BANKRUPTCY LAW360

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Assuming Patent, Technology Licences Under Ch. 11

Thursday, Dec 20, 2007 --- Lawmakers' efforts to overhaul the nation's bankruptcy laws two years ago as part of the sweeping reforms implemented by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") failed to resolve a number of important business bankruptcy issues that have been and continue to be the subject of protracted debate among the bankruptcy and appellate courts.

One lingering controversy concerns restrictions in the Bankruptcy Code on the ability of a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to assume "executory" contracts that cannot be assigned without consent under applicable non-bankruptcy law.

On one side of the divide stand the circuit courts of appeal for the Third, Fourth, Ninth and Eleventh Circuits. These courts, applying the "hypothetical test," have held that section 365(c)(1) of the Bankruptcy Code should be strictly interpreted to prohibit the assumption of any unassignable contract, whether or not the DIP or trustee intends to assign it.

Arrayed against them is the First Circuit as well as the great majority of lower courts, which have applied the "actual test" in ruling that unassignable contracts can be assumed if the DIP intends to continue performing under them.

Yet another view — the Footstar approach — permits a DIP to assume such a contract, but not a bankruptcy trustee. A ruling recently handed down by a New Mexico bankruptcy court suggests that the Tenth Circuit Court of Appeals may soon have an opportunity to weigh in on the issue.

In In re Aerobox Composite Structures, LLC, the court adopted the actual test and the Footstar approach, holding that a chapter 11 debtor licensee was not precluded from assuming a patent and technology license agreement.

Assumption, Rejection and Assignment of Executory Contracts

Section 365(a) of the Bankruptcy Code allows a DIP or bankruptcy trustee to "assume" (reaffirm) or "reject" (breach) most kinds of contracts or agreements that are in force — in bankruptcy parlance, "executory" — as of the bankruptcy filing date.

In a chapter 11 case, the decision to assume or reject contracts (other than non-residential real property leases) can be made at any time prior to confirmation of a chapter 11 plan, unless the court orders otherwise upon

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request of the non-debtor contracting party.

This latitude affords the DIP an opportunity to determine which of its executory contracts should be retained because they are beneficial and which should be jettisoned.

The advantages of having the ability to assume or reject contracts extend beyond relief from onerous obligations that may be instrumental to the success of a reorganization.

This is so because the Bankruptcy Code allows a DIP or trustee to extract value from favorable contracts and leases by first assuming a contract and then assigning it to a third party for consideration.

Under section 365(f)(1), moreover, assignment is generally permitted "notwithstanding a provision in an executory contract...or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease."

Despite the broad powers granted to a DIP or trustee in this respect, certain parties that contract with a debtor are granted special protection by the Bankruptcy Code.

Section 365(c) of the statute provides that a DIP or trustee may not "assume or assign" an executory contract or unexpired lease if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession" and such party does not consent to assumption or assignment.

Courts have applied this provision to a wide variety of contracts. Among these are personal service contracts, including employment agreements, contracts with the United States government, which cannot be freely assigned under federal law, certain kinds of franchise agreements, and licenses of intellectual property, which cannot be assigned without consent under federal intellectual property law.

Thus, many debtors (especially those in the technology industry) find that their options with respect to certain executory contracts are significantly limited.

The Statutory Muddle

Few (if any) courts quarrel with the proposition that section 365(c) prevents a debtor from assigning a contract without the non-debtor’s consent if the contract cannot be assigned outside of bankruptcy without it.

The language of section 365(c), however, would seem to mean that a debtor cannot assume the contract and agree to perform under it, even if the debtor has no intention of assigning the contract to a third party.

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The confusion stems from the statute's use of the phrase "may not assume or assign" instead of "assume and assign." Many courts construe this language to mean that the statutory proscription applies to a debtor who seeks either: (i) to assume and render performance under the agreement; or (ii) to assume the agreement and assign it to a third party. Under this literal interpretation, the court posits a hypothetical question: Could the debtor assign the contract to a third party under applicable non-bankruptcy law? If the answer is no, the debtor may neither assume nor assign the contract.

This approach is commonly referred to as the "hypothetical test." The Third Circuit applied it in In re West Electronics, Inc., ruling that the debtor could not assume a contract with the federal government calling for production of military equipment because federal law prohibited assignment of the contract without the government's consent. The Fourth, Ninth and Eleventh Circuits have also adopted this approach.

