. 1977)).

Commentators have also recognized that a “ride through” strategy to avoid the “hypothetical test” may be an option available to the debtor licensee. *See, e.g.*, Mark R. Campbell and Robert C. Hastie, *Executory Contracts: Retention Without Assumption in Chapter 11 - “Ride Through” Revisited*, 19 AM. BANKR. INST. J. 33, 34-35 (2000). These commentators

note that, because the Bankruptcy Code contains no formal requirement that a Chapter 11 debtor assume or reject an executory contract, a debtor licensee may simply allow the license to “ride through” the bankruptcy proceeding and have it vest in the reorganized debtor.

Other commentators have questioned the viability of the “ride through” strategy because the failure to assume an executory contract may result in the license being deemed rejected. *See e.g.,* David R. Kuney, *Intellectual Property Law in Bankruptcy Court: the Search for a More Coherent Standard in Dealing With a Debtor’s Right to Assume and Assign Technology Licenses*, 9 AM. BANKR. INST. L. REV. 593, 636 (2001) (citing *Sea Harvest Corp. v. Riviera Land Co.*, 868 F.2d 1077, 1079 (9th Cir. 1998) (the statutory presumption of rejection, unless the debtor or trustee acts affirmatively to assume a lease, protects the estate from unexpected liability)). *See also In re Access Beyond Techs., Inc.*, 237 B.R. at 47, where the bankruptcy court held that the *Catapult* problem cannot be avoided by attempting to sell the license without assumption because, until assumed, an executory contract is not an asset of the estate and cannot be sold.

To summarize, a literal reading of 11 U.S.C. § 365(c) suggests that if an executory contract may not be assigned under applicable non-bankruptcy law then it cannot even be assumed by the debtor (the “hypothetical test”). A less literal reading of the statute has led some courts to look to whether actual assignment will occur (the “actual test”).

### **A Legislative Solution**

This split among the courts may affect WIPC’s ability to assume its licenses. This problem could be consensually resolved or could be resolved by Congress through an amendment to Section 365(c) of the Bankruptcy Code which would allow a debtor licensee to assume a license if, in its business judgment, there were a benefit to be conferred upon its estate and no substantial harm or prejudice to the licensor.<sup>12</sup>

From an historical perspective, the original derivation of the concepts underlying Section 365(c) pertained to prohibitions on assumption or assignment of personal services contracts, and financial accommodation contracts. These were clearly intended by Congress to be non-assumable even if executory. However, the broad language of 365(c)(1) and the lack of expressed legislative intent to the contrary have resulted in a continuing expansion of the scope of 365(c), beyond personal services contracts and financial accommodation agreements, to military and other governmental contracts, and to patent, copyright and trademark licenses. Increasingly, the impact of the “non-assignment means non-assumption” school of thought can severely impact a debtor’s reorganization capabilities and recoveries by creditors.

A lot of time and effort is devoted in the case law to discussing possible confusion caused by differences between 365(c)(1) and 365(f) but, as interpreted in the majority of cases, the sections are not really inconsistent, as 365(f) simply overrides applicable law that prohibits assignment where non-assignment is a matter of contracts, as opposed to a matter of “applicable

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<sup>12</sup> Attached to this Article as Exhibit A is a copy of a proposed amendment to Section 365(c) of the Bankruptcy Code prepared by The Association of the Bar of the City of New York, Committee on Bankruptcy and Corporate Reorganization, entitled “A Proposed Revision to 11 U.S.C. Section 365(c)(1) Regarding a Debtor/Trustee’s Right to Assume Executory Contracts Where Assignment is Prohibited by Law, dated January, 2005.

non-bankruptcy law.” The real problem is relatively simple: should bankruptcy law countenance restrictions on a trustee’s or debtor-in-possession’s right to assume executory contracts (with the full panoply of cure obligations) simply because applicable non-bankruptcy law prohibits assignment of such contracts to a third party without the counterparty’s consent?

