

# The Future Of Non-Exclusive License Agreements In California After The Ninth Circuit's Ruling IN RE CATAPULT ENTERTAINMENT, INC.

By: Rebecca Callahan, Diane C. Weil, Jennifer Hagle<sup>1</sup>

The Ninth Circuit Court of Appeals' recent decision in *In re Catapult Entertainment, Inc.*<sup>2</sup> refusing to allow the debtor to assume critical technology licenses has imposed new restrictions on reorganization in Chapter 11 cases, the impact of which may alter not only reorganization practice, but business lending practices as well. A petition for certiorari has been filed with the Supreme Court, but the pending result is, of course, uncertain. This article will explain the decision and discuss its potential impact on business practice.

## BANKRUPTCY LAW OVERVIEW

One of the major tools available to a debtor-in-possession or bankruptcy

trustee in a bankruptcy case is the power to assume executory contracts<sup>3</sup> under Section 365(a) of the Bankruptcy Code<sup>4</sup> and, in some instances, to assign such assumed contracts to third parties under Section 365(f).<sup>5</sup> To enhance this power, and thus the value of a debtor's bankruptcy estate and the prospects for such debtor's reorganization, Section 365(f) provides that an assumed contract may be assigned notwithstanding the existence of an anti-assignment clause or a provision of applicable law prohibiting or conditioning such assignment on the non-debtor party's consent.<sup>6</sup> There is, however, an exception to this broad assumption and assignment power. Under Section 365(c)(1) of the Bankruptcy Code,<sup>7</sup> if "applicable law" excuses the non-debtor party from accept-

performance to anyone other than the debtor, the nondebtor party's consent to the assignment is required.

In 1996, in the first reported decision addressing the effect of Section 365(c)(1) on patent licenses at the Circuit Court of Appeals level, the Ninth Circuit stated that it "recognized the apparent conflict between" Sections 365(f) and 365(c), but declined at that point to attempt to reconcile the two provisions.<sup>8</sup> More recently, the Ninth Circuit noted, in an automobile dealership case, that what Section 365(f)(1) gives in terms of free assignability, Section 365(c)(1)(A) "seems to take away."<sup>9</sup> Now, with its decision in *Catapult* the Ninth Circuit has resolved the issue, at least arguably, in favor of licensors.

1 The authors all are members of the Debtor/Creditor Relations and Bankruptcy Committee of the Business Law Section of the State Bar. Rebecca Callahan specializes in the areas of corporate reorganization and bankruptcy litigation/appeals and practices in Irvine, California. Jennifer Hagle is a partner with Sidley & Austin, Los Angeles, California, and specializes in the areas of bankruptcy, corporate reorganization and finance. Diane C. Weil is of counsel to Andrews & Kurth L.L.P., in its Los Angeles, California office, and specializes in the areas of corporate bankruptcy and reorganizations, complex individual bankruptcy and the representation of trustees.

2 *Pelzman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)*, 165 F.3d 747 (9th Cir. 1999) ("Catapult").

3 The Bankruptcy Code does not explicitly define what contracts are executory. The generally accepted definition of an executory contract is one in which the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and excuse the performance of the other. The fact that the subject matter of an agreement is licensing does not per se make it an executory contract. The inquiry turns on the particular rights and duties of each contracting party. Where material and unperformed obligations exist on both sides, the license will be deemed executory and must thus be assumed before it can be used by the debtor in its reorganized business or assigned to a third party for value.

4 Unless otherwise indicated, all statutory references are to Title 11 of the United States Code (the "Bankruptcy Code"). Section 365(a) of the Bankruptcy Code provides as follows:

Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.

5 Section 365(f) of the Bankruptcy Code provides in pertinent part as follows:

Except as provided in subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection; . . .

6 See *Worthington v. General Motors Corp. (In re Claremont Acquisition Corp.)*, 113 F.3d 1029, 1031 (9th Cir. 1997) ("Claremont Acquisition").

7 Section 365(c) of the Bankruptcy Code provides in pertinent part as follows:

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:

(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; . . .

8 *Everex Systems, Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 676-77 (9th Cir. 1996) ("Everex").

9 *Claremont Acquisition, supra*, 113 F.2d at 1031. (Continues on page 7)

## SUMMARY OF THE CATAPULT ENTERTAINMENT DECISION

Catapult Entertainment, Inc. ("Catapult") was a California corporation, formed in 1994 for the purpose of creating and operating an online gaming network for console videogames. In connection with that business enterprise, Catapult had, prior to filing bankruptcy, entered into approximately 140 licenses and leases, including two license agreements with Stephen Perlman ("Perlman") whereby it acquired the right to exploit certain relevant technologies created by the licensor.

