I Want to Use My Licensed Intellectual Property in My Company's Chapter 11 Case by Assuming My Already Existing License, but My Lawyer Tells Me We Are in the Wrong State to Do It. Really?

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Our Circuits are divided on whether a debtor-in-possession can assume the intellectual property license that the debtor company was using under a license before the Chapter 11 case was filed. Some Circuits employ the "hypothetical test" and some Circuits apply the "actual test." These two diametrically opposed tests make the results about whether an intellectual property license can be assumed dependent upon where the case is filed. This discussion explores these tests and the American Bankruptcy Institute Chapter 11 Reform Commission recommendation on the subject.

Introduction

The ability of a debtor-in-possession to assume or assign executory contracts under 11 U.S.C. Section 365 in the context of intellectual property law is the subject of a Circuit split.

This discussion examines the debtor-in-possession's power under Section 365 to assume and assign intellectual property licenses in a Chapter 11 bankruptcy and reviews the current Circuit split over the two adopted analytical formats: the hypothetical test and the actual test.

This discussion also discusses the American Bankruptcy Institute Commission's ("Commission") recommendations to adopt the actual test.

Under Bankruptcy Code Section 365(a) and (d), a debtor-in-possession may assign, assume or reject executory contracts and unexpired leases in a Chapter 11 restructuring even if the agreement expressly prohibits the assignment or assumption.[1]

Therefore, in carrying on its business through and after bankruptcy, the debtor-in-possession will typically assume profitable contracts and reject nonprofitable contracts.

Similarly, in the context of intellectual property licenses, where the debtor-in-possession licensee would like to continue to use the licensed intellectual property in its own business, especially where the debtor relies heavily on the license to run its business, the debtor-in-possession licensee will seek to assume the license.

However, depending on the jurisdiction, the debtor-in-possession licensee may not be permitted to assume, or assign, the license, even if the debtor-in-possession does not intend to assign the license to a third party.

Therefore, a conflict arises between intellectual property concepts of monopoly and nonassignability and the goals of the bankruptcy court in maximizing value for all parties.

The Definition of Executory Contracts

Under Section 365, only contracts which are executory may be assumed, assigned, or rejected.[2] If the

contract is assumed, the debtor-in-possession will continue performing under the terms of the original contract. The debtor-in-possession may assign contracts to third parties, who will then perform under the contract with the other original contracting party.

If the contract is rejected, the debtor-in-possession is effectively permitted to breach the contract. The Bankruptcy Code contains exceptions to the debtor-in-possession's ability to assign, assume, and reject executory contracts.

The Bankruptcy Code does not explicitly define "executory contracts." Bankruptcy courts most often cite the *Countryman* definition in determining, on a case-by-case basis, whether a contract is executory.

Under the *Countryman* definition, an executory contract is a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either party to complete performance would constitute a material breach excusing the performance of the other.[3]

Courts generally characterize intellectual property licenses as executory contracts because the licensor and the licensee owe each other a continuing material obligation.[4]

Therefore, the general nonbankruptcy rules requiring consent to assign certain types of intellectual property licenses have treated such licenses as executory contracts and have considered their assignability under Sections 365(a) and (f).[5]

Assumption and Assignment of Executory Contracts in the Context of Intellectual Property Law

While Section 365(a) generally permits the assignment and assumption of executory contracts, in the context of intellectual property licenses, a conflict arises between the Bankruptcy Code and intellectual property law.

An important exception to Section 365(a) is found under Section 365(c), which forbids the assignment or assumption of a contract where applicable nonbankruptcy law would bar the assignment, regardless of whether the contract is silent, or specifically prohibits such an assignment.[6]

Section 365(c) bans the assignment of executory contracts that qualify as personal service contracts. Licenses are often classified as personal to the licensee, because it is presumed that the licensor chose the licensee for reasons specific to that licensee.[7]

Intellectual property law typically treats licensing agreements, such as nonexclusive patent licenses, like personal contracts, and unless the licensor consents, the law precludes performance by a party other than the original licensee.[8]

This conflict between the Bankruptcy Code and intellectual property law affects the debtor-in-possession's ability to "assume *and/or* assign" intellectual property licenses after the filing of a Chapter 11 bankruptcy. Courts should balance the interest of the nondebtor licensor and the goals of Chapter 11.

For instance, intellectual property licensors may have only intended to provide licenses to the debtor-in-possession. If that debtor-in-possession licensee assigns the license to a third party, the licensor could be obliged to license its property to an unwanted party.

On the other hand, a debtor-in-possession depends on these licenses, sometimes to sustain its entire operation. Thus, in order to reorganize, a debtor-in-possession must be able to assume, or "assume and assign," these contracts to a third party.

The question of whether intellectual property licenses are "assumable *and/or* assignable" has created a circuit split. The Ninth, Third, Eleventh, and Fourth Circuits apply the "hypothetical" test, which effectively prohibits the assumption of these intellectual property license agreements.

On the other hand, the First and Fifth Circuits apply the "actual test" which may permit the assumption of the license—upon satisfying the other conditions of Section 365.

The Hypothetical Test

The Ninth, Third, Eleventh, and the Fourth Circuits have adopted the hypothetical test.[9]

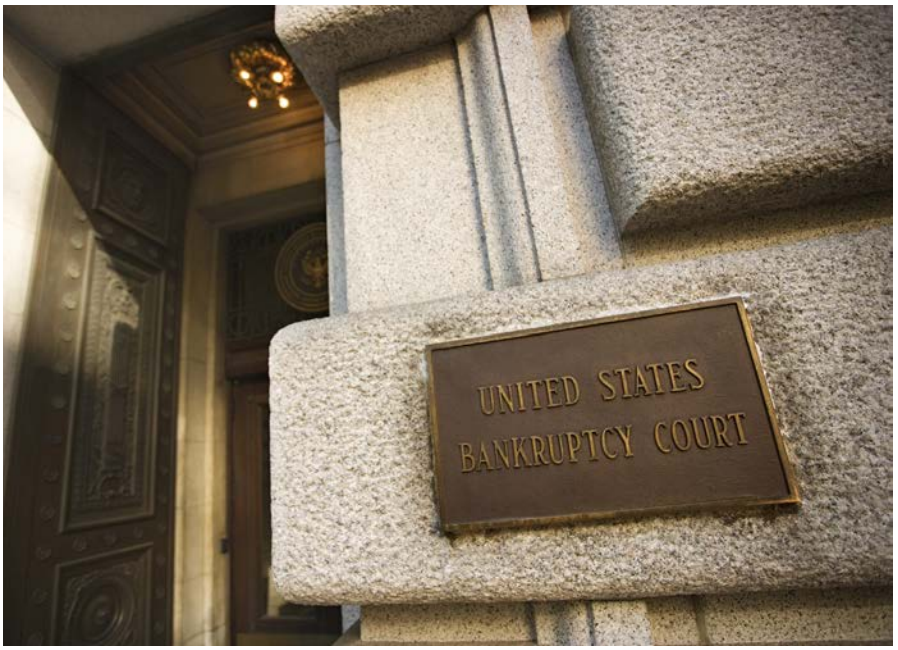
In the hypothetical test, the plain meaning of Section 365(c) dictates that the debtor-in-possession cannot "assume and assign" an executory contract, if applicable nonbankruptcy law would preclude the debtor-in-possession from assigning the license to a third party regardless of whether the debtor-in-possession has the intent to assign the license.

The controlling logic of the hypothetical test is that the identity of the debtor-in-possession, or the entity performing under the license agreement, is material to the agreement.[10]

Under the law, the debtor-in-possession is a separate, distinct legal entity from the prebankruptcy debtor. Therefore, to permit the debtor-in-possession to assume the license would have the same effect of an assignment to a third party.

Thus, the determinative question under the hypothetical test is, "could the debtor-in-possession assign the contract to a third party under applicable non-bankruptcy law?"

If the answer to that question is no, then the debtor-in-possession may not assume the contract. Effectively, the hypothetical test prevents the debtor-in-possession from assuming the license without the consent of the nondebtor licensor.



The Ninth Circuit's ruling from *In re Catapult Entertainment, Inc.* ("*Catapult*") used the hypothetical test to determine that federal patent law prohibits the debtor-in-possession from assuming or assigning nonexclusive patent licenses without the licensor's consent.

In *Catapult*, Perlman licensed patents to Catapult. Catapult subsequently filed its Chapter 11 petition. Prior to filing its petition, Catapult entered into a merger agreement in which it would be the surviving entity. Catapult then filed a motion to assume the patents at issue.

The court, however, adopted the hypothetical test and ruled that Catapult was not permitted to assume the contracts. The court held that it was bound by the plain meaning of Section 365(c)(1). The court reasoned that the plain language of the statute "link[s] non-assignability under 'applicable law' together with a prohibition on assumption in bankruptcy."[11]

Therefore, if applicable law would bar a debtor-in-possession's subsequent assignment of the license, the debtor-in-possession may not assume the executory contract without the consent of the nondebtor—even if the debtor-in-possession does not intend to assign the contract.

The court reasoned that the plain language of the statute dictates that the question as to whether the contract is assignable is "whether 'applicable law excuses a party from accepting performance from or rending performance to an entity other than . . . the debtor-in-possession.'"[12]

The court set forth that the applicable law overrides the Bankruptcy Code where the applicable law prohibits assignment on the rationale that the identity of the contracting party is material to the agreement.

The court reasoned that because under federal patent law, a nonexclusive patent license is "personal and assignable only with the consent of the licensor," the plain language of Section 365(c) dictates that the debtor-in-possession may not assume, or assign, an intellectual property license without the consent of the debtor-in-possession.

The Actual Test

The First and Fifth Circuits apply the actual test.[13]

The actual test looks at each case to determine if the debtor-in-possession "actually" intends to assign the executory contract. The actual test operates under the assumption that the debtor-in-possession is not materially distinct from the prebankruptcy entity that is the party to the executory contract.

In support of this assumption, the Court held that "[w]here the particular transaction envisions that the debtor-in-possession would assume and continue to perform under an executory contract, the bankruptcy court cannot simply presume as a matter of law that the debtor-in-possession is a legal entity materially distinct from the prepetition debtor with whom the nondebtor party . . . contracted."[14]

The actual test contemplates what is best for both the nondebtor licensor and the debtor-in-possession, and focuses, not on the entity performing, but "ensuring that the nondebtor party . . . will receive the full benefit of [its] bargain."[15]

Thus, by applying the actual test, courts promote the enforcement of these contracts, and the debtor-in-possession's right to assume these contracts, as well as ensuring that the nondebtor continues to receive its benefit under the contract. The unassignable contract can be assumed if the debtor-in-possession intends to continue performing under the terms of the contract.

Therefore, the debtor-in-possession would be prohibited from assuming the contract if it intends to assign the contract to a third party. The actual test recognizes that a debtor seeking to emerge from a Chapter 11 bankruptcy as a reorganized entity may want to simply assume the license and continue to use the license post-bankruptcy.

To permit licensors to cancel these contracts effectively permits the licensors to cancel contracts that they would otherwise be obligated to perform, but for the debtor's bankruptcy. The actual test is said to better accomplish the intent of Congress.[16]

The First Circuit used the actual test to determine that the subject license was assumable. In *Pasteur*, CBC and Pasteur entered into a series of cross-license agreements.

Each agreement prohibited the licensee from assigning or subleasing the license to others. CBC subsequently filed a Chapter 11 petition, and as part of that petition CBC asserted that it would assume the cross-licenses and then sell all of its stock to a subsidiary.

The subsidiary also happened to be a direct competitor of Pasteur. Pasteur alleged that the sale of the stock amounted to assumption of patent cross-licenses and assignment to a third party. Pasteur argued that the reorganized entity is a different entity than the pre-petition entity because it sold all of its shares and is now owned by a new company.

The court disagreed and ruled that the stock sales are not mergers and that under the terms of the cross-licenses, CBC was permitted to transfer its license rights with any affiliated company, such as the subsidiary in this case.

The court based its holding primarily on the recognition that the debtor-in-possession would lose the right to assume the contract even though it never intended to assign the contract to a third party.

Further, the court asserted that it cannot be presumed that the debtor-in-possession is a materially distinct entity from the prepetition debtor. The court emphasized the importance of focusing on the performance actually to be rendered by the debtor-in-possession; and to ensure that the nondebtor will receive the full benefit of its bargain.

The Difference between the Plain Meaning and the Constructed Meaning of Section 365

The significant difference between the actual test and the hypothetical test is found in the reading of the Code. Courts that have adopted the hypothetical test strictly construe Section 365, or take its "plain meaning," to mean that the debtor-in-possession may not "assume *or* assign" the license agreement if nonbankruptcy law would prohibit the assumption or the assignment.

