

**DEBTORS BEWARE:  
THE EXPANDING UNIVERSE OF NON-ASSUMABLE/  
NON-ASSIGNABLE CONTRACTS IN BANKRUPTCY**

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INTRODUCTION

A debtor's ability to assume (*i.e.*, affirm) or reject (*i.e.*, disavow) executory contracts and unexpired leases in bankruptcy has long been recognized as one of the primary and essential tools available to a debtor under the Bankruptcy Code.<sup>1</sup> This tool generally allows a debtor to keep favorable contracts (and compel continued performance by the nondebtor parties to such contracts) and to discard burdensome contracts (and avoid any future performance obligations under such contracts).<sup>2</sup> In fact, a debtor generally may assume and then assign an executory contract or unexpired lease to a third party notwithstanding any provision in the contract or lease, or in applicable law, "that prohibits, restricts, or conditions the assignment of such contract or lease."<sup>3</sup> An assignment by a debtor under this section of the

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<sup>1</sup> See 11 U.S.C. §§ 101–1330 (2000) (the "Bankruptcy Code"). The Bankruptcy Code does not define the term "executory contract," however, the legislative history to section 365 of the Bankruptcy Code suggests that a contract is executory if "... performance remains due to some extent on both sides" to the contract. See S. REP. NO. 95-989, at 58 (1978) ("Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides."); H.R. REP. NO. 95-595, at 347 (1977) (noting executory contract "... generally includes... [one in] which performance remains due to some extent on both sides."); see also Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973) ("[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 to complete performance would constitute a material breach excusing the performance of the other."). In addition, some courts employ a "functional approach" to determine if a contract is executory for purposes of the Bankruptcy Code. See cases cited *infra* note 22.

<sup>2</sup> See 11 U.S.C. § 365(a) (2000) ("[T]he trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."); see also *Eagle Ins. Co. & Newark Ins. Co. v. BankVest Capital Corp.* (*In re BankVest Capital Corp.*), 360 F.3d 291, 295 (1st Cir. 2004) ("Section 365 generally allows [a debtor] . . . to assume or reject [a contract] . . . subject to the approval of the bankruptcy court."); *In re Gray Truck Line Co.*, 34 B.R. 174, 177 (Bankr. M.D. Fla. 1983) ("One of the most important . . . tools available to a debtor is the right to either assume . . . or to reject [a contract] . . . pursuant to § 365(a) of the Bankruptcy Code.").

<sup>3</sup> See 11 U.S.C. § 365(f)(1) (2000); see also *In re Ames Dep't Stores*, 287 B.R. 112, 118–19 (Bankr. S.D.N.Y. 2002) (noting "... debtors may assume and assign their interest in leases even without lessor consent, and that notwithstanding any provisions in leases that prohibit, restrict, or condition the assignment of those leases, they may nevertheless be assigned."); *In re Office Prods. of Am., Inc.*, 136 B.R. 992, 996–97 (Bankr. W.D. Tex. 1992) (noting section 365(f)(1) generally permits a debtor to assume and assign executory contracts notwithstanding any provision "... that prohibits, restricts, or conditions the assignment of such contract or lease . . .").

Bankruptcy Code also does not require the consent of the nondebtor party to the contract or lease.

In a perfect debtor's world, that would be the end of the story. There are, however, a few "limited" exceptions to a debtor's general assumption and assignment authority under the Bankruptcy Code.<sup>4</sup> As a result of its more frequent invocation in recent years by nondebtor parties (as well as its broader acceptance by courts), at least one of these so-called limited exceptions has become far more expansive. This exception, found in section 365(c)(1) of the Bankruptcy Code, provides that a trustee or debtor in possession may not assume or assign an executory contract or unexpired lease if "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."<sup>5</sup> The section 365(c)(1) exception often is called the "personal service contracts" exception because courts initially limited the application of section 365(c)(1) to contracts and leases qualifying as personal service contracts under applicable state law.<sup>6</sup> This is no longer the case. Courts are now adopting a far more expansive approach to section 365(c)(1)—an approach often described as covering "personal contracts and contracts of public importance."<sup>7</sup> Under this broader approach, a wide array of contracts and leases have been excluded from a debtor's general assignment (and, as discussed below, assumption) authority, including personal service contracts (which can include contracts with corporations as well as individuals), partnership agreements, intellectual property licenses, government contracts, franchise agreements and limited liability company agreements.

Once a contract is found to be within the scope of section 365(c)(1) of the Bankruptcy Code, a second issue arises as to whether section 365(c)(1) prevents the debtor from assuming the contract for the benefit of the estate and the reorganized debtor.<sup>8</sup> Indeed, numerous courts have determined that section 365(c)(1) not only

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<sup>4</sup> See *Texaco Inc. v. La. Land & Exploration Co.*, 136 B.R. 658, 670–71 (M.D. La. 1992) (noting Congress intended section 365(c) to be narrow exception); *Abney v. Fulton County (In re Fulton Air Serv., Inc.)*, 34 B.R. 568, 571 (Bankr. N.D. Ga. 1983) ("[C]ourts have interpreted that an executory contract or an unexpired lease is assignable under the general rule provided for in § 365(f) unless it falls under the narrow exception provided in § 365(c).").

<sup>5</sup> See 11 U.S.C. § 365(c)(1)(A) (2000).

<sup>6</sup> See cases cited *infra* note 65.

<sup>7</sup> *In re Headquarters Dodge Inc.*, No. 92-1030, 1992 U.S. Dist. LEXIS 18640, at \*15 (D.N.J. Nov. 25, 1992) (noting that some courts have applied section 365(c) to personal contracts and contracts of public importance), *rev'd sub nom.*, 13 F.3d 674 (3d Cir. 1993); see also *Texaco*, 136 B.R. at 670–71 (recognizing exception applies to contracts of public importance).

<sup>8</sup> Courts utilize two different approaches with respect to this issue under section 365(c)(1) of the Bankruptcy Code. Under the "actual test," section 365(c)(1) applies only if the debtor actually seeks to assign an executory contract or unexpired lease that cannot be assigned under applicable nonbankruptcy law. In contrast, under the "hypothetical test," section 365(c)(1) prohibits the assumption of any executory contract or unexpired lease when applicable law prohibits the assignment of the particular contract or lease,

prevents the assignment of certain contracts, but also prevents the assumption and performance of the contract by the debtor itself.<sup>9</sup> Consequently, if a contract or lease falls within the section 365(c)(1) exception, bankruptcy may end a debtor's rights under that contract or lease. This harsh result may be avoided if the debtor obtains the nondebtor contract party's consent to the assumption (or assignment) of the contract or lease by the debtor.<sup>10</sup> In addition, because some courts have determined that, notwithstanding the non-assumable nature of a contract or lease under section 365(c)(1), the nondebtor party must first obtain relief from the automatic stay imposed by section 362(a) of the Bankruptcy Code before terminating the contract or lease, termination may be postponed.<sup>11</sup> If, however, the contract or lease at issue is an integral or valuable component of the debtor's business, neither of these potential alternatives will likely provide comfort to a potential debtor. On the other hand, nondebtor parties often view section 365(c)(1) as one of the few protections provided to them under the Bankruptcy Code and are increasingly utilizing this protection in the drafting and characterization of their agreements with entities potentially facing financial distress.

Regardless of whether you are or represent a financially troubled entity or a party dealing with a financially troubled entity, it is important to understand the scope, application and consequences of section 365(c)(1) of the Bankruptcy Code. Such an understanding will allow a potential debtor to anticipate and prepare for any section 365(c)(1) issues in its bankruptcy case and will help the nondebtor party utilize the protections provided by this section. Accordingly, this article: (A) provides a basic overview of section 365 of the Bankruptcy Code; (B) examines the courts' application of section 365(c)(1) to personal service contracts,<sup>12</sup> partnership agreements,<sup>13</sup> intellectual property and technology licenses,<sup>14</sup> government contracts,<sup>15</sup> franchise agreements,<sup>16</sup> limited liability company agreements and joint venture agreements;<sup>17</sup> (C) reviews the current split in the courts regarding whether section 365(c)(1) prohibits only assignment or, rather, assumption *and* assignment of protected contracts and leases; (D) examines the rights of nondebtor parties to a contract or lease subject to section 365(c)(1); and (E) provides some basic related practice tips for both potential debtors and nondebtor parties in light of all of the foregoing.

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even if no such assignment is actually contemplated. A more detailed discussion of these two tests can be found in Section IV of the article.

<sup>9</sup> See cases cited *infra* note 196.

<sup>10</sup> See 11 U.S.C. § 365(c)(1)(B) (2000) ("The trustee may not assume or assign any executory contract or unexpired lease of the debtor . . . [if] such party does not consent to such assumption or assignment . . ."); see also cases cited *infra* note 272.

<sup>11</sup> See cases cited *infra* note 240.

<sup>12</sup> See *infra* Section II.B.1.

<sup>13</sup> See *infra* Section II.B.2.

<sup>14</sup> See *infra* Section II.B.3.

<sup>15</sup> See *infra* Section II.B.4.

<sup>16</sup> See *infra* Section II.B.5.

<sup>17</sup> See *infra* Section II.B.6.

## I. ASSUMPTION AND ASSIGNMENT OF EXECUTORY CONTRACTS AND UNEXPIRED LEASES

### A. General Overview of Assumption

Section 365(a) of the Code sets forth the basic power of a trustee in bankruptcy or a debtor in possession<sup>18</sup> to assume or reject an executory contract or unexpired lease.<sup>19</sup> Although section 365 does not define the term "executory contract," the legislative history refers with approval to the following definition developed by Professor Countryman: "[An executory contract is a] contract under which the obligations 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 performance of the other."<sup>20</sup> Accordingly, under the Countryman definition, section 365 applies to "contracts on which performance

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<sup>18</sup> In a chapter 11 case, a debtor in possession has the right to exercise the trustee's power to assume or reject an executory contract or unexpired lease. In particular, section 1107(a) of the Bankruptcy Code provides:

Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter.

11 U.S.C. § 1107(a) (2000).

<sup>19</sup> 11 U.S.C. § 365(a) (2000) ("Except as provided in sections 765 and 766 or 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."). The rejection of an executory contract or unexpired lease constitutes a breach of such contract or lease immediately before the date of the filing of the bankruptcy petition. *See* 11 U.S.C. § 365(g) (2002) ("[T]he rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease[.]"). Accordingly, the nondebtor party to a rejected contract becomes a general unsecured creditor and is permitted to seek allowance of its rejection damages claim under section 502 of the Bankruptcy Code. Section 502(g) provides:

A claim arising from the rejection, under section 365 of this title or under a plan under chapter 9, 11, 12, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b) or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

11 U.S.C. § 502(g) (2000).

<sup>20</sup> S. REP. NO. 95-989, at 58 (1978); H.R. REP. NO. 95-595, at 347 (1977); Countryman, *supra* note 1, at 460; *see In re Kiwi Int'l Air Lines, Inc.*, 344 F.3d 311, 318 n.5 (3d Cir. 2003) (quoting *Sharon Steel Corp. v. Nat'l Fuel Gas Distrib. Corp.*, 872 F.2d 36, 39 (3d Cir. 1989)); *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1045 (4th Cir. 1985); *In re Newcomb*, 744 F.2d 621, 624 (8th Cir. 1984); *In re Select-a-Seat Corp.*, 625 F.2d 290, 292 (9th Cir. 1980); *Butler v. Resident Care Innovation Corp.*, 241 B.R. 37, 42 (Bankr. D.R.I. 1999); 3 COLLIER ON BANKRUPTCY ¶ 365.02[1] (Lawrence P. King et al. eds., 15th ed. rev. 2003). Similar to the Countryman definition, the legislative history to section 365 of the Bankruptcy Code explains that the term "executory contract" generally "includes contracts on which performance remains due to some extent on both sides." S. REP. NO. 95-989, at 58 (1978); H.R. REP. NO. 95-595, at 347 (1977).

remains due to some extent on both sides" prior to the bankruptcy filing.<sup>21</sup> In contrast, many courts employ the "functional approach," under which a contract is executory when the estate would benefit from the assumption or rejection of the contract.<sup>22</sup> Using either analysis, courts have found that a wide variety of contractual arrangements can constitute executory contracts under the Bankruptcy Code, including, among others, partnership agreements,<sup>23</sup> intellectual property and

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<sup>21</sup> H.R. REP. NO. 95-595, at 347 (1977). A contract that expires on its own terms pre-petition is not executory and cannot be assumed under section 365 of the Bankruptcy Code. *See* *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1212 (7th Cir. 1984) ("If a contract has been terminated pre-bankruptcy, there is nothing left for the debtor to assume."); *In re Pyramid Operating Auth., Inc.*, 144 B.R. 795, 808 (Bankr. W.D. Tenn. 1992) ("It is well established that an agreement or contract which is validly terminated prepetition under applicable state law is not assumable under section 365(a)."); *In re Southold Dev. Corp.*, 134 B.R. 705, 710 (E.D.N.Y. 1991) ("Contracts terminated prior to the filing of a bankruptcy petition are not property of the debtor's estate, and the court cannot resuscitate previously extinguished contract rights.")

<sup>22</sup> *Chattanooga Mem'l Park v. Still (In re Jolly)*, 574 F.2d 349, 350-51 (6th Cir. 1978) (criticizing rigid application of above-quoted Countryman executory contract definition and proposing functional approach to determining whether contracts are executory: "If those objectives [*i.e.*, the purposes behind allowing a debtor to assume or reject the contract] have already been accomplished, or if they can't be accomplished through rejection, then the contract is not executory within the meaning of the Bankruptcy Act."); *see Sipes v. Atl. Gulf Cmty. Corp. (In re Gen. Dev. Corp.)*, 84 F.3d 1364, 1374 (11th Cir. 1996) (applying functional approach); *Phar-Mor, Inc. v. Strouss Bldg. Assocs.*, 204 B.R. 948, 954-55 (N.D. Ohio 1997) (applying functional approach); *Laughlin v. Nickless*, 190 B.R. 719, 723 (D. Mass. 1996) (same); *In re Spectrum Info. Techs., Inc.*, 190 B.R. 741, 747 (Bankr. E.D.N.Y. 1996) ("[Several] courts have employed a result-oriented approach which focuses upon whether or not the estate will benefit from the assumption or rejection of the contract rather than fundamentally looking at mutuality of commitments."); *In re Cardinal Indus., Inc.*, 146 B.R. 720, 729 (Bankr. S.D. Ohio 1992) ("[E]ven though there may be material obligations outstanding on the part of only one of the parties to the contract, a contract may nevertheless be deemed executory under the functional approach if its assumption or rejection will ultimately benefit the estate and its creditors."); *Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group Inc.)*, 138 B.R. 687, 703 (Bankr. S.D.N.Y. 1992) ("The concept of the 'executory contract' in bankruptcy should be defined in light of the purpose for which the trustee is given the option to assume or reject."); *In re Drake*, 136 B.R. 325, 327 (Bankr. D. Mass. 1992) (applying functional approach); *In re Bluman*, 125 B.R. 359, 363 (Bankr. E.D.N.Y. 1991) (stating same); *Camp v. Nat'l Union Fire Ins. Co. (In re Gov't Sec. Corp.)*, 101 B.R. 343, 349 (Bankr. S.D. Fla. 1989) ("In applying the functional approach, it is necessary to work backward, proceeding from an examination of the goals rejection is expected to accomplish."); *aff'd*, 111 B.R. 1007 (S.D. Fla. 1990), *aff'd*, 972 F.2d 328 (11th Cir. 1992); *In re Taylor*, 91 B.R. 302, 311 (Bankr. D.N.J. 1988) (applying functional approach); *Arrow Air Inc. v. Port Auth. (In re Arrow Air, Inc.)*, 60 B.R. 117, 122 (Bankr. S.D. Fla. 1986) ("[E]ven though there may be material obligations outstanding on the part of only one of the parties to the contract, a contract may nevertheless be deemed executory under the functional approach if its assumption or rejection will ultimately benefit the estate and its creditors.")

<sup>23</sup> *See Woskob v. Woskob (In re Woskob)*, 305 F.3d 177, 187 (3d Cir. 2002) (characterizing partnership agreement as executory contract); *In re O'Connor*, 258 F.3d 392, 400 (5th Cir. 2001) (assuming, without discussion, partnership agreement was executory contract); *In re Schick*, 235 B.R. 318, 322 (Bankr. S.D.N.Y. 1999) (stating same); *Weaver v. Nizny (In re Nizny)*, 175 B.R. 934, 936 (Bankr. S.D. Ohio 1994) (assuming, without discussion, partnership agreement was executory contract); *Breeden v. Catron (In re Catron)*, 158 B.R. 629, 632 (E.D. Va. 1993) (characterizing partnership agreement as executory contract), *aff'd*, 25 F.3d 1038 (4th Cir. 1994); *In re Antonelli*, 148 B.R. 443, 446-50 (D. Md. 1992) (stating same), *aff'd*, 4 F.3d 984 (4th Cir. 1993); *In re Cardinal Indus. Inc.*, 116 B.R. 964, 973 (Bankr. S.D. Ohio 1990) (adopting parties' contention that partnership agreement was executory contract); *In re Priestley*, 93 B.R. 253, 258 (Bankr. D.N.M. 1988) (finding limited partnership agreement was executory contract because "substantial performance remained due from all parties to the contract."); *In re Sunset Developers*, 69 B.R. 710, 713 (Bankr. D. Idaho 1987) ("[T]he partnership agreement is an executory contract[.];"); *Skeen v.*

technology licenses,<sup>24</sup> government contracts,<sup>25</sup> franchise agreements<sup>26</sup> and limited

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Harms (*In re Harms*), 10 B.R. 817, 821 (Bankr. D. Colo. 1981) ("Applying the Tenth Circuit definition to the limited partnership agreements . . . the Court concludes that the agreements are executory.").

<sup>24</sup> See, e.g., RCI Tech. Corp. v. Sunterra Corp. (*In re Sunterra Corp.*), 361 F.3d 257, 264 (4th Cir. 2004) (characterizing intellectual property licensing agreements as executory contracts); Perlman v. Catapult Entm't, Inc. (*In re Catapult Entm't, Inc.*), 165 F.3d 747, 749 (9th Cir. 1999) (stating same); Everex Sys. v. Cadtrak Corp. (*In re CFLC, Inc.*), 89 F.3d 673, 677 (9th Cir. 1996) (finding license constitutes executory contract because a license is "in essence, 'a mere waiver of the right to sue' the licensee for infringement."); Encino Bus. Mgmt., Inc. v. Prize Frize, Inc. (*In re Prize Frize, Inc.*), 32 F.3d 426, 428 (9th Cir. 1994) (concluding license of technology, patents and proprietary rights in certain machinery was executory contract for purposes of section 365 of Bankruptcy Code because "there were obligations on both sides which to some extent were unperformed."); Otto Preminger Films, Ltd. v. Qintex Entm't, Inc. (*In re Qintex Entm't, Inc.*), 950 F.2d 1492, 1494-96 (9th Cir. 1991) (finding exclusive film license was executory contract because licensor had continuing obligation not to license film to third parties and licensee had continuing obligation to pay royalties); *In re Richmond Metal Finishers, Inc.*, 756 F.2d at 1045 (characterizing nonexclusive license to technical process as an executory contract); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 511 (Bankr. D. Del. 2003) (characterizing exclusive licensing agreements as executory contracts); *In re BuildNet, Inc.*, No. 01-82293, 2002 Bankr. LEXIS 1851, at \*8 (Bankr. M.D.N.C. Sept. 20, 2002) ("As a general rule, most patent, trademark, technology and other intellectual property licenses are executory contracts."); *In re Hernandez*, 285 B.R. 435, 438 (Bankr. D. Ariz. 2002) ("The parties do not dispute the fact that the [license agreement] is an executory contract . . ."); *In re Valley Media, Inc.*, 279 B.R. 105, 135 (Bankr. D. Del. 2002) ("The Third Circuit follows the general rule that intellectual property licenses, including copyright licenses, are executory contracts within the meaning of 11 U.S.C. § 365(c) under the Countryman test."); *In re Golden Books Family Entm't, Inc.*, 269 B.R. 300, 308-09 (Bankr. D. Del. 2001) (characterizing intellectual property licenses as executory contracts); *In re Access Beyond Techs. Inc.*, 237 B.R. 32, 44 (Bankr. D. Del. 1999) (characterizing patent license agreement as executory contract); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 241 (Bankr. S.D.N.Y. 1997) ("Bankruptcy Courts have generally treated nonexclusive copyright and patent licenses as executory contracts . . ."); Univ. of Conn. Research & Dev. Corp. v. Germain (*In re Biopolymers, Inc.*), 136 B.R. 28, 29-30 (Bankr. D. Conn. 1992) (holding that exclusive licensing agreement was executory contract because obligations remained outstanding on both sides where licensor had to forebear from granting licenses to others and not to unreasonably withhold its consent to licensee's sublicensing decisions); Blackstone Potato Chip Co., Inc. v. Mr. Popper, Inc. (*In re Blackstone Potato Chip Co., Inc.*), 109 B.R. 557, 560 (Bankr. D.R.I. 1990) (finding trademark license agreement to be executory contract); *In re Alltech Plastics, Inc.*, 71 B.R. 686 (Bankr. W.D. Tenn. 1987) (assuming, without discussion, patent license was executory contract); *In re Chipwich, Inc.*, 54 B.R. 427, 430 (Bankr. S.D.N.Y. 1985) ("[T]he [trademark] licenses in the instant case are executory as to both the debtor and Farmland and, therefore, they are executory contracts within the meaning of 11 U.S.C. § 365(a)."). But see *In re Learning Publ'ns, Inc.*, 94 B.R. 763, 765 (Bankr. M.D. Fla. 1988) (finding assignment of all rights in a book by the author to a publisher not an executory contract under the Countryman definition); *In re Stein & Day, Inc.*, 81 B.R. 263, 267 (Bankr. S.D.N.Y. 1988) (same).

<sup>25</sup> See *In re W. Elecs. Inc.*, 852 F.2d 79, 82-84 (3d Cir. 1988) (assuming, without discussion, that contract for manufacturing services with defense contractor was executory contract); *In re Mirant Corp.*, 303 B.R. 319, 322 (Bankr. N.D. Tex. 2003) (assuming, without discussion, that contract for purchase of power with unit of Department of Energy was executory contract); *In re TechDyn Sys. Corp.*, 235 B.R. 857, 858-59 (Bankr. E.D. Va. 1999) (assuming, without discussion, that contract to provide telephone services to office of federal government was executory contract); *In re Am. Ship Bldg. Co.*, 164 B.R. 358, 359 (Bankr. M.D. Fla. 1994) (assuming, without discussion, that contracts to build vessels for United States Navy were executory contracts); *In re Plum Run Serv. Corp.*, 159 B.R. 496, 498-500 (Bankr. S.D. Ohio 1993) (assuming, without discussion, that military base operational support contract was executory contract); *In re Ontario Locomotive & Indus. Ry. Supplies (U.S.) Inc.*, 126 B.R. 146, 146-47 (Bankr. W.D.N.Y. 1990) (assuming, without discussion, that contract to remanufacture Navy locomotives was executory contract); United States Dep't of Air Force v. Carolina Parachute Corp. (*In re Carolina Parachute Corp.*), 108 B.R. 100, 102 (M.D.N.C. 1989) (assuming, without discussion, that contract to manufacture parachutes for United States Government was executory contract), *aff'd in part, vacated in part sub nom.*, 907 F.2d 1469 (4th Cir. 1990); Pa. Peer Review Org., Inc. v. United States (*In re Pa. Peer Review Org., Inc.*), 50 B.R. 640, 645

liability company agreements.<sup>27</sup>

The purpose of section 365 of the Bankruptcy Code is to "allow a debtor to reject executory contracts in order to relieve the estate of burdensome obligations while at the same time providing a means whereby a debtor can force others to continue to do business with it when the bankruptcy filing might otherwise make them reluctant to do so."<sup>28</sup> A debtor must assume an executory contract or unexpired lease in its entirety and cannot assume only part of the contract or lease or rewrite the terms of the contract or lease.<sup>29</sup>

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(Bankr. M.D. Pa. 1985) (assuming, without discussion, that contract to review health care services with Department of Health and Human Resources was executory contract); *Gov't Nat'l Mortgage Corp. v. Adana Mortgage Bankers, Inc.* (*In re Adana Mortgage Bankers, Inc.*), 12 B.R. 977, 983 (Bankr. N.D. Ga. 1980) (assuming, without discussion, that guarantee agreements with Government National Mortgage Association were executory contracts).