Obviously, the precise wording of such an amendment may need to be analyzed by legal scholars and advisers to assure that the rights of all interested parties are reasonably addressed. However, the substantive effect of any amendment should be to preserve the going concern value of a Chapter 11 debtor licensee by allowing it to assume licenses that are necessary to continue its business. Stated differently, a debtor licensee should not be forced to cease operating its business because the bankruptcy statute prohibits assumption of its key license agreement(s).

As things stand today, if the licensor has conditionally consented to assignment in the license itself, the license should be assumable and assignable, subject to the relevant assignment conditions. Additionally, because Section 365(c)(1) does not compel rejection by a date certain, a debtor licensee may be able to use the license during the administration of its estate for so long as it remains in a Chapter 11 proceeding. While this may not solve the problem entirely, it may create enough leverage for the licensee to broker a deal with the licensor at some point during the Chapter 11 case.

### **Assumption of Nonexclusive Copyright and Trademark Licenses**

A number of courts have held that nonexclusive copyright licenses are nonassignable without consent of the licensor under the Copyright Act. *See Emmylou Harris v. Emus Records Corporation*, 734 F.2d 1329 (9th Cir. 1994) (court refused to approve an assignment of a nonexclusive recording copyright license because of the personal nature of the contract); *In re Patient Educ. Media, Inc.*, 210 B.R. at 240 (holding generally that nonexclusive copyright licenses are nonassignable because the Copyright Act protects rights that are designed to “motivate the creative activity of authors and inventors” that include the right to control who uses materials under copyrights); *In re Valley Media, Inc.*, 279 B.R. 105, 135 (Bankr. D. Del. 2002) (nonexclusive copyright licenses are nonassignable without consent of the licensor under Copyright Act).

Further, WIPC’s assumption of any nonexclusive trademarks may be affected by statutory restrictions imposed under 15 U.S.C. § 1060 which require that a mark may not be assigned alone, but only together with the goodwill associated with it. Therefore, if New Corp. takes a trademark “in gross” without the associated goodwill, its rights in the mark will be voided. *See Marshak v. Green*, 746 F.2d 927 (2d Cir. 1984); *Clark & Freeman Corp. v. Heartland Co. Ltd.*, 811 F. Supp. 137 (S.D.N.Y. 1993); *Matter of Roman Cleanser Co.*, 802 F.2d (6th Cir. 1986); *In re Specialty Foods of Pittsburgh, Inc.*, 91 B.A. (W.D. Pa. 1988); *Bambu Sales, Inc. v. Sultana Crackers, Inc.*, 683 F. Supp. 899 (E.D.N.Y. 1988) Thus, New Corp. must be sure to acquire the goodwill and business associated with any of WIPC’s trademarks that it acquires.

### **Assumption of Exclusive Copyright Licenses**

As to assignability of exclusive copyright licenses, the courts are split.<sup>13</sup> The Ninth Circuit has held that exclusive copyright licenses are nonassignable without consent of licensor because the Copyright Act prohibits such assignment. *Gardner v. Nike, Inc.*, 279 F.3d 774, 780 (9th Cir. 2002) (exclusive copyright license non-assignable); *Ward v. National Geographic Society*, 208 F. Supp. 2d 429, 442 (S.D.N.Y. 2002) (agreeing with *Gardner*); *In re Hernandez*, 285 B.R. at 806-809 (holding that an exclusive patent license was not assignable without the consent of licensor and fellow licenses because under federal patent law such assignment is likewise prohibited). Other courts have disagreed. *In re Golden Books Family Entertainment, Inc.*, 269 B.R. 300 (Bankr. Del. 2001) (holding the copyright license was assignable because it was exclusive); *ITOFCA Inc. v. Mega Trans Logistics, Inc.*, 2003 U.S. App. LEXIS 4024, at \*38 (7th Cir. 2003) (citing *In re Golden Books* that exclusive licenses can be assigned without the licensor's consent); *Murray v. Franke-Misal Techs. Group LLC*, 268 B.R. 759 (Bankr. M.D. La. 2001).

