The Metamorphosis of Assignment Clauses in Bankruptcy

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Last month, we discussed "The Debtor's Nightmare," explaining how the Fourth Circuit joined the Ninth, Third and Eleventh Circuits in adopting the "hypothetical test" in denying a debtor in possession's assumption of an executory contract under section 365 (c) of the Bankruptcy Code despite an express assignability provision in the contract. *RCI Tech. v. Sunterra Corp.* (*In re Sunterra Corp*), 361 F.3d 257 (4th Cir. 2004). This month, we continue with "the debtor's paradox."

The Debtor's Paradox

Sunterra begs the question: If a debtor is prohibited from assuming an agreement when the debtor could not hypothetically assign the agreement, why can't the debtor assume the agreement when the agreement contains consent to assignment so that the debtor hypothetically assign the agreement? The Fourth Circuit seems to be telling debtors that they are stuck either way by saying, "Debtor, you can't assume if you can't assign, but even if you do have consent to assign, you still can't assume."

Practitioners Must Attempt to Cover All Anticipated Events in the Contract

Several options to avoid a result such as in the *Catapult* (*In re Catapult Entm't, Inc.*, 165 F3d 747 (9th Cir.), cert. dismissed, 528 U.S. 924 (1999) and *Sunterra* cases have been suggested by practitioners and scholars alike. The first, and most practical solution, is to negotiate express 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. *See, e.g.*, Schechter D: Software Licensing Agreement May Not Be Assumed By Chapter 11 Debtor, Even If It Does Not Seek to Assign License, 2004 *Com. Fin. News* 25 (Apr. 5, 2004). 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, assumption should not be too much to ask. Moreover, the logic is compelling -- if the parties are willing to deal with each other, why should they object to the ability of one party to assume an agreement in which it already has rights, under which it is performing and will need to prove ability to perform under section 365?

Moreover, while parties are loathe to mention the word "bankruptcy" in a contract for fear that the other party will sniff a financial issue of which it would otherwise not be aware, the "standard" assignment clause could merely cover assumption, if the contracting party was deemed to be a new or distinct entity at a later date, and/or assignment of the contract to the contracting party's affiliated entities and successors in interest. If able to make a bolder move, include that the contracting party can assume or assign whether inside or outside of bankruptcy -- the more precise the language the less a court or other party can attempt to change its meaning. Obviously if you are the other party to the contract you may not want to give up your future rights so easily (or be perceived to do so), or you may want the leverage of prohibiting any future assignment without receiving acceptable consideration. Thus, it will be a tough negotiation. While nothing is certain and no matter what you do a court may rule contrary to the original intent of the contracting parties, it certainly cannot hurt to attempt to address these uncertainties in advance of any bankruptcy situation with express language in the contract.

In the context of secured financings of intellectual property, it has even been suggested that if the technology is critical to the functioning of the business, the debtor may consider paying a fee to ensure that consent is given. Depending on the crucial nature of the technology, this may be an option to consider when negotiating licenses since there will be separate and distinct consideration exchanged for the assumption and assignment right. *Moreover, it is also important to note that if the debtor rejects a contract under which the debtor is the* licensor *of certain intellectual property, section 365(n) of the Bankruptcy Code gives the licensee the option to retain its rights under the agreement so long as certain conditions are met. Thus,* licensees *of debtor-owned intellectual property have more options in the event of a bankruptcy filing by a licensor.* See, e.g., *11 U.S.C. § 365(n)(2)(B) (requiring the licensee to continue all royalty payments called for under the agreement).*

Letting The Contract 'Ride Through' The Bankruptcy May Be a Risky Option

Assuming that a debtor has not negotiated an all-inclusive assumption and assignment provision, what options does a debtor have once it has filed Chapter 11? Some have suggested that the debtor in possession simply allow the contract to "ride through"

the bankruptcy case. *See, e.g.*, Hon. J Aug J.V. et al.: The Plan of Reorganization: A Thing of the Past?, *J. 13 Bankr. L. & Prac.* 4 Art. 1., Sec. II.J(1)-(2) (2004). The "ride-through" or "pass-through" doctrine provides that an executory contract that is neither assumed nor assigned during the bankruptcy case passes through the bankruptcy unaffected. *See, e.g., Century Indem. Co. v. Nat'l Gypsum Co. Settlement Trust* (*In re Nat'l Gypsum Co.*), 208 F.3d 498, 504 n.4 (5th Cir. 2000) ("If an executory contract is neither assumed nor rejected, it will 'ride through' the proceedings and be binding on the debtor even after a discharge is granted."); *In re Texaco, Inc.*, 254 B.R. 536, 556 (Bankr. S.D.N.Y. 2000) ("The plan may provide for the assumption or assignment of an executory contract. On the other hand, the contract may 'ride through' the plan without being affected."). While the "ride through doctrine" may be a tempting solution, the authors caution debtors about this option.

Just what is accomplished by allowing a contract to "ride through" a bankruptcy without assumption or rejection is not clear and, in fact, such an action may be adverse to the reorganized debtor. Indeed, a detailed discussion of the practical applications and ramifications of the ride-through doctrine in Chapter 11 bankruptcies are subject to debate and would require an entirely separate article. Allowing an executory contract to ride through the bankruptcy process simply means that it remains in full force and effect against the reorganized debtor upon its emergence from Chapter 11. *Compare In re Hernandez*, 287 B.R. 795, 803 (Bankr. D. Az. 2002) (refusing to compel the debtor to reject a patent licensing agreement and holding that the agreement could ride through the debtor's Chapter 11 case unaffected), with *In re O'Connor*, 258 F.3d 392, 404 (5th Cir. 2001) ("There appears to be general agreement that the 'pass-through' theory continues to apply in Chapter 11 cases ... where an *assumable* executory contract is neither assumed nor rejected, *and* the Reorganized Debtor continues to operate the debtor's pre-bankruptcy business.") (emphasis in original). However, once the debtor has emerged from Chapter 11, all of the protections of section 365 of the Bankruptcy Code are gone. Therefore, the reorganized debtor must accept the burdens along with the benefits of the contract. If the contract contains an *ipso facto* clause (one which automatically triggers a default or termination upon a bankruptcy filing) the counter-party may be able to immediately terminate the contract whereas, in bankruptcy, such clauses statutorily are not enforceable. If there are other breaches to the contract the default provisions will be in full effect outside of the protections of bankruptcy.

In light of the pitfalls, what does allowing the contract to ride through really get for the debtor? The practical answer seems to be "time." By allowing the agreement to ride through the bankruptcy process the debtor buys time to negotiate with the counter-party to the agreement and hopefully reach resolution on the breaches that have occurred. It further allows the debtor time to investigate alternatives, if any, to the contract and to establish new agreements with other parties to fill any gap left by the loss of the contract. Other than this extra time, however, allowing the contract to ride through really does not put the debtor in a better position than simply rejecting the contract while the debtor is in bankruptcy and thus may take away leverage that the debtor has while in bankruptcy, including any limitation on damages distributed through a confirmed plan of reorganization.

Abandonment of the Contract to the Debtor May Provide Little Comfort

Another option for the debtor that has been suggested, is that the debtor in possession abandon the agreement to the debtor pursuant to section 554 of the Bankruptcy Code. *See Aug, supra*, at Sec. II.J(2). The argument is that if, as the courts in *Sunterra* and *Catapult* have held, a contract that cannot be assigned cannot be assumed by the debtor in possession, then the contract must not have any value to the debtor in possession and should be able to be abandoned to the debtor. *See Id.* The argument has been made that this would preserve the contract for the reorganized debtor upon emergence from Chapter 11. *See, e.g., Dewsnup v. Timm* (*In re Dewsnup*), 908 F.2d 588, 590 (2d Cir. 1990) ("Following abandonment, whoever had the possessory right to the property at the filing of bankruptcy again reacquires that right.") (internal quotation omitted). While this argument has been raised, it is significant to note that *Dewsnup* was a case involving a Chapter 7 debtor where the Chapter 7 trustee abandoned property to the debtor. It is unclear how abandonment would fare in a reorganization case and, again, the authors caution debtors about the viability of this "solution."

Similar to the problems with the ride-through doctrine, abandonment is not necessarily helpful for a debtor in this situation. Not only could abandonment possibly allow the enforcement of any ipso facto clauses in the contract, it would remove the contract immediately from the protections of section 365. Therefore, the non-debtor counter-party could terminate the agreement immediately if the debtor was in default. Thus, abandonment does not even allow the debtor in possession the additional time to renegotiate the contract or to migrate from the critical nature of the contract that the ride through doctrine fosters. In the end, the question remains: What real benefit is there to the reorganized debtor when the contract is abandoned to the debtor?

Conclusion

The *Sunterra* decision seems to turn the hypothetical test on its head. Yet, until the Supreme Court takes on section 365(c), debtors' counsel should be very aware of the effects of *Sunterra* on their clients. In the best of scenarios, pre-bankruptcy counseling will allow practitioners to identify those intellectual property contracts that are critical to the debtor's operations, so that negotiations can begin early. It is paramount that the debtor's assets, specifically including intellectual property critical to the debtor's continued business operations and the value thereof, be identified and analyzed so that the ramifications of any prohibition on the debtor's assumption or assignment are fully understood. It may be too late to attempt to negotiate when the debtor in bankruptcy is confronted with an opposition to assumption or assignment by the counter-party to the license. Either way, *Sunterra* tosses yet another obstacle in the path of reorganizing debtors that depend on intellectual property for their survival.

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