<sup>26</sup> See *City of Jamestown v. James Cable Partners, L.P.* (*In re James Cable Partners, L.P.*), 27 F.3d 534, 537 (11th Cir. 1994) (assuming, without discussion, that cable franchise agreement was executory contract); *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27, 28 (1st Cir. 1984) (assuming, without discussion, that franchise agreement with Ford was executory contract); *In re Sunrise Rests., Inc.*, 135 B.R. 149, 153 (Bankr. M.D. Fla. 1991) (assuming, without discussion, that franchise agreement with Burger King Restaurants was executory contract); *In re Tom Stimus Chrysler-Plymouth, Inc.*, 134 B.R. 676, 677 (Bankr. M.D. Fla. 1991) (assuming, without discussion, that franchise agreement with Chrysler was executory contract); *In re Van Ness Auto Plaza*, 120 B.R. 545, 546 (Bankr. N.D. Cal. 1990) ("The parties agree that the franchise agreement is an executory contract within the meaning of 11 U.S.C. § 365."); *In re Bronx-Westchester Mack Corp.*, 20 B.R. 139, 141 (Bankr. S.D.N.Y. 1982) ("Both parties to the distributorship contract agree that it is executory in nature and that the debtor's right to assume and assign it over the objections of Mack Trucks, Inc. is governed by 11 U.S.C. § 365."); *Varisco v. Oroweat Food Co.* (*In re Varisco*), 16 B.R. 634, 639 (Bankr. M.D. Fla. 1981) (concluding that "[Franchise] Agreement is still a viable and assumable executory contract and may be assumed in the absence of adverse economic factors . . .").

<sup>27</sup> See *Northrop Grumman Technical Servs., Inc. v. Shaw Group Inc.* (*In re IT Group, Inc.*), 302 B.R. 483, 487-89 (D. Del. 2003) (assuming, without discussing, that operating agreement governing limited liability company was executory contract); *Broyhill v. DeLuca* (*In re DeLuca*), 194 B.R. 65, 77 (Bankr. E.D. Va. 1996) ("[T]his court concludes that the operating agreement governing D & B Countryside [LLC] is an executory contract, since the object of the agreement . . . has not yet been accomplished and the parties have on-going duties and responsibilities to bring the project to a successful conclusion."); *In re Daugherty Constr., Inc.*, 188 B.R. 607, 611 (Bankr. D. Neb. 1995) ("[T]he LLC Articles or Organization and the Operating Agreement among the LLC members . . . constitute, on the facts of this case, executory contracts which the debtor may attempt to assume under section 365 . . ."); see also *Milford Power Co., L.L.C. v. PDC Milford Power L.L.C.*, No. Civ.A. 506-N, 2004 WL 2978293, at \*11 n.28 (Del. Ch. Dec. 17, 2004) ("Case law holding that LLC agreements are executory contracts is less abundant, however, the trend seems to be that LLC agreements are being treated the same as partnership agreements in most cases."). *But see In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 708-09 (Bankr. E.D. Va. 2000) (finding that limited liability company agreement was not executory contract under section 365 where agreement merely provided structure for management of company).

<sup>28</sup> See *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 563-64 (1994) (stating central purpose of contract assumption and rejection provisions is allowing debtor a fresh start); *Frito-Lay, Inc. v. LTV Steel Co., Inc.* (*In re Chateaugay Corp.*), 10 F.3d 944, 954-55 (2d Cir. 1993) (quoting, in part, *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1310 (5th Cir. 1985)). Section 541(a) of the Bankruptcy Code defines property of the bankruptcy estate broadly to include most executory contracts and unexpired leases to which the debtor is a party. 11 U.S.C. § 541(a) (2000) ("The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held . . . all legal or equitable interests of the debtor in property as of the commencement of the case.").

<sup>29</sup> See *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984) (stating debtor must assume executory contract "*cum onere*"); *Cinicola v. Scharffenberger*, 248 F.3d 110, 119 (3d Cir. 2001) ("If the trustee meets

If the debtor determines that the assumption of the executory contract or unexpired lease in its entirety is advantageous to the estate, the debtor must still obtain the court's approval before it can assume the agreement.<sup>30</sup> Courts generally evaluate a debtor's request for authority to assume an executory contract or unexpired lease under the "business judgment" standard.<sup>31</sup> For the most part, courts are reluctant to interfere with a debtor's decision under the business judgment standard and, thus, generally grant authority to assume an executory contract or

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the assumption requirements under § 365, it must assume the executory contract entirely."); *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741 (5th Cir. 1996) ("It is well established that as a general proposition an executory contract must be assumed or rejected in its entirety.") (quotation omitted); *City of Covington v. Covington Landing Ltd. P'ship*, 71 F.3d 1221, 1226 (6th Cir. 1995) ("When the debtor assumes the lease or the contract under § 365, it must assume both the benefits and the burdens of the contract."); *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1311 (5th Cir. 1985) ("[T]he often-repeated statement that the debtor must accept the contract as a whole means only that the debtor cannot choose to accept the benefits of the contract and reject its burdens to the detriment of the other party to the agreement."); *Cajun Elec. Members Comm. v. Mabey (In re Cajun Elec. Power Coop., Inc.)*, 230 B.R. 693, 710 (Bankr. M.D. La. 1999) ("An executory contract may not be assumed in part and rejected in part."); *In re GP Express Airlines, Inc.*, 200 B.R. 222, 227 (Bankr. D. Neb. 1996) ("A debtor must assume an executory contract *cum onere* . . ."); *In re Nitec Paper Corp.*, 43 B.R. 492, 498 (S.D.N.Y. 1984) ("[An executory contract] may not be assumed in part and rejected in part."); *Cottman Transmissions, Inc. v. Holland Enters., Inc. (In re Holland Enters., Inc.)*, 25 B.R. 301, 303 (E.D.N.C. 1982) ("It is axiomatic that an assumed contract under section 365 is accompanied by all its provisions and conditions."); *In re Village Rathskeller, Inc.*, 147 B.R. 665, 671 (Bankr. S.D.N.Y. 1992) ("[W]hen the executory contract or lease is assumed, it is said to be assumed *cum onere*."); 3 COLLIER ON BANKRUPTCY ¶ 365.02[1][b] (Lawrence P. King et al. eds., 15th ed. rev. 1997) ("An executory contract may not be assumed in part and rejected in part.").

<sup>30</sup> 11 U.S.C. § 365(a) (2000) ("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.") (emphasis added); *see, e.g., In re Office Prods. of Am., Inc.*, 136 B.R. 675, 685–86 (Bankr. W.D. Tex. 1992) ("Pursuant to the express language of § 365(a), an executory contract cannot be assumed without a formal motion and the court's approval."); *Univ. Med. Ctr. v. Sullivan*, 122 B.R. 919, 927 (Bankr. E.D. Pa. 1990) ("Section 365 provides that the power to accept or reject executory contracts is 'subject to court approval.'").

<sup>31</sup> *See, e.g., Bildisco & Bildisco*, 465 U.S. at 523 (explaining business judgment test is traditional standard by which to evaluate debtor's decision under section 365 of Bankruptcy Code (citing *Group of Inst. Invs. v. Chicago, Milwaukee, St. Paul & Pacific R.R.*, 318 U.S. 523, 549–51 (1943) (explaining decision to assume or reject lease is one of business judgment))); *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1047 (4th Cir. 1985) (explaining that debtor's decision to assume or reject executory contract under section 365 must be evaluated under business judgment standard); *see also Durkin v. Bendor Corp. (In re G.I. Indus., Inc.)*, 204 F.3d 1276, 1282 (9th Cir. 2000) (stating that "a bankruptcy court applies the business judgment rule to evaluate a trustee's rejection decision."); *Four B. Corp. v. Food Barn Stores, Inc. (In re Food Barn Stores, Inc.)*, 107 F.3d 558, 567 n.16 (8th Cir. 1997) (recognizing that "the court uses a business judgment test in deciding whether to approve a trustee's motion to assume, reject, or assign an unexpired lease or executory contract."); *Orion Pictures Corp. v. Showtime networks, Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1099 (2d Cir. 1993) (explaining that "a bankruptcy court reviewing a trustee's or debtor-in-possession's decision to assume or reject an executory contract should examine [the] contract and the surrounding circumstances and apply its best 'business judgment' to determine if it would be beneficial or burdensome to the estate to assume."); *In re Market Square Inn, Inc.*, 978 F.2d 116, 121 (3d Cir. 1992) (stating that "[t]he resolution of this issue of assumption or rejection will be a matter of business judgment by the bankruptcy court."); *Sharon Steel Corp. v. Nat'l Fuel Gas Distr. Corp.*, 872 F.2d 36, 39–40 (3d Cir. 1989) (approving bankruptcy court's application of business judgment test); *Control Data Corp. v. Zelman (In re Minges)*, 602 F.2d 38, 43 (2d Cir. 1979) (stating that business judgment test is flexible test for determining when executory contract may be rejected).



unexpired lease absent a showing of bad faith or abuse of discretion.<sup>32</sup>

If a default exists under the executory contract or unexpired lease, section 365(b) protects the nondebtor party by requiring the debtor to cure the default, compensate the other party for any actual pecuniary loss caused by the default and provide adequate assurance of future performance under the terms of the contract or lease before the debtor can assume the executory contract or unexpired lease.<sup>33</sup> Nevertheless, pursuant to section 365(b)(2), a debtor does not have to cure any default relating to (1) the debtor's insolvency or financial condition, (2) the commencement of the bankruptcy case or (3) the appointment of a trustee, a receiver or a custodian before the case, in order to assume an executory contract or unexpired lease.<sup>34</sup> Section 365(b)(2)(D) also provides that a debtor need not cure any default relating to "the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease" in order to assume an executory contract or unexpired lease.<sup>35</sup>

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<sup>32</sup> See, e.g., *In re Richmond Metal Finishers, Inc.*, 756 F.2d at 1047 (explaining that, under business judgment test, "courts should defer to—should not interfere with—decisions of corporate directors upon matters entrusted to their business judgment except upon a finding of bad faith or gross abuse of their 'business discretion.'"); see also *In re Market Square Inn*, 978 F.2d at 121 (explaining same); *Sharon Steel*, 872 F.2d at 39–40 (explaining same); *In re S. Cal. Sound Sys., Inc.*, 69 B.R. 893, 896–99 (Bankr. S.D. Cal. 1987) (explaining same).

<sup>33</sup> Section 365(b)(1) of the Bankruptcy Code provides:

If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of the assumption of such contract or lease, the trustee —

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

11 U.S.C. § 365(b)(1) (2000).

<sup>34</sup> Section 365(b)(2) provides:

Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to —

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title;

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement; or

(D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

*Id.* § 365(b)(2) (2000).

<sup>35</sup> There is a split of authority as to whether section 365(b)(2)(D) of the Bankruptcy Code creates one or two exceptions to the cure requirements in section 365(b)(1) of the Bankruptcy Code. Compare *Worthington*

## B. General Overview of Assignment

Section 365(f) of the Code permits a debtor to assume and assign an executory contract or unexpired lease to a third party.<sup>36</sup> A debtor that wishes to assign an executory contract or unexpired lease to a third party must first assume the contract or lease in accordance with section 365(a) of the Bankruptcy Code.<sup>37</sup> The debtor also must provide the nondebtor party to the contract or lease with adequate assurance of future performance by the proposed assignee, even if there has been no default under the contract or lease.<sup>38</sup> Adequate assurance of future performance by the proposed assignee is an important protection for nondebtor contract parties because, once the contract has been assumed by the debtor and assigned to a third party, the debtor is no longer liable for a breach occurring after the assignment.<sup>39</sup>

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v. Gen. Motors Corp. (*In re Claremont Acquisition Corp., Inc.*), 113 F.3d 1029, 1034 (9th Cir. 1997) (finding that term "penalty" modifies both "rate" and "provision" thus creating one "exception concerning those provisions of a contract which impose a penalty for a debtor's failure to perform a nonmonetary obligation."); *Beckett v. Coatesville Hous. Assocs.*, No. 00-5337, 2001 U.S. Dist. LEXIS 9281, at \*16-17 (E.D. Pa. July 5, 2001) (affirming bankruptcy court's decision to lift automatic stay where debtor's nonmonetary default was material and, thus, could not be cured under section 365 of Bankruptcy Code); *In re Williams*, 299 B.R. 684, 686 (Bankr. S.D. Ga. 2003) (following Ninth Circuit's decision in *Claremont Acquisition Corp.*); *In re New Breed Realty Enters.*, 278 B.R. 314, 321 (Bankr. E.D.N.Y. 2002) (stating same); *In re Christopher Vitanza*, No. 98-19611, 1998 Bankr. LEXIS 1497, at \*75 (Bankr. E.D. Pa. Nov. 13, 1998) (same), with *Eagle Ins. Co. & Newark Ins. Co. v. BankVest Capital Corp.* (*In re BankVest Capital Corp.*), 360 F.3d 291, 298 (1st Cir. 2004) (finding that section 365(b)(2)(D) frees debtor "from lease provisions requiring the payment of penalty rates" and "non-monetary defaults."); *In re GP Express Airlines, Inc.*, 200 B.R. 222, 233-34 (Bankr. D. Neb. 1997) ("[A] debtor is not required to cure or satisfy any penalty rate obligation and the debtor is not required to cure any defaults in nonmonetary obligations."). Section 328 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, as recently passed by the Senate, attempts to resolve this conflict by relaxing the cure requirement for certain nonmonetary defaults and by striking "penalty rate or provision" and inserting "penalty rate or penalty provision" in section 325(b)(2)(D) of the Bankruptcy Code. See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, 109th Cong. § 328 (2005) (enacted).

<sup>36</sup> 11 U.S.C. § 365(f)(1) (2000) ("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 . . .").

<sup>37</sup> *Id.* § 365(f)(2)(A) ("The trustee may assign an executory contract or unexpired lease of the debtor only if . . . the trustee assumes such contract or lease in accordance with the provisions of this section . . ."); see *Cinicola v. Scharffenberger*, 248 F.3d 110, 120 (3d Cir. 2001) (explaining before an executory contract may be assigned, trustee must first assume the contract); *In re Schick*, 235 B.R. 318, 322-23 (Bankr. S.D.N.Y. 1999) (holding trustee must first assume agreement pursuant to section 365(f)(2)(A) in order to assign it).

<sup>38</sup> *Id.* § 365(f)(2)(B) ("The trustee may assign an executory contract or unexpired lease of the debtor only if . . . adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease."); see *Cinicola*, 248 F.3d at 120 (stating "adequate assurance of future performance" of the contract must be provided); *In re Fleming Cos.*, No. 03-10945, 2004 Bankr. LEXIS 198, at \*3-\*6 (Bankr. D. Del. Feb. 27, 2004) (finding debtor must first provide adequate assurance of future performance before executory contract can be assigned and explaining necessity of protection for the non-debtor party which assurance provides).

<sup>39</sup> *Id.* § 365(k) ("Assignment by the trustee to an entity of a contract or lease assumed under this section relieves the trustee and the estate from any liability for any breach of such contract or lease occurring after such assignment."); see also *L.R.S.C. Co. v. Rickel Home Ctrs., Inc.* (*In re Rickel Home Ctrs., Inc.*), 209 F.3d 291, 299 (3d Cir. 2000) (affirming adequate assurance is necessary to protect the non-debtor because

Outside of bankruptcy, a debtor's ability to assign an executory contract or unexpired lease may be prohibited, restricted or conditioned by a provision in the agreement itself or by applicable nonbankruptcy law. Section 365(f)(1) of the Bankruptcy Code, however, provides that a debtor may assume and assign an executory contract or unexpired lease "notwithstanding a provision in [the] executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease."<sup>40</sup> Accordingly, on its face, section 365(f) appears to permit a debtor to assume and assign an executory contract or unexpired lease even if: (1) the contract or lease includes a provision that prohibits, restricts or conditions the assignment of the contract or lease; or (2) *applicable law* prohibits, restricts or conditions the assignment of the contract or lease.<sup>41</sup> As discussed below, however, a debtor's ability to assign an executory contract or unexpired lease under section 365(f) may be limited by other sections of the Bankruptcy Code.

### C. General Overview of Section 365(c)(1) of the Bankruptcy Code

In contrast to the language of section 365(f)(1) of the Bankruptcy Code, section 365(c)(1) provides that, absent the nondebtor party's consent, a "trustee may *not* assume or assign any executory contract or unexpired lease of the debtor ... if *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 debtor in possession . . . ."<sup>42</sup> Accordingly, the plain language of section 365(c)(1) appears to prohibit a debtor from assuming or assigning an executory contract or unexpired lease if "applicable law" excuses the nondebtor party from accepting performance from a new obligor.

Read broadly, section 365(c)(1) of the Bankruptcy Code arguably renders section 365(f)(1) superfluous in certain factual contexts. The assignment of an executory contract or unexpired lease necessarily involves the substitution of a new obligor and, thus, performance under the contract or lease by a party other than the debtor or debtor in possession. Accordingly, sections 365(f) and 365(c)(1) are brought into conflict when a debtor seeks to assume and assign an executory

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assignment relieves the trustee and the estate from liability arising from a post-assignment breach); *In re Fleming Cos.*, 2004 Bankr. LEXIS 198 at \*3-\*6 (declaring assignment relieves the debtor and bankruptcy estate from liability for breaches arising after the assignment).

<sup>40</sup> *Id.* § 365(f)(1).

<sup>41</sup> *Id.* ("[N]otwithstanding 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."); *see also In re Golden Books Family Entmt, Inc.*, 269 B.R. 311, 316 (Bankr. D. Del. 2001) (holding boilerplate non-assignment clause in a executory contract ineffective under section 365(f)(1)); *cf. Trak Auto Corp. v. W. Town Ctr. L.L.C. (In re Trak Auto Corp.)*, 367 F.3d 237, 242 (4th Cir. 2004) (discussing general provision in section 365(f)(1) which prohibits enforcement in bankruptcy of anti-assignment clauses in leases).

<sup>42</sup> *Id.* § 365(c)(1)(A) (emphasis added). Section 365(c)(1)(B) of the Bankruptcy Code provides that an executory contract or unexpired lease falling within the scope of section 365(c)(1)(A) may nonetheless be assumed or assigned with the consent of the nondebtor contract party. *See id.* § 365(c)(1)(B).

contract or unexpired lease and "applicable law" excuses a nondebtor party from accepting performance from a new obligor.<sup>43</sup> Because assumption is a prerequisite to assignment, this conflict informs many courts' interpretation of section 365(c)(1) when a debtor seeks only to assume an executory contract or unexpired lease under section 365(a) of the Bankruptcy Code.<sup>44</sup>

#### *D. Reconciling Sections 365(c)(1) and 365(f) of the Bankruptcy Code*

Courts have adopted various approaches to reconcile sections 365(c)(1) and 365(f) of the Bankruptcy Code. One court has found that sections 365(c)(1) and 365(f) simply cannot be reconciled and decided to ignore the phrase "applicable law" in section 365(f).<sup>45</sup> Most courts, however, have resolved the apparent conflict between sections 365(c)(1) and 365(f) by ascribing a different meaning to the phrase "applicable law" appearing in each section.<sup>46</sup> For example, the United States

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<sup>43</sup> Although the language of section 365(c)(1) of the Bankruptcy Code suggests a narrow exception to a debtor's general assignment powers (*i.e.*, where a party's rights or obligations are nondelegable under applicable law), some courts read section 365(c)(1) to include any applicable law that prohibits, restricts or conditions assignment. *See* discussion *infra* Section I.D.

<sup>44</sup> *See* discussion *infra* Section III.A.

<sup>45</sup> *See* *Breeden v. Catron* (*In re Catron*), 158 B.R. 629, 637 (E.D. Va. 1993) ("[W]hile § 365(c) explicitly directs the court to consider whether 'applicable law' prohibits assignment, the language 'notwithstanding a provision . . . in applicable law, that prohibits . . . assignment' of § 365(f) just as explicitly directs the court to ignore applicable law. The two clauses at the beginning of § 365(f) simply cannot be reconciled.").

<sup>46</sup> *See, e.g.*, *RCI Tech. Corp. v. Sunterra Corp.* (*In re Sunterra Corp.*), 361 F.3d 257, 266 ("[U]nder the broad rule of § 365(f)(1), the 'applicable law' is the law prohibiting or restricting assignments as such; whereas the 'applicable law' under § 365(c)(1) embraces 'legal excuses for refusing to render or accept performance, regardless of the contract's status as 'assignable' . . . ." (quotation omitted); *Perlman v. Catapult Entmt, Inc.* (*In re Catapult Entmt, Inc.*), 165 F.3d 747, 752 (9th Cir. 1999):

Subsection (f)(1) states the broad rule—a law that, as a general matter, 'prohibits, restricts, or conditions the assignment' of executory contracts is trumped by the provisions of subsection (f)(1). Subsection (c)(1), however, states a carefully crafted exception to the broad rule—where applicable law does not merely recite a general ban on assignment, but instead more specifically 'excuses a party . . . from accepting performance from or rendering performance to an entity' different from the one with which the party originally contracted, the applicable law prevails over subsection (f)(1).

*Id.* (internal citation omitted); *City of Jamestown v. James Cable Partners, L.P.* (*In re James Cable Partners, L.P.*), 27 F.3d 534, 538 (11th Cir. 1994) ("Subsection (f) states that 'applicable law' prohibiting assignment of an executory contract does not bar assignment of an executory contract by a trustee (or debtor in possession). Thus, the 'applicable law' to which subsection (c) refers must mean 'applicable law' other than general prohibition barring assignment."); *Rieser v. Dayton Country Club Co.* (*In re Magness*), 972 F.2d 689, 695 (6th Cir. 1992) ("While subsections (f) and (c) appear contradictory by referring to 'applicable law' and commanding opposite results, a careful reading reveals that each subsection recognizes an 'applicable law' of markedly different scope."); *Murray v. Franke-Misal Techs. Group, LLC* (*In re Supernatural Foods*), 268 B.R. 769, 777–80 (Bankr. M.D. La. 2001) (discussing the differing approaches to defining the scope of "applicable law" as referred to in sections 365(f)(1) and 365(c)(1)(A) of the Bankruptcy Code); *In re Schick*, 235 B.R. 318, 323 (Bankr. S.D.N.Y. 1999) ("The use of 'applicable law' in both provisions yields an apparent inconsistency—section 365(f) seems to give what section 365(c) then takes away. The courts have resolved this dilemma by ascribing different meanings to the phrase 'applicable law' appearing in each subparagraph."); *In re Lil' Things, Inc.*, 220 B.R. 583, 590–91 (Bankr. N.D. Tex. 1998):

Court of Appeals for the First Circuit has interpreted the phrase "applicable law" in section 365(f) as applying only to state laws that *enforce* contract provisions that prohibit, restrict or condition assignment, and the phrase "applicable law" in section 365(c)(1) as applying to state laws that, on their own terms, prohibit, restrict or condition assignment of a particular type of contract.<sup>47</sup>

In *Pioneer Ford Sales*,<sup>48</sup> a bankrupt Ford dealership sought to assume and assign its franchise agreement with the Ford Motor Company to Toyota Village, another car dealership. The Ford Motor Company objected to the proposed assignment and argued that the franchise agreement was non-transferable on its own terms and that assignment was barred under section 365(c)(1) of the Bankruptcy Code. The bankruptcy court and the district court both ruled that section 365(c)(1) was inapplicable because the franchise agreement was not a personal service contract based on a special relationship.<sup>49</sup> Accordingly, the bankruptcy court and the district court applied section 365(f)(1) and permitted the assignment of the franchise agreement with Ford to Toyota Village.<sup>50</sup>

The First Circuit reversed the bankruptcy court and the district court and found that the bankrupt Ford dealership could not assume and assign its franchise agreement, pursuant to section 365(c)(1) of the Bankruptcy Code.<sup>51</sup> The First

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[T]his court finds that § 365(f)(1) states the general rule that a trustee or debtor in possession may assign an executory contract notwithstanding "applicable law" that prohibits assignment, while § 365(c)(1)(A) represents an exception to that rule where applicable law protects the right of the non-debtor contracting party to refuse to accept from or render performance to an assignee, and does not apply to general prohibitions on assignments.

*Id.*

<sup>47</sup> See *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27, 29 (1st Cir. 1984):

As a matter of logic, however, we see no conflict, for (c)(1)(A) refers to state laws that prohibit assignment 'whether or not' the contract is silent, while (f)(1) contains no such limitation. Apparently (f)(1) includes state laws that prohibit assignment only when the contract is *not* silent about assignment; that is to say, state laws that enforce contract provisions prohibiting assignment.

*Id.*; see also *In re Supernatural Foods*, 268 B.R. at 777-79 (adopting First Circuit's interpretation of the interplay between section 365(c)(1) and section 365 (f)(1)).

<sup>48</sup> *In re Pioneer Ford Sales, Inc.*, 26 B.R. 116, 118 (Bankr. D.R.I. 1983).

<sup>49</sup> *Id.* (refusing to apply section 365(c)(1) of the Bankruptcy Code because the franchise agreements were not personal service contracts based on a special relationship between the parties), *aff'd*, 30 B.R. 458, 462 (D.R.I. 1983) ("The Court finds that the Ford Franchise Agreement is not a 'personal' contract within the meaning of Section 365(c)(1) . . . [T]he Franchise Agreement was not based on 'special trust and confidence and on a special relationship of the parties.'"), *rev'd*, 729 F.2d 27 (1st Cir. 1984).