### **Licensee Protections Under Section 365(n) of the Bankruptcy Code**

On October 18, 1998 Congress amended § 365 of the Bankruptcy Code to protect non-debtor licensees of intellectual property. 11 U.S.C. § 365(n). Now, in the event that a debtor licensor rejects a license, the non-debtor licensee may elect to treat the contract as terminated or retain its rights for the duration of the contract and any applicable extensions. If the licensee elects to retain its rights, it must make all royalty payments and waive claims and offset rights for prior non-performance and any administrative expense claims arising under Section 503(b) of the Bankruptcy Code. Section 365(n) further requires the debtor licensor to continue to provide the licensee with the intellectual property during the period prior to assumption or rejection of the license.

The protections afforded by Section 365(n), however, can trap the unwary. For example, a sale free and clear of liens and encumbrances may be subject to the § 365(n) rights of licensees even if the licenses are not assigned under the purchase agreement. In *In re Cellnet Data Systems.*, 327 F.3d 242 (3rd Cir. 2003), *substantially* all of the intellectual property assets of the debtor were purchased free and clear from liens and encumbrances pursuant to an agreement, except for certain licenses between the debtor and one licensee. The debtor subsequently rejected licenses that were not included in the sale. Pursuant to § 365(n), the licensee, whose license had been rejected, elected to retain its rights and continued to make royalty payments. The purchaser claimed a right to the royalty payments based on ownership of the underlying intellectual property. The bankruptcy court, however, held that the royalties were tied to the rejected license, not the intellectual property, and thus the royalties belonged to the debtor.

However, a licensee of intellectual property may lose its rights in the event of a sale free and clear of liens and encumbrances. In *In Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003), the Seventh Circuit held that despite the protections granted by § 365(h), a real property lessee's interest in its premises was extinguished by a sale free and clear

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<sup>13</sup> An exclusive copyright license with a retained termination right upon default may be treated as a completed sale with a retained security interest, rather than as an executory contract. *See generally* Schuyler M. Moore, *Entertainment Bankruptcies, The Copyright Act Meeting the Code*, 48 BUS. LAWYER 567 (1993).

of liens and encumbrances under § 363(f). The Circuit Court stated that “Congress authorized the sale of estate property free and clear of ‘any interest,’ not ‘any interest except a lessee’s possessory interest.’” Like § 365(n), § 365(h) grants certain protections to lessees, allowing them to remain in possession for the balance of the lease term following a rejection of the lease by the debtor/landlord. *Id.* at 548. By analogy, the Seventh Circuit’s logic could be equally applicable to the interest of a licensee of intellectual property to retain its rights under § 365(n).

### **Trademarks Are Not Treated as Intellectual Property Under Bankruptcy Code**

Section 101(35)(A) of the Bankruptcy Code defines intellectual property as including trade secrets, inventions and works of authorship protected under Title 17, but does not include trademarks. Thus, a non-debtor licensee of trademarks is not protected under § 365(n) of the Code in the event of rejection of the license agreement. *See In Licensing by Paolo, Inc. v. Sinatra (In re Gucci)*, 126 F.3d 380 (2d Cir. 1997) (Section 365(n) does not apply to trademarks); *In re HQ Global Holdings, Inc.*, 2003 Bankr. LEXIS 146, at \*14-15 (Bankr. D. Del. 2003) (“Trade names, trademarks and other proprietary marks are expressly excluded from the definition of intellectual property”); *In re Centura Software Corp.*, 281 B.R. 660 (Bankr. N.D. Cal. 2002) (“§ 365(n) governs intellectual property rights post-rejection and it explicitly excludes “trademarks”).

Thus, a non-debtor licensee of trademarks is not protected under § 365(n) in the event of rejection of the license agreement. This is an important exclusion from § 365(n) protections. In *Gucci*, licensees of the debtor’s trademark appealed the sale of the trademark. The licensees argued that the purchaser was not a good-faith purchaser under 11 U.S.C. § 363(m) because the purchaser intended to terminate the trademark.