In October, 1996, Catapult filed a petition under Chapter 11 of the Bankruptcy Code. Shortly before the bankruptcy filing, Catapult had entered into a merger agreement with Mpath Interactive, Inc. ("Mpath"). The merger agreement contemplated the filing of a bankruptcy proceeding by Catapult, to be followed by a reverse triangular merger, which would ultimately result in Catapult being the surviving entity. Under the contemplated reorganization plan, Catapult's creditors and equity holders would receive approximately \$14 million in cash, notes and securities. Catapult's creditors voted in favor of the plan by the majorities required under the Bankruptcy Code.

Upon filing Chapter 11, Catapult proposed a plan of reorganization, as contemplated by the merger agreement. In connection therewith, Catapult filed a motion under Section 365(a) seeking to

assume the 140 licenses and leases which were necessary to its ongoing business, including the two Perlman technology licenses. Over the licensor's objection, the Bankruptcy Court approved Catapult's assumption of the Perlman technology licenses and confirmed Catapult's plan of reorganization.

Perlman appealed the Bankruptcy Court's order approving assumption of the technology licenses to the District Court, which affirmed the Bankruptcy Court's decision. Perlman then appealed the District Court decision to the Ninth Circuit, which reversed the decision, finding that the Bankruptcy Court erred in permitting Catapult to assume the Perlman technology licenses over the licensor's objection. In so holding, the Ninth Circuit found that the "extraordinary authority" created under Section 365(a) and (f) of the Bankruptcy Code is "not absolute."<sup>10</sup>

In addressing the scope of the exception to the debtor's general right to assume and assign contracts in Section 365(c)(1), the Ninth Circuit adopted what is termed the "hypothetical test" and found that if, under applicable law, a debtor is not allowed to assign an executory contract to a third party without the other party's consent, then the debtor cannot assume the contract even though the debtor may have no intention of assigning it to a third party.<sup>11</sup> Relying on its earlier decision in *Everex*, the Ninth Circuit opined that "our precedents make it clear that federal patent law constitutes 'applicable law' within the meaning of § 365(c), and that nonexclusive patent

licenses are 'personal and assignable only with the consent of the licensor.'"<sup>12</sup>

## DISCUSSION

The *Catapult* decision will (unless overturned) affect a number of practice areas, including intellectual property, particularly those involving the licensing of patented technology, and practices involving the representation of business debtors and their creditors whose contract relationships are ongoing and could be characterized as personal service contracts or those driven by the personalities or identities of the contracting parties: e.g., entertainers, dealerships, franchises, partnerships and consultants. Broad application of the *Catapult* decision could significantly expand an otherwise relatively limited exception to the broad assumption and assignment powers under the Bankruptcy Code, thereby eliminating the bankruptcy reorganization option for those debtors whose continued existence depends upon continued contractual relations with others.

In 1997, the First Circuit Court of Appeals held in *Institute Pasteur v. Cambridge Biotech Corp.*<sup>13</sup> that a licensee under a non-exclusive patent license may assume such license in bankruptcy over the objection of the patent owner. One commentator noted that, as a result of the *Cambridge Biotech* decision, the "back door" appeared to be open for the strategic acquisition of otherwise inaccessible patented technology by industry competitors through a licensee's bankruptcy.<sup>14</sup> With the Ninth Circuit's

Section 365(f)(1) appears to authorize a trustee to assign an executory contract, notwithstanding any contrary provision in the contract or in applicable law, provided that adequate assurance of future performance by the assignee is provided. Section 365(f)(1), explicitly states, however, that it applies except as provided in subsection (c) of § 365. Subsection (c), in turn, prohibits an assignment of an executory contract if applicable law excuses the non-debtor party from accepting performance from the assignee. What § 365(f)(1) appears to give, § 365(c)(1)(A) seems to take away.

Recently, . . . this court recognized the apparent conflict between subsections (f) and (c), and noted that this conflict has led to two different constructions of § 365 and the meaning of the phrase "applicable law" in both subsections. . . . [We] did not find it necessary to resolve this conflict, however, because assignment of the patent at issue in that case was barred under either construction of the statute. Likewise, in the instant case, we find it unnecessary to address this matter because resolution of the conflict will not result in the assignment of the GM Dealer Agreements. Instead, we find that the issue raised by GM's cross-appeal, regarding the proper interpretation of § 365(b)(2)(D), is dispositive of this appeal.