<sup>50</sup> *In re Pioneer Ford Sales Inc.*, 26 B.R. at 118 ("It is clear from § 365(f)(1) . . . that an executory contract may be assigned notwithstanding any provisions to the contrary either in applicable law or in the contract itself—such as the prohibition on assignment contained in paragraph F of the Preamble of the Ford Sales and Service Agreement . . ."), *aff'd*, 30 B.R. at 461 n.3 (D.R.I. 1983) ("The Franchise Agreement may be assigned by the trustee in bankruptcy notwithstanding the express prohibition against assignment. 11 U.S.C. § 365(f) provides . . .").

<sup>51</sup> See *In re Pioneer Ford Sales, Inc.*, 729 F.2d at 31.

Circuit found that not only did the franchise agreement restrict the assignment of the dealership, but state law also restricted the assignment of the dealership irrespective of the language contained in the franchise agreement itself.<sup>52</sup> The state law in question was thus "applicable nonbankruptcy law" under section 365(c)(1) because it restricted the bankrupt automobile dealer from assigning its franchise agreement as opposed to merely enforcing the provision in the franchise agreement that restricted the bankrupt automobile dealer from assigning its franchise agreement.<sup>53</sup> The First Circuit expressly rejected the argument that section 365(c)(1) is limited to personal service contracts.<sup>54</sup> As such, the bankrupt Ford dealership could not assign its franchise agreement to Toyota Village.

Other courts have rejected the First Circuit's construction but nonetheless have attempted a similar method of resolving the apparent conflict between sections 365(c)(1) and 365(f)(1) of the Bankruptcy Code.<sup>55</sup> For example, the United States Courts of Appeal for the Fourth, Sixth, Ninth and Eleventh Circuits have interpreted the phrase "applicable law" in section 365(f)(1) as applying to general prohibitions against assignment, and the phrase "applicable law" in section 365(c)(1) as applying to specific laws that excuse a contracting party from rendering performance to, or accepting performance from, a third party.<sup>56</sup> Under

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<sup>52</sup> *Id.* at 28:

The nonbankruptcy law to which both sides point us is contained in Rhode Island's "Regulation of Business Practices Among Motor Vehicle Manufacturers, Distributors and Dealers" Act, R.I. Gen. Laws § 31-5.1-4(C)(7). It states that "No dealer . . . shall have the right to . . . assign the franchise . . . without the consent of the manufacturer, except that such consent shall not be unreasonably withheld." . . . The statute's language . . . indicates that it applies "whether or not" the franchise contract itself restricts assignment.

*Id.*

<sup>53</sup> *Id.* ("The statute by its terms, allows a manufacturer to veto an assignment where the veto is reasonable but not otherwise. The statute's language also indicates that it applies 'whether or not' the franchise contract itself restricts assignment.")

<sup>54</sup> *Id.* at 29 ("The language of [§ 365(c)(1)] does not limit its effect to personal service contracts. It refers generally to contracts that are not assignable under nonbankruptcy law.")

<sup>55</sup> See *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 266 (4th Cir. 2004) (indicating court "must ask *why* 'applicable law' prohibits assignment" and holding "only applicable anti-assignment law predicated on the rationale that the identity of the contracting party is material to the agreement is resuscitated by § 365(c)(1)."); *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 752 (9th Cir. 1999) (stating broad rule of section 365 (f)(1) is trumped by section 365(c)(1)); *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)* 27 F.3d 534, 538 (11th Cir. 1994) (emphasizing section 365(f)(1) states general rule and section 365(c)(1) limits trustee's power of assignment; reasoning "applicable law" as used in subsections (c) and (f) must refer to non-bankruptcy law); *Rieser v. Dayton Country Club Co. (In re Magness)*, 972 F.2d 689, 695 (6th Cir. 1992) (disagreeing with First Circuit's interpretation in *Pioneer Ford Sales* because "[t]here is simply nothing in the language of § 365(f) which supports the limitation read into it . . ."); see also *In re ANC Rental Corp.*, 278 B.R. 714, 721 (Bankr. D. Del. 2002) (requiring applicable law to "specifically state that the contracting party is excused from accepting performance from a third party under circumstances" where identity is material or public safety is at stake); *In re Schick*, 235 B.R. 318, 323 (Bankr. S.D.N.Y. 1999) (agreeing that Circuits "ascribe[] different meanings to the phrase 'applicable law.'").

<sup>56</sup> See *In re Sunterra Corp.*, 361 F.3d at 266:

this construction, section 365(c)(1) applies when the identity of the original contracting party is material.<sup>57</sup>

For example, in *Magness*, golfing members<sup>58</sup> of the Dayton Country Club filed petitions under chapter 7 of the Bankruptcy Code. The trustee sought to assume and assign, through a sale, the debtors' membership interests to members of the Dayton Country Club who were on the waiting list to become golfing members or to the general public, and the Dayton Country Club objected. The bankruptcy court

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[Section] 365(f)(1) lays out the broad rule—"a law that, as a general matter, 'prohibits, restricts, or conditions the assignment' of executory contracts is trumped by the provisions of subsection (f)(1)." . . . Section 365(c)(1), in contrast, creates a carefully crafted exception to the broad rule, under which "applicable law does not merely recite a general ban on assignment, but instead more specifically 'excuses a party . . . from accepting performance from or rendering performance to an entity' different from the one with which the party originally contracted . . . ."

*Id.* (citations omitted); *In re Catapult Entm't, Inc.*, 165 F.3d at 752 (stating same); *In re James Cable Partners, L.P.*, 27 F.3d at 538 ("[T]he 'applicable law' to which subsection (c) refers must mean 'applicable law' other than general prohibitions barring assignment . . . . A general prohibition against assignment does not excuse the City from accepting performance from a third party within the meaning of § 365(c)(1)."); *In re Magness*, 972 F.2d at 699 (Guy, J., concurring) ("[T]he two sections refer to completely different legal concerns, with 365(f) covering 'applicable law' (and contractual clauses) prohibiting or restricting assignments as such, and 365(c) embracing legal excuses for refusing to render or accept performance, regardless of the contract's status as 'assignable' according to state law or its own terms.").

<sup>57</sup> See *In re Sunterra Corp.*, 361 F.3d at 266–67 ("[O]nly applicable anti-assignment law predicated on the rationale that the identity of the contracting party is material to the agreement is resuscitated by § 365(c)(1)."); *In re Catapult Entm't, Inc.*, 165 F.3d at 752:

[I]n determining whether an "applicable law" stands or falls under § 365(f)(1), a court must ask *why* the "applicable law" prohibits assignment . . . . Only if the law prohibits assignment on the rationale that the identity of the contracting party is material to the agreement will subsection (c)(1) rescue it.

*Id.*; *In re Magness*, 972 F.2d at 699–700 (Guy, J., concurring):

I turn instead to the longstanding Ohio rule which excuses a contracting party from rendering performance to, or accepting performance from, a third person or entity where the identity of the original contracting party was material. Such contracts are considered non-assignable precisely because of this right of first refusal. In my view, this recognition of the right to refuse is the very sort of 'applicable law' saved by section 365(c).

*Id.*; *In re ANC Rental*, 278 B.R. at 721 ("[T]he applicable law must specifically state that the contracting party is excused from accepting performance from a third party under circumstances where it is clear from the statute that the identity of the contracting party is crucial to the contract or public safety is at issue.").

<sup>58</sup> *In re Magness*, 972 F.2d at 691:

[M]embers of the club are entitled to play, eat, and socialize in all activities except golf. If . . . a member desires to play golf . . . he or she . . . [must pay] a substantial fee . . . [to be] placed on the waiting list . . . . When a vacancy occurs because of a failure to pay dues or a resignation, the first person on the waiting list is given the option to become a golfing member by paying an additional substantial fee.

*Id.*

and the district court both found that the debtors' golfing memberships were not assignable under section 365(c)(1).<sup>59</sup> The United States Court of Appeals for the Sixth Circuit agreed with the lower courts and held that the debtors' golfing memberships could not be assumed and assigned under section 365(c)(1).

The Sixth Circuit found that the phrase "applicable law" in section 365(c)(1) applies to laws that excuse a contracting party from accepting performance from a third party.<sup>60</sup> As discussed in the concurring opinion, under Ohio law, a contracting party is excused "from rendering performance to, or acceptance performance from, a third person or entity where the identity of the original contracting party [is] material."<sup>61</sup> Further, the agreement between the Dayton Country Club and its members was the type of contract that fell within the scope of Ohio law because the identity of the member was material to the membership agreement.<sup>62</sup> Thus, the Dayton Country Club would be excused from permitting a substitute member, or a member that acquired his or her membership interest through assignment, to play golf.<sup>63</sup> Accordingly, Ohio law in this case was not a general prohibition against assignment but a specific law governing restrictions on personal associations that was applicable in bankruptcy under section 365(c)(1).<sup>64</sup>

In sum, courts seeking to resolve the conflict between sections 365(c)(1) and 365(f) of the Bankruptcy Code generally have given effect to section 365(c)(1) when the assignment of the contract in question conflicts with a specific nonbankruptcy law that would excuse the nondebtor party from accepting performance under the contract from another person and the identity of the original contracting party is material. This exception thus often is referred to as the "personal service contracts" exception to section 365(f)(1) of the Bankruptcy Code. The universe of contracts to which section 365(c)(1) applies, however, has expanded to include a wide array of contracts and leases that generally would not

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<sup>59</sup> *Id.* at 693 ("The bankruptcy court[] found that the trustee was barred from assigning the full golf memberships by Ohio law under § 365(c) . . . . The district court affirmed the order barring assignment of Magness' full golf membership on the basis of the bankruptcy court's reasoning . . . .").

<sup>60</sup> *See id.* at 696 (applying section 365(c) to determine whether Ohio law excuses club from accepting golfing member chosen by trustee); *see also id.* at 699 (Guy, J., concurring) ("[T]he two sections refer to completely different legal concerns, with 365(f) covering 'applicable law' (and contractual clauses) prohibiting or restricting assignments as such, and 365(c) embracing legal excuses for refusing to render or accept performance, regardless of the contract's status as 'assignable' according to state law or its own terms.").

<sup>61</sup> *Id.* at 699–700 (Guy, J., concurring).

<sup>62</sup> *Id.* at 700 (Guy, J., concurring) ("Given that the club is a voluntary association, the identity of its members is surely 'material' to the membership agreements. The club's objection to the proposed assignment is the resulting interference with its ability to confer the full golf privileges on those members by the method of its choice.").

<sup>63</sup> *Id.* at 699–700 (Guy, J., concurring) (stating that golf club memberships "create personal relationships among individuals who play golf together. They are personal contracts and Ohio law does not permit the assignment of personal contracts.").

<sup>64</sup> In his concurring opinion, Judge Guy expressly rejected the argument that section 365(c)(1) of the Bankruptcy Code is limited to personal service contracts. *Id.* at 699 ("One court has limited [§ 365(c)] to rules regarding 'contracts for the performance of nondelegable duties . . . . This case . . . is clearly in error since section 365(c) governs not only delegation of duties but also assignment of rights.").



qualify as "personal service" contracts under state law.

## II. THE EXPANDING APPLICATION OF SECTION 365(c)(1) OF THE BANKRUPTCY CODE

### A. General Overview

Some of the first courts to address the conflict between sections 365(c)(1) and 365(f) of the Bankruptcy Code found that section 365(c)(1) applies only to personal service contracts.<sup>65</sup> At common law, the contractual duties of an individual to perform personal services generally were regarded as inherently nondelegable or nonassignable.<sup>66</sup> For example, if a famous opera singer contracted with an opera

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<sup>65</sup> *In re Raby*, 139 B.R. 833, 835–36 (Bankr. N.D. Ohio 1991) ("[Section 365(c)] incorporates the doctrine of non-delegable duties."); *In re Sunrise Rests., Inc.*, 135 B.R. 149, 153 (Bankr. M.D. Fla. 1991) ("Section 365(c)(1) was designed only to prevent a Debtor-In-Possession from assigning unexpired executory contracts including personal service contracts, which are ordinarily not assignable by law."); *In re Tom Stimus Chrysler-Plymouth, Inc.*, 134 B.R. 676, 679 (Bankr. M.D. Fla. 1991) ("This Court has previously held that franchise agreements are not personal service contracts, and thus are assignable."); *Abney v. Fulton County (In re Fulton Air Serv. Inc.)*, 34 B.R. 568, 572 (Bankr. N.D. Ga. 1983) ("The Court agrees with the majority point of view that . . . subsection (c) must be limited to executory contracts and unexpired leases in which applicable law excuses acceptance of performance such as nondelegable personal service contracts."); *In re Haffner's 5 Cent to \$1.00 Stores, Inc.*, 26 B.R. 948, 950 (Bankr. N.D. Ind. 1983) ("[S]ection (c)(1)(A) is generally understood to refer to contracts for nondelegable personal services, and not to leases for the occupancy of real property."); *In re Pioneer Ford Sales Inc.*, 26 B.R. 116, 118 (Bankr. D.R.I. 1983) ("[Section 365(c)(1)], which is specifically excepted from the provisions of § 365(f)(1), clearly pertains to 'executory contracts that are personal in nature.'"); *In re Bronx-Westchester Mack Corp.*, 20 B.R. 139, 143 (Bankr. S.D.N.Y. 1982) ("[Section 365(c)(1)] relates to executory contracts that are personal in nature. A distributorship or franchise agreement which does not depend upon a special relationship between the parties is not within the reach of this exception."); *In re U.L. Radio Corp.*, 19 B.R. 537, 541 (Bankr. S.D.N.Y. 1982) ("Such 'nondelegable' and, therefore, non-assumable contracts and leases include those for unique personal services, as well as those to extend credit, to make loans, and to issue securities."); *In re Boogaart of Fla. Inc.*, 17 B.R. 480, 486 (Bankr. S.D. Fla. 1981) ("[Section] 365(c)'s exception to § 365(f) applies only to personal service contracts or contracts based upon personal trust or confidence."); *Varisco v. Oroweat Food Co. (In re Varisco)*, 16 B.R. 634, 638 (Bankr. M.D. Fla. 1981) ("[Section 365(c)(1)'s] application is limited to executory contracts which are truly personal and this is not really the type of contract involved here [because the franchise agreement was not based upon a special relationship]."); *In re Taylor Mfg., Inc.*, 6 B.R. 370, 372 (Bankr. N.D. Ga. 1980) ("The Court finds that the exception to the general rule of the assignability of contracts was intended by Congress to be applied narrowly and to such circumstances as contracts for the performance of nondelegable duties.").

<sup>66</sup> RESTATEMENT (SECOND) OF CONTRACTS § 318 (1981) ("Delegation of performance is a normal and permissible incident of many types of contract . . . . The principal exceptions relate to contracts for personal services and to contracts for the exercise of personal skill or discretion."); 3 COLLIER ON BANKRUPTCY ¶ 365.06[1][b] at 365–58 (Lawrence P. King et al. eds., 15th ed. rev. 1997) ("Under the common law, the duties under a contract to perform personal services could not be assigned."); FARNSWORTH, CONTRACTS § 11.10 at 744 (3d ed. 1999) ("One of the most significant [circumstances in which performance is nondelegable] is the extent to which the performance is 'personal,' in the sense that the recipient must rely on qualities such as the character, reputation, taste, skill, or discretion of the party that is to render it."); CHARLES KNAPP ET AL., PROBLEMS IN CONTRACT LAW 875 (4th ed. 1999) ("Where a contract imposes on an individual the duty of personal service, that duty is almost always regarded as inherently undelegable, unless the other party assents."); see U.C.C. § 2-210, cmt. (1977) ("The principal exceptions relate to contracts for personal services and to contracts for the exercise of personal skill or discretion.").

company to perform in an opera, the singer could not assign her contractual duty to perform to another singer because the nature of those services is unique and personal.<sup>67</sup> Section 365(c)(1) of the Bankruptcy Code originally was thought to give effect to this common law restriction in bankruptcy—*i.e.*, the opera singer could not assign her contractual duties even if she filed a bankruptcy case. Indeed, the legislative history behind section 365(c)(1) refers to duties that are "nondelegable" under applicable nonbankruptcy law as not being assignable in bankruptcy.<sup>68</sup>

The position that section 365(c)(1) of the Bankruptcy Code is limited to personal service contracts, however, has since been rejected by several appellate courts.<sup>69</sup> According to the United States Court of Appeals for the Fifth Circuit, although the impetus for Congress' enactment of section 365(c)(1) may have been to preserve the common law rule precluding the assignment of personal service contracts, the language of section 365(c)(1) "codifie[s] a much broader principle. Surely if Congress had intended to limit [section] 365(c) specifically to personal service contracts, its members could have conceived of a more precise term than

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<sup>67</sup> See RESTATEMENT (SECOND) OF CONTRACTS § 318 illus. 6 (1981) ("A contracts with B, a corporation, to sing three songs over the radio as part of an advertisement of B's product. A's performance is not delegable unless B assents."); FARNSWORTH § 11.10 at 744–45 ("[A]n artist who contracts to paint a portrait or a singer who contracts to sing in an opera cannot delegate performance, even though the delegate's performance might be superior to that of the delegating party."); see also *Taylor v. Palmer*, 31 Cal. 240, 248 (1866) (stating in dictum "All painters do not paint portraits like Sir Joshua Reynolds, nor landscapes like Claude Lorraine [sic], nor do all writers write dramas like Shakespeare or fiction like Dickens. Rare genius and extraordinary skill are not transferable, and contracts for their employment are therefore personal, and cannot be assigned.").

<sup>68</sup> H.R. DOC. NO. 93-137, at 199 (1973) ("[E]xecutory contracts requiring the debtor to perform duties *nondelegable* under applicable nonbankruptcy law should not be subject to assumption against the interest of the nondebtor party.") (emphasis added); see *In re Cardinal Indus. Inc.*, 116 B. R. 964, 978–80 (Bankr. S.D. Ohio 1990) (analyzing legislative history of section 365(c)(1)).

<sup>69</sup> See *Rieser v. Dayton Country Club Co.* (*In re Magness*), 972 F.2d 689, 699 (6th Cir. 1992) (Guy, J., concurring) ("One court has limited [section 365(c)] to rules regarding 'contracts for the performance of nondelegable duties . . . . This case . . . is clearly in error since section 365(c) governs not only delegation of duties but also assignment of rights."); *Metro. Airports Comm'n. v. N.W. Airlines, Inc.* (*In re Midway Airlines, Inc.*), 6 F.3d 492, 495 (7th Cir. 1993) ("Since the statutory language does not limit the applicability of § 365(c) exclusively to 'personal service contracts,' we agree with those circuits holding that it need not be so constrained."); *In re W. Elecs. Inc.*, 852 F.2d 79, 83 (3d Cir. 1988) ("This provision limiting assumption of contracts is applicable to any contract subject to a legal prohibition against assignment."); *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27, 29 (1st Cir. 1984) ("The language of [section 365(c)(1)] does not limit its effect to personal service contracts. It refers generally to contracts that are not assignable under nonbankruptcy law."); *Pension Benefit Guar. Corp. v. Braniff Airways, Inc.* (*In re Braniff Airways, Inc.*), 700 F.2d 935, 943 (5th Cir. 1983) ("Surely if Congress had intended to limit § 365(c) specifically to personal service contracts, its members could have conceived of a more precise term than 'applicable law' to convey that meaning."); see also *Murray v. Franke-Misal Techs. Group, L.L.C.* (*In re Supernatural Foods*), 268 B.R. 769, 777 (Bankr. M.D. La. 2001) ("Following *Braniff*, a number of courts recognized that the reference within § 365(c)(1)(A) to 'applicable law' is more expansive than merely a veiled reference to 'applicable law' regarding only personal service contracts."); *In re Lil' Things, Inc.*, 220 B.R. 583, 588 (Bankr. N.D. Tex. 1998) ("The circuit courts which have considered whether § 365(c) is limited solely to personal service contracts, have found that § 365(c) was not written so narrowly by the drafters as to put such a drastic limitation on its scope."); *In re Nitec Paper Corp.*, 43 B.R. 492, 497 (S.D.N.Y. 1984) ("Appellee's contention that 11 U.S.C. § 365(c) applies only to personal service contracts, though having some support in case law, is essentially incorrect.").

'applicable law' to convey that meaning."<sup>70</sup> For this reason, courts have found section 365(c)(1) to apply to contracts beyond those generally classified as personal service contracts.<sup>71</sup>

## *B. Types of Contracts Generally Covered by Section 365(c)(1) of the Bankruptcy Code*

### 1. Personal Service Contracts

As a general rule, under state law, contracts for personal services are not assignable outside of bankruptcy.<sup>72</sup> A personal service contract is a contract under which the parties' respective duties are "so unique" that the obligee under the contract has a "substantial interest" in having the original obligor perform,

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<sup>70</sup> *In re Braniff Airways*, 700 F.2d at 943.

<sup>71</sup> Indeed, given the predilection for plain language arguments announced by the Supreme Court after *Braniff Airways*, it is highly unlikely that a court would explicitly limit section 365(c)(1) of the Bankruptcy Code to personal service contracts. See *Lamie v. United States Tr.*, 540 U.S. 526, 534 (2004) ("It is well established that 'when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.'"); *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 6 (2000) ("[W]hen the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.") (internal quotations omitted); *United States v. Ron Pair Enters. Inc.*, 489 U.S. 235, 241 (1989) (stating that the interpretation of the Bankruptcy Code, as with all statutes, must begin "with the language of the statute itself.").

<sup>72</sup> See, e.g., *Farmland Irrigation Co. v. Dopplmaier*, 308 P.2d 732, 740 (Cal. 1957) ("[T]he duties imposed upon one party may be of such a personal nature that their performance by someone else would in effect deprive the other party of that for which he bargained. The duties in such a situation cannot be delegated."); *Rossetti v. City of New Britain*, 303 A.2d 714, 718–19 (Conn. 1972) ("[I]t is indeed the general rule that contracts for personal services cannot be assigned."); *Menenberg v. Carl R. Sams Realty Co.*, 59 N.W.2d 125, 127 (Mich. 1953) ("Ordinarily, the execution of an agency for the sale of land involves the performance of services that are personal in the sense that they are neither delegable nor assignable."); *Sympson v. Rogers*, 406 S.W.2d 26, 30 (Mo. 1966) ("[A]n executory contract for personal services which involves special knowledge, skill or a relation of personal confidence, may not be assigned without the consent of both parties."); *Paige v. Faure*, 127 N.E. 898, 899 (N.Y. 1920) ("The general rule is that rights arising of a contract cannot be transferred if they are coupled with liabilities or if they involve a relationship of personal credit and confidence."); *Saxe v. Feinstein*, 77 A.2d 419, 421 (Pa. 1951) ("While a party to a contract may assign his rights and benefits thereunder, he may not, unless the contract so provides, assign his liability under the contract to perform duties involving his personal ability, integrity, credit or responsibility."); *Scott v. Fox Bros. Enters., Inc.*, 667 P.2d 773, 774 (Colo. Ct. App. 1983) ("Generally, absent an express provision to the contrary, executory contracts are assignable unless they involve a matter of personal trust or confidence or are for personal services."); *Schweiger v. Hoch*, 223 So.2d 557, 558 (Fla. Dist. Ct. App. 1969) ("Florida is committed to the general law that contracts for personal services, or those involving a relationship of personal confidence, are not assignable by either party unless the contract so provides, or unless the other party consents thereto or ratifies the assignment."); *Martin v. City of O'Fallon*, 670 N.E.2d 1238, 1241 (Ill. App. Ct. 1996) ("Where the personal qualities of either party are material to the contract, the contract is not assignable without the assent of both parties."); *Pestel Milk Co. v. Model Dairy Prods. Co.*, 52 N.E.2d 651, 658 (Ohio Ct. App. 1943) ("An executory contract for personal services, to be paid for as performed, cannot be assigned by the employer, unless the employee assents to the substitution of the assignee as employer."); *S. Cmty. Gas Co. v. Houston Natural Gas*, 197 S.W.2d 488, 489 (Tex. App. 1946) ("A contract establishing a personal relationship between the parties is not assignable.").

rendering the contract nondelegable.<sup>73</sup>

In other words, personal service contracts (including those that are based on a relationship of personal confidence and trust) are contracts under which the parties rely on "qualities such as the character, reputation, skill, or discretion of the party that is to render" performance.<sup>74</sup> For example, courts have characterized the following types of agreements as personal service contracts: (a) an agreement to render professional services as a physician, lawyer or architect; (b) an option to purchase stock given to an employee; and (c) an agency agreement for the sale of land.<sup>75</sup> A contract may be "personal" to a corporate entity, as well as to an individual.<sup>76</sup>

As previously stated, some of the first courts to address the conflict between sections 365(c)(1) and 365(f) of the Bankruptcy Code found that section 365(c)(1) applies only to personal service contracts.<sup>77</sup> By narrowing the scope of section 365(c)(1) to personal service contracts, these courts avoided the application of section 365(c)(1) to most types of executory contracts and unexpired leases, thereby permitting a debtor to assume or assign such contracts and leases.<sup>78</sup>

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<sup>73</sup> *In re Compass Van & Storage Corp.*, 65 B.R. 1007, 1011 (Bankr. E.D.N.Y. 1986) (discussing personal service contracts as demarcated in the Restatement (Second) of Contracts). *See generally* Sally Beauty Co. v. Nexxus Prod. Co., 801 F.2d 1001, 1008 (7th Cir. 1986) (explaining that within personal service contracts is the implicit expectation that the original party will perform the contract, making such contracts per se nondelegable); RESTATEMENT (SECOND) OF CONTRACTS § 318 (2) (1981) (defining nondelegable duties as agreements that require performance by particular individual).