The Second Circuit disagreed. The Circuit Court held that that Section 365(n) did not apply to trademarks and therefore concluded that the protections provided to licensees of “intellectual property” under Section 365(n) of the Bankruptcy Code, including any challenge to a purchaser’s good faith of such assets, were irrelevant in connection with a good faith inquiry. *See id.*

### **Conclusion**

As this report demonstrates, the purchase and sale of intellectual property in bankruptcy cases is an evolving area of the law. Thus, a purchaser of such assets should keep abreast of case law and statutory developments to properly structure such transactions.

Two statutory provisions that play a significant role in the purchase and sale of intellectual property are Sections 365(n) and 365(c)(1) of the Bankruptcy Code. Section 365(n) was enacted by Congress in 1988 to protect a licensee in the event that its license is rejected by a debtor licensor. One of the primary purposes of Section 365(n) is to allow the licensee to elect to perform and receive benefits under the license, subject to certain limitations, even though the licensee has been rejected by the licensor. On the other hand, Congress has not addressed Section 365(c)(1) which deals with, among other things, the right of a debtor licensee to assume a licensee agreement without the consent of the licensor. In fact, Section 365(c)(1) has generated a substantial split among Circuit and lower courts as to how it is to be applied.



In the beginning of this report, we posed a question as to whether a legislative amendment to Section 365(c)(1) of the Bankruptcy Code would resolve the conflict in the courts. We believe such an amendment is necessary. A copy of proposed amendment, which we support, is attached to this report. If the proposed amendment were to be considered and adopted by Congress, it reasonably follows that transaction risk could be reduced and more certainty created in the purchase and sale of intellectual property in bankruptcy cases.

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

COMMITTEE ON BANKRUPTCY AND CORPORATE REORGANIZATION

A PROPOSED REVISION TO 11 U.S.C. SECTION 365(c)(1)  
REGARDING A DEBTOR/TRUSTEE'S RIGHT TO ASSUME EXECUTORY  
CONTRACTS WHERE ASSIGNMENT IS PROHIBITED BY LAW

JANUARY, 2005

There is a long and troubled record of disparate decisions out of Federal Bankruptcy Courts, District Courts and Courts of Appeal grappling with the language, Congressional intent, and impact of 11 U.S.C. Section 365(c)(1) on a Debtor's rights to assume, or assume and assign, contracts where assignment is prohibited by applicable law. The lower courts in particular have tried to circumvent the clear language of Section 365(c)(1) (which prohibits assumption or assignment where applicable law prohibits assignment), in order to facilitate the reorganization of a debtor and/or maximize the value of its assets, where doing so requires the continuation of a contract otherwise terminable under Section 365(c)(1). Many courts have been confused by the scope of Section 365(c)(1), or have found it to be in conflict with the provisions of Sections 365(a) and 365(f), and other Courts have tried to find other structural ways around the provisions of Section 365(c)(1) (e.g., finding that the acquisition of the stock of a debtor by an otherwise prohibited assignee is not a violation of the non-assignment provisions of Section 365(c)(1)).<sup>14</sup> A lot of time and

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<sup>14</sup> See *West Electronics Inc.*, 852 F.2d 79 (3d Cir. 1988)(Chapter 11 Debtor could not assume pre-petition contract with federal gov't where federal law prohibited assignment of contract without government's consent, formulating "hypothetical" test prohibiting debtor-in-possession from assuming contract if applicable law prohibited assignment to a third party other than the debtor or debtor-in-possession; reversing lower courts' approval of assumption); See also *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 534, 538 (11th Cir. 1994) (lower courts rejected hypothetical test, finding that 365(c)(1) did not prohibit assumption; court of appeals allowed assumption of municipal cable franchise on grounds that City ordinance prohibiting assignment was not "applicable law" prohibiting assignment, but rather a contractual anti-assignment clause invalid

effort is devoted in the case law to discussing possible confusion caused by differences between Sections 365(c)(1) and 365(f), but as interpreted in the majority of cases, they are not really inconsistent, as Section 365(f) simply overrides applicable law that prohibits assignment where non-assignment is a matter of contract, as opposed to a matter of "applicable non-bankruptcy law."