Key Points

A widening rift exists among the circuit and lower courts concerning the ability of a DIP to assume an executory contract if applicable non-bankruptcy law excuses the non-debtor contracting party from accepting performance from or rendering performance to anyone other than the debtor.

Courts have developed three different approaches to the issue.

Under the "hypothetical test," a DIP cannot assume or assign such a contract.

Under the "actual test," a DIP will be prohibited from assuming such a contract only if it intends to assign the contract to a third party.

Under the Footstar approach, a DIP may assume such a contract, but a bankruptcy trustee may not.

Congress had an opportunity to resolve this controversy when it enacted BAPCPA in 2005, but the reforms made no changes to section 365(c)(1). It may be left to the U.S. Supreme Court to address an issue that is of vital importance to licensees of intellectual property and patents.

Other courts have determined that the phrase "may not assume or assign" should be read to mean "may not assume and assign," and they apply the statutory proscription only when the debtor actually intends to assign the contract to a third party.

This approach is commonly referred to as the "actual test." Prominent among its adherents is the First Circuit, which ruled in Institut Pasteur v. Cambridge Biotech Corp. that federal common-law and contractual restrictions against assignment of patents did not preclude assumption of a patent by a chapter 11 debtor.

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The vast majority of lower courts considering the issue have adopted this approach to section 365(c)(1). Also, the Fifth Circuit applied the actual test in construing the Bankruptcy Code's exception to the prohibition against enforcement of ipso facto clauses that act to terminate or modify a contract as a consequence of a bankruptcy filing.

Many courts have rejected the literalist hypothetical test because it arguably flies in the face of the general goals of chapter 11 in permitting licensees to benefit from the protections of bankruptcy law while encouraging maximization of the economic value of the estate.

Moreover, these courts suggest, the odd result required by the hypothetical test, which effectively allows the non-debtor party to free itself from some kinds of contracts simply because of the debtor's bankruptcy filing, cannot be supported by any recognized bankruptcy policy.

Finally, actual test adherents emphasize that the relevant language of section 365(c)(1) appears to be a simple drafting error — lawmakers meant "and" but said "or."

The provision's scant legislative history does little to resolve the controversy. In its current form, the provision likely had its genesis in a 1980 House amendment to an earlier Senate technical corrections bill.

That amendment was accompanied by an obscure committee report, which states in relevant part:

This amendment makes it clear that the prohibition against a trustee's power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition had been filed because of the personal nature of the contract.

The First Circuit relied on the 1980 report in adopting the actual test, but other courts find it unpersuasive in divining what Congress intended in section 365(c).

In In re Footstar, Inc., the bankruptcy court adopted a slightly different test predicated upon the legal distinctions between the debtor and the DIP, on the one hand, and the bankruptcy trustee, on the other.

The court reasoned that the term "trustee" in section 365(c)(1) should not automatically be read (as it is in many other provisions "as a matter of simple logic and common sense") as synonymous with the term "debtor-in-possession," such that the proscription of assumption and assignment is limited to situations where a trustee, rather than a DIP, seeks to assume an executory contract.

Under the Footstar approach, the DIP would be precluded from assigning a

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qualifying contract because assignment would force the non-debtor contracting party to accept performance from or render performance to an entity other than the debtor, but the DIP can assume the contract because, unlike a bankruptcy trustee, the DIP is "not an entity other than itself."

According to the court, this approach is consistent with both the language and purpose of section 365(c):

This conclusion comports with the "plain meaning" of all of the words employed in Section 365(c)(1) and gives full effect to that section and to the provisions and objectives of Chapter 11, which are designed to foster, not frustrate, the reorganization and the economic well-being of debtors in possession.

And it avoids the perverse and anomalous consequence of the "hypothetical test" rule under which a debtor may lose the benefit of a non-assignable contract vital to its economic future solely because it filed for bankruptcy.

Footstar was a welcome development for debtors, particularly for licensees of intellectual property and patents, but the ruling did little to end the debate concerning section 365(c)(1).

The latest salvo in the controversy came in Aerobox. The ruling may be a prelude to review by the Tenth Circuit Court of Appeals.