<sup>74</sup> *See In re Midway Airlines*, 6 F.3d at 495 ("The paradigmatic example of [a personal service contract is] a contract entered into on the basis of 'the character, reputation, taste, skill or discretion of the party that is to render [performance].'"); FARNSWORTH, CONTRACTS § 11.10 at 744 (3d ed. 1999) (stating "personal" contracts are those which "the recipient must rely on qualities such as the character, reputation, taste, skill, or discretion of the party that is to render [performance].").

<sup>75</sup> *See* 6 AM. JUR. 2D *Assignments* § 30 (2004) (identifying types of agreements courts have found to be personal service contracts).

<sup>76</sup> *See* Ford, Bacon & Davis, Inc. v. Holahan, 311 F.2d 901, 904 (5th Cir. 1962) (holding contract was personal to corporate debtor; the pertinent "inquiry is into the nature of the contract itself, to determine if it calls for the exercise of some personal skill and judgment on the part of the bankrupt, or rests upon the other party's placing trust and confidence in the reputation of the bankrupt for skill and integrity."); *In re Rooster, Inc.*, 100 B.R. 228, 233 (Bankr. E.D. Pa. 1989) ("Certain employment contracts of individuals also create a categorical 'personal services' exception . . . Corporations can also, however, enter into such contracts."); *In re Compass Van & Storage Corp.*, 65 B.R. 1007, 1010 (Bankr. E.D.N.Y. 1986) ("The nonassignability imprint of personal service contracts is firmly established New York law . . . The general rule has been extended to encompass contracts with corporations as well as individuals.").

<sup>77</sup> *See* cases cited *supra* note 65; *see, e.g., In re Sunrise Rests., Inc.*, 135 B.R. 149, 153 (Bankr. M.D. Fla. 1991) (finding section 365(c)(1) was designed to apply only to personal service contracts); *In re Terrace Apartments, Ltd.*, 107 B.R. 382, 384 (Bankr. N.D. Ga. 1989) (upholding authorities that limit section 365(c) to personal service contracts); *Abney v. Fulton County (In re Fulton Air Serv., Inc.)*, 34 B.R. 568, 572 (Bankr. N.D. Ga. 1983) ("[S]ubsection (c) must be limited to executory contracts . . . such as nondelegable personal service contracts.").

<sup>78</sup> *See, e.g., In re Raby*, 139 B.R. 833, 836 (Bankr. N.D. Ohio 1991) (granting trustee's assumption of land installment contract); *In re Sunrise Rests. Inc.*, 135 B.R. at 154 (granting debtor's motion to assume and assign franchise agreement); *In re Tom Stimus Chrysler-Plymouth, Inc.*, 134 B.R. 676, 679 (Bankr. M.D. Fla. 1991) (granting debtor's motion to assume franchise agreement); *In re Haffner's 5 Cent to \$1.00 Stores, Inc.*, 26 B.R. 948, 951 (Bankr. N.D. Ind. 1983) (granting trustee's motion to assume and assign leases for occupancy of real property); *In re Pioneer Ford Sales Inc.*, 26 B.R. 116, 119 (Bankr. D.R.I. 1983) (granting

## 2. Partnership Agreements

As discussed above, courts have found partnership agreements to be executory contracts.<sup>79</sup> Accordingly, the assumption or assignment of a partnership agreement or the debtor's interest in a partnership is governed by section 365 of the Bankruptcy Code. This has important implications for debtors that are members of partnerships because the ability of partners to assign their partnership interests often is restricted by state law.

The Uniform Partnership Act of 1997 and the Uniform Partnership Act of 1914 (collectively, the "Uniform Partnership Acts") both provide that a person can become a partner only with the consent of all of the existing partners.<sup>80</sup> Additionally, the Uniform Partnership Acts both provide that a partner's only transferable interest in the partnership is the partner's share of the partnership's profits and losses and the partner's right to receive distributions.<sup>81</sup> A transferee of a partner's transferable interest has the right to receive distributions of the partnership's profits; however, a transferee does not become a partner by virtue of the assignment<sup>4</sup> or sale of the partner's transferable interest and has no right to participate in the management of the partnership.<sup>82</sup> In this respect, the Uniform

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debtor's motion to assume and assign franchise agreement); *In re Bronx-Westchester Mack Corp.*, 20 B.R. 139, 143 (Bankr. S.D.N.Y. 1982) (allowing debtor to assume and assign franchise agreement); *In re U.L. Radio Corp.*, 19 B.R. 537, 545 (Bankr. S.D.N.Y. 1982) (granting debtor's motion to assume and assign its leasehold interest); *In re Boogaart of Fla., Inc.*, 17 B.R. 480, 486 (Bankr. S.D. Fla. 1981) (granting debtor's motion to assume and assign certain real property and equipment leases); *In re Taylor Mfg., Inc.* 6 B.R. 370, 372 (Bankr. N.D. Ga. 1980) (granting trustee's motion to assume and assign real property lease).

<sup>79</sup> See cases cited *supra* note 23.

<sup>80</sup> Compare UNIF. P'SHIP ACT § 401(i) (1997) ("A person may become a partner only with the consent of all of the partners."), and CAL. CORP. CODE § 16401(i) (West 2004) (same), and DEL. CODE ANN. tit. 6 § 15-401(i) (2004), and 805 ILL. COMP. STAT. 206/401(i) (2004) (same), and N.J. STAT. ANN. § 42:1A-21(i) (West 2004) (same), and VA. CODE ANN. § 50-73.106 (Michie 2004) (same), with UNIFORM PARTNERSHIP ACT § 18(g) (1914) ("No person can become a member of a partnership without the consent of all the partners."), and N.Y. PARTNERSHIP LAW § 40(7) (McKinney 2004) (same), and OHIO REV. CODE ANN. § 1775.17(G) (Anderson 2004) (same).

<sup>81</sup> Compare UNIF. P'SHIP ACT § 502 (1997) ("The only transferable interest of a partner in the partnership is the partner's share of the profits and losses of the partnership and the partner's right to receive distributions. The interest is personal property."), and CAL. CORP. CODE § 16502 (same), and 805 ILL. COMP. STAT. 206/502 (same), and N.J. STAT. ANN. § 42:1A-28 (same), and VA. CODE ANN. § 50-73.106 (same), with UNIF. P'SHIP ACT § 26 (1914) ("A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property."), and N.Y. PARTNERSHIP LAW § 52 (same), and OHIO REV. CODE ANN. § 1775.25 (same). The comparable provision under Delaware law provides: "A partnership interest is personal property. Only a partner's economic interest may be transferred." DEL. CODE ANN. tit. 6 § 15-502 (2004).

<sup>82</sup> Compare UNIF. P'SHIP ACT § 503(a)(3) (1997) ("A transfer, in whole or in part, of a partner's transferable interest in the partnership . . . does not, as against the other partners or the partnership, entitle the transferee, during the continuance of the partnership, to participate in the management or conduct of the partnership business, to require access to information concerning partnership transactions, or to inspect or copy the partnership books or records."), and CAL. CORP. CODE § 16503(a)(2) (same), and DEL. CODE ANN. tit. 6 § 15-503(a)(3) (same), and 805 ILL. COMP. STAT. 206/503 (same), and N.J. STAT. ANN. § 42:1A-29(a)(3) (same), and VA. CODE ANN. § 50-73.107(A)(3) (same), with UNIF. P'SHIP ACT § 27(1) (1914):

A conveyance by a partner of his interest in the partnership does not . . . as against

Partnership Acts restrict the assignment of a partner's full or entire partnership interest.

Invoking section 365(c)(1) of the Bankruptcy Code, courts have given effect to the restrictions imposed by the Uniform Partnership Acts, as codified in full or in part in various states, on the attempted transfer or assignment of a partnership interest in bankruptcy.<sup>83</sup> For example, a court that decided (or was required) to follow the First Circuit's reasoning in *Pioneer Ford Sales* most likely would enforce such restrictions because the Uniform Partnership Acts restrict the assignment of partnership interests irrespective of any language contained in the partnership agreement.<sup>84</sup> Courts that consider whether the identity of the contracting party is material to the agreement have enforced such restrictions because the identity of the

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the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books[.]

*Id.*; and N.Y. PARTNERSHIP LAW § 53(1) (same), and OHIO REV. CODE ANN. § 1775.26(A) (same); *see also* 59A AM. JUR. 2D *Partnership* § 322 (2003):

The assignment of a partner's profit rights to a third party, without the consent to his or her admission as a partner, does not make the third party a partner but merely an assignee entitled to receive profits under his or her contract with the assignor in the sum to which the assignor would have been entitled.

*Id.*

<sup>83</sup> *See* *Stumpf v. McGee (In re O'Connor)*, 258 F.3d 392, 402 (5th Cir. 2001) ("[T]he district court correctly held the [partnership] agreement was *not* assumable under § 365(c)(1)."); *In re Schick*, 235 B.R. 318, 325 (Bankr. S.D.N.Y. 1999) (finding section 365(c)(1) prevents assignment of partnership interest unless other parties agree to admit assignee as substitute limited partner); *Weaver v. Nizny (In re Nizny)*, 175 B.R. 934, 939 (Bankr. S.D. Ohio 1994) (stating partnership interest would not be assignable "to a separate third party" under section 365(c)(1)); *Breeden v. Catron (In re Catron)*, 158 B.R. 629, 635 (E.D. Va. 1993) ("[T]he court concludes, based on the facts and applicable law, that this Partnership Agreement is the type of contract that cannot be assumed under § 365(c)(1)(A), absent the consent of the nondebtor parties . . ."); *In re Antonelli*, 148 B.R. 443, 448 (D. Md. 1992) (stating whether section 365(c)(1) of the Bankruptcy Code prohibits assignment of partnership interest depends "upon the materiality of the identity of the partners to the performance of the obligations remaining to be performed under the partnership in question."); *In re Cardinal Indus., Inc.*, 116 B.R. 964, 979 (Bankr. S.D. Ohio 1990) (stating that limited partnership agreement was not assignable under section 365(c)(1)); *In re Priestley*, 93 B.R. 253, 260 (Bankr. D.N.M. 1988) (finding that debtor's rights to manage partnership were nonassignable under section 365(c)(1)); *In re Sunset Developers*, 69 B.R. 710, 713 (Bankr. D. Idaho 1987) ("Section 365(c) prevents the Debtor-in-Possession from assuming or assigning the partnership other than such assignment as allowed by the Idaho Uniform Partnership Law."); *Skeen v. Harms (In re Harms)*, 10 B.R. 817, 821–22 (Bankr. D. Colo. 1981) (finding section 365(c)(1) prevented trustee from assuming position of general partner); *cf.* *In re Woskob*, 305 F.3d at 187 ("Subsections 365(c) and 365(e) will prevent a debtor in bankruptcy from continuing to serve as a partner, however, only when a non-debtor partner does not consent to continue in the partnership with the debtor."); *see also* *Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65, 78 (Bankr. E.D. Va. 1996) (finding debtors' bankruptcy filing effectively terminated their membership in limited liability company).

<sup>84</sup> *See* *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 612 (1st Cir. 1995) (rejecting "hypothetical test" but finding Massachusetts limited partnership statute "applicable nonbankruptcy law" under section 365(e)(2)(A) of the Bankruptcy Code); *see also supra* note 47.

partner generally is considered material to the underlying partnership agreement.<sup>85</sup>

Along these lines, the bankruptcy court in *Schick*, following the Sixth and Ninth Circuits' interpretations of section 365(c)(1), considered whether the debtors could assign their interests as limited partners<sup>86</sup> in a partnership to a corporation.<sup>87</sup> The partnership agreement prohibited the assignment of any partnership interest without both the consent of the general partner and a certain percentage of the limited partners.<sup>88</sup> Under the applicable state partnership law, *i.e.*, New York partnership law, a partnership interest is assignable, but the assignee is only entitled to receive distributions and allocations of profits and losses and does not become a member in the partnership absent the consent of the other partners.<sup>89</sup>

The bankruptcy court found section 365(c)(1) of the Bankruptcy Code applicable because New York partnership law was premised on the principle of *delectus personarum*: "[A]t the heart of the partnership contract is the principle that partners may choose with whom they wish to be associated."<sup>90</sup> According to the

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<sup>85</sup> See, e.g., *In re Catron*, 158 B.R. at 635 ("Because a partner must accept performance from and render performance to only his/her fellow partners, and . . . is conditioned on the consent of the partnership's current partners, the court concludes that . . . the nondebtor parties [are excused] . . . from accepting performance from or rendering performance to a party other than Catron."); *In re Antonelli*, 148 B.R. at 448 (stating whether section 365(c)(1) prohibits assignment of partnership interest depends "upon the materiality of the identity of the partners to the performance of the obligations remaining to be performed under the partnership in question."); *In re Schick*, 235 B.R. at 324 ("The statutory proscription barring non-consensual assignments of membership in the partnership is based upon the principle of *delectus personarum* (or *delectus personae*), the choice of person."); see also cases cited *supra* note 65.

<sup>86</sup> See UNIF. LTD. P'SHIP ACT § 701 (2001) (containing substantially similar restrictions on assignment as do Uniform Partnership Acts); *id.* § 702(a)(3) (2001) ("A transfer, in whole or in part, of a partner's transferable interest . . . does not, as against the other partners or the limited partnership, entitle the transferee to participate in the management or conduct of the limited partnership's activities . . .").

<sup>87</sup> See *In re Schick*, 235 B.R. at 325 (following Sixth Circuit's and Ninth Circuit's interpretation of section 365(c)(1) of the Bankruptcy Code in finding section 365(c)(1) applicable to partnership agreement).

<sup>88</sup> *Id.* at 321–22. The partnership agreement provided:

[A] Partner shall not assign . . . his interest in the Partnership or any part thereof, without both (a) the consent of the General Partner which consent may be granted or withheld in the absolute discretion of the General Partner and (b) the consent of partners holding, in the aggregate, sixty (60%) percent in interest of all partnership interest. Any actual attempt at assignment . . . without such consents shall be void and shall not bind the parties.

*Id.*

<sup>89</sup> *Id.* at 323–24 ("[A] partnership interest is assignable . . . . An assignment does not, however, entitle the assignee to become or to exercise the rights of a partner . . . . Rather, it only entitles the assignee to receive distributions and allocations of profits and losses.").

<sup>90</sup> *In re Schick*, 235 B.R. at 324 ("The statutory proscription barring non-consensual assignments of membership in the partnership is based upon the principle of *delectus personarum* (or *delectus personae*), the choice of person. 'At the heart of the partnership concept is the principle that partners may choose with whom they wish to be associated.'" (internal citation omitted)); see also *In re Nizny*, 175 B.R. at 937 ("The partnership agreement creates a fiduciary relationship among the partners . . . . A partnership agreement is a contract based on personal trust and confidence, which cannot be assigned or assumed without consent of the parties."); *In re Catron*, 158 B.R. at 627 ("Fundamentally a partnership is based upon the personal trust and confidence of the partners."); *In re Manor Place Dev. Assocs.*, 144 B.R. 679, 686 (Bankr. D.N.J. 1992) ("[A] partnership agreement is a contract based upon personal trust and confidence."); *In re Sovereign Group*, 88

bankruptcy court, "[t]he assignment of economic rights does not violate the principle of *delectus personarum*, 'but it would be violated by the admission of a new speaking and voting member into the closely knit arrangement that typifies the general partnership.'"<sup>91</sup> Thus, under New York law, the identity of the partner was material to the partnership agreement. Accordingly, the bankruptcy court found section 365(c)(1) of the Bankruptcy Code applicable and refused to authorize the assignment of the estates' status as limited partners.<sup>92</sup>

### 3. Intellectual Property and Technology Licenses

Because courts have found that intellectual property and technology licenses are executory contracts, the assumption or assignment of these licenses also is governed by section 365 of the Bankruptcy Code.<sup>93</sup> This has important implications for debtors that hold intellectual property and technology licenses because federal common law generally restricts the ability of licensees to transfer or assign their licenses outside of bankruptcy.

#### a. Patent Licenses

Under the Patent Act, a party that "invents or discovers a new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent . . ."<sup>94</sup> A party that obtains a patent has, among other things, the right to exclude others from making, using, selling, offering to sell or importing the patented invention within the United States<sup>95</sup> for a period of 20 years from the date of filing.<sup>96</sup> If a party makes, uses, sells, offers to sell or

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B.R. 325, 329 (Bankr. D. Colo. 1988) ("[A Partnership] agreement among partners is unique in law because it is not only a legal relationship that is created, but it reflects a personal relation or status somewhat akin to the relationship of individuals in a marriage."); *In re Sunset Developers*, 69 B.R. 710, 713 (Bankr. D. Idaho) ("A partnership agreement is a contract based on personal trust and confidence, which cannot be assigned or assumed without consent of the parties."); *Skeen v. Harms (In re Harms)*, 10 B.R. 817, 821 (Bankr. D. Colo. 1981) ("A partnership agreement creates a fiduciary relationship among the members of the partnership. It is a contract based upon personal trust and confidence."); *Kellis v. Ring*, 155 Cal. Rptr. 297, 300 (Cal. Ct. App. 1979) ("Personality is the very essence of a general partnership and although not as inherently pervasive in a limited partnership, it is clear that . . . the nature of this legal entity does place a premium on personality.").

<sup>91</sup> *In re Schick*, 235 B.R. at 324 (internal citation omitted).

<sup>92</sup> *Id.* ("I conclude that the trustee cannot compel the assignment of the estates' status as limited partners over the objection of the general partner.").

<sup>93</sup> See cases cited *supra* note 24.

<sup>94</sup> 35 U.S.C. § 101 (2000).

<sup>95</sup> See *id.* § 271(a) ("Except as otherwise provided in this title, whoever without authority makes, uses, offers to sell, or sells any patented invention, within the United States or imports into the United States any patented invention during the term of the patent therefore, infringes the patent."); see also *Fla. Prepaid Postsecondary Educ. Expense Bd. v. Coll. Sav. Bank*, 527 U.S. 627, 632–33 (1999) (explaining what might constitute infringement under 35 U.S.C. § 271 (a)); *Valley Drug Co. v. Geneva Pharm., Inc.*, 344 F.3d 1294, 1296 (11th Cir. 2003) (explaining what might constitute infringement under 35 U.S.C. § 271(a)).

<sup>96</sup> See 35 U.S.C. § 154(a)(2) (2000) ("Subject to the payment of fees under this title, such grant shall be for a term beginning on the date on which the patent issues and ending 20 years from the date on which the application for the patent was filed in the United States . . ."); see also *Golan v. Pingel Enter., Inc.*, 310



imports a patented invention within the United States or induces another or contributes to any of the foregoing, that party can be held liable as an infringer.<sup>97</sup>

A license agreement, as opposed to a sale or assignment of intellectual property, does not transfer title in the patent from the licensor to the licensee.<sup>98</sup> Rather, license agreements are covenants not to sue—*i.e.*, the licensor agrees not to sue the licensee for patent infringement if the licensee uses the patented invention and performs (such as by paying royalties) in accordance with the terms of the license agreement.<sup>99</sup> Under federal common law, patent license agreements are personal to the licensee<sup>100</sup> and, consequently, are not assignable by the licensee to a third party without the consent of the licensor unless the license agreement expressly provides otherwise.<sup>101</sup> This proposition appears to be true for both exclusive and

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F.3d 1360, 1364 n.1 (Fed. Cir. 2002) (stating patent expires 20 years, measured from filing date of earliest U.S. application for which priority is claimed.); *Geneva Pharm., Inc. v. Glaxosmithkline P.L.C.*, 189 F. Supp. 2d 377, 383 n.9 (E.D. Va. 2002) (stating patent holder has 20 years of exclusivity before public may copy invention for profit).

<sup>97</sup> See 35 U.S.C. § 271(b), (c) (2000); see also *Fina Research v. Baroid Ltd.*, 141 F.3d 1479, 1482 (Fed. Cir. 1998) (providing example of infringement based upon both 35 U.S.C. § 271(b) and (c)); *Whitfield & Sheshunoff, Inc. v. Fairchild Engine & Airplane Corp.*, 269 F.2d 427, 439 (2d Cir. 1959) (providing example of infringement of 35 U.S.C. § 271(b)).

<sup>98</sup> A debtor may be able to avoid the issues discussed in this article regarding section 365(c)(1) of the Bankruptcy Code by arguing, in the context of an exclusive patent license, that the exclusive license was a sale or complete assignment of the underlying intellectual property. See *Black Clawson Co. v. Kroenert Corp.*, 245 F.3d 759, 765 (8th Cir. 2001) (holding exclusive patent license may be constructive assignment if "the parties intended a grant of all substantial rights."); *Prima Tek II, L.L.C. v. A-Roo Co.*, 222 F.3d 1372, 1377 (Fed. Cir. 2000) ("[A]n exclusive, territorial license is equivalent to an assignment and may therefore confer standing upon the licensee to sue for patent infringement."). If a complete assignment occurred, then the agreement is arguably not executory and thus outside the scope of section 365. A thorough analysis of recharacterizing an exclusive patent license as a sale or complete assignment is beyond the scope of this article.

<sup>99</sup> See Richard M. Cieri & Michelle M. Morgan, *Licensing Intellectual Property and Technology from the Financially-Troubled or Startup Company: Prebankruptcy Strategies to Minimize the Risk in a Licensee's Intellectual Property and Technology Investment*, 55 BUS. LAW. 1649, 1661–63 (2000). Covenants not to sue may also be included in the license agreement itself. See, e.g., *Syndia Corp. v. Lemelson Med., Educ., & Research Found., Ltd. P'ship*, 165 F. Supp. 2d 728, 741 (N.D. Ill. 2001). Further, parties can agree to expand covenants not to sue beyond the particular license agreement. See, e.g., *Inamed Corp. v. Kuzmak*, 275 F. Supp. 2d 1100, 1124 (C.D. Cal. 2002).

<sup>100</sup> An interesting issue would arise if a nondebtor licensee attempted to use section 365(c)(1) to force a bankrupt licensor to terminate an intellectual property license that the licensor otherwise wanted to assume. Although federal law generally restricts the right of a licensee, rather than the right of a licensor, to assign or transfer an intellectual property license (*i.e.*, the license agreement is personal to the licensee and not the licensor under federal law), the license agreement could be drafted in a manner that arguably could cause the license agreement to be characterized as a personal service contract under state law. See discussion *supra* Part II.B.1. If the license agreement were so characterized, and the licensee desired to terminate the license agreement, the licensee could argue that section 365(c)(1) would prevent the licensor from assuming the license. This issue is distinct from the issue raised when the debtor/licensor wants to reject the license and nondebtor licensee desires to continue its rights under the license. This latter situation is addressed by section 365(n) of the Bankruptcy Code. See generally Cieri & Morgan, *supra* note 99.