The difficulties courts sitting in Bankruptcy have in determining that a Debtor cannot assume contract rights that may be critical to its business or valuable to its creditors, because applicable non-bankruptcy law prohibits assignment without consent, underlie the multitude of conflicting, inconsistent rulings on these issues. These conflicting rulings include a split of interpretation of Section 365(c)(1) in the Circuits, between those that view Section 365(c)(1) as establishing a "hypothetical test" which prohibits assumption if assignment would be prohibited, and those that view the issue in the context of an "actual test," whether the debtor actually intends to assign or not.<sup>15</sup> The majority of Circuit Courts favor the hypothetical test, because the language of Section 365(c)(1) is straightforward, and there is no clear legislative history to the contrary.<sup>16</sup> However, this is not a desirable result in terms of Bankruptcy policy, and many if not most lower courts strain to reach a different conclusion, because the "no assumption if no assignment" outcome potentially is so chilling to the interests of Debtors and their general creditor constituents.

The original derivation of the concepts underlying Section 365(c) pertained to prohibitions on assumption or assignment of personal services contracts, and financial accommodation contracts. These were clearly intended by Congress to be non-assumable even if executory. However, the

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under 365(f) ); But See *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997) (rejected hypothetical test, applying "actual performance" test, holding that sale of stock of debtor company holding license to a competitor of licensor was not an assignment to a new entity, upholding lower court findings). In *In re Sunterra*, 361 F.3d 257 (4<sup>th</sup> Cir. 2004), the Court of Appeals applied the "hypothetical test" as consistent with the literal meaning of the statute, referring parties to Congress to seek modification of result that is at odds with bankruptcy policy; reversing lower courts' holdings rejecting hypothetical test as causing "absurd" and unintended results.

<sup>15</sup> See *In re Sunterra Corp.*, 361 F.3d 257 (4<sup>th</sup> Cir. 2004) (holding that hypothetical test is proper test for assumption of non-exclusive patent license); *Perlman v. Catapult Entm't, Inc.* (*In re Catapult Entm't, Inc.*), 165 F.3d 747, 749-50 (9<sup>th</sup> Cir. 1999)(same); *In re James Cable Partners, L.P.*, 27 F.3d at 537 (11<sup>th</sup> Cir. 1994) (applying hypothetical test); *In re West Elecs. Inc.*, 852 F.2d 79, 83 (3<sup>rd</sup> Cir. 1988) (same); but see *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d at 493 (1<sup>st</sup> Cir. 1997) (rejecting hypothetical test, in favor of pragmatic "actual performance" test for assumability).

<sup>16</sup> See *In re Catapult Entm't, Inc.*, 165 F.3d 747 at 750 (opining that actual test requires courts to rewrite § 365(c); reading the "plain language of § 365(c)(1)" as supporting hypothetical test).

broad language of Section 365(c)(1) and the lack of expressed legislative intent to the contrary, has resulted in a continuing expansion of the scope of Section 365(c), beyond personal services contracts and financial accommodation agreements, to military and other governmental contracts, and to patent, copyright and trademark licenses, and other types of agreements.<sup>17</sup> Increasingly, the "non-assignment means non-assumption" school of thought can severely impact a debtor's reorganization capabilities and recoveries by creditors. This is at odds particularly with the rehabilitative intent of Chapter 11, but also with policies applicable to contracts in Chapter 7 liquidations, which preserve asset values for creditors.<sup>18</sup>

The real problem is relatively simple: should bankruptcy law countenance restrictions on a trustee's or debtor-in-possession's right to assume executory contracts (with the full panoply of cure obligations) simply because applicable non-bankruptcy law prohibits assignment of such contracts to a third party without the counterparty's consent? Most practitioners, on both the debtor and creditor side, would say "No".