Aerobox

Aerobox Composite Structures, LLC ("Aerobox"), a manufacturer of unit load devices for the airline industry using unique pre-formed thermoplastic body panels, filed for chapter 11 protection in January 2007 in New Mexico.

Prior to filing its bankruptcy case, Aerobox entered into a 15-year license agreement with Tubus Bauer GmbH ("Tubus Bauer") in which Tubus Bauer granted Aerobox a license in North America to use patent rights and confidential information for the manufacture of certain Tubus Bauer products for resale.

The license agreement permits assignment only with Tubus Bauer’s prior written approval, but provides that such approval may not be withheld unreasonably.

Shortly after Aerobox filed for chapter 11 protection, Tubus Bauer filed a motion to compel Aerobox to reject the license agreement, contending that, consistent with the rulings of courts applying the hypothetical test, section 365(c)(1) precludes assumption or assignment of the agreement. The bankruptcy court denied the motion.

After determining that the license agreement was in fact executory, the court examined section 365(c)(1) and the competing views on the ability of a DIP to assume a contract covered by it.

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Because the license agreement involved the use of a patent, the bankruptcy court determined that "applicable law" in the statute means federal patent law, which generally prohibits assignment of both exclusive and non-exclusive license agreements absent consent of the licensor.

The court rejected the hypothetical test as the appropriate standard to apply in assessing whether a DIP may assume an unassignable contract.

Emphasizing that the DIP is not "materially distinct from the pre-bankruptcy entity that is a party to the executory contract," the court adopted the actual test and the reasoning articulated in Footstar as being most true to both the language and purpose of section 365(c)(1):

[B]ecause the limitation contained in § 365(c)(1) is aimed at protecting non-debtor parties to personal services contracts from being forced to accept service from or render service to an entity other than the entity with whom it originally contracted, it is appropriate to determine whether the nondebtor party is actually being forced to accept performance under its executory contract from an entity other than the debtor...[W]here the debtor-in-possession seeks to assume, or, as is the situation in the instant case, where the debtor-in-possession has neither sought to assume nor reject the executory contract but simply continues to operate post-petition under its terms, 11 U.S.C. § 365(c)(1) does not prohibit assumption of the contract by the debtor-in-possession and cannot operate to allow the non-debtor party to the executory contract to compel the Debtor to reject the contract.

In reaching this conclusion, the Court finds that the "actual test" articulated in Cambridge Biotech, and the reasoning of the court in Footstar, is the better approach to § 365(c)(1) when determining whether a debtor-in-possession is precluded from assuming an executory contract.

Conclusion

Aerobox is unquestionably a welcome development for intellectual property and patent licensees facing the prospect of a chapter 11 filing, but it neither ends the debate on this important issue nor gives prospective debtors any sense of certainty regarding their ability to avoid forfeiture of assets that may be vital to their chances for successful reorganization and ongoing business operations.

Because the decision was appealed, this issue may eventually make its way to yet another circuit court of appeals if the bankruptcy appellate panel's ruling is appealed to the Tenth Circuit.

The ruling highlights the need for clarification of the meaning of section 365(c)(1) by either Congress or the Supreme Court. Neither has acted so far to resolve a conflict that has been smoldering for nearly 20 years.

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The issue isn't likely to be settled any time soon. The Supreme Court has yet to agree to hear a case on whether the hypothetical, the actual, or some other test is the proper one.

Lawmakers have not been moved to solve the problem either. With no resolution of this matter on the horizon, the practical challenges confronting parties to these kinds of contracts can be accurately assessed only on a case-by-case basis by reference to the particular court presiding over the debtor's bankruptcy case.

--By Mark Douglas, Jones Day

Mark Douglas is the restructuring practice communications coordinator at Jones Day and the managing editor of the firm's Business Restructuring Review.

In re Aerobox Composite Structures, LLC, 373 B.R. 135 (Bankr. D.N.M. 2007).

RCI Technology Corp. v. Sunterra Corp., 361 F.3d 257 (4th Cir. 2004).

In re West Electronics Inc., 852 F.2d 79 (3d Cir. 1988).

Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997).

Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.), 165 F.3d 747 (9th Cir. 1999).

City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 534 (11th Cir. 1994).

In re Mirant Corp., 440 F.3d 238 (5th Cir. 2006).

In re Footstar, Inc., 323 B.R. 566 (Bankr. S.D.N.Y. 2005).

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