<sup>101</sup> See *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 679 (9th Cir. 1996) ("Federal law holds a nonexclusive patent license to be personal and nonassignable . . ."); *Stenograph Corp. v. Fulkerson*, 972 F.2d 726, 729 n.2 (7th Cir. 1992) ("Patent licenses are *not* assignable in the absence of express language."); *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986) ("It is well settled that a nonexclusive licensee of a patent has only a personal and not a property interest in the patent and that

nonexclusive patent licenses.<sup>102</sup>

Again, invoking section 365(c)(1) of the Bankruptcy Code, courts generally have given effect to these restrictions on the assignment of patent licenses in bankruptcy.<sup>103</sup> Although there is no reported case law in the First Circuit dealing with the assignment of patent licenses in bankruptcy, a court that decided (or was required) to follow the First Circuit's reasoning in *Pioneer Ford Sales* most likely would restrict the assignment of the license if the license agreement were otherwise silent.<sup>104</sup> Courts that consider whether the identity of the contracting party is material to the agreement have applied the federal rule against the assignment of patent licenses in bankruptcy, on the theory that patent licenses are personal to the licensee.<sup>105</sup>

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this personal right cannot be assigned unless the patent owner authorizes the assignment or the license itself permits assignment."); *PPG Indus., Inc. v. Guardian Indus. Corp.*, 597 F.2d 1090, 1093 (6th Cir. 1979) ("It has long been held by federal courts that agreements granting patent licenses are personal and not assignable unless expressly made so."); *Unarco*, 465 F.2d at 1306 ("The long standing federal rule of law with respect to the assignability of patent license agreement provides that these agreements are personal to the licensee and not assignable unless expressly made so in the agreement."); *In re Alltech Plastics, Inc.*, 71 B.R. 686, 689 (Bankr. W.D. Tenn. 1987) ("Pursuant thereto, albeit federal common rather than statutory law, it has long been the rule that patent licenses are personal and not assignable unless expressly made so."); *see also* *Oliver v. Rumford Chem. Works*, 109 U.S. 75, 82 (1883) ("[T]he instrument of license is not one which will carry the right conferred to any one but the licensee personally, unless there are express words to show an intent to extend the right to an executory, administrator, or assignee."); *The Troy Iron & Nail Factory v. Corning*, 55 U.S. 193, 216 (1852) ("A mere license to a party, without having his assigns or equivalent words to them, showing that it was meant to be assignable, is only the grant of a personal power to the licensees, and it not transferable by him to another.").

<sup>102</sup> *See In re Hernandez*, 285 B.R. 435, 440 (Bankr. D. Ariz. 2002) ("The court . . . finds that applicable federal patent law would require the consent of the Licensor to assign the License in this case even if the License is exclusive.").

<sup>103</sup> *See In re Catapult Entm't, Inc.*, 165 F.3d at 754–55 (finding because the debtor-licensee could not assign the patent license to a hypothetical third party, the debtor-licensee could not assume the patent license pursuant to section 365(c)(1)); *In re Hernandez*, 285 B.R. at 442 (stating same); *In re Access Beyond Techs., Inc.*, 237 B.R. 32, 48–49 (Bankr. D. Del. 1999) (stating same); *In re Alltech Plastics, Inc.*, 71 B.R. at 689 (finding that the trustee was without authority to assign a patent license absent consent from the licensor).

<sup>104</sup> An argument could be made, however, that a court that decided to follow or was required to follow *Pioneer Ford* should not enforce such restrictions in bankruptcy because the Patent Act does not restrict the assignment of nonexclusive licenses "whether or not" the license agreement is silent. *See In re Pioneer Ford Sales, Inc.*, 729 F.2d 27, 29 (1st Cir. 1984) ("As a matter of logic, however, we see no conflict, for (c)(1)(A) refers to state laws that prohibit assignment 'whether or not' the contract is silent, while (f)(1) contains no such limitation."). The First Circuit did not address this issue in *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 494–95 (1st Cir. 1997), because the First Circuit found that the transfer of the debtor's stock to a third party did not effect an assignment of the debtor's patent licenses under state law.

<sup>105</sup> *See In re Catapult Entm't, Inc.*, 165 F.3d at 750 ("[O]ur 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.'" (quoting *In re CFLC*, 89 F.3d at 680)); *In re Access Beyond Techs., Inc.*, 237 B.R. at 45 (stating longstanding federal rule of law with respect to assignability of patent license agreements provides that these agreements are personal to licensee and not assignable unless expressly made so in agreement) (citing *Unarco*, 465 F.2d at 1306)); *In re Alltech Plastics Inc.*, 71 B.R. at 689 ("[A]lthough their nonassignment is not statutorily mandated, the century old common law classification of patent licenses appears to place them within the realm of the types of contracts traditionally associated with section 365(c).").

For example, in *Catapult Entertainment*, a software company commenced a case under chapter 11 of the Bankruptcy Code. The debtor in possession sought to assume certain patent licenses as a part of its plan of reorganization, and the party that granted the debtor the right to use certain relevant technologies objected. The lower courts granted the debtor's motion and approved the plan of reorganization. The United States Court of Appeals for the Ninth Circuit, however, reversed and found that, under section 365(c)(1) of the Bankruptcy Code, the debtor could not assume the patent licenses<sup>106</sup> because, under federal patent law, patent licenses are "personal and assignable only with the consent of the licensor."<sup>107</sup> Accordingly, the Ninth Circuit concluded that the debtor could not assume or assign the underlying patent licenses.<sup>108</sup>

### b. Copyright Licenses

Like patent licenses, nonexclusive copyright licenses also are not assignable by the licensee without the consent of the licensor unless the license agreement provides otherwise.<sup>109</sup> There is a split of authority, however, as to whether exclusive copyright licenses are freely assignable by the licensee.<sup>110</sup> Under the Copyright Act,

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<sup>106</sup> See *In re Catapult Entm't, Inc.*, 165 F.3d at 754–55 ("[W]here applicable nonbankruptcy law makes an executory contract nonassignable because the identity of the nondebtor party is material, a debtor in possession may not assume the contract absent consent of the nondebtor party."). As suggested above, in *Catapult*, the Ninth Circuit restricted the debtor's ability to assume the patent licenses. A detailed discussion of this type of prohibition on assumption alone can be found at Section IV of the article.

<sup>107</sup> *Id.* at 750 ("[O]ur 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.'") (quotation omitted).

<sup>108</sup> *Id.* at 754–55.

<sup>109</sup> See *PlayMedia Sys. v. Am. Online, Inc.*, 171 F. Supp. 2d 1094, 1099 (C.D. Cal. 2001) ("Copyright licenses are presumed to prohibit any use not authorized . . . . A non-exclusive licensee such as Nullsoft/AOL has 'no right to re-sell or sublicense the rights acquired unless he has been expressly authorized to do so.'") (quoting *Harris v. Emus Records Corp.*, 734 F.2d 1329, 1333 (9th Cir. 1984)); *In re Valley Media, Inc.*, 279 B.R. 105, 135 (Bankr. D. Del. 2002) ("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."); *In re Golden Books Family Entm't, Inc.*, 269 B.R. 300, 311 (Bankr. D. Del. 2001) (finding licenses relating to Scooby-Doo and the Power Puff Girls nonexclusive and non-assignable under copyright law.); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997) ("[T]he nonexclusive license is personal to the transferee . . . and the licensee cannot assign it to a third party without the consent of the copyright owner.").

<sup>110</sup> Compare *In re Golden Books Family Entm't, Inc.*, 269 B.R. at 318–19:

The more natural reading of § 201(d) is that Congress intended exclusive licensees to have all of the rights of an owner to the extent the license is intended to cover each of these rights. The court therefore declines to adopt the holding of the *Gardner* court and instead finds, in accordance with *Patient Educ. Media* and *Nimmer*, that exclusive licenses have the right to freely assign their rights.

*Id.*; *In re Patient Educ. Media, Inc.*, 210 B.R. at 240 ("Ownership is the *sine qua non* of the right to transfer, and the copyright law distinguishes between exclusive and nonexclusive licenses. A 'transfer of copyright ownership' includes the grant of an exclusive license, but not a nonexclusive license."); Melville B. Nimmer,

a party that creates a work of authorship, including a literary work, motion pictures, sound recordings, architectural works and the like, has a copyright in such work<sup>111</sup> from the date of the work's creation until 70 years after the author's death.<sup>112</sup> A copyright gives the owner the exclusive right to (i) reproduce the copyrighted work, (ii) prepare derivative works based on the copyrighted work, (iii) distribute copies of the copyrighted work, (iv) perform the work publicly and (v) display the work publicly.<sup>113</sup> If a party violates any of these exclusive rights of the copyright owner,

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3 NIMMER ON COPYRIGHT § 10.02[B][4] (2004) ("Generalizing from the foregoing, sound policy reasons combine with copyright's constitutional moorings to construe exclusive licenses as transferable. It is therefore submitted that the district and circuit court rulings in *Gardner v. Nike* should not be followed."), with *Gardner v. Nike, Inc.*, 279 F.3d 774, 780 (9th Cir. 2002) ("[W]e hold that the 1976 Act does not allow a copyright licensee to transfer its rights under an exclusive license, without the consent of the original licensor."); see also *I.A.E., Inc. v. Shaver*, 74 F.3d 768, 775 (7th Cir. 1996) ("The 'transfer of copyright ownership' is defined, in the Copyright Act, as an exclusive license or some other instrument of conveyance. The definition expressly excludes a nonexclusive license.").

<sup>111</sup> Section 102(a) of the Copyright Act provides:

Copyright protection subsists, in accordance with this title, in original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. Works of authorship include the following categories:

- (1) literary works;
- (2) musical works, including any accompanying words;
- (3) dramatic works, including any accompany music;
- (4) pantomimes and choreographic works;
- (5) pictorial, graphic, and sculptural works;
- (6) motion pictures and other audiovisual works;
- (7) sound recordings; and
- (8) architectural works.

17 U.S.C. § 102(a) (1976).

<sup>112</sup> *Id.* § 302(a) (1976) ("Copyright in a work created on or after January 1978, subsists from its creation and, except as provided by the following subsections, endures for a term consisting of the life of the author and 70 years after the author's death."). With respect to joint works, the duration of the copyright generally is 70 years after the death of the last surviving author, and with respect to anonymous works and works for hire, the duration of the copyright is 95 years from the year of its first publication or 120 years from the year of its creation, whichever expires first. See *id.* § 302(b), (c) (1976).

<sup>113</sup> Section 106 of the Copyright Act provides:

Subject to section 107 through 120, the owner of copyright under this title has the exclusive right to do and to authorize any of the following:

- (1) to reproduce the copyrighted work in copies or phonorecords;
- (2) to prepare derivative works based upon the copyrighted work;
- (3) to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending;
- (4) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, to perform the copyrighted work publicly; and
- (5) in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work, to display the copyrighted work publicly.

that party can be held liable as an infringer.<sup>114</sup> An exclusive license to a copyright is considered a transfer of copyright ownership under the Copyright Act.<sup>115</sup> For this reason, courts, excluding the Ninth Circuit, have found that exclusive licenses to copyrights are freely assignable by the licensee.<sup>116</sup> In contrast, a nonexclusive license to a copyright is not a transfer of copyright ownership under the Copyright Act.<sup>117</sup> Thus, under federal law, most nonexclusive license agreements in copyrighted material are personal to the licensee and, consequently, are not assignable to third parties without the consent of the licensor unless the license agreement expressly provides otherwise.<sup>118</sup>

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*Id.* § 106 (1976).

<sup>114</sup> *Id.* § 501(a):

Anyone who violates any of the exclusive rights of the copyright owner as provided in sections 106 through 118 or of the author as provided in section 106(A)(a), or who imports copies or phonorecords into the United States in violation of section 602, is an infringer of the copyright or right of the author, as the case may be.

*Id.*

<sup>115</sup> *See id.* § 101 ("A 'transfer of copyright ownership' is an assignment, mortgage, exclusive license, or any other conveyance, alienation, or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license.").

<sup>116</sup> *See* cases cited *supra* note 110.

<sup>117</sup> *See* 17 U.S.C. § 101; *id.* § 201(d)(2) ("The owner of any particular exclusive right is entitled, to the extent of that right, to all of the protection and remedies accorded to the copyright owner by this title."); *See also* 3 NIMMER ON COPYRIGHT § 10.02[B][4]:

The limitations on a licensee's right to re-sell or sublicense under the 1909 Act would appear to continue under the current Act with respect to nonexclusive licensees, but not as to exclusive licensees. The latter having acquired 'title' or ownership of the rights conveyed, may recover them absent contractual restrictions.

*Id.*

<sup>118</sup> *See* cases cited *supra* note 109. A distinction should be made, however, for shrinkwrap licenses provided with the sale of software because courts generally have found that the purchase of copyrighted software constitutes a sale of goods rather than a license to use the software. *See* *Softman Prods. Co., L.L.C. v. Adobe Sys., Inc.*, 171 F. Supp. 2d 1075, 1085 (C.D. Cal. 2001):

The Court finds that the circumstances surrounding the transaction strongly suggests that the transaction is in fact a sale rather than a license. For example, the purchaser commonly obtains a single copy of the software, with documentation, for a single price, which the purchaser pays at the time of the transaction, and which constitutes the entire payment for the 'license.' The license runs for an indefinite term without provisions for renewal. In light of these indicia, many courts and commentators conclude that a 'shrinkwrap license' transaction is a sale of goods rather than a license.

*Id.*; *Novell, Inc. v. Network Trade Ctr., Inc.*, 25 F. Supp. 2d 1218, 1230 (D. Utah 1997), *vacated in part by* 187 F.R.D. 657 (D. Utah 1999):

[T]he purchaser is an 'owner by way of sale and is entitled to the use and enjoyment of the software with the same rights as exist in the purchaser of any other good. Said software transactions do not merely constitute the sale of a license to use the software. The shrinkwrap license included with the software is therefore invalid as

Again, invoking section 365(c)(1) of the Bankruptcy Code, courts generally have given effect to these restrictions on the assignment of nonexclusive copyright licenses in bankruptcy.<sup>119</sup> While there is no reported case law in the First Circuit dealing with the assignment of nonexclusive copyright licenses in bankruptcy, a court that decided (or was required) to follow the First Circuit's reasoning in *Pioneer Ford Sales* would likely prohibit the assignment of the license if the license agreement were otherwise silent.<sup>120</sup> Courts that consider whether the identity of the contracting party is material to the agreement have applied the federal rule against the assignment of copyright licenses in bankruptcy because nonexclusive copyright licenses are personal to the licensee.<sup>121</sup>

For example, in *Sunterra Corp.*, a company that owned and managed numerous resort properties filed a case under chapter 11 of the Bankruptcy Code.<sup>122</sup> Before filing, the debtor had launched a program called "Club Sunterra," under which timeshare owners at Sunterra resorts could trade their timeshare rights for similar

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against such a purchaser insofar as it purports to maintain title to the software in the copyright owner.

*Id. But cf. Adobe Sys., Inc. v. Stargate Software Inc.*, 216 F. Supp. 2d 1051, 1060 (N.D. Cal. 2002) ("[T]he [distribution agreement that permits the distributors to engage in limited re-distribution of copyrighted software subject to a shrink-wrap End User License Agreement] should be characterized as a license, rather than a sale."); *Adobe Sys. Inc. v. One Stop Micro, Inc.*, 84 F. Supp. 2d 1086, 1092 (N.D. Cal. 2000) ("[T]he Court holds that . . . the [Off Campus Reseller Agreement under which an educational reseller makes Educational Software Products available to customers that are Educational End Users] is a licensing agreement.").

<sup>119</sup> See *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 271 (4th Cir. 2004) (finding debtor-licensee could not assume nonexclusive license of copyrighted software pursuant to section 365(c)(1) of Bankruptcy Code); *In re Valley Media, Inc.*, 279 B.R.105, 136 (Bankr. D. Del. 2002) ("Since non-exclusive licenses may not be assigned under applicable non-bankruptcy law [such as federal copyright law], they may not be assumed by the debtor in possession."); *In re BuildNet, Inc.*, No. 01-82293, 2002 Bankr. LEXIS 1851, at \*18 (Bankr. M.D.N.C. Sept. 20, 2002) (finding copyright licenses nonassignable under section 365(c)(1) of the Bankruptcy Code by debtor-licensee); *In re Golden Books Family Entm't., Inc.*, 269 B.R. 300, 309 (Bankr. D. Del. 2001) (finding four license agreements relating to Scooby-Doo and Power Puff Girls nonexclusive licenses therefore non-assignable under copyright law); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 243 (Bankr. S.D.N.Y. 1997) (finding debtor-licensee could not sell nonexclusive license to use copyrighted photographs under section 365(c)(1) of Bankruptcy Code).

<sup>120</sup> Again, an argument could be made that a court that decided to follow or was required to follow *Pioneer Ford Sales* should not enforce such restrictions in bankruptcy because the Copyright Act does not restrict the assignment of licenses "whether or not" the license agreement is silent. See *Pioneer Ford Sales, Inc.*, 729 F.2d 27, 29 (1st Cir. 1984) ("As a matter of logic, however, we see no conflict, for (c)(1)(A) refers to state laws that prohibit assignment 'whether or not' the contract is silent, while (f)(1) contains no such limitation.").

<sup>121</sup> See *In re Valley Media, Inc.*, 279 B.R. at 135 ("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."); *In re Golden Books Family Entm't., Inc.*, 269 B.R. at 309 ("Under copyright law, 'a nonexclusive licensee . . . has only a personal and not a property interest in the [intellectual property],' which 'cannot be assigned unless the [intellectual property] owner authorizes the assignment . . .'" (quoting *In re Patient Educ. Media, Inc.*, 210 B.R. at 242-43)).

<sup>122</sup> See *In re Sunterra Corp.*, 361 F.3d at 257.

rights at other Sunterra resorts.<sup>123</sup> The debtor needed software to facilitate the trading. Thus, the debtor entered into a software license agreement with RCI Technology Corp. under which it obtained a nonexclusive license to use and modify certain copyrighted software.<sup>124</sup> After filing its bankruptcy case, the debtor sought to assume the license of copyrighted software, and RCI Technology Corporation objected on the grounds that the license did not expressly permit assignment.

The bankruptcy court overruled the objection and held that the license agreement was not an executory contract, and, even if it were, section 365(c)(1) of the Bankruptcy Code did not prohibit the debtor from assuming the agreement because no assignment was contemplated. The district court disagreed with the bankruptcy court's finding that the license agreement was not executory, stating that "there is a long line of authority holding that intellectual property licensing agreements . . . are executory contracts."<sup>125</sup> The district court, however, affirmed the bankruptcy court's decision that section 365(c)(1) of the Bankruptcy Code did not prohibit the debtor from assuming the agreement.<sup>126</sup> The United States Court of Appeals for the Fourth Circuit reversed the district court and found that, under section 365(c)(1) of the Bankruptcy Code, the debtor could not assume the license agreement.<sup>127</sup>

The Fourth Circuit agreed with the district court that the license agreement was executory under the Countryman definition,<sup>128</sup> but disagreed with the district court and the bankruptcy court as to the correct application of section 365(c)(1). The Fourth Circuit reconciled the apparent conflict between sections 365(c)(1) and 365(f) of the Bankruptcy Code by finding the term "applicable law" in section 365(c)(1) to refer to specific laws that excuse a contracting party from rendering performance to, or accepting performance from, a third party.<sup>129</sup> It further

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<sup>123</sup> *Id.* at 260.

<sup>124</sup> *Id.* ("In 1997, RCI and Sunterra entered into a software license agreement (the 'Agreement'), pursuant to which RCI granted Sunterra a nonexclusive license to use Premier Software (the 'Software').").

<sup>125</sup> *RCC Tech. Corp. v. Sunterra Corp.*, 287 B.R. 864, 865 (D. Md. 2003):

The Bankruptcy Court found that the [software license] is not an executory contract. If the Bankruptcy Court had been writing on a clean slate, there might be merit in its reasoning. However, there is a long line of authority holding that intellectual property licensing agreements such as the [software license] are executory contracts.

*Id.*

<sup>126</sup> *Id.* at 866 ("I find the actual test to be far more harmonious with the statutory scheme."). See Section III.B. *infra* for a discussion of the actual test.

<sup>127</sup> See *In re Sunterra Corp.*, 361 F.3d at 271–72 ("Without RCI's consent, Sunterra was precluded from assuming the Agreement. Pursuant to the foregoing, the bankruptcy court erred, and the district court erred in affirming the bankruptcy court. We therefore reverse, and we remand for such other and further proceedings as may be appropriate.").

<sup>128</sup> *Id.* at 264 ("[W]e agree with the district court that the Agreement was executory when Sunterra petitioned for bankruptcy.").

<sup>129</sup> *Id.* at 266 ("Therefore, under the broad rule of § 365(f)(1), the 'applicable law' is the law prohibiting or restricting assignments as such; whereas the 'applicable law' under § 365(c)(1) embraces 'legal excuses for refusing to render or accept performance, regardless of the contract's status as assignable . . .'" (citing

determined that federal copyright law was "applicable law" under section 365(c)(1) because it excused RCI Corporation from accepting performance from an entity other than the debtor.<sup>130</sup> Accordingly, the Fourth Circuit concluded that the debtor could not assume or assign the copyright licenses.<sup>131</sup>

In contrast to the cases dealing with nonexclusive copyright licenses, at least one court has held that an exclusive copyright license is not subject to section 365(c)(1) of the Bankruptcy Code.<sup>132</sup> Again, an exclusive copyright license is considered a transfer of copyright ownership under the Copyright Act.<sup>133</sup> For this reason, the bankruptcy court in *Golden Books Family Entertainment* held that section 365(c)(1) does not prevent the assumption or assignment of exclusive copyright licenses.<sup>134</sup> A court that adopted or was required to follow the Ninth Circuit's position on the assignability of exclusive copyright licenses, however, might reach a different result and find exclusive copyright licenses, in addition to nonexclusive copyright licenses, subject to section 365(c)(1).<sup>135</sup>

### c. Trademark Licenses

Licenses to use trademarks generally are not assignable to third parties.<sup>136</sup>

Rieser v. Dayton Country Club Co. (*In re Magness*), 972 F.2d 689, 699 (6th Cir. 1992) (Guy, J., concurring).

<sup>130</sup> *Id.* at 262 n.7 ("Because the Software is a duly registered copyrighted computer program, copyright law is the applicable nonbankruptcy law that would excuse RCI from accepting performance under the Agreement from an entity other than Sunterra.").

<sup>131</sup> *Id.* at 271 ("Without RCI's consent, Sunterra was precluded from assuming the Agreement.").

<sup>132</sup> See *In re Golden Books Family Entm't, Inc.*, 269 B.R. 311, 319 (Bankr. D. Del. 2001):

The court finds that the Madeline Agreement is an exclusive license. The court also finds that, under applicable copyright law, exclusive licenses convey an ownership interest to the licensee that allows that licensee to freely transfer its rights. Therefore, in this case, copyright law does not prevent the assumption and assignment of the Madeline Agreement.

*Id.*; *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997) (exclusive licensee "may freely transfer his rights, and moreover, the licensor cannot transfer the same rights to anyone else."). *But see Gardner v. Nike, Inc.*, 110 F. Supp. 2d 1282, 1287 (C.D. Cal. 2000) (analyzing the Copyright Act and holding licensees cannot freely transfer rights even under exclusive license).

<sup>133</sup> See 17 U.S.C. § 101 (stating "transfer of copyright ownership" includes the grant of exclusive license, but not nonexclusive license).

<sup>134</sup> See *In re Golden Books Family Entm't, Inc.*, 269 B.R. at 313–19 (finding exclusive copyright license not affected by section 365(c)(1) of Bankruptcy Code because of 17 U.S.C. § 101).

<sup>135</sup> See *Gardner*, 279 F.3d at 781 ("[W]e hold that federal law governs the present case and that exclusive licenses are only assignable with the consent of the licensor."); see also *In re Golden Books Family Entm't, Inc.*, 269 B.R. at 318 (rejecting Ninth Circuit's decision in *Gardner* in finding exclusive copyright license not subject to section 365(c)(1) of Bankruptcy Code).

<sup>136</sup> *In re Travelot Co.*, 286 B.R. 447, 455 (Bankr. S.D. Ga. 2002):

For trademark law to preclude assumability of the Travelot-CNN Contract, the Contract must be construed as containing a non-exclusive trademark license. The grant of a non-exclusive license is 'an assignment in gross,' that is, one personal to the assignee and thus not freely assignable to a third party . . . . Accordingly, a licensor



Under the Lanham Act, the term "trademark" is defined as "any word, name, symbol, or device, or any combination thereof . . . [used by a person] to identify and distinguish his or her goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown."<sup>137</sup> The owner of a trademark used in commerce or intended for use in commerce may register the trademark.<sup>138</sup> The federal registration of a trademark does not create or enhance an exclusive property right, as the owner of the trademark acquires his or her exclusive rights therein by prior use in commerce.<sup>139</sup> If a party violates the trademark of another by using the trademark in a manner that is likely to cause confusion or misrepresent the nature of the party's goods, that party can be held liable as an infringer<sup>140</sup> or otherwise liable for civil damages.<sup>141</sup>

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need not accept performance to an entity other than the licensee.

*Id.*; Tap Publ'ns, Inc. v. Chinese Yellow Pages (New York) Inc., 925 F. Supp. 212, 218 (S.D.N.Y. 1996) ("[T]he general rule is that unless the license states otherwise, the licensee's right to use the licensed mark is personal and cannot be assigned to another."); J. THOMAS MCCARTHY, 4 MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 25:33 (4th ed. 2004):

While the case law is sparse, it appears to be the rule that unless the license states otherwise, a licensed mark is personal and cannot be assigned. The rule as to nonexclusive licenses of patents and copyrights is the same: the license is a personal right and cannot be transferred by the licensee to another without the permission of the licensor.