113 F.3d at 1032 (citations omitted).

10 165 F.3d at 749.

11 165 F.3d at 750.

12 *Id.*

13 104 F.3d 489 (1st Cir.), *cert. denied*, 521 U.S. 1120, 117 S.Ct. 2511, 138 L.Ed.2d 1014 (1997) ("*Cambridge Biotech*").

decision in *Catapult*, other commentators have noted that such "back door" access to patented technology appears to have been appropriately slammed shut.<sup>15</sup>

Further, the *Catapult* decision is unlikely to be limited to its facts with regard to the test to be applied under Section 365 in determining whether an executory contract may be assumed without the nondebtor party's consent. In this regard, the Ninth Circuit described its task as one which required it to decide between the "competing visions" of Section 365(c)(1).<sup>16</sup> The Ninth Circuit also called attention to the fact that it had declined to choose between the competing visions of the "hypothetical test" and the "actual test" on two prior occasions in the *Claremont Acquisition* and *Everex* cases, and expressly stated that it was now deciding that issue and joining "the Third and Eleventh Circuits in adopting the 'hypothetical test.'"<sup>17</sup>

Under the "hypothetical test" as described by the Ninth Circuit, the plain language of Section 365(c)(1) links nonassignability with a prohibition on assumption in bankruptcy and bars a debtor from assuming an executory contract without the nondebtor party's consent where "applicable law" would excuse the nondebtor party from accepting performance from or rendering performance to someone other than the original contracting party.<sup>18</sup>

[T]he statute by its terms bars the debtor-in-possession from assuming an executory contract without the non-debtor's consent where applicable law precludes assignment of the contract to a third party. The literal language of § 365(c)(1) is thus said

to establish a 'hypothetical test': a debtor-in-possession may not assume an executory contract over the non-debtor's objection if applicable law would bar assignment to a hypothetical third party, even where the debtor-in-possession has no intention of assigning the contract in question to any such third party.<sup>19</sup>

Where the law recognizes the identity of the contracting parties as material to the agreement, Section 365(c)(1), as construed by the Ninth Circuit, will prevent a debtor in bankruptcy from assuming the contract without the consent of the nondebtor party. As reasoned by the Ninth Circuit, this rule applies even where the debtor does not propose to substitute a new party into the contract via an assignment because, by its literal terms, Section 365(c)(1) addresses two conceptually distinct events: assumption and assignment.<sup>20</sup> "The plain language of the provision makes it clear that each of these events is contingent on the nondebtor's separate consent."<sup>21</sup>

While *Catapult* announced a general rule concerning the interpretation of Section 365(c)(1) and its relationship to pro-assignment provisions of Section 365(f)(1), one could (and some undoubtedly will) argue that the Ninth Circuit's application of that rule should be limited to its facts: namely, the assumability of a non-exclusive patent license by a debtor/licensee. The Ninth Circuit's discussion was focused almost entirely on the competing interpretations of Section 365(c)(1) theretofore advanced in other jurisdictions and on justifying its adoption of the "literal language" approach as the proper method of interpretation.<sup>22</sup>

However, the Court did not address the question of what types of contracts will be subject to the "hypothetical test" and instead noted that it was a preliminary issue which was "either not disputed by the parties, or so clearly established as to deserve no more than passing reference."<sup>23</sup> The Ninth Circuit noted that nonexclusive patent licenses are "personal and assignable only with the consent of the licensor", based on its earlier decision in *Everex*,<sup>24</sup> but offered no further guidance and made no further ruling as to what other types of executory contracts might fall within Section 365(c)(1).

## HOW CATAPULT MAY AFFECT PRACTICE IN THE 9TH CIRCUIT

What effect might the *Catapult Entertainment* decision have on bankruptcy practice in California and in the Ninth Circuit? *Catapult Entertainment*, particularly when taken together with *Claremont Acquisition*, and other cases that might be seen as limiting what have been viewed as "traditional" rights of debtors-in-possession or trustees, may well have a far-reaching impact. Clearly, *Catapult Entertainment* will discourage the filing of significant reorganization cases involving contracts of any kind in the Ninth Circuit. Since there is no assurance (or even likelihood) that *Catapult* will be limited to non-exclusive patent licenses, the "chilling effect" may extend to other areas as well, such as sports and entertainment, manufacturing and any other industry involving rights acquired by contract. To the extent debtors have options regarding where to file, they will

14 See Henschel, Virginia, *Back Door Access to Patented Technology*, 17 ABI Journal 40, 41 (February, 1998).

15 See Hesse, Gregory G., *Ninth Circuit Slams Shut the "Back Door" Access to Patented Technology*, 18 ABI Journal 18 (April 1999).