The legislative solution would be easy: amend section 365(c) to differentiate between limited, generally accepted instances where a trustee cannot assume or assign an executory contract or unexpired lease (e.g., a financial accommodation agreement, a personal services contract, or a lease that has expired), and instances where assumption is permitted but assignment is prohibited without consent (namely, any other agreements where the trustee can otherwise meet the statutory requirements for assumption).

Attached hereto is (i) the current version of 11 U.S.C § 365(c)(1), (ii) the proposed revision, and (iii) a blackline comparing the original with the revisions. We urge that this revision be enacted.

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<sup>17</sup> See *In re Access Beyond Tech., Inc.*, 237 B.R. 32 (Bankr. D. Del. 1999) (preventing assignment of patent license, based on hypothetical test); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 241 (Bankr. S.D.N.Y. 1997) (prohibiting assignment of copyright license based on consideration of 365(c) and the underlying purpose of federal copyright law, the encouragement of creative endeavors); *West Elecs.*, 852 F.2d at 83 (finding government's contract with debtor to buy military equipment was non-assumable); *In re Catron*, 158 B.R. 629 (E.D. Va. 1993) (holding that hypothetical test rendered partnership agreement non-assumable without consent of non-debtor party).

<sup>18</sup> Among other problems, there doesn't seem to be any consideration in the case law of the conflicts between prohibiting assumption based on governmental statutes prohibiting assignment, and the provisions of Section 525 of the Bankruptcy Code, which prohibit discrimination by governmental units based on a debtor's bankruptcy filing.



Original 11 U.S.C. Section 365(c)(1)

(c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1) (A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment; or

(2) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor;

(3) such lease is of nonresidential real property and has been terminated under applicable nonbankruptcy law prior to the order for relief; or

(4) such lease is of nonresidential real property under which the debtor is the lessee of an aircraft terminal or aircraft gate at an airport at which the debtor is the lessee under one or more additional nonresidential leases of an aircraft terminal or aircraft gate and the trustee, in connection with such assumption or assignment, does not assume all such leases or does not assume and assign all of such leases to the same person, except that the trustee may assume or assign less than all of such leases with the airport operator's written consent. [No longer effective]

**Proposed Revision to 11 U.S.C. Section 365(c)(1)**

(c)(1) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, without the consent of the counterparty, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(A) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor;

(B) such contract is a personal services contract; or

(C) such lease is of nonresidential real property and has been terminated under applicable nonbankruptcy law prior to the order for relief.

(2) The trustee may assume in accordance with the provisions of this Section 365, but may not assume and assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if-

(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption and assignment; provided, however, that such contract or lease shall be assignable to the extent and under the circumstances provided for in such contract or lease, if any.

Blackline

(c)(1) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, without the consent of the counterparty, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

~~(1) (A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and~~

~~\_\_\_\_\_ (B) such party does not consent to such assumption or assignment; or~~

~~(2A) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor;~~

~~**(B) such contract is a personal services contract; or**~~

~~(3C) such lease is of nonresidential real property and has been terminated under applicable nonbankruptcy law prior to the order for relief; or,~~

~~(4) such lease is of nonresidential real property under which the~~

~~**(2) The trustee may assume in accordance with the provisions of this Section 365, but may not assume and assign any executory contract or unexpired lease of the** debtor is the lessee of an aircraft terminal or aircraft gate at an airport at which the debtor is the lessee under one or more additional nonresidential leases of an aircraft terminal, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if-~~

~~**\_\_\_\_\_ (A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if-**~~  
~~aircraft gate and the trustee, in connection with such assumption or restricts assignment, does not~~



~~assume all such leases or does not assume and assign all of such leases to the same person, except that the trustee may assume or assign less than all of such leases with the airport operator's written consent. [No longer effective].~~ **of rights or delegation of duties; and**

**(B) such party does not consent to such assumption and assignment; provided, however, that such contract or lease shall be assignable to the extent and under the circumstances provided for in such contract or lease, if any.**