*Id.*; see Denison Mattress Factory v. Spring-Air Co., 308 F.2d 403, 409 (5th Cir. 1962) ("[T]he licensee acquires only the right to a limited use of the trademark and the control, right and title to the product remains in the licensor."); Visa Int'l Serv. Ass'n v. Bankcard Holders of Am., 211 U.S.P.Q. 28, 41 (N.D. Cal. 1981) ("Member banks may not assign their contractual right to use the VISA logo in an unauthorized manner without the consent of the licensor. Such assignment being void, the assignee of the right acquires nothing."); Delta Tire Corp. v. Marion, 159 U.S.P.Q. 601, 603 (C.D. Cal. 1968):

It has not been alleged that Oliver & Winston had any rights to sue the Delta trademark apart from the sale of Delta Tires made by the Delta Tire Corporation. Therefore, it does not appear that Oliver & Winston had the authority to assign or license to defendant any rights to the Delta trademark; an assignment or license of the trademark would not be effective as against the Delta Tire Corporation . . . .

*Id.*; cf. Superior Bedding Co. v. Serta Assocs., Inc., 353 F. Supp. 1143, 1150 (D.C. Ill. 1972) (finding that anti-assignment provision in trademark license agreement was "eminently reasonable."); McCullough v. Dairy Queen of Mich., Inc., 121 U.S.P.Q. 302, 304 (W.D. Mich. 1959) (finding that provision in contract prohibiting assignment of trademark without licensor's consent was valid). *But see In re Rooster, Inc.*, 100 B.R. 228, 232-35 (Bankr. E.D. Pa. 1989) (finding trademark license assignable by bankrupt licensee because license agreement was not personal service contract).

<sup>137</sup> 15 U.S.C. § 1127 (2000).

<sup>138</sup> See *id.* § 1051.

<sup>139</sup> See *In re Int'l Flavors & Fragrances, Inc.*, 183 F.3d 1361, 1366 (Fed. Cir. 1999) ("The federal registration of trademarks does not create an exclusive property right in the mark. The owner of the mark already has the property right established by prior use."); *Gilbert/Robinson, Inc. v. Carrie Beverage-Mo., Inc.*, 989 F.2d 985, 991 (8th Cir. 1993) ("Unlike the registration of a patent, a trademark registration of itself does not create the underlying right to exclude. Nor is a trademark created by registration.").

<sup>140</sup> Section 1114(1) of the Lanham Act provides:

Because a trademark, by definition, is used to identify goods with a person or business,<sup>142</sup> a trademark cannot be assigned apart from the goodwill of the business

Any person who shall, without the consent of the registrant—

(a) use in commerce any reproduction, counterfeit, copy, or colorable imitation of a registered mark in connection with the sale, offering for sale, distribution, or advertising of any goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake, or to deceive; or

(b) reproduce, counterfeit, copy, or colorably imitate a registered mark and apply such reproduction, counterfeit, copy, or colorable imitation to labels, signs, prints, packages, wrappers, receptacles or advertisements intended to be used in commerce upon or in connection with the sale, offering for sale, distribution, or advertising of goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake or to deceive,

shall be liable in a civil action by the registrant for the remedies hereinafter provided. Under subsection (b) hereof, the registrant shall not be entitled to recover profits or damages unless the acts have been committed with knowledge that such imitation is intended to be used to cause confusion, or to cause mistake, or to deceive.

As used in this paragraph, the term "any person" includes the United States, all agencies and instrumentalities thereof, and all individuals, firms, corporations, or other persons acting for the United States and with the authorization and consent of the United States, and any State, any instrumentality of a State, and any officer or employee of a State or instrumentality of a State acting in his or her official capacity. The United States, all agencies and instrumentalities thereof, and all individuals, firms, corporations, other persons acting for the United States and with the authorization and consent of the United States, and any State, and any such instrumentality, officer, or employee, shall be subject to the provisions of this chapter in the same manner and to the same extent as any governmental entity.

15 U.S.C. § 1114(1) (2000). A party also can be liable as an infringer under state law for using a trademark registered under state law. *See, e.g.*, CAL. BUS. & PROF. CODE § 14320(a)(2); DEL. CODE ANN. tit. 6 § 3312(2); FLA. STAT. ANN. § 495.131(2); § 765 ILL. COMP. STAT. 1036/60(b); N.Y. GEN. BUS. LAW § 360-k(b); OHIO REV. CODE ANN. § 1329.65(B); VA. CODE ANN. § 59.1-92.12(2).

<sup>141</sup> Section 1125(a)(1) of the Lanham Act provides:

Any person who, on or in connection with any goods or services, or any container for goods, uses in commerce any word, term, name, symbol, or device, or any combination thereof, or any false designation of origin, false or misleading description of fact, or false or misleading representation of fact, which —

(A) is likely to cause confusion, or to cause mistake, or to deceive as to the affiliation, connection, or association of such person with another person, or as to the origin, sponsorship, or approval of his or her goods, services, or commercial activities by another person, or

(B) in commercial advertising or promotion, misrepresents the nature, characteristics, qualities, or geographic origin of his or her or another person's goods, services, or commercial activities,

shall be held liable in a civil action by any person who believes that he or she is likely to be damaged by such act.

15 U.S.C. § 1125(a)(1) (2000). A party also can be liable under state law for using a trademark registered under state law. *See, e.g.*, CAL. BUS. & PROF. CODE § 14320(a)(1); DEL. CODE ANN. tit. 6 § 3312(1); FLA. STAT. ANN. § 495.131(1); § 765 ILL. COMP. STAT. 1036/60(a); N.Y. GEN. BUS. LAW § 360-k(a); OHIO REV. CODE ANN. § 1329.65(A); VA. CODE ANN. § 59.1-92.12(1).

<sup>142</sup> *See Ty Inc. v. Perryman*, 306 F.3d 509, 510 (7th Cir. 2002) ("The fundamental purpose of a trademark is to reduce consumer search costs by providing a concise and unequivocal identifier of the particular source

with which the mark has been associated.<sup>143</sup> The owner of a trademark may license the use of the trademark to another party as long as the owner takes affirmative steps to ensure that the product sold by the licensee is of the same quality as the product sold by the licensor.<sup>144</sup> The grant of a trademark license generally is considered personal to the licensee<sup>145</sup> and cannot be freely transferred to a third party under federal common law.<sup>146</sup>

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of the particular goods."); *In re Int'l Flavors & Fragrances, Inc.*, 183 F.3d at 1367 ("It is well established . . . that the purpose of a trademark is to distinguish goods and to identify the source of goods."); *Sugar Busters L.L.C. v. Brennan*, 177 F.3d 258, 265 (5th Cir. 1999) ("The purpose of the rule prohibiting the sale or assignment of a trademark in gross is to prevent a consumer from being misled or confused as to the source and nature of the goods or services that he or she acquires.").

<sup>143</sup> See 15 U.S.C. § 1060(a)(1) (2000) (mark "shall be assignable with the goodwill of the business in which the mark is used."); see also *Vittoria N. Am., L.L.C. v. Euro-Asia Imports Inc.*, 278 F.3d 1076, 1082 (10th Cir. 2001) ("Courts have consistently held that a valid assignment of a trademark or service mark requires the transfer of the goodwill associated with the mark."); *Sugar Busters*, 177 F.3d at 265 ("The sale or assignment of a trademark without the goodwill that the mark represents is characterized as in gross and is invalid."); *Sands, Taylor & Wood Co. v. Quaker Oats Co.*, 978 F.2d 947, 956 (7th Cir. 1992) ("[T]he transfer of a trademark apart from the goodwill of the business which it represents is an invalid 'naked' or 'in gross' assignment, which passes no right to the assignee."); *Berni v. Int'l Gourmet Rests. of Am., Inc.*, 838 F.2d 642, 646 (2d Cir. 1988) (stating same).

<sup>144</sup> See *Stanfield v. Osborne Indus., Inc.*, 52 F.3d 867, 871 (10th Cir. 1995) ("Naked (or uncontrolled) licensing of a mark occurs when a licensor allows a licensee to use the mark on any quality of good the licensee chooses . . . [S]uch a practice is inherently deceptive and constitutes abandonment of any rights to the trademark by the licensor."); *AmCAN Enters., Inc. v. Renzi*, 32 F.3d 233, 235 (7th Cir. 1994):

[T]he owner of a trademark is allowed to license its use, provided that it takes effective steps to ensure that the product sold by the licensee is of the same quality as the product sold by the licensor under the same name, so that consumers are not deceived by the identity of names into buying products different from what they reasonably expected.

*Id.*; *In re Travelot Co.*, 286 B.R. 447, 455 ("[I]t appears well settled . . . [that] to be the recipient of a license to use [a] trademark, there must have been (1) a grant of . . . permission to use [the] mark and (2) retention of quality control by [the licensor] over [the licensee's] use of the mark in the Contract.").

<sup>145</sup> See 4 MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 25:33:

While the case law is sparse, it appears to be the rule that unless the license states otherwise, a licensed mark is personal and cannot be assigned. The rule as to nonexclusive licenses of patents and copyrights is the same: the license is a personal right and cannot be transferred by the licensee to another without the permission of the licensor.

*Id.*

<sup>146</sup> See cases cited *supra* note 136; see also 15 U.S.C. § 1114(1) (2000). The Lanham Act is silent as to licensing; thus, there is no provision in the Lanham Act comparable to section 101 of the Copyright Act. In this respect, federal trademark law appears to be more akin to federal patent law. Again, a debtor may be able to avoid the issues discussed in this Article regarding section 365(c)(1) of the Bankruptcy Code by arguing, in the context of an exclusive trademark license, that the exclusive license was a sale or complete assignment of the underlying intellectual property. See *Ste. Pierre Smirnoff, Fls., Inc. v. Hirsch*, 109 F. Supp. 10, 12 (S.D. Cal. 1952) ("It has been repeatedly held over a long period of time that the grant of an exclusive and irrevocable right to use a mark in a designated territory is an assignment and not a mere license."). If a complete assignment occurred, then the agreement arguably is not executory and thus outside the scope of section 365 of the Bankruptcy Code. A thorough analysis of recharacterizing an exclusive trademark license as a sale or complete assignment, however, is beyond the scope of this article.

Indeed, if a third party were to use a federally registered trademark in accordance with a license agreement purportedly assigned to such third party without consent of the licensor, such third party could be liable as an infringer under the Lanham Act.<sup>147</sup>

At least one bankruptcy court has suggested that federal trademark law constitutes "applicable law" under section 365(c)(1) of the Bankruptcy Code.<sup>148</sup> In *Travelot*, a web-based travel bookings company filed a chapter 11 case. Before filing, the debtor entered into a contract with the Cable News Network ("CNN") under which CNN would provide Travelot with "popup" adds on CNN.com, and Travelot agreed to purchase advertising from CNN and pay a "licensing fee." This "licensing fee," however, was not tied to Travelot's use of CNN's trademarks but was part of the total consideration paid by Travelot to CNN for the "popup" adds. When Travelot missed the first and second installment payments due under the contract and failed to procure the necessary technology to integrate Travelot's website with CNN.com, CNN declared Travelot in default. Travelot thereafter filed its bankruptcy case to preserve its contract rights with CNN.

CNN filed a motion to dismiss Travelot's bankruptcy case, asserting, among other things, that section 365(c)(1) of the Bankruptcy Code prohibited the debtor from assuming the contract because the contract provided Travelot with a license to use CNN's trademarks on its website.<sup>149</sup> The bankruptcy court ultimately concluded that the contract did not provide Travelot with a license to use CNN's trademarks.<sup>150</sup> Thus, Travelot was not precluded from assuming the contract under section 365(c)(1).<sup>151</sup> Although ultimately not pertinent to its holding, the bankruptcy court in *Travelot* initially observed that, without authorization, a party cannot use another's federally registered trademark in commerce under the Lanham Act<sup>152</sup> and suggested that federal trademark law would be "applicable law" under

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<sup>147</sup> See 15 U.S.C. § 1114(1) ("Any person who shall, without the consent of registrant, use a trademark, . . . shall be liable in a civil action by the registrant for the remedies hereinafter provided."); see, e.g., *Lopes v. Int'l Rubber Distribs.*, 309 F. Supp. 2d 972, 981–83 (N.D. Ohio 2004) (quoting 15 U.S.C. § 1114(1) and discussing resulting application).

<sup>148</sup> See *In re Travelot Co.*, 286 B.R. 447, 455 (Bankr. S.D. Ga. 2002) ("Trademark law is 'applicable law' under § 365(c).") (emphasis removed).

<sup>149</sup> See *id.* 286 B.R. at 453.

<sup>150</sup> *Id.* at 459 ("Conclusion: The Contract does not contain a trademark license grant to Travelot.") (emphasis removed).

<sup>151</sup> *Id.* at 462 ("The Travelot Company as Debtor-in-Possession IS NOT PRECLUDED as a matter of law from attempting to assume the contract with CNN by application of 11 U.S.C. § 365(c) . . .").

<sup>152</sup> *Id.* at 455:

A trademark registrant may successfully sue an infringer upon a showing that the infringer, without authorization from the registrant, used the mark in commerce and that the unauthorized use caused or was likely to cause confusion or deception . . . . With authorization, however, a would-be infringer may use another's registered trademark in commerce.

*Id.*

section 365(c)(1) for licenses to federally registered trademarks.<sup>153</sup>

At least one bankruptcy court, however, considered only whether a trademark license agreement constitutes a personal service contract under state law to determine whether the agreement could be assigned in bankruptcy without the consent of the licensor.<sup>154</sup> In *Rooster*, a company that manufactured and sold men's neckwear filed a case under chapter 11 of the Bankruptcy Code. Before filing, the debtor entered into a license agreement with Bill Bass and Pincus Brothers Inc. ("Pincus") under which the debtor paid royalties to Pincus, and Pincus permitted the debtor to use the "Bill Bass" trademark on its neckwear. Under the terms of the trademark license agreement, the debtor was subject to substantial supervision by Pincus with respect to the designs and materials to which the "Bill Bass" trademark could attach, as required for a valid license.<sup>155</sup>

Pincus sought relief from the automatic stay in order to terminate the debtor's rights under the trademark license agreement. It does not appear that Pincus argued that the requested relief was appropriate pursuant to federal trademark law. Rather, Pincus introduced evidence that the trademark license agreement was a personal service contract under Pennsylvania law because the debtor was given the license after Pincus had carefully considered the debtor's financial status, physical plant and key personnel to ensure that the debtor's "taste" was in harmony with the fashion sense of Bill Bass.<sup>156</sup> The bankruptcy court rejected this argument on the grounds that Pincus' control over the debtor's use of the "Bill Bass" trademark meant that the debtor's performance under the trademark license agreement did not depend upon "any special personal relationship, knowledge, unique skill or talent."<sup>157</sup> Accordingly, the bankruptcy court denied Pincus' motion for relief from the automatic stay.

#### 4. Government Contracts

Executory contracts and unexpired leases to which the federal government is a party may not be assigned outside of bankruptcy.<sup>158</sup> Courts generally have found

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<sup>153</sup> *Id.* ("If the Contract provided for Travelot to be the recipient of a trademark license, then applicable trademark law precludes assignment of that trademark.").

<sup>154</sup> *In re Rooster, Inc.*, 100 B.R. 228, 232–35 (Bankr. E.D. Pa. 1989).

<sup>155</sup> *Id.* at 230 ("[U]nder the licensing agreement *sub judice*, Ex. P-1, the debtor is subject to a substantial amount of supervision and control by Bill Bass and Pincus . . .").

<sup>156</sup> *Id.* at 230–31.

<sup>157</sup> *Id.* at 233–34 ("I cannot conclude that the debtor's performance under the licensing agreement draws upon any special personal relationship, knowledge, unique skill or talent . . . Instead, I find that this actual control over Rooster's performance removes Rooster's duties from the sphere of personal service and from the ambit of § 365(c)(1)(A).").

<sup>158</sup> See cases cited *supra* note 25. In some circumstances, an executory contract to which a state government is a party may not be assigned outside of bankruptcy under state law. See, e.g., *In re Nitec Paper Corp.*, 43 B.R. 492, 498 (S.D.N.Y. 1984) (finding debtor could not sell excess power generated by Niagara-Mohawk Power Corporation, a political subdivision of State of New York, pursuant to section 365(c)(1) of Bankruptcy Code, where right to purchase excess power was "nondelegable" under New York law). The

that this prohibition continues to apply in bankruptcy, pursuant to section 365(c)(1) of the Bankruptcy Code. Accordingly, a debtor may not assign (and may be prohibited from assuming) contracts or leases to which the federal government is a party.<sup>159</sup>

The Anti-Assignment Act prevents the original contracting party from transferring a contract with the federal government to a third party.<sup>160</sup> The purpose of the Anti-Assignment Act is to allow the federal government to deal exclusively with the original party (rather than, for example, multiple subcontractors) to prevent persons from obtaining claims against the government and using them to influence officers of the government.<sup>161</sup> Thus, the purpose of the Anti-Assignment Act is

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majority of cases dealing with governmental contracts and section 365(c)(1) of the Bankruptcy Code, however, concern contracts to which the federal government is a party.

<sup>159</sup> See *In re W. Elecs. Inc.*, 852 F.2d 79, 83 (3d. Cir. 1988) (finding debtor could not assume contract for manufacturing services with a defense contractor); *In re TechDyn Sys. Corp.*, 235 B.R. 857, 864 (Bankr. E.D. Va. 1999) (finding debtor could not assume government contract pursuant to section 365(c)(1) of the Bankruptcy Code); *In re Plum Run Serv. Corp.*, 159 B.R. 496, 501 (Bankr. S.D. Ohio 1993) (holding debtor could not assume a contract with the United States Department of Navy under section 365(c)(1) of the Bankruptcy Code); *United States Dept't of Air Force v. Carolina Parachute Corp.* (*In re Carolina Parachute Corp.*), 108 B.R. 100, 103 (M.D.N.C. 1989) (finding debtor did not have authority to assume a contract with United States Air Force); *Pa. Peer Review Org. v. United States* (*In re Pa. Peer Review Org.*), 50 B.R. 640, 645 (Bankr. M.D. Pa. 1985) (holding debtor could not assume a contract with agencies and official of the United States government under section 365(c)(1) of the Bankruptcy Code); *Gov't Nat'l Mortgage Corp. v. Adana Mortgage Bankers, Inc.* (*In re Adana Mortgage Bankers, Inc.*), 12 B.R. 977, 985 (Bankr. D. Ga. 1980) (finding debtor could not assume or assign guarantee an agreement pursuant to Anti-Assignment Act). *But see In re Mirant Corp.*, 303 B.R. 319, 328 (Bankr. N.D. Tex. 2003) (stating it was "not at all clear that the Anti-Assignment Act limits assumption of contracts in chapter 11."); *In re Am. Ship Bldg. Co.*, 164 B.R. 358, 363 (Bankr. M.D. Fla. 1994) (finding debtor did have authority to assume a contract with the United States Department of Navy notwithstanding section 365(c)(1) of the Bankruptcy Code); *In re Ontario Locomotive & Indus. Ry. Supplies, (U.S.) Inc.*, 126 B.R. 146, 148 (Bankr. W.D.N.Y. 1991) (stating same); *In re Hartec Enters., Inc.*, 117 B.R. 865, 872 (Bankr. W.D. Tex. 1990) ("The 'actual' test better fulfills the purposes of anti-assignment statutes, including specifically 41 U.S.C. § 15.").

<sup>160</sup> 41 U.S.C. § 15(a) (1996):

No contract or order, or any interest therein, shall be transferred by the party to whom such contract or order is given to any other party, and any such transfer shall cause the annulment of the contract or order transferred, so far as the United States is concerned. All rights of action, however, for any breach of such contract by the contracting parties, are reserved to the United States.

*Id.*

<sup>161</sup> *Johnson Controls World Servs., Inc. v. United States*, 44 Fed. Cl. 334, 343 (1999) (quoting *Monchamp Corp. v. United States*, 19 Cl. Ct. 797, 801 (1990)):

Past judicial interpretation of the Act leaves no doubt that it is intended for the benefit of the Government, and that it serves two primary purposes: "first, to prevent persons of influence from buying up claims against the United States, which might then be improperly urged upon officers of the Government; and second, to enable the United States to deal exclusively with the original claimant instead of several parties."

*Id.*; *Summerfield Hous. Ltd. P'ship v. United States*, 42 Fed. Cl. 160, 172 (1998) ("[Statute was] enacted in order to allow government to deal exclusively with original claimant, and enable government to be aware of its obligations."); *Patterson v. United States*, 173 Ct. Cl. 819, 827 (1965) ("[T]he purposes generally imputed

unrelated to the nature of the contract in question—*i.e.*, it applies regardless of whether (a) the contract is one for personal services or (b) the identity of the party is material to the contract. Nonetheless, courts generally have given effect to the Anti-Assignment Act in bankruptcy, invoking section 365(c)(1).<sup>162</sup>

For example, in *Techdyn Systems*, the bankruptcy court considered whether a debtor whose primary business involved furnishing telephone systems and support to military bases could assume or assign six contracts that it had entered into pre-petition with the United States Army.<sup>163</sup> The government argued that the Anti-Assignment Act, read in conjunction with section 365(c)(1) of the Bankruptcy Code, prohibited the assignment or assumption of these contracts.<sup>164</sup> The bankruptcy court did not consider whether the contracts were personal service contracts or whether the identity of the party performing under the contracts was material. Instead, after performing a detailed analysis of section 365(c)(1) of the Bankruptcy Code, the court concluded that, because the Anti-Assignment Act prohibited the assignment of the contracts, the debtor could not assume or assign the contracts in bankruptcy.<sup>165</sup>

The district court in *Carolina Parachute Corp.*<sup>166</sup> reached a similar result. In *Carolina Parachute Corp.*, a company that manufactured parachutes and related items for the United States Army filed a case under chapter 11.<sup>167</sup> The debtor sought to assume its contract with the Army under its plan of reorganization. The Army filed a motion for modification of the automatic stay, seeking to terminate its contract with the debtor because the debtor was delinquent in performing under the

to Congress in enacting the anti-assignment statute—of preventing fraud and immunizing the United States from the inconvenience and uncertainty of having to deal with several parties.”).

<sup>162</sup> See *In re W. Elecs. Inc.*, 852 F.2d at 82–83 (finding that the Anti-Assignment Act was “applicable law” under section 365(c)(1) of the Bankruptcy Code); *In re TechDyn Sys. Corp.*, 235 B.R. at 861 (stating same); *In re Plum Run Serv. Corp.*, 159 B.R. at 501 (stating same); *In re Carolina Parachute Corp.*, 108 B.R. at 103–04 (same); *In re Pa. Peer Review Org.*, 50 B.R. at 645 (stating same); *In re Adana Mortgage Bankers Inc.*, 12 B.R. at 984 (stating same). *But see In re Mirant Corp.*, 303 B.R. at 332 (finding that debtor had authority to assume government contract notwithstanding section 365(c)(1) of the Bankruptcy Code); *In re Am. Ship Bldg. Co.*, 164 B.R. at 363 (stating same); *In re Ontario Locomotive*, 126 B.R. at 148 (stating same); *In re Hartec Enters. Inc.*, 117 B.R. at 872 (stating same).

<sup>163</sup> *In re TechDyn Sys. Corp.*, 235 B.R. at 859.

<sup>164</sup> *Id.* at 860 (“The United States contends that the plain language of § 365(c)(1) effectively prohibits the debtor from assuming the Fort Benning and Fort Buchanan contracts without its consent.”).

<sup>165</sup> *Id.* at 864 (“Because the Anti-Assignment Act plainly prohibits assignment of the debtor’s contracts with the United States Government, the debtor, in its capacity as debtor in possession, is barred by § 365(c)(1) from assuming those contracts over the Government’s objection even though the debtor does not intend to assign them.”); see also *In re W. Elecs. Inc.*, 852 F.2d at 83 (“We conclude that assignment of a contract calling for the production of military equipment is precisely what Congress intended to prevent when it prohibited assignments in 41 U.S.C. § 15.”); *In re Plum Run Serv. Corp.*, 159 B.R. at 500 (“The Anti-Assignment Act Prohibits the Debtor From Assuming the Contract or Options.”); *In re Carolina Parachute Corp.*, 108 B.R. at 102 (“The Court determines that the outcome of this case is controlled by the interplay of 41 U.S.C. § 15 and 11 U.S.C. § 365(c)(1) . . .”); *In re Pa. Peer Review Org.*, 50 B.R. at 645 (“The government argues that 41 U.S.C. § 15 prohibits the assignment of its contract with Peer Review and that the contract is therefore unassumable under 11 U.S.C. § 365(c)(1). We agree.”).

<sup>166</sup> *In re Carolina Parachute Corp.*, 108 B.R. at 100.

<sup>167</sup> *Id.* at 101.

delivery schedules set forth in the contract.<sup>168</sup> The bankruptcy court denied the motion, and the Army appealed.

Finding that relief from the automatic stay should have been granted pursuant to the Anti-Assignment Act and section 365(c)(1) of the Bankruptcy Code, the district court reversed the bankruptcy court's decision.<sup>169</sup> The district court did not consider whether the contracts were personal service contracts or whether the identity of the party performing under the contracts was material. The district court instead reasoned that, because the Anti-Assignment Act would prevent a non-bankrupt party from assigning such an agreement without the consent of the government, the contract could not be assumed by the debtor.<sup>170</sup> Accordingly, the district court found that the automatic stay should have been modified to permit the Army to terminate the contract with the debtor.<sup>171</sup>

## 5. Franchise Agreements

Various state laws restrict the ability of a franchisee to transfer, assign or sell a franchise (or interest therein) without the consent of the franchisor.<sup>172</sup> Such restrictions are particularly prevalent in laws that govern the transfer or assignment of automobile franchises.<sup>173</sup> For example, in Florida, a motor vehicle dealer must

<sup>168</sup> *Id.*

<sup>169</sup> *Id.* at 103–04 ("Accordingly, following the legal reasoning of the Third Circuit in *Matter of West Electronics*, the Court determines that the automatic stay should have been modified to allow the government to terminate the contract with debtor, pursuant to the provisions of 41 U.S.C. § 15.").

<sup>170</sup> *Id.* at 103.

<sup>171</sup> Courts applying the "actual test" under section 365(c)(1) of the Bankruptcy Code have found that a party to a government contract can assume such contract even when the assignment of such contract would be prohibited under section 365(c)(1) of the Bankruptcy Code and 41 U.S.C. § 15. *See In re Mirant Corp.*, 303 B.R. 319, 325 (Bankr. N.D. Tex. 2003) (finding that the debtor had authority to assume a contract with the United States notwithstanding Anti-Assignment Act); *In re Am. Ship Bldg. Co.*, 164 B.R. 358, 363 (Bankr. M.D. Fla. 1994) (finding that the debtor did have authority to assume a contract with the United States Department of Navy notwithstanding section 365(c)(1) of the Bankruptcy Code); *In re Ontario Locomotive & Indus. Ry. Supplies, (U.S.) Inc.*, 126 B.R. 146, 148 (Bankr. W.D.N.Y. 1991) (stating same); *In re Hartec Enters., Inc.*, 117 B.R. 865, 872 (Bankr. W.D. Tex. 1990) ("The 'actual' test better fulfills the purposes of anti-assignment statutes, including specifically 41 U.S.C. § 15.").

<sup>172</sup> *See, e.g.*, ARK. CODE ANN. § 4-72-205(a) (Michie 2004) ("It shall be a violation of this subchapter for any franchisee to transfer, assign, or sell a franchise or interest therein to another person . . ."); N.J. STAT. ANN. § 56:10-6 (West 2004):

It shall be a violation of this act for any franchisee to transfer, assign or sell a franchise or interest therein to another person unless the franchisee shall first notify the franchisor of such intention by written notice setting forth in the notice of intent the prospective transferee's name, address, statement of financial qualification and business experience during the previous 5 years. The franchisor shall . . . either approve in writing to the franchisee such sale to proposed transferee or by written notice advise the franchisee of the unacceptability of the proposed transferee setting forth material reasons relating to the character, financial ability or business experience of the proposed transferee.

*Id.*

<sup>173</sup> CAL. VEH. CODE § 11713.3(e) (Deering 2000):



first notify the manufacturer in writing of its intent to transfer its franchise agreement to another party and set forth the financial qualifications and business experience of the proposed transferee.<sup>174</sup> Upon notification, the manufacturer has 60 days to reject the proposed assignment (or else the manufacturer is deemed to have consented to the assignment).<sup>175</sup> If the manufacturer rejects the proposed transfer, it must notify the dealer in writing of the material reasons for the

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It is unlawful and a violation of this code for any manufacturer, manufacturer branch, distributor, or distributor branch licensed under this code to do any of the following: . . . (e) To prevent, or attempt to prevent, a dealer from receiving fair and reasonable compensation for the value of the franchise business. There shall be no transfer or assignment of the dealer's franchise without the consent of the manufacturer or distributor, which consent shall not be unreasonably withheld or conditioned upon the release, assignment, novation, waiver, estoppel, or modification of any claim or defense by the dealer.

*Id.*; FLA. STAT. ANN. § 320.643(1)(a) (West 2005):

A motor vehicle dealer who desires to sell, assign, transfer, alienate, or otherwise dispose of a franchise shall notify, or cause the proposed transferee to notify, the licensee, in writing, setting forth the prospective transferee's name, address, financial qualifications, and business experience during the previous 5 years. A licensee . . . shall notify the motor vehicle dealer, in writing, that the proposed transferee is not a person qualified to be a transferee under this section and setting forth the material reasons for such rejection.

*Id.*; IND. CODE § 9-23-3-11 (2004) ("A dealer, an officer, a partner, or a stockholder may not sell, transfer, or assign the franchise or a right under the franchise without the consent of the manufacturer or distributor, which consent may not be unreasonably withheld."); R.I. GEN. LAWS § 31-5.1-4(c)(7) (2004):

It shall be deemed a violation of this chapter for a manufacturer, or officer, agent, or other representative: . . . (7) To prevent or attempt to prevent by contract or otherwise any new motor vehicle dealer or any officer, partner, or stockholder of any new motor vehicle dealer from selling or transferring any part of the interest of any of them to any other person or persons or party or parties. Provided, however, that no dealer, officer, or stockholder shall have the right to sell, transfer or assign the franchise or power of management or control without the consent of the manufacturer, except that the consent shall not be unreasonably withheld.

*Id.*; see also 15 U.S.C. § 1222 (2000):

An automobile dealer may bring suit against any automobile manufacturer engaged in commerce, in any district court of the United States in the district in which said manufacturer resides, or is found, or has an agent, without respect to the amount in controversy, and shall recover the damages by him sustained and the cost of suit by reason of the failure of said automobile manufacturer from and after the passage of this Act to act in good faith in performing or complying with any of the terms or provisions of the franchise, or in terminating, canceling, or not renewing the franchise with said dealer: Provided, That in any such suit the manufacturer shall not be barred from asserting in defense of any such action the failure of the dealer to act in good faith.

*Id.*  
<sup>174</sup> FLA. STAT. ANN. § 320.643(1)(a) (West 2004).

<sup>175</sup> *Id.*

rejection.<sup>176</sup> The dealer can then file a complaint seeking a declaration that the rejection violates Florida law.<sup>177</sup> In this respect, Florida law, like the laws of other states, restricts the assignment of automobile franchises.

Because, in certain circumstances, nonbankruptcy law restricts the ability of a franchisee to assign or transfer its interest in the franchise agreement, some courts have found that section 365(c)(1) of the Bankruptcy Code applies to restrict the assignment of franchise agreements in bankruptcy.<sup>178</sup> For example, in *Van Ness Auto Plaza*, the bankruptcy court considered whether a bankrupt automobile dealer could assume and assign its franchise agreement with Porsche to another automobile dealer. The bankruptcy court found that the California Vehicle Code restricted the transfer of the franchise agreement with Porsche because the agreement could not be assigned absent Porsche's consent (unless Porsche's refusal was unreasonable).<sup>179</sup> The bankruptcy court examined Porsche's basis for withholding consent and found that Porsche was not being unreasonable.<sup>180</sup>

Upon concluding that the bankrupt automobile dealer could not transfer its interest in the franchise agreement to another party under California law, the bankruptcy court, following the First Circuit's decision in *Pioneer Ford Sales*, determined that the franchise agreement fell within the scope of section 365(c)(1) of

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<sup>176</sup> *Id.*

<sup>177</sup> FLA. STAT. ANN. § 320.643(1)(b) (West 2004).

<sup>178</sup> See *In re Pioneer Ford Sales Inc.*, 729 F.2d 27, 29 (1st Cir. 1984) (finding an automobile franchise agreement could not be assigned under section 365(c)(1) of the Bankruptcy Code); *In re Van Ness Auto Plaza*, 120 B.R. 545, 547 (Bankr. N.D. Cal. 1990) ("[S]ection 365(c)(1) applies to state statutes restricting transfer of automobile dealership franchises."). *But see* *City of Jamestown, Tenn. v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 534, 538 (11th Cir. 1994) (finding a city ordinance prohibiting assignment of cable franchise without city approval was a mere general prohibition of assignment and thus insufficient to constitute applicable law under section 365(c)(1) of the Bankruptcy Code); *In re Sunrise Rests., Inc.*, 135 B.R. 149, 153 (Bankr. M.D. Fla. 1991) (finding a Burger King franchise was not a personal service contract and, therefore, was assignable); *In re Tom Stimus Chrysler-Plymouth, Inc.*, 134 B.R. 676, 679 (Bankr. M.D. Fla. 1991) (finding a franchise agreement was assignable because "the franchise agreement [was] not 'a personal service contract . . .'"); *In re Bronx-Westchester Mack Corp.*, 20 B.R. 139, 143 (Bankr. N.Y. 1982) (finding a distributorship agreement was not a personal service contract and, therefore, was assignable); *Varisco v. Oroweat Food Co. (In re Varisco)*, 16 B.R. 634, 638 (Bankr. Fla. 1981) (finding a franchise agreement to market and distribute baked goods was assignable because it was not a personal service contract).

<sup>179</sup> *In re Van Ness Auto Plaza*, 120 B.R. at 547 (referring to Cal. Veh. Code section 11713.3 as applicable nonbankruptcy law).

<sup>180</sup> *Id.* at 547. The court considered the following factors in determining whether consent to assignment was reasonably withheld:

- (1) whether the proposed dealer has adequate working capital;
- (2) the extent of prior experience of the proposed dealer;
- (3) whether the proposed dealer has been profitable in the past;
- (4) the location of the proposed dealer;
- (5) the prior sales performance of the proposed dealer;
- (6) the business acumen of the proposed dealer;
- (7) the suitability of combining the franchise in question with other franchises at the same location; and
- (8) whether the proposed dealer provides the manufacturer sufficient information regarding its qualifications.

*Id.*

the Bankruptcy Code.<sup>181</sup> The court reached this conclusion without considering whether the contract was personal to the dealership or whether Porsche would have been excused from accepting performance from a new dealer. Assignment was prohibited under section 365(c)(1) simply because assignment was prohibited under California law.

Other courts, however, have found that franchise agreements do not fall within the scope of section 365(c)(1) of the Bankruptcy Code even if the assignment of such contracts is restricted by state law,<sup>182</sup> in large measure because franchise agreements generally are not considered personal service contracts.<sup>183</sup> As discussed above, prior to the Fifth Circuit's decision in *Braniff Airways*, courts generally considered whether the contract was one for personal services in determining whether section 365(c)(1) applied. Although most courts have declined to limit section 365(c)(1) to personal service contracts, a few courts have imposed this limitation in the context of franchise agreements in cases decided after *Braniff Airways*.<sup>184</sup>

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<sup>181</sup> *Id.* at 547 ("In a well-reasoned opinion that this court finds persuasive, the First Circuit held that section 365(c)(1) applies to state statutes restricting transfer of automobile dealership franchises.").

<sup>182</sup> See *In re James Cable Partners, L.P.*, 27 F.3d at 537 (finding a city ordinance prohibiting assignment of cable franchise without city approval was a mere general prohibition of assignment and thus insufficient to constitute applicable law under section 365(c)(1) of the Bankruptcy Code); *In re Sunrise Rests. Inc.*, 135 B.R. at 153 (finding a Burger King franchise was not a personal service contract and, therefore, was assignable); *In re Tom Stimus Chrysler-Plymouth Inc.*, 134 B.R. at 679 (finding a franchise agreement was assignable because "the franchise agreement [was] not 'a personal service contract[.]'"); *In re Bronx-Westchester Mack*, 20 B.R. at 143 (finding a distributorship agreement was not personal service contract and, therefore, was assignable); *In re Varisco*, 16 B.R. at 638 (finding a franchise agreement to market and distribute baked goods was assignable because it was not a personal service contract).

<sup>183</sup> See *In re Sunrise Rests. Inc.*, 135 B.R. at 153:

There is hardly any question that the relationship between [the] parties was nothing more than a strict business transaction to furnish economic gains to both contracting parties. To run a Burger King retail establishment does not require a special knowledge in a conventional sense, that is a special judgment, taste, skill or ability.

*Id.*; *In re Tom Stimus Chrysler-Plymouth Inc.*, 134 B.R. at 679 ("[F]ranchise agreements are not personal service contracts . . ."); *In re Compass Van & Storage Corp.*, 65 B.R. 1007, 1011-12 (Bankr. E.D.N.Y. 1986):

The Agency Contract by its terms is not dependent upon any special personal relationship, special knowledge, or unique skill or talent, but rather it typifies and tracks the ordinary consensual agency, *franchise*, or distributorship agreements, which have been consistently interpreted by the courts as not within the ambit or proscript of Section 365(c)(1)(A).

*Id.*; *In re Bronx-Westchester Mack*, 20 B.R. at 143 ("[Section 365(c)(1)(A)] relates to executory contracts that are personal in nature. A distributorship or franchise agreement which does not depend upon a special relationship between the parties is not within the reach of this exception."); *In re Varisco*, 16 B.R. at 638 ("[Section 365(c)(1)(A)'s] application is limited to executory contracts which are truly personal and this [franchise agreement] is not really the type of contract involved here.").

<sup>184</sup> *In re Sunrise Rests. Inc.*, 135 B.R. at 153:

For example, in *Tom Stimus Chrysler-Plymouth*, the bankruptcy court considered whether a bankrupt automobile dealership could assume and assign its franchise agreement with Chrysler.<sup>185</sup> Chrysler argued that, since the franchise agreement could not be assumed absent its consent under Florida law, the franchise agreement could not be assumed and assigned under section 365(c)(1) of the Bankruptcy Code. The bankruptcy court disagreed and found that the franchise agreement could be assumed and assigned because the agreement was not a contract for personal services.<sup>186</sup> According to the bankruptcy court, "the franchise agreement is not 'a personal service contract based on a special trust and confidence and on a special relationship' between the Debtor and Chrysler."<sup>187</sup> Thus, the bankruptcy court granted the debtor's motion to assume and assign the franchise agreement.<sup>188</sup>

Given the trend of a majority of the courts to apply section 365(c)(1) of the Bankruptcy Code beyond the personal services context, the continued utility of cases like *Tom Stimus Chrysler-Plymouth* (and its progeny) is questionable.<sup>189</sup> Nevertheless, courts that consider whether the identity of the contracting party is material to the agreement in analyzing section 365(c)(1) may find the reasoning of the court in *Tom Stimus Chrysler-Plymouth* persuasive and may reach a similar

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There is hardly any question that the relationship between the parties was nothing more than a strict business transaction to furnish economic gains to both contracting parties . . . . This being the case, the objection by BKC of the Debtor's right to assume or assign the franchise agreements and other contractual rights is without merit and must be rejected.

*Id.*; *In re Tom Stimus Chrysler-Plymouth Inc.*, 134 B.R. at 679 (finding that a franchise agreement was assignable because "the franchise agreement [was] not 'a personal service contract . . . .'"); *see also In re James Cable Partners, L.P.*, 27 F.3d at 538:

In order to be excused from accepting performance, the City would need to point to applicable law such as a Tennessee law that renders performance under the cable franchise agreement nondelegable. A classic example of a contract under which performance is nondelegable is a personal service contract. The City proffers no Tennessee law, other than the general prohibition against assignment found in section 12 of the Ordinance and laws validating such a prohibition, that would excuse the City from accepting performance from a third party. Accordingly, we conclude that applicable Tennessee law does not excuse the City from accepting performance from an entity other than James Cable, that the § 365(c)(1) exception does *not* apply in this case . . . .

*Id.* (emphasis added).

<sup>185</sup> *In re Tom Stimus Chrysler-Plymouth Inc.*, 134 B.R. at 676.

<sup>186</sup> *Id.* at 679.

<sup>187</sup> *Id.*

<sup>188</sup> *Id.*

<sup>189</sup> Although not expressly limiting the application of section 365(c)(1) of the Bankruptcy Code to personal service contracts, the Eleventh Circuit in *In re James Cable Partners* did cite *In re Sunrise Restaurants* and *In re Tom Stimus Chrysler-Plymouth* in finding a cable franchise agreement beyond the scope of section 365(c)(1). *See In re James Cable Partners, L.P.*, 27 F.3d at 538 n.9 ("A number of bankruptcy courts have concluded that 11 U.S.C. § 365(c) only applies to 'nondelegable contracts such as personal service contracts. Several of our sister circuits, however, have concluded that § 365(c) applies more broadly 'to contracts that are not assignable under nonbankruptcy law.'" (citations omitted)).

result.<sup>190</sup>

## 6. Expanding Application

The expansion of section 365(c)(1) of the Bankruptcy Code beyond traditional "personal service" contracts creates uncertainty regarding the types of contracts that eventually may be subject to the strictures of section 365(c)(1). Courts following the Sixth Circuit's decision in *Magness* will consider whether the federal or state law in question would excuse the nondebtor party's performance if the contract were assigned. This approach to section 365(c)(1) echoes the reasoning employed by bankruptcy courts that, prior to *Braniff Airways*, focused on whether the contract in question involved personal services. Using an analysis that focuses on the identity of the contracting parties and whether applicable law excuses performance under the contract potentially opens the door for additional types of agreements to fall within the scope of section 365(c)(1).<sup>191</sup> In fact, some courts employing this reasoning have found that operating agreements governing limited liability companies are subject to section 365(c)(1).<sup>192</sup> Because state limited liability statutes

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<sup>190</sup> See discussion *supra* Section I.D.

<sup>191</sup> The scope of section 365(c)(1) of the Bankruptcy Code arguably could be expanded by creative arguments as to what is "personal" to the contracting parties. A research and development agreement, for example, could be drafted in a manner that arguably would cause it to be characterized as a personal service contract under state law, which could trigger the application of section 365(c)(1) of the Bankruptcy Code if a party to the contract were to file for bankruptcy.

<sup>192</sup> See *In re IT Group, Inc.*, 302 B.R. 483, 488–89 (D. Del. 2003) (affirming bankruptcy court's decision prohibiting debtor from transferring membership rights in LLC but permitting debtor to assign bare economic interest in LLC to a third party, subject to the other members' rights of first refusal); *Broyhill v. Deluca (In re DeLuca)*, 194 B.R. 65, 77 (Bankr. E.D. Va. 1996):

Upon careful consideration, this court concludes that the operating agreement governing D & B Countryside [L.L.C.] is an executory contract, since the object of the agreement—the development of the Parc City Center project—has not yet been accomplished and the parties have on-going duties and responsibilities to bring the project to a successful conclusion. The court further concludes that the nature of those duties and responsibilities are such as to make the contract one for personal services.

*Id.*; *In re Daugherty Constr., Inc.*, 188 B.R. 607, 614 (Bankr. D. Neb. 1995) ("The fact that a partnership agreement or LLC agreement constitutes an intensely personal contract is . . . irrelevant to the question of whether the interest of the debtor in the partnership or the LLC can be 'transferred' to the debtor in possession upon commencement of a bankruptcy case under section 541."); see also *Milford Power Co. v. PDC Milford Power, L.L.C.*, No. C.A. No. 506-N, 2004 WL 3088704, at \*19 (Del. Ch. Dec. 17, 2004):

[T]he Ipsa Facto Clause in the Milford Power LLC Agreement is effective to the extent that it deprived PDC of its ability to participate as a member in the governance of Milford Power . . . . By contrast, under the Delaware LLC Act, the other members of Milford Power are not excused—again, as a matter of default law—from accepting an assignment of PDC's bare economic rights as an equity owner.

*Id.* But see *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 709 (Bankr. E.D. Va. 2000):

[E]ither member can, without being in breach of the Operating Agreement, resign from all his offices and committee positions and no longer actively participate in the

largely are patterned after state partnership statutes, arguments can be made in favor of applying section 365(c)(1) to prevent a debtor from assuming or assigning its interest in a limited liability company.<sup>193</sup>

Moreover, many courts give no consideration to the nature of the contract and move from the conclusion that state or federal law prohibits assignment outside of bankruptcy to the conclusion that section 365(c)(1) of the Bankruptcy Code prohibits assignment in bankruptcy, notwithstanding section 365(f)(1) of the Bankruptcy Code. Courts that consider only whether the contract is executory and whether nonbankruptcy law prohibits assignment outside of bankruptcy could easily apply section 365(c)(1) to joint venture agreements, as courts have found joint venture agreements to be executory contracts.<sup>194</sup> Indeed, joint ventures generally are governed by the same rules as partnerships,<sup>195</sup> which arguably places joint ventures

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affairs of the company. He would stand in an analogous position to the company as a shareholder to a corporation. In the circumstances of this case, there is no executory contract, the provisions of § 365(c) and (e) are not applicable . . . .

*Id.*

<sup>193</sup> See UNIF. LTD. LIAB. CO. ACT § 502, 6A U.L.A. 604 (1996) ("A transfer of a distributional interest does not entitle the transferee to become or to exercise any rights of a member. A transfer entitles the transferee to receive, to the extent transferred, only the distributions to which the transferor would be entitled."); 805 ILL. COMP. STAT. ANN. 180/30-5 (West 2004) (stating same); S.D. CODIFIED LAWS § 47-34A-502 (Mitchie 2000) (stating same).

<sup>194</sup> Post v. Sigel & Co. (*In re Sigel & Co.*), 923 F.2d 142, 144 (9th Cir. 1991) ("The joint venture agreement between Post and Sigel was an executory contract."); Petrallex Stainless, Ltd. v. Bishop Tube Div. of Christiana Metals (*In re Petrallex Stainless, Ltd.*), 78 B.R. 738, 741 (Bankr. E.D. Pa. 1987) (treating joint venture agreement as an executory contract); E.C. Ernst, Inc. v. Alrich-Elec. Contracting Co., 20 B.R. 583, 586 (Bankr. S.D.N.Y. 1982) (stating same).

<sup>195</sup> Lutheran Gen. Hosp., Inc. v. Printing Indus. of Ill./Ind. Employee Benefit Trust, 24 F. Supp. 2d 846, 851 (N.D. Ill. 1998) (citing *Goark v. Thorleif Larsen & Son, Inc.*, 231 Ill. App. 3d 61, 66 (1st Dist. 1992)):

As a practical matter, the only distinction between a joint venture and a partnership is that "a joint venture relates to a single enterprise or transaction while a partnership relates to a general business of a particular kind." . . . Partnership principles govern joint ventures and the rights and liabilities of the members of a joint venture are tested by the same legal principles which govern partnerships.

*Id.*; *Napoli v. Domnitch*, 226 N.Y.S.2d 908, 913 (Sup. Ct. Queens County 1962):

Since it has been said, however, that "A joint adventure is subject to exactly the same rules as a technical partnership" . . . and that "Generally speaking, the principles of the law of partnership apply, at least by analogy" . . . and since the basic elements of a partnership, except perhaps for limitation in scope . . . the court will treat the parties as partners and determined their rights and duties under the Partnership Law . . . .

*Id.* (citations omitted); *Busler v. D & H Mfg., Inc.*, 611 N.E.2d 352, 356 (Ohio Ct. App. 1992) ("Essentially, a joint venture is a partnership entered into for a single transaction or limited period of time . . . . Hence, courts generally apply principles of partnership law to govern the relationship."); *Milton Kauffman, Inc. v. Superior Court of Los Angeles County*, 210 P.2d 88, 94 (Cal. App. Dep't Super Ct. 1949) ("The resemblance between a partnership and a joint venture is so close that the rights as between adventurers are governed practically by the same rules that govern partners."); see also 46 AM. JUR. 2D *Joint-Stock Companies* § 3 (1994) ("Joint ventures are, in general, governed by the same rules as partnerships."); *id.* § 40 ("An

within the scope of section 365(c)(1). Given the expanding application of section 365(c)(1) beyond the *assignment* of executory contracts to the *assumption* of executory contracts, whether a contract falls within the scope of section 365(c)(1) has become increasingly important.

### III. THE DISTINCTION BETWEEN ASSUMPTION AND ASSIGNMENT UNDER SECTION 365(C)(1): *THE HYPOTHETICAL TEST V. THE ACTUAL TEST*

The expanding application of section 365(c)(1) of the Bankruptcy Code also has important consequences for debtors that merely seek to assume an executory contract or unexpired lease when applicable nonbankruptcy law restricts or prohibits the assignment of the particular contract or lease. If a court determines that a contract falls within the scope of section 365(c)(1), then the debtor will not be able to assign the contract to another party even if doing so would serve to maximize the value of the bankruptcy estate. As previously illustrated, some courts have gone further and found that, if a contract falls within the scope of section 365(c)(1), the debtor is prohibited not only from assigning the contract to another party but also from *assuming* the contract for the benefit of the reorganized debtor.

There is a split of authority regarding whether section 365(c)(1) of the Bankruptcy Code creates a hypothetical<sup>196</sup> or actual<sup>197</sup> test for determining whether

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assignment by one venturer of his interest in the enterprise without the consent of his coventurer is a violation of the fiduciary relationship."). Under some statutes, a partnership is explicitly defined to include a joint venture. *See, e.g.*, TEX. CORPS. & ASS'NS CODE ANN. § 152.051(b) (Vernon 2004) ("[A]n association of two or more persons to carry on a business for profit as owners creates a partnership, regardless of whether: (1) the persons intend to create a partnership; or (2) the association is called a 'partnership,' 'joint venture,' or other name.").

<sup>196</sup> *See* RCI Tech. Corp. v. Sunterra Corp. (*In re Sunterra Corp.*), 361 F.3d 257, 271 (4th Cir. 2004) ("Without RCI's consent, Sunterra was precluded from assuming the Agreement."); *In re O'Connor*, 258 F.3d 392, 402 (5th Cir. 2001) ("Under Louisiana law, a partner *cannot* make a third person a member of the partnership *without* his partners' consent . . . Appellees did *not* consent to substituting the Trustee for the Debtor. Accordingly, the district court correctly held the agreement was *not* assumable under § 365(c)(1)."); *Cinicola v. Scharffenberger*, 248 F.3d 110, 126 n.19 (3d Cir. 2001) ("In *West*, we held § 365(c)(1) created a 'hypothetical test' whereby an assignment of an executory contract was invalid if precluded by applicable law."); *Perlman v. Catapult Entm't, Inc.* (*In re Catapult Entm't, Inc.*), 165 F.3d 747, 754–55 (9th Cir. 1999) ("[W]e hold that, where applicable nonbankruptcy law makes an executory contract nonassignable because the identity of the nondebtor party is material, a debtor in possession may not assume the contract absent consent of the nondebtor party."); *City of Jamestown v. James Cable Partners, L.P.* (*In re James Cable Partners, L.P.*), 27 F.3d 534, 537 (11th Cir. 1994) ("The first condition presents a hypothetical question: Whether under applicable law the City is excused from accepting performance from a third party, that is a party other than James Cable as debtor or debtor in possession."); *In re W. Elecs. Inc.*, 852 F.2d 79, 83 (3d Cir. 1988) ("11 U.S.C. § 365(c)(1) creates a hypothetical test—*i.e.*, under the applicable law, could the government refuse performance from 'an entity *other* than the debtor or the debtor in possession.'"); *Tonry v. Hebert* (*In re Tonry*), 724 F.2d 467, 469 (5th Cir. 1984) ("Under § 365(c) the trustee may not assume an executory contract if, under applicable law, the non-debtor party is free to decline performance by the trustee."); *In re Neuhoft Farms, Inc.*, 258 B.R. 343, 350 (Bankr. E.D.N.C. 2000) ("For the purposes of this order, the court will apply the hypothetical test in analyzing Hatfield's contentions as to § 365(c)(1) . . ."); *In re TechDyn Sys., Corp.*, 235 B.R. 857, 864 (Bankr. E.D. Va. 1999) ("Because the Anti-Assignment Act plainly prohibits assignment of the debtor's contracts with the United States Government, the debtor . . . is

a debtor can assume an executory contract or unexpired lease. Section 365(c)(1) provides that a debtor "may not assume or assign any executory contract or unexpired lease . . . if . . . applicable law excuses a party, other than the debtor, to such contract from accepting performance from or rendering performance to an

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barred by § 365(c)(1) from assuming those contracts . . ."); *In re Grove Rich Realty Corp.*, 200 B.R. 502, 510 (Bankr. E.D.N.Y. 1996) ("It is well settled that when an executory contract is of such a nature as to be based upon personal services or skills, or upon personal trust or confidence, the debtor-in-possession or trustee is unable to assume or assign the rights of the bankrupt in such contract."); *Breeden v. Catron (In re Catron)*, 158 B.R. 629, 633 (E.D. Va. 1993) (affirming bankruptcy court's decision finding debtor could not assume partnership agreement pursuant to section 365(c)(1) of Bankruptcy Code); *In re Plum Run Serv. Corp.*, 159 B.R. 496, 501 (Bankr. S.D. Ohio 1993) ("[Section] 365(c)(1) creates a hypothetical test: Under applicable law, could the government refuse performance from an entity other than the debtor or the debtor-in-possession?"); *United States Dep't of Air Force v. Carolina Parachute Corp. (In re Carolina Parachute Corp.)*, 108 B.R. 100, 103-04 (M.D.N.C. 1989) (following *West Electronics* lifting automatic stay); *Pa. Peer Review Org. v. United States (In re Pa. Peer Review Org.)*, 50 B.R. 640, 645-46 (Bankr. M.D. Pa. 1985) ("[B]ecause the applicable statute prohibits the transfer of a government contract 'to any other party,' the section 365(c) requirement of a general nontransferability statute is satisfied and the Bankruptcy Code itself precludes any assumption on the contract, even where such an assumption might otherwise occur by operation of law.").

<sup>197</sup> See *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997) ("We rejected the proposed hypothetical test in *Leroux*, holding instead that subsection 365(c) and (e) contemplate a case-by-case inquiry into whether the nondebtor party . . . actually was being 'forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.'"); *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 613 (1st Cir. 1995) ("[S]ection 365(c)(1) presents no bar to [the] assumption of the Agreement."); *In re Mirant Corp.*, 303 B.R. 319, 332 (Bankr. N.D. Tex. 2003) ("This court shares the view that the Anti-Assignment Act does not prevent assumption of an agreement under section 365(c)(1) . . ."); *In re Cajun Elec. Power Coop.*, 230 B.R. 693, 705 (Bankr. M.D. La. 1999) ("The court concludes that section 365(c) does not operate to preclude the Trustee from seeking to assume the Supply Contracts on the basis of the reasoning set forth in *West*."); *In re Lil' Things, Inc.*, 220 B.R. 583, 587 (Bankr. N.D. Tex. 1998) ("Following the lead of the Supreme Court, this Court also rejects the 'separate entity' theory and finds that a debtor may assume its own contracts and leases if it complies with § 365(b)(1)."); *In re GP Express Airlines, Inc.*, 200 B.R.222, 233 (Bankr. D. Neb. 1996) ("My conclusion that section 365(c)(1) does not bar assumption of contracts by the debtor in possession is consistent with other provisions of the Bankruptcy Code which decline to enforce forfeiture provisions in private contracts."); *In re Am. Ship Bldg. Co.*, 164 B.R. 358, 363 (Bankr. M.D. Fla. 1994) ("[A] hypothetical test is not the intent of the statute."); *Weaver v. Nizny (In re Nizny)*, 175 B.R. 934, 938 (Bankr. S.D. Ohio 1994) ("Where the . . . assumption . . . would not change the essential identity of the entity performing the services under the contract, the exception is not effective."); *In re James Cable Partners, L.P.*, 154 B.R. at 815, *aff'd*, 27 F.3d 534 (11th Cir. 1994) ("This court agrees with the bankruptcy court and these courts and rejects the hypothetical test."); *Texaco Inc. v. a. Land & Exploration Co.*, 136 B.R. 658, 671 (M.D. La. 1992) ("[T]he phrase 'applicable law' is commonly used to refer to the law applicable to the facts of the case at hand rather than some law that may be applicable to another set of circumstances."); *In re Ontario Locomotive & Indus. Ry. Supplies, (U.S.) Inc.*, 126 B.R. 146, 148 (Bankr. W.D.N.Y. 1991) ("[T]his Court concludes . . . that Congress did not intend to bar assumption of any contract as long as it will be performed by the debtor or debtor in possession."); *In re Fastrax, Inc.*, 129 B.R. 274, 277 (Bankr. M.D. Fla. 1991) ("[T]he prohibition against a trustee's power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition had been filed . . ."); *In re Cardinal Indus. Inc.*, 116 B.R. 964, 979 (Bankr. S.D. Ohio 1990) ("[A] debtor in possession can assume a personal service contract that is nonassignable under state law as long as its performance is going to be the same as if no petition had been filed."); *In re Hartec Enters., Inc.*, 117 B.R. 865, 872 (Bankr. W.D. Tex. 1990) ("[T]his court concludes that this 'actual test' is a more faithful reading of the statute, one which is both harmonious with other sections of the Code and with the Code's purposes.").



entity other than the debtor or debtor in possession . . . ."<sup>198</sup> Courts that have adopted the "actual" test interpret this provision as applying only when the debtor actually seeks to assign an executory contract or unexpired lease that cannot be assigned under applicable nonbankruptcy law. Courts that have adopted the "hypothetical" test interpret this provision as prohibiting the assumption of any executory contract or unexpired lease if applicable law prohibits the assignment of the particular contract or lease—regardless of whether the debtor actually seeks to assign the contract or lease. Thus, under the hypothetical test, a debtor could not assume an executory contract or unexpired lease even if applicable law permitted or did not speak to the *assumption* of the particular contract or lease by the debtor.

### A. *The Hypothetical Test*

The United States Court of Appeals for the Third Circuit was the first Circuit Court to adopt the hypothetical test.<sup>199</sup> In *West Electronics*, the debtor sought to assume a contract with the United States pursuant to which it supplied a substantial number of AIM-9 missile launcher supply units to the Air Force.<sup>200</sup> The government objected and argued that, since the Anti-Assignment Act prevented the debtor from assigning the contract to a third party, the debtor could not assume the contract for its own benefit. The Third Circuit agreed and found that, under section 365(c)(1) of the Bankruptcy Code, the debtor could not assume the contract because the Anti-Assignment Act, being "applicable nonbankruptcy law," prevented the debtor from assigning the contract.<sup>201</sup>

The Third Circuit justified its decision on two grounds. First, it found that the "literal meaning of the words chosen by Congress" requires the application of a hypothetical test (*i.e.*, a plain language argument).<sup>202</sup> Section 365(c)(1) of the Bankruptcy Code does not say that a debtor "may not assume *and* assign" an executory contract if applicable nonbankruptcy law excuses the nondebtor party from accepting performance from an entity other than the debtor in possession. Rather, it says that a debtor "may not assume *or* assign" an executory contract if applicable nonbankruptcy law excuses the nondebtor party from accepting

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<sup>198</sup> 11 U.S.C. § 365(c)(1) (2000).

<sup>199</sup> *In re W. Elecs. Inc.*, 852 F.2d at 79.

<sup>200</sup> *Id.* at 80.

<sup>201</sup> *Id.* at 83:

We conclude that assignment of a contract calling for the production of military equipment is precisely what Congress intended to prevent when it prohibited assignments in 41 U.S.C. § 15. Thus, West could not force the government to accept the "personal attention and services" of a third party without its consent. It therefore necessarily follows that under 11 U.S.C. § 365(c)(1) West, as a debtor in possession, cannot assume this contract.

*Id.*

<sup>202</sup> *Id.* at 83 ("The literal meaning of the words chosen by Congress clearly requires the analysis and conclusion we have just articulated and we are confident that it is what Congress intended.").

performance from an entity other than the debtor in possession.<sup>203</sup> Second, the Third Circuit found that "a solvent contractor and an insolvent debtor in possession are materially distinct entities" (*i.e.*, a separate entity argument).<sup>204</sup> Accordingly, the assumption of the contract by the debtor in possession constituted a constructive assignment from the pre-petition company to the post-petition company.

The Third Circuit's plain language argument has been adopted by other courts that have adopted the hypothetical test.<sup>205</sup> The Third Circuit's separate entity argument, however, has been rejected by most, if not all, of these courts as being inconsistent with Supreme Court precedent.<sup>206</sup> Before the Third Circuit decided *West Electronics*, the United States Supreme Court decided *Bildisco & Bildisco*, in which the Supreme Court rejected the argument that a debtor in possession is anything other than the "same 'entity' which existed before the filing of the

<sup>203</sup> 11 U.S.C. § 365(c)(1) (2000) (emphasis added).

<sup>204</sup> *In re W. Elecs. Inc.*, 852 F.2d at 83:

We think that by including the words "or the debtor in possession" in 11 U.S.C. § 365(c)(1) Congress anticipated an argument like the one here made and wanted that section to reflect its judgment that in the context of the assumption and assignment of executory contracts, a solvent contractor and an insolvent debtor in possession going through bankruptcy are materially distinct entities.

*Id.*

<sup>205</sup> *In re Sunterra Corp.*, 361 F.3d 257, 267 (4th Cir. 2004) ("By its plain language, § 365(c)(1) addresses both assumption and assignment."); *Perlman v. Catapult Entm't, Inc.* (*In re Catapult Entm't, Inc.*), 165 F.3d 747, 753 (9th Cir. 1999) ("[T]he plain language of § 365(c)(1) compels the result Perlman urges: Catapult may not assume the Perlman licenses over Perlman's objection."); *In re Neuhoff Farms, Inc.*, 258 B.R. 343, 350 (Bankr. E.D.N.C. 2000) ("The literal language of § 365(c)(1) is . . . said to establish a 'hypothetical test': a debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical party . . ."); *In re TechDyn Sys. Corp.*, 235 B.R. 857, 861 (Bankr. E.D. Va. 1999) ("[T]he remaining text of § 365(c)(1) unmistakably makes it clear that the debtor may neither assume nor assign the contracts without the government's consent.").

<sup>206</sup> *See Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 614 (1st Cir. 1995) ("[P]ertinent Supreme Court decisions diminish the legal 'fiction' that the prepetition debtor and the postpetition debtor are to be treated as though they were separate legal entities . . ."); *In re Cajun Elec. Power Coop.*, 230 B.R. 693, 705 (Bankr. M.D. La. 1999) (rejecting separate entity theory); *In re Lil' Things, Inc.*, 220 B.R. 583, 587 (Bankr. N.D. Tex. 1998) ("This view is consistent with the one expressed by the Supreme Court . . . that a debtor in possession is a new entity separate and distinct from its pre-bankruptcy persona unrealistic when reconciling conflicting provisions of the National Labor Relations Act and the Bankruptcy Code."); *In re GP Express Airlines, Inc.*, 200 B.R. 222, 232 (Bankr. D. Neb. 1996) ("[T]here is no meaningful distinction between GP Express and GP Express debtor in possession."); *In re Daugherty Constr., Inc.*, 188 B.R. 607, 613 (Bankr. D. Neb. 1995) ("The Supreme Court rejected the distinction between debtor and Chapter 11 debtor in possession . . ."); *Texaco Inc. v. La. Land & Exploration Co.*, 136 B.R. 658, 669 (M.D. La. 1992) ("[T]he Supreme Court squarely held that a debtor in possession is the same 'entity' as the prepetition debtor."); *In re Cardinal Indus. Inc.*, 116 B.R. 964, 981 (Bankr. S.D. Ohio 1990) ("[T]he postpetition debtor in Chapter 11 is not a different legal entity from its prepetition entity."); *see also Perlman v. Catapult Entm't, Inc.* (*In re Catapult Entm't, Inc.*), 165 F.3d 747, 754 n.9 (9th Cir. 1999) ("We emphasize that our holding today is based on the plain language of the statute, and does not rely on the 'separate entity' theory touched on in *In re W. Elecs. Inc.*, 852 F.2d at 83, and subsequently [sic] discredited in *NLRB v. Bildisco & Bildisco* . . ."); *In re TechDyn Sys. Corp.*, 235 B.R. at 862 ("It is true that the 'separate entity' theory is not without its problems in the context of § 365(c)(1), but neither *West* nor *Catron* is wholly dependent on a separate entity analysis and both courts rely on other considerations as well.").

bankruptcy petition."<sup>207</sup> If a debtor in possession were a new entity, it would be unnecessary for a debtor in possession to reject formally any executory contract or unexpired leases because the debtor in possession, being a new entity, would not be bound by the terms of the contracts or leases.<sup>208</sup> The separate entity theory thus would render meaningless those provisions in the Bankruptcy Code dealing with the rejection of executory contracts and unexpired leases since a bankruptcy filing itself would have the effect of rejecting all executory contracts.<sup>209</sup> Accordingly, courts that have followed *West Electronics* generally do so because they believe that the plain language of section 365(c)(1) necessitates the application of the hypothetical test and not because they view a debtor in possession as a new or separate entity.<sup>210</sup>

### B. The Actual Test

Under the actual test, a debtor can assume an executory contract or unexpired lease even if the debtor cannot assign the particular contract or lease to a third party.<sup>211</sup> The debtor must still cure any existing monetary defaults under the terms

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<sup>207</sup> NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984):

For our purposes, it is sensible to view the debtor-in-possession as the same "entity" which existed before the filing of the bankruptcy petition, but empowered by virtue of the Bankruptcy Code to deal with its contracts and property in a manner it could not have employed absent the bankruptcy filing.

*Id.*

<sup>208</sup> *Id.* ("Obviously if the [debtor in possession] were a wholly 'new entity,' it would be unnecessary for the Bankruptcy Code to allow it to reject executory contracts, since it would not be bound by such contracts in the first place.")

<sup>209</sup> See *In re Cajun Elec. Power Coop.*, 230 B.R. at 705 ("If the court were to adopt the rationale of *West* and focus primarily upon assignability, a chapter 11 filing would have the virtual effect of rejecting executory contracts covered by section 365(f).")

<sup>210</sup> See *Sunterra Corp.*, 361 F.3d at 267 ("By its plain language, § 365(c)(1) addresses both assumption and assignment."); *In re Catapult Entm't, Inc.*, 165 F.3d at 753 ("[T]he plain language of § 365(c)(1) compels the result that Perlman urges: Catapult may not assume the Perlman licenses over Perlman's objection."); *In re Neuhoff Farms, Inc.*, 258 B.R. at 350 ("The literal language of § 365(c)(1) is . . . said to establish a 'hypothetical test': a debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical party . . . ." (quoting *In re Catapult Entm't, Inc.*, 165 F.3d at 750)); *In re TechDyn Sys. Corp.*, 235 B.R. at 861 ("[T]he remaining text of § 365(c)(1) unmistakably makes it clear that the debtor may neither assume nor assign the contracts without the government's consent."). But see *In re Plum Run Serv. Corp.*, 159 B.R. 495, 501 (Bankr. S.D. Ohio 1993) ("However, case law clearly notes the distinction between a pre-petition debtor and the debtor-in-possession. To allow a debtor-in-possession to assume a contract, in essence, creates an assignment of the contract from the pre-petition debtor to the debtor-in-possession.")

<sup>211</sup> See *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997) (finding section 365(c) and section 365(e) contemplate case-specific inquiry into whether non-debtor party was forced to accept performance under executory contract from third party. (quoting *Summit Inv. & Dev. Corp.*, 69 F.3d at 612)); *Summit Inv. & Dev. Corp.*, 69 F.3d at 613 ("[S]ection 365(c) presents no bar to [the] assumption of the Agreement."); *In re Mirant Corp.*, 303 B.R. 319, 332 (Bankr. N.D. Tex. 2003) (stating Anti-Assignment Act does not prevent assumption of agreement under statute); *In re Cajun Elec. Power Coop.*, 230 B.R. at 705 ("The court concludes that section 365(c) does not operate to preclude the Trustee from seeking to assume the Supply Contracts on the basis of the reasoning set forth in *West*."); *In re Lil' Things, Inc.*, 220

of the executory contract or unexpired lease prior to assumption,<sup>212</sup> but section 365(c)(1) of the Bankruptcy Code does not serve as an obstacle to assumption under the actual test when no assignment is actually contemplated. Courts that have adopted the actual test have posited various reasons why the actual test presents a better interpretation of the Bankruptcy Code than the hypothetical test.

First, courts have found that the actual test is compatible with the literal language of section 365(c)(1) of the Bankruptcy Code.<sup>213</sup> Section 365(c)(1) gives effect to applicable nonbankruptcy law that restricts or conditions assignment outside of bankruptcy. The assumption of an executory contract or unexpired lease does not effect an assignment, as so defined outside of bankruptcy, because the debtor in possession is not a new or separate entity.<sup>214</sup> Thus, if nonbankruptcy law is

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B.R. at 587 (stating "debtor may assume its own contracts and leases if it complies with § 365(b)(1)."); *In re GP Express Airlines, Inc.*, 200 B.R. at 233 (explaining section 365(c)(1) does not bar assumption of contracts by debtor in possession); *Weaver v. Nizny (In re Nizny)*, 175 B.R. 934, 938 (Bankr. S.D. Ohio 1994) (stating where assumption would not alter "essential identity" of entity performing services under contract, exception is not effective (quoting *In re Cardinal Indus., Inc.*, 116 B.R. at 982)); *In re Am. Ship Bldg. Co.*, 164 B.R. 358, 362-63 (Bankr. M.D. Fla. 1994) (reading statute in conjunction with applicable law, including the Non-Assignment Act, to prevent Debtor from assigning contract without approval); *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 154 B.R. 813, 815 (Bankr. M.D. Ga. 1993) (positing because rights are acquired without assignment from the debtor to the debtor in possession, it makes no sense to prohibit debtor in possession from 'assuming' executory contract); *In re Ontario Locomotive & Indus. Ry. Supplies*, 126 B.R. 145, 148 (Bankr. W.D.N.Y. 1991) (concluding "Congress did not intend to bar assumption of any contract as long as it will be performed by the debtor or debtor in possession."); *In re Fastrax, Inc.*, 129 B.R. 274, 277 (Bankr. M.D. Fla. 1991) (holding prohibition against trustee's power to assume executory contract does not apply where debtor is in possession under personal service contract (quoting H.R. REP. NO. 1195, 96th Cong., 2d Sess. § 27(b) (1980))); *In re Hartec Enters., Inc.*, 117 B.R. 865, 872 (Bankr. W.D. Tex. 1990) (deciding "actual" test fulfills purposes of anti-assignment statutes); *In re Cardinal Indus. Inc.*, 116 B.R. at 979 ("[A] debtor in possession can assume nonassignable personal service contract under state law as long as performance is going to be same as if no petition had been filed.").

<sup>212</sup> See 11 U.S.C. § 365(b) (2000); *In re Nat'l Gypsum Co.*, 208 F.3d 498, 506 (5th Cir. 2000) (stating debtor must cure all existing defaults owed to non-debtor party); *In re Res. Tech. Corp.*, 254 B.R. 215, 221 (Bankr. N.D. Ill. 2000) (explaining debtor must cure all defaults before assigning to debtor in possession).

<sup>213</sup> See *Summit Inv. & Dev. Corp.*, 69 F.3d at 612 (finding it plausible to construe statute as requiring actual showing prior to termination of debtor's post-petition contract rights that nondebtor party would not be forced to accept performance under its executory contract from someone other than debtor party with whom it originally contracted); *Texaco v. La. Land & Exploration Co.*, 136 B.R. 658, 671 (M.D. La. 1992) (allowing proposed assumption of lease, on basis that phrase "applicable law" is commonly used to refer to law applicable to the facts of case at hand); *In re Hartec Enters. Inc.*, 117 B.R. at 872 (concluding "actual test is a more faithful reading of the statute, one which is both harmonious with other sections of the Code and with the Code's purpose.").

<sup>214</sup> See *Summit Inv. & Dev. Corp.*, 69 F.3d at 614 (determining Supreme Court decisions diminish the legal "fiction" that pre-petition debtor and post-petition debtor are to be treated as separate legal entities); *In re Cajun Elec. Power Coop.*, 230 B.R. at 705 (stating most courts have rejected separate entity theory (quoting *In re Lil' Things, Inc.*, 220 B.R. at 586)); *In re Lil' Things, Inc.*, 220 B.R. at 587 ("[I]t is sensible to view the debtor-in-possession as the same 'entity' which existed before the filing of the bankruptcy petition, but empowered by virtue of the Bankruptcy Code to deal with its contracts and property in the same manner it could not have done absent the bankruptcy filing." (quoting *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984))); *In re GP Express Airlines, Inc.*, 200 B.R. at 232 (discerning no meaningful distinction between GP Express and GP Express debtor in possession); *In re James Cable Partners, L.P.*, 154 B.R. at 815-16

not applicable because no assignment is actually contemplated, then it arguably makes little sense to give effect to such anti-assignment law in bankruptcy when a debtor does not seek to assign a contract. Under this interpretation, the term "applicable law" in section 365(c)(1) refers only to law that actually applies to the actions that the debtor wishes to take.

Moreover, the hypothetical test arguably renders the words "or assign" in section 365(c)(1) of the Bankruptcy Code mere surplusage.<sup>215</sup> As previously stated, assumption is a prerequisite to assignment. A contract cannot be assigned unless it is first assumed in accordance with section 365(b) of the Bankruptcy Code. Accordingly, if section 365(c)(1) applies to the assumption and assignment of executory contracts, it does not need to include the words "or assign." It would be sufficient for the clause to say that the trustee may not assume any executory contract or unexpired lease of the debtor if applicable law excuses the nondebtor party from rendering performance to an entity other than the debtor in possession.

Advocates of both the hypothetical test and the actