

DON'T TAKE FOR GRANTED THE DRAFTING OF A "SIMPLE" ASSIGNMENT PROVISION, ESPECIALLY IN A NON-EXCLUSIVE INTELLECTUAL PROPERTY LICENSE, YOU MAY END UP IN A BANKRUPTCY COURT

BY ROBBIN L. ITKIN AND KATHERINE C. PIPER

How often in the midst of negotiating an agreement have you taken for granted that your affluent client would never be the subject of a bankruptcy proceeding? Did you happen to represent Executive Life Insurance Company, Enron, United Airlines, or the myriad of other corporate giants before they shockingly commenced bankruptcy cases? As this article will address, even the simplest assignment clause in a contract can drastically affect the ability of a debtor to restructure a business through an unforeseen bankruptcy.

The Basics: How Does Bankruptcy Affect A Contract?

Title 11 of the United States Code (the "Bankruptcy Code") gives debtors many protections to achieve the goal of providing debtors with a "fresh start." One of the most significant protections is the ability of a debtor to assume,¹ reject, or assume and assign² an "executory contract" pursuant to section 365. An executory contract—a term unique to bankruptcy law—is almost universally accepted as "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 to complete performance would constitute a material breach excusing the performance of the other."³

It is important for the non-bankruptcy lawyer to know that certain provisions in an executory contract are not enforceable in bankruptcy. Clauses that trigger the automatic termination of a contract upon the filing of a bankruptcy, for example, are not enforceable when a debtor files for bankruptcy. (See 11 U.S.C. § 365(e) (providing that an executory contract may not be "terminated or modified" solely because the debtor files for bankruptcy).) For example, despite the routinely included provision that a contract terminates, or a payment obligation accelerates, upon the filing of a bankruptcy by a contracting party, such a provision is deemed an *ipso facto* clause that is not enforceable in bankruptcy as contrary to public policy and the "fresh start" goals of the Bankruptcy Code. Moreover, the standard anti-assignment provision in a contract is generally also unenforceable once the debtor files for bankruptcy. (See 11 U.S.C. § 365(f)(1) (providing that a debtor may assign a contract in bankruptcy regardless of whether the contract contains an anti-assignment provision).)⁴ On the other hand, a client that becomes a debtor in bankruptcy may not be able to retain a desired contract if the contract is of a type that requires, under applicable state law, the consent of the non-debtor counter-party to that contract for assignment. It is this latter precarious situation that is the subject of this article.

If the vagaries of what standard contract provisions are or are not enforceable in a bankruptcy were not confusing enough for the non-bankruptcy lawyer, a recent Fourth Circuit Court of Appeals decision, *RCI Tech. v. Sunterra Corp.* (*In re Sunterra Corp.*) (4th Cir. 2004) 361 F.3d 257, has further confused bankruptcy and non-bankruptcy practitioners alike by concluding that even where a pre-petition intellectual property license expressly provides for the assignability of the license, such license may not be able to be assigned, or even assumed by the debtor in bankruptcy, if the counter-party refuses to consent to such assumption or assignment in the bankruptcy case. The inability to retain or transfer the license to another party through a sale of the business can severely hamper a client's ability to reorganize in a bankruptcy case, to maximize the value of the assets for a sale of the business, or to continue operations depending upon the critical nature of the license to a client's ongoing business.

Based on *Sunterra*, An Express Consent to Assignment in a License Agreement May Not Be Enforceable in a Bankruptcy to Allow the Debtor in Bankruptcy to Retain the License

Section 365(c) of the Bankruptcy Code provides that a debtor in possession or a trustee "may not *assume or assign* any executory contract . . . [if] 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," and such counter-party does not consent to the "*assumption or assignment*." (11 U.S.C. § 365(c)(1).) In interpreting section 365(c)(1), the majority of circuits, including the Ninth Circuit, have found that the use of the word "or"



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Assignment Provisions

between “assumption” and “assignment” in that section means that a debtor cannot assume a contract if non-bankruptcy law prohibits that debtor from *assigning* the contract without the consent of the counter-party. This test—the “hypothetical test”⁵—holds that subsection (c)(1) prohibits assumption by a debtor when applicable non-bankruptcy law prohibits assignment—even though the debtor has no intention of assigning the contract.