16 165 F.3d at 749-50.

17 *Id.*

18 165 F.3d at 752.

19 165 F.3d at 750, citing 1 David G. Epstein, Steve H. Nickles & James J. White, *Bankruptcy* § 5-15 at 474 (1992); *City of Jamestown v. James Cable Partners, L.P.* (In re *James Cable Partners, L.P.*), 27 F.3d 534, 537 (11th Cir. 1994); and *In re West Elec., Inc.*, 852 F.2d 79, 83 (3d Cir. 1988).

20 165 F.3d at 752.

21 *Id.*

22 165 F.3d at 750-54.

23 165 F.3d at 750.

24 *Id.*

file elsewhere. (Although Delaware, the most common alternative, is in the Third Circuit, and that is likewise a "hypothetical test" circuit.)<sup>25</sup>

In extreme cases, debtors might even be advised to relocate their principal place of business prior to filing a bankruptcy petition<sup>26</sup> to a venue where the "actual test" has been adopted,<sup>27</sup> to avoid the "hypothetical test." Not only is that detrimental to lawyers practicing in the Ninth Circuit, it could have a negative effect on developing businesses in California and elsewhere in the Ninth Circuit by encouraging affected businesses to locate or maintain their primary operations elsewhere.

Perhaps the most disturbing repercussion of *Catapult* is that businesses with financial problems, which have no alternative venue to the Ninth Circuit and who are thus faced with the prospect of losing their business if they cannot assume critical license agreements, will be encouraged to run their businesses to the very end, to extract every possible dollar, and then simply walk away rather than attempt a court-supervised reorganization under Chapter 11 of the Bankruptcy Code. Some would say that *Catapult* takes a "form over substance" approach and, in its wake, will leave creditors in general with far less return on their claims than they would otherwise receive if the debtor had the option of staying in business through a Chapter 11 reorganization which would allocate future profits towards the repayment of their debts.

Thus, the Ninth Circuit, and particularly California, already burdened with the highest volume of consumer and liquidation cases in the nation, may see only those Chapter 11 bankruptcies where the debtor has no alternative venue option.

What types of businesses will be affected by the *Catapult* decision? Virtually any type of company which specializes in, or utilizes to any significant extent, specialized non-exclusive licenses as an integral part of its business will be affected by the Ninth Circuit's decision in *Catapult*. This would include distribution companies, which rely heavily on software packages to manage their businesses; entertainment and computer/technology companies, whose infrastructure is dependent upon the licensing of intellectual property; companies which use specialized licenses in connection with their production or manufacturing activities; and companies which design and manufacture hardware and software used for transmitting information between complex systems or who provide technical support, training, maintenance and repair services.

In what ways will businesses be affected by the *Catapult* decision? First, businesses can no longer forecast a favorable outcome in bankruptcy with respect to technology licenses which are non-exclusive. Accordingly, as a counter-measure, management may seek to have a VAR (value added reseller) customize the technology in question. Such customizing would, arguably, make what is essentially a non-exclusive software product qualify as exclusive technology, resulting in the treatment of such licenses as present transfers of property interests so that the licensee's rights "vest" upon transfer, thereby removing the license from characterization as an executory contract falling within the purview of Section 365 because there is nothing material left to be performed by the licensor.

In cases where customization is not feasible, a company whose business depends

upon licensed technology may attempt to obtain the licensor's consent to assumption and/or assignment up front. However, such consent would inevitably come at a cost, thereby changing the economics of the initial licensing transaction, and may or may not ultimately be enforceable should the licensee file bankruptcy.

As long as *Catapult* is controlling law, as soon as a business dependent upon licensed technology identifies that it is experiencing serious financial difficulty, its workout discussions must now address the issue of ongoing consent from the licensor in the context of bankruptcy. Obtaining such concessions from the licensor will also no doubt come at a cost because of the increased leverage which *Catapult* gives to licensors. Because of that added leverage, an out-of-court workout setting may offer better restructuring alternatives than a bankruptcy reorganization.

Any high-risk venture should give serious consideration, on a forward-going basis, to whether it makes sense to rely primarily on one or two critical non-exclusive licenses. If at all possible, the leverage of any one licensor will by definition be reduced if there are other, more cooperative licensors, upon which the company may rely. The extent to which the licensee can offer a particular licensor unique benefits will also increase the licensee's leverage.

Finally, reliance upon one or two critical non-exclusive licenses may directly affect the ability of a licensee to obtain financing upon reasonable terms given that the risk of the licensee's control over the asset in bankruptcy may directly and adversely affect the ultimate value of the lender's security interest in such asset.

25 See *In re Catron, supra*, 158 B.R. 629, 633-38.

26 The term "venue," in the context of a bankruptcy case, refers to the district in which the case is filed and will be administered. See *In re Pinehaven Associates*, 132 B.R. 982, 987 (Bankr. E.D.N.Y. 1991). Venue of cases under the Bankruptcy Code is governed by 28 U.S.C. § 1408, which provides that a bankruptcy case may be commenced in the district court for the district in which the principal place of business or the principal assets of the debtor have been located for the 180 days immediately preceding the bankruptcy filing or for a longer period of such 180 day period (i.e., 91 days) where domicile, residence or principle place of business has changed during the 180 days period.

27 As of this writing, such jurisdictions include the First Circuit, *Cambridge Biotech, supra*, 104 F.3d 489, 493; and a number of lower courts in Louisiana, Florida, Texas and Ohio. See, e.g., *Texaco Inc. v. Louisiana Land and Expl. Co.*, 136 B.R. 658, 668-71 (M.D. La. 1992); *In re GP Express Airlines, Inc.*, 200 B.R. 222, 231-33 (Bankr. D.Neb. 1996); *In re Am. Ship Bldg. Co.*, 164 B.R. 358, 362-63 (Bankr. M.D. Fla. 1994); *In re Fastrax*, 129 B.R. 274, 277 (Bankr. M.D. Fla. 1991); *In re Hartec Enters, Inc.*, 117 B.R. 865, 871-73 (Bankr. W.D. Tex. 1990), *vacated on other grounds*, 130 B.R. 929 (W.D. Tex. 1991); *In re Cardinal Indus., Inc.*, 116 B.R. 964, 976-82 (Bankr. S.D. Ohio 1990).

Consequently, without licensor consent, it is likely that both a lender's initial credit decision (at worst) and pricing (at best) would be affected.

Will the *Catapult* decision affect any segment of business or industry besides licensees? Without a doubt, the *Catapult* decision will be taken into account principally by lenders to licensees where significant value has been allocated to collateral consisting of licensed intellectual property. Bankruptcy is always in the back of a lender's mind when negotiating a loan involving any type of collateral. Where the collateral for a loan is a license of intellectual property, *Catapult* creates the risk that the lender may lose its collateral if the borrower/licensee files bankruptcy. This increased level of uncertainty as to whether or not the borrower licensee will be able to retain its license rights following a bankruptcy filing is likely to impact the initial credit decision of whether or not to make a loan where a license is critical to the borrower's business.

*Catapult* is but another example of a number of recent decisions<sup>28</sup> which highlight the tension between the modern rule of free transferability of commercial contract rights, which is a basic tenet of the modern credit economy,<sup>29</sup> and the intellectual property law restrictions on assignability, rooted in the Constitution,<sup>30</sup> which prefer the rights of the creator over the licensee with respect to any transfer of the right to use the licensed discovery or invention, thus discouraging free assignability. In the area of non-exclusive licenses of software rights (which really are more in the nature of a commercial commodity), however, the policies which drove the courts and legislators to protect an author's proprietary rights simply do not apply. This is especially true for distributors as opposed to end users.

How might the lending industry respond to the *Catapult* decision? Where a particular intellectual property license is critical to the value of the lender's collateral package, currently most lenders generally require the consent to assignment of the licensor as a condition to making the loan. That protocol most likely will not change after *Catapult*. What may change is the willingness of a lender to waive the licensor's consent as a precondition if obtaining such consent is costly or will cause a delay. Additionally, the type of licensor consent will probably be expanded considerably so as to not only include the advance express consent of the licensor to agree to assumption of the subject license in the event of a licensee bankruptcy, but also to include other detailed provisions similar to those found in landlord consents or other non-disturbance-type agreements (i.e., licensor will continue to honor license as long as payments are made, either by licensee or by lender upon default, etc.).

Is the "hypothetical test" adopted by the Ninth Circuit in *Catapult* necessarily a benefit to licensors when their licensees go into bankruptcy? At first blush, the hypothetical test might seem to favor licensors by providing them with leverage when licensees go into bankruptcy — the ability to force the debtor to provide new consideration in exchange for consent to the assumption of the license agreement. However, in cases where no agreement can be reached, the ability to force a rejection by the licensee, and thus a termination of the licensee's rights thereunder, may not be at all beneficial to the licensor, especially if the licensor is a creditor of the licensee.

In *In re Dak Industries*,<sup>31</sup> the Ninth Circuit held that the debtor's continued post-petition use of a license did not give rise to an administrative priority claim, such that, upon rejection, the licensor's

claim was limited to an unsecured claim. *Dak Industries*, binding case precedent in the Ninth Circuit, thus poses the threat to licensors that a debtor licensee may be able to use licensed property for some period of time before being compelled to assume or reject the license agreement, and may not have to pay for that use in full. This counter-balancing authority may help level the playing field for debtor licensees faced with *Catapult* and non-consenting licensors, but probably not enough to balance the risk of losing a critical license completely.

If the Ninth Circuit's ruling placed such restrictions on reorganization, what might the alternative have been? The First Circuit, in *Cambridge Biotech*,<sup>32</sup> citing its prior ruling in *Summit Investment and Development Corp. v. Leroux (In re Leroux)*,<sup>33</sup> rejected the "hypothetical test" in favor of "case by case inquiry into whether the non-debtor party actually was being 'forced to accept performance . . . from someone other than the debtor with whom it originally contracted.'"<sup>34</sup>

The First Circuit's analysis was intended to be "sensitive to the rights of the non-debtor party," but directed the bankruptcy court to "focus on the performance actually to be rendered by the debtor-in-possession with a view to ensuring that the non-debtor party will receive the full benefit of its bargain."<sup>35</sup> Hence, the term "actual test."

The difference between the two can be best described by looking at the facts and the holding in *Cambridge Biotech*, which allowed the debtor to assume a license for technology, even though it was now a subsidiary of another company (through a change in stock ownership as part of a plan of reorganization). Thus, on facts very similar to those in *Catapult*,<sup>36</sup> the First Circuit held that because in that

28 See *In re Avalon Software, Inc.*, 209 B.R. 517 (Bankr. D. Ariz. 1997).

29 See 3 E. Allan Farnsworth, *Contracts*, 11.1, 61-65 (Little Brown & Co. 1990).

30 U.S. Const., art. I, § 7 (promoting "the Progress of Science and useful Arts, but securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries").

31 66 F.3d 1091 (9th Cir. 1995) ("Dak Industries").

32 104 F.3d 489 (1st Cir. 1997).

33 69 F.2d 608 (1st Cir. 1995) ("Leroux").

34 *Cambridge Biotech, supra*, 104 F.3d at 493, citing *Leroux, supra*, 69 F.2d at 612 (emphasis in original).

35 *Id.*, citing *Leroux*, 69 F.3d at 612-613.

36 The facts in *Catapult* involved a reverse triangular merger whereby the debtor corporation was the surviving entity.

particular case, performance was to be rendered by substantially the same entity as that with which the non-debtor party had contracted, the non-debtor party would get the full benefit of its bargain, and the contract could be assumed. The "hypothetical test," as the name suggests, assumes hypothetical facts; namely, that the debtor will seek to assign the contract in issue to another party without the non-debtor party's consent. If "applicable law" prohibits such an assignment, then, under the "hypothetical test," the debtor may not assume the contract even though the debtor may have no intention of assigning it to a third party.<sup>37</sup>

While the First Circuit acknowledged the Ninth Circuit's ruling in *Everex*,<sup>38</sup> preventing the assignment of a patent license, it held that the transfer of stock did not alter the corporate identity of the debtor corporation, such that the license was not being assigned.<sup>39</sup>

Is there any way to avoid *Catapult*? For instance, can license rights be sold under 11 U.S.C. § 363 instead of assigned so as to avoid the assumption/rejection issues and the "hypothetical test"? In the Ninth Circuit, at present, the only way to avoid *Catapult* and its "hypothetical test" is to avoid Section 365 of the Bankruptcy Code.

Section 363 of the Bankruptcy Code allows a bankruptcy trustee or debtor-in-possession to sell "property of the estate."<sup>40</sup> However, because executory contracts involve future liabilities, not just rights, an executory contract does not become an asset of the estate until it is assumed pursuant to Section 365 of the Bankruptcy Code.<sup>41</sup> Section 365 thus

operates as a gatekeeper to ensure that the debtor's bankruptcy estate is not charged with future liabilities without a corresponding benefit to the estate that, presumably, will outweigh the liabilities.<sup>42</sup>

For the licensee which finds itself in a Chapter 11 reorganization proceeding, there are two critical questions which must be answered before the debtor/licensee takes any action vis-à-vis the licenses: (1) Does the debtor intend to reorganize and continue operating its business or is the purpose of the bankruptcy to liquidate the business as a going concern? (2) If the debtor intends to reorganize (versus liquidate), are any licenses or other executory contracts necessary to the continued operation and success of the debtor's business? If the debtor is using the bankruptcy proceeding to conduct an orderly liquidation of its assets, it may prefer to make a motion under Section 363 to sell those contract rights for which it has found a buyer — without first making a motion to assume any contracts which might be deemed to be executory — because the debtor does not want to undertake the burdens of the contract; it simply wants to capture the value which will then be used to pay the debtor's pre-petition liabilities. Under this scenario, the executory contract issue might be avoided by utilizing Section 363. However, if the nondebtor party objects to the proposed sale, as occurred in *In re Quintex Entertainment*,<sup>43</sup> the Court still might decline to approve a sale of executory contracts without prior assumption.<sup>44</sup>

For the debtor who resorts to bankruptcy for the purpose of reorganizing

and continuing with the operation of its business, *Catapult Entertainment* threatens and perhaps even spells the death knell for such prospects by providing technology licensors and possibly others with veto power concerning the debtor's continued rights under pre-petition contracts which may qualify as "executory." In advance of filing for bankruptcy, a debtor will want to carefully assess what contracts are critical to its continued operations and, of those contracts, which might qualify as "executory contracts" because significant performance is still owed by both parties to the contract. For those contracts which do not appear to be "executory," the debtor might plan on filing a "first-strike" motion under Section 363 seeking an order allowing the debtor to use such contracts in its post-petition business operations. If any non-debtor parties object to such use on the grounds that the contracts are executory and cannot be used as property of the estate unless and until assumed, then the debtor will know that Section 365 is going to be an issue in its case and that assumption may not be possible without the non-debtor party's consent. This would appear to be a harsh construction of Section 365, especially in cases where there is to be no change in the debtor as a result of the bankruptcy. However, according to the Ninth Circuit, such "[p]olicy arguments cannot displace the plain language of the statute; that the plain language of § 365(c)(1) may be bad policy does not justify a judicial rewrite. . . . Because the statute speaks clearly, and its plain language does not produce a patently absurd result or contravene any clear legislative

37 165 F.3d at 750.

38 89 F.3d at 673.

39 *Cambridge Biotech, supra*, 104 F.3d at 494.

40 11 U.S.C. § 363(b)(1).

41 11 U.S.C. § 365(a); *In re Tleel*, 876 F.2d 769, 770 (9th Cir. 1989) ("Unless and until rights under an executory contract are timely and affirmatively assumed by the trustee, they do not become property of the debtor's estate").

42 See *Cheadle v. Appleatchee Riders Ass'n (In re Lovitt)*, 757 F.2d 1035, 1041 (9th Cir.), *cert. denied*, 474 U.S. 849 (1985). "[T]he debtor's decision to assume is not a unilateral decision, but rather, is subject to the court's approval." *Sea Harvest Corp. v. Riviera Land Co.*, 868 F.2d 1077, 1079 (9th Cir. 1989).

43 950 F.2d 1492 (9th Cir. 1991).

44 The debtor in the *Quintex Entertainment* case sold its entertainment assets under Section 363, which assets included a movie distribution agreement and an agreement allowing the debtor to use and license George C. Scott's name and likeness in connection with four television movies for which Scott had completed his acting services. The Ninth Circuit determined that the movie distribution agreement was executory and, as such, could not be sold under Section 363 without first being assumed by the debtor under Section 365. 950 F.2d at 1497. As to the other contracts, the Ninth Circuit concluded that the contracts were not executory and were thus properly sold pursuant to Section 363. 950 F.2d at 1497.

history, we must 'hold Congress to its words.'<sup>45</sup>

Can the drafting of the contract avoid the problems of *Catapult*? The primary concern of the Ninth Circuit, as expressed in both the *Catapult Entertainment* and *Everex* decisions, was the protection of the expectations of the nondebtor party where the identity of the other contracting party was material to the agreement so that upon the bankruptcy of one party, the other party was not forced to accept performance from or render performance to an entity different from the one with which it originally contracted.<sup>46</sup> One way to avoid this issue would be to include a provision in the contract whereby the parties acknowledge and agree that the obligations being exchanged under the contract are not personal; that the identity of the parties to the agreement is not material. Alternatively, the drafter could include a provision in the contract which provides for advance consent to the other party's assumption of the contract in bankruptcy.

