Gaining Leverage Through § 365 Consent Rights

Why Some Parties To Intellectual Property Agreements Should Seize The Moment When A Contract Party Resorts To Bankruptcy

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Section 365(c) of the United States Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.* (sections of which are cited here as " § ___"), sometimes referred to as "consent rights," provides important limitations on assumption and assignment of certain agreements, including agreements for the use of intellectual property. Yet despite its force and increasing relevance, this section remains underused by some.

This is worth considering because intellectual property agreements, in one form or another, permeate the business landscape. Frequently, owners of trademarks, patents, or copyrights grant permission to others by entering into license or franchise agreements, allowing use of their intellectual property for a fee. A software license agreement is a good example, because in many instances the licensor holds a copyright on the software. When granting these and other types of intellectual property licenses to parties who then resort to bankruptcy, licensors and others are protected to an important degree under § 365(c). By leveraging these protections, the astute and active licensor can make the most of a potentially bad situation.

Through §§ 365(a) and (f), a debtor has the exceptional power to assume and assign executory contracts to third parties, even despite language in an agreement expressly prohibiting assignment. This power, however, is not without limits, and a licensor of intellectual property has reason to pay close attention when it learns a contract party has filed bankruptcy. A licensor may have strong footing, for example, to challenge a debtor's attempt to assume and assign its license agreement (presumed here as an executory contract) in connection with a ubiquitous § 363 sale.

Relying on § 365(c)(1), an important exception to the general rule that assignments are favored, the licensor may have an argument that the agreement is neither assumable nor assignable. Section 365(c)(1) provides:

> 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:
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> (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[.]

11 U.S.C. § 365(c)(1).

In short, this means that if the licensor (as the non-debtor party) does not (and did not) consent to assignment, then § 365(c)(1) precludes a debtor from assuming and assigning an executory contract if "applicable law" would allow the licensor to refuse acceptance of performance from a party other than the debtor.

Generally, courts agree that laws protecting intellectual property rights, including the laws governing trademarks, patents, and copyrights, are "applicable law" within the meaning in § 365(c)(1)(A). *See, e.g., In re Valley Media, Inc.*, 279 B.R. 105, 135 (Bankr. D. Del. 2002); *In re Golden Books Family Entm't, Inc.*, 269 B.R. 300, 307-10 (Bankr. D. Del. 2001); *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004). In addition, licensors of most trademarks and *non*-exclusive patents or copyrights are in many cases allowed to refuse to accept performance from a party other than the debtor under such laws. *See, e.g., In re Trump Entm't Resorts, Inc.*, 526 B.R. 116, 124 (Bank. D. Del. 2015) (explaining that "federal trademark law generally bans assignment of trademark licenses absent the licensor's consent because, in order to ensure that all products bearing its trademark are of uniform quality, the identity of the licensee is crucially important to the licensor"); *Perlman v. Catapult Entm't, Inc.* (*In re Catapult Entm't, Inc.*), 165 F.3d 747, 750-51 (9th Cir. 1999) (concluding that "[s]ince federal patent law makes nonexclusive patent licenses personal and nondelegable, § 365(c)(1)(A) is satisfied"); *Valley Media*, 279 B.R. at 135 (stating that "[a] non-exclusive license of rights by a copyright owner to another party is not assignable by that party without the permission of the copyright holder under federal copyright law since the license represents only a personal and not a property interest in the copyright"). Consequently, it is possible — and perhaps likely — for a licensor to thwart a debtor's attempt to assign an agreement for the use of a licensor's trademarks and *non*-exclusive patents or copyrights by withholding consent to the proposed assignment. In doing so, the licensor or franchisor could potentially leverage "consent rights" to, among other things, obtain more favorable agreement terms.

Less clear, but more striking, is whether a debtor who has no plans to assign an agreement is even permitted to assume it. This could put a debtor in a precarious situation upon entering bankruptcy, giving a licensor "super" consent rights. Courts are divided on this issue, generally adopting two different approaches referred to as the "hypothetical" and "actual" tests.

Many courts, including four circuit courts of appeals, have adopted a "hypothetical test," concluding under this test that a debtor may not assume an agreement if applicable law prohibits the assignment of the agreement to a *hypothetical* third party. *See, e.g., Sunterra*, 361 F.3d at 271; *Catapult Entm't*, 165 F.3d at 751-55; *City of Jamestown, Tenn. v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 534, 537 (11th Cir. 1994); *In re West Elecs. Inc.*, 852 F.2d 79, 83 (3d Cir. 1988). Applying this test could have significant results, as demonstrated by two recent bankruptcy court decisions. In *In re Trump Entertainment Resorts, Inc.*, 526 B.R. 116 (Bank. D. Del. 2015), for example, even though the debtors had no immediate plans to assign the agreement to a third party, the Delaware bankruptcy court concluded that the debtors were prohibited from assuming a trademark license agreement allowing for the use of the "Trump" name and mark for branding various casino properties, including the Trump Taj Mahal. Applying the hypothetical test (as adopted by the Third Circuit), the bankruptcy court in *Trump* granted the trademark licensor relief from the

automatic stay to continue an action to terminate the agreement. *See Trump*, 526 B.R. at 124. Similarly, in *Moe's Franchisor, LLC v. Taylor Invest. Partners II, LLC (In re Taylor Invest. Partners, II, LLC)*, __B.R. __, 2015 WL 4083871 (Bank. N.D. Ga. June 30, 2015), the Georgia bankruptcy court applied the hypothetical test established in the Eleventh Circuit and granted the franchisor of the Moe's Southwest Grill® brand relief from the automatic stay to terminate a number of franchise agreements with the debtor.

Though not addressed by the court, the franchisor in *Moe's* also argued that because § 365(c)(1) applied to bar assumption, the franchise agreements terminated automatically under the agreements' "*ipso facto clauses*." While § 365(e)(1) generally prohibits a non-debtor counter party to an executory contract from terminating the contract under such clauses, this section is not without exception. In particular, § 365(e)(2) — a corollary to § 365(c) — provides that § 365(e)(1) does not apply if:

> (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to assumption or assignment[.] 11 U.S.C. § 365(e)(2)(A).

Accordingly, if the license or franchise agreement contains an "*ipso facto clause*," it may in fact apply and give a licensor a relatively straightforward path to termination.

With or without an "*ipso facto clause*," where § 365(c) could apply to bar an assignment, courts following the "hypothetical" test will generally bar a debtor's assumption and, it follows, permit a licensor to proceed to terminate the agreement. This gives some licensors and franchisors potentially strong leverage in their post-petition relations with a debtor. For example, instead of waiting (and waiting) to learn whether or not a debtor intends to assume or reject its agreement, a licensor or franchisor who is able to press the issue will likely either force a debtor to decide relatively quickly or, at the very least, convince a debtor to keep current on its post-petition obligations in the meanwhile.

Other courts, including two circuit courts of appeals and a large number of bankruptcy courts, hold otherwise, adopting an "actual test," concluding under this test that § 365(c) does not apply to bar assumption unless a debtor *actually* seeks to assume and assign the agreement. *See, e.g., Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238, 247-51 (5th Cir. 2006); *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997); *see also Ohio Skill Games Inc.*, 2010 WL 2710522, at *4-*5 (Bank. N.D. Ohio July 8, 2010); *In re Adelphia Commn's Corp.*, 359 B.R. 65, 72 (Bank. S.D.N.Y. 2007). In other words, under this test § 365(c) does not apply to bar a debtor merely seeking to assume an agreement; the debtor must actually seek to assign it under this test.

In sum, no matter what test might apply, parties to intellectual property agreements such as licensors and franchisors should be mindful when a contract party enters bankruptcy. Effectively leveraging § 365 "consent rights" may ensure getting paid post-petition, resolve uncertainties regarding assumption or rejection, and provide a basis to modify or terminate an agreement. In any event, the licensor or franchisor likely stands to gain.