In *Sunterra*, the Fourth Circuit joined the Ninth, Third, and Eleventh Circuits in adopting the “hypothetical test” and denying a debtor in possession’s motion to *assume* an executory contract under section 365(c) of the Bankruptcy Code, despite an express assignability provision in the contract that allowed the assignment of the contract to the debtor’s successors-in-interest. In *Sunterra*, the debtor was a licensee of software. The applicable non-bankruptcy law—federal copyright law—prohibits the assignment of such a license without the consent of the licensor. However, the software agreement contained the following consent provision (the “Transfer Provision”):

The provisions of this section shall not preclude the transfer of this license to a successor in interest of substantially all of [Sunterra’s] assets if the assignee agrees in writing to be bound by this license. (*Sunterra, supra*, 361 F.3d at p. 271 n. 15 (brackets in original).)

In *Sunterra*, the counter-party argued that the Transfer Provision only applied to *assignments* and Sunterra was trying to *assume* the Agreement—thus, the Transfer Provision was inapplicable. The court agreed and held that because the Transfer Provision only applied to *assignments* and Sunterra was trying to *assume* the Agreement, the debtor could not rely on the Transfer Provision to assume the Agreement. Therefore, the Fourth Circuit relied on the “hypothetical test” and held that Sunterra was unable to assume the Agreement over the objection of the counter-party because copyright law (the applicable non-bankruptcy law) barred assignment to a hypothetical third party, even though the pre-petition Agreement contained consent to assignment and Sunterra was not going to assign the Agreement.⁶

How Can Counsel Protect Their Clients From The Sunterra Problem Before A Bankruptcy Filing?

Sunterra begs the question: if a debtor is unable to assume an agreement when the debtor could not hypothetically assign the agreement, why is the debtor prohibited from assuming the agreement when the agreement contains consent to assignment so that the debtor in reality could assign the agreement? What can counsel do to protect their clients from this bizarre result?

The most practical solution is to negotiate better assumption and assignment provisions from the beginning—particularly when intellectual property rights have become so crucial to the operation of many businesses. The negotiation of a succinct and precise assumption and assignment clause can prevent debtors from facing the *Sunterra* problem. Adding the concept of assumption to the standard assignment provision certainly eliminates one reason given for the denial of the assumption of the Agreement in *Sunterra*. If the counter-party to the agreement is willing to consent to assignment, is assumption too much to ask? The logic for such a negotiation is compelling—if the parties are already dealing with each other, why should they object to the ability of one party to assume an agreement in which it already has rights and under which it is performing?

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An additional concept that may be added to the standard assignment provision is the concept of a bankruptcy. The “standard” assignment clause could include that the contracting party can assume or assign whether inside or outside of bankruptcy⁷—the more precise the language the less a court or other party can attempt to change its meaning. However, many parties fear using the term “bankruptcy” as it will lead to suspicions about the financial stability of their business. If that concern exists, merely adding to the contract the concept of assumption by the contracting party (to the extent it is ever deemed a distinct entity from its current form) and/or assignment to the contracting party’s affiliated entities and successors in interest certainly would help. Obviously, the other party to the contract may not want to give up future rights so easily (or be perceived to do so), or it may want the leverage of prohibiting any future assignment subject to receiving acceptable consideration.⁸ Thus, these will be difficult negotiations, but negotiating precise language *before* a bankruptcy is almost certain to help avoid ambiguity later. A myriad of judicial doctrines and Bankruptcy Code provisions will apply once a bankruptcy is actually filed.⁹ How these provisions and doctrines may be utilized to favor the client will depend on the language in a pre-bankruptcy contract, thus making pre-bankruptcy negotiations critical.

Conclusion

The *Sunterra* decision appears to turn the hypothetical test on its head. Until the Supreme Court addresses section 365(c), counsel should be very aware of *Sunterra*’s effects on their clients.

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Pre-bankruptcy counseling allows practitioners to identify those contracts that are critical to their clients so that contract negotiations can anticipate all circumstances affecting the enforceability of the negotiated contract and the terms thereof, including the possibility of the subsequent bankruptcy of one or more parties to the contract. For debtors, it is paramount that the debtor's assets, specifically including intellectual property critical to the debtor's continued business operations, be identified and analyzed so that the ramifications of any prohibition on the debtor's assumption or assignment of governing contracts are fully understood. For creditors, it is key to keep in mind what allowances a client is willing to make and still retain its rights in the event that a counter-party files for bankruptcy. For both, it is a delicate line to walk given that any one of our clients is a potential debtor in bankruptcy. ■

Endnotes

¹ In order for a debtor in bankruptcy to retain an executory contract, it needs to "assume" such contract in accordance with the requirements of section 365 of the Bankruptcy Code. This is because the Bankruptcy Code treats a debtor in possession as a separate legal entity from the pre-bankruptcy debtor. Thus, in order to continue to operate the debtor's pre-bankruptcy business after emerging from bankruptcy, a debtor in possession must assume the agreements that it desires going forward.

² In order to assign an executory contract, the debtor must first assume the executory contract. See 11 U.S.C. § 365(f)(2).

³ Countryman, *Executory Contracts in Bankruptcy, Part I* (1974) 57 Minn. L.Rev. 439, 450; see, e.g., *Unsecured Creditors' Comm. v. Southmark Corp. (In re Robert L. Helms Const. & Dev. Co.)* (1998) 139 F.3d 702, 705 (adopting the Countryman definition).

⁴ However, this is subject to certain limitations. For example, an executory contract may not be able to be assumed and/or assigned by a debtor despite the anti-assignment provisions if it is a contract to make a loan, or extend other debt financing or financial accommodations. (See, e.g., 11 U.S.C. § 365(c).)

⁵ The "hypothetical test" provides that a debtor in possession may not assume an executory contract over the objection of the counter-party to the contract if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession does not intend to assign the contract to any third party. See, e.g., *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)* (9th Cir. 1999) 165 F.3d 747; *In re James Cable Partners* (11th Cir. 1994) 27 F.3d 534, 537; *In re West Elecs., Inc.* (3d Cir. 1988) 852 F.2d 79, 83.

⁶ Significant to the analysis of *Sunterra* is the fact that no other Circuit following the hypothetical test has analyzed a contract that contained a clause allowing assignment.

⁷ The enforceability of a provision in a pre-petition contract that dictates what happens in a bankruptcy is questionable, although the presence of such provision certainly supports the intention of the parties.

⁸ In the context of secured financings of intellectual property, it has also been suggested that if the technology is crucial to business, the debtor may consider paying a fee to ensure that consent to assumption and/or assignment is given in the contract.

⁹ See, e.g., 11 U.S.C. § 365(n) (providing additional protections to licensee of certain intellectual property when a licensor files for bankruptcy and rejects the license agreement); see also *In re Hernandez* (Bankr. D.Az. 2002) 287 B.R. 795 (allowing the debtor to use the judicially created "ride-through" doctrine to avoid assuming or rejecting an exclusive patent license during the bankruptcy proceeding).

The PPI Enterprises Case

The recent series of favorable decisions for solvent tenants began with the *PPI Enterprises* case³ in 2003, where tenants won a major battle permitting a solvent debtor-tenant to file for bankruptcy in good faith and to cap a landlord's lease termination damages. In *PPI Enterprises*, the commercial landlord of a Manhattan office tower leased space to the tenant for its corporate headquarters. After facing financial difficulties and abandoning its corporate headquarters, the tenant owed approximately \$6 million in remaining rent to its landlord. On the eve of a damages trial following nearly four and one-half years of litigation in federal court, the tenant filed for Chapter 11 bankruptcy. One of the debtor's stated objectives was to limit the landlord's lease termination damages under section 502(b)(6) of the Bankruptcy Code.

The landlord moved to dismiss the tenant's Chapter 11 filing for bad faith. In its motion, the landlord alleged that the debtor-tenant's bankruptcy was a sham filing designed to create value for the tenant's corporate parent and its creditors at the landlord's expense, and that the bankruptcy served no legitimate purpose because the company had no ongoing business, only one remaining employee, and no assets other than stock certificates representing a 2% interest in a non-related public company worth at least \$11 million. Importantly, the landlord also challenged about \$55 million in insider claims as improperly characterized equity interests, which, if successful, would render the debtor solvent. Other than liability under