Neither of the drafting tips discussed above addresses what qualifies a contract as executory. In fact, they both implicitly assume that the contract in issue might qualify as executory, and simply seek to eliminate the need for the nondebtor party's consent as a condition to assumption by the debtor party. Drafting to avoid the contract being deemed executory is a more challenging task because it turns upon the particular rights and duties of each contracting party<sup>47</sup> as to which state construction-of-contracts law will control.<sup>48</sup> In the area of nonexclusive

patent licensing, there would appear to be very little that one could do to eliminate the contract being deemed executory by contractually defining the parties' respective performance obligations as material or immaterial because the Ninth Circuit has determined that the licensor's contractual obligation to refrain from suing for infringement and the licensee's obligation to mark all products made under the license with the proper statutory patent notice qualify as meaningful performance obligations remaining on either side of such contracts.<sup>49</sup> Where technology or intellectual property is critical to the continued operation of a business, that business should consider negotiating for an assignment of the patent (which would transfer ownership interest in the patent), versus licensing. Alternatively, the business should try negotiating for an exclusive license, even if limited by geography or industry. Under either of these latter scenarios, the licensee could then argue that the contract is not executory because, by virtue of giving the licensee ownership of the technology or the exclusive right to exploit the technology for commercial gain, the licensor does not owe any remaining material duties to the licensee.<sup>50</sup>

## CONCLUSION

There is a clear split between the First Circuit<sup>51</sup> and a whole host of lower courts (which favor the "actual test") and the Third,<sup>52</sup> Fourth,<sup>53</sup> Ninth<sup>54</sup> and Eleventh<sup>55</sup> Circuits (which favor the "hypothetical test") concerning the proper method of

applying Section 365(c)(1) and harmonizing it with Section 365(f)(1). So as to have uniform standards that apply to debtors, creditors and bankruptcy estates nationwide, regardless of the Circuit in which a case is filed, Supreme Court review in *Catapult Entertainment* would appear to be in order for purposes of defining what an executory contract is under the Bankruptcy Code and when the nondebtor party's consent shall be required for assumption and/or assignment of such contracts. As stated above, a petition for such review has been filed.

In addition, another possible avenue, legislative amendment of Section 365, is also available and being pursued. Representative Howard L. Berman (D-Calif.) has introduced an amendment to the bankruptcy legislation presently pending in Congress that would allow trustees or debtors-in-possession to assume personal service contracts, intellectual property licenses or other non-assignable contracts, as was, according to UCLA Law Professor Ken Klee, the original intent of the amendments to Section 365 made in 1984.<sup>56</sup> Clarification of the language of the statute would, at least, assist the courts and practitioners in future cases.

45 165 F.3d at 754, citing *Brooker v. Desert Hosp. Corp.*, 947 F.2d 412, 414-115 (9th Cir. 1991).

46 165 F.3d at 752.

47 See *In re Alexander*, *supra*, 670 F.2d at 887; *In re Select-A-Seal Corp.*, *supra*, 625 F.2d at 292.

48 See *In re Asian*, 909 F.2d 367, 369 (9th Cir. 1990).

49 See *Everex*, *supra*, 89 F.3d at 677.

50 See *In re Learning Publications, Inc.*, *supra*, 94 B.R. 763, 765 (book contract in which the author/licensor gave the debtor licensee broad publication and distribution rights as to books that had been written as of the debtor's bankruptcy filing, held not an executory contract); *In re Stein and Day, Inc.*, *supra*, 81 B.R. 263, 267 (same).

51 See *Cambridge Biotech*, *supra*, 104 F.3d 489.

52 See *In re West Elec., Inc.*, *supra*, 852 F.2d 79, 83.

53 See *In re Catron*, 158 B.R. 629, 633-38 (E.D. Va. 1993), *aff'd* without op., 25 F.3d 1038 (4th Cir. 1994).

54 See *Catapult Entertainment*, *supra*, 165 F.3d 747, 750-52.

55 See *In re James Cable Partners*, *supra*, 27 F.3d 534, 537.

56 "Amendment Would Fix Section 365," *Bankruptcy Court Decisions, Weekly News & Comment*, Vol. 34, Issue 9, p. 3 (June 15, 1999).