Section 365 states that "[t]he trustee [debtor-in-possession] 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."

Thus, the hypothetical test adheres to the plain meaning of Section 365, in that a debtor-in-possession may not assume *or* assign the license if nonbankruptcy law would prohibit the assignment without the consent of the nondebtor.[17]

However, under the actual approach, the statute is read as the debtor-in-possession may not "assume *and* assign" the license if nonbankruptcy law would prohibit the assignment. Meaning that the debtor-in-possession may assume the license, if it intends to continue to perform under the original agreement, but may not thereafter assign the license.

Because the actual test does not believe that the identity of the one performing under the license is material, the actual test takes into account the reality of the circumstances and whether the debtor-in-possession actually intends to assign the license.[18]

This analytical difference has a determinative impact on a debtor-in-possession's ability to assume intellectual property license.

The Problems with Hypothetical Test and the Reasons for Using the Actual Test

While the hypothetical test adequately addresses the interests of nondebtor licensors and their interest in protecting their property, it completely ignores the goals of a Chapter 11 reorganization.

The hypothetical test contemplates a scenario where the Chapter 11 debtor-in-possession, after giving adequate assurance, proposes to carry on its regular business and comply with the terms of the contract, but nevertheless permits the nondebtor party to cancel the contract regardless of whether the debtor-in-possession intends to assign the contract.

The hypothetical test enables nondebtors to utilize *ipso facto* clauses without ever having to put them in the contract. By utilizing Section 365(e)(2), in applying intellectual property law, it excuses the nondebtor from performing/accepting performance from another regardless of whether the contract prohibits or restricts assignment or assumption (e.g., regardless of nonassignment clause).

Under the hypothetical test, licensors, or nondebtors, are effectively permitted to avoid contracts under which they would otherwise be obligated to perform if not for the debtor-in-possession's bankruptcy.

Justice Kennedy summarized the problems with the "hypothetical" approach by stating that:

> The hypothetical test is not, however, without its detractors. One arguable criticism of the hypothetical approach is that it purchases fidelity to the Bankruptcy Code's text by sacrificing sound bankruptcy policy. For one thing, the hypothetical test may prevent debtors-in-possession from continuing to exercise their rights under nonassignable contracts, such as patent and copyright licenses. Without these contracts, some debtors-in-possession may be unable to effect the successful reorganization that Chapter 11 was designed to promote. For another thing, the hypothetical test provides a windfall to nondebtor parties to valuable executory contracts: If the debtor is outside of bankruptcy, then the nondebtor does not have the option to renege on its agreement; but if the debtor seeks bankruptcy protection, then the nondebtor obtains the power to reclaim-and resell at the prevailing, potentially higher market rate-the rights it sold to the debtor.[19]

The actual test has several benefits that facilitate the reorganization process. The actual test promotes the policy of holding the nondebtor parties to their obligations. The actual test also places more weight on maximizing the value of the estate while adequately addressing the nondebtor's interest in protecting its property rights.

The actual test helps prevent a nondebtor from terminating a license that the debtor-in-possession licensee relies on in its business. Preventing the debtor-in-possession from assuming its profitable contracts would contradict the purpose of Chapter 11 and would hinder the debtor-in-possession's ability to reorganize and continue its business.

"The actual test also places more weight on maximizing the value of the estate while adequately addressing the nondebtor's interest in protecting its property rights."

Moreover, there are safeguards in place to ensure the nondebtor licensor is adequately protected. A condition to assuming any contract under Section 365(a) is that the debtor-in-possession must cure all defaults and provide adequate assurance of future performance.[20]

Thus, the actual test ensures that the nondebtor party gets the benefit of its bargain, while at the same time, facilitating the goals of Chapter 11.

The Commission's Recommendations: The Modified Actual Test

The American Bankruptcy Institute formed a Commission to study the reform of Chapter 11. Based on the Commission's recommendations and findings, the Commission voted to codify the "actual approach" to permit the debtor-in-possession to assume and assign executory intellectual property licenses.

The Commission reasoned that while nondebtor licensors are understandably concerned with being required to maintain a license with an unwanted party, the fact that the debtor-in-possession should provide adequate assurances of future performance in order to assume the executory contract ensures that the nondebtor licensor would still be receiving the benefit of its bargain.

The Commission emphasized that the actual identity of the entity performing under the license is not as critical as the ability to pay, maintain the quality and integrity of the intellectual property, and comply with all the obligations under the license.

A condition to assuming an executory contract under Section 365 is that the debtor-in-possession must cure all defaults and provide adequate assurances of the performance under the agreement.

Thus, the Commission findings mirror the First Circuit's conclusion in that the identity of the individual/entity performing under the contract is not material, and the focus should be on ensuring the nondebtor party receives the full benefit of its bargain.[21]

Additionally, the Commission determined that the debtor-in-possession should be able to assign intellectual property licenses under Section 365 regardless of the applicable nonbankruptcy law or provisions to the contrary in the license.

The Commission asserted that the identity of the licensee is only relevant if the debtor-in-possession intends to assign the license to a direct competitor of the licensor. Therefore, to account for this possibility, the Commission determined the debtor-in-possession may assign an intellectual property license under Section 365 if the nondebtor licensor is unable to demonstrate that the repercussions of the assignment outweigh the benefit to the estate.

Thus, the Commission concluded the court could deny the assignment if the nondebtor licensor carried this burden of proof.

Conclusion

This divide between the purpose of intellectual property law and the goals of Chapter 11 has a great impact on the rights of licensors and licensees throughout bankruptcy. Ultimately, a debtor-in-possession's ability to assume an intellectual property license—regardless of whether the nondebtor licensor consents—depends on the jurisdiction of the bankruptcy case.

Therefore, until this issue is brought to the Supreme Court, or Congress codifies a solution, it is of the utmost importance for licensors and licensees to understand how their rights are affected in their jurisdiction.

Notes:

1. 11 U.S.C. § 365(a), (d).
2. 11 U.S.C. § 365(a).
3. In re Sunterra Corp., 361 F.3d 257, 264 (4th Cir. 2004); Prof. Vern Countryman, Executory Contracts in Bankruptcy. Part 1, 57 Minn. L. Rev. 439, 460 (1973).
4. Id.; In re Catapult Entm't, Inc., 165 F.3d 747, 750 (9th Cir. 1999).
5. In most jurisdictions, nonexclusive licenses generally are not assignable over licensor's objection. However, exclusive licenses are generally assignable over objection of Licensor. Everex Systems v. Cadtrak (In re CFLC, Inc.), 89 F.3d 673 (9th Cir. 1996); Leicester v. Warner Bros. Corp., 232 F.3d 1212 (9th Cir. 2000).
6. 11 U.S.C. § 365(c).
7. PPG Indus. Inc. v. Guardian Indus. Corp., 597 F.2d 1090, 1093 (6th Cir. 1979).
8. In re Catapult, 165 F.3d at 750.
9. N.C.P. Mktg. Grp., Inc. v. BG Star Prods., Inc. (In re N.C.P. Mark. Gr., Inc.), 279 F. App'x. 561 (9th Cir. 2008), *cert. denied*, 129 S. Ct. 1577 (2009); In re Sunterra Corp., 361 F.3d 257, 260 (4th Cir. 2004); In re Catapult, 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 West Elec., 852 F.2d 79 (3d Cir. 1988) (gov't contract).
10. In re Catapult, at 750.
11. Id. (quoting 1 DAVID G. EPSTEIN, STEVE H. NICKLES & JAMES J. WHITE, BANKRUPTCY § 5–15 at 474 (1992)).
12. In re Catapult, at 752.
13. Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997) *abr* by Hardemon v. City of Boston, No. 97-2010, 1998 WL 148382 (1st Cir. Apr. 6, 1998); In re Mirant Corp., 440 F.3d 238 (5th Cir. 2006).
14. Institut Pasteur, at 493.
15. Id.
16. In re Catapult, 165 F.3d at 749.
17. In re Catapult, 165 F.3d 747, 749-750.
18. Id. at 751.
19. N.C.P. Mktg. Grp., Inc. v. BG Star Prods., Inc., 556 U.S. 1145, 129 S. Ct. 1577 (2009).
20. § 365(b).
21. In re Catapult, 165 F.3d 747, 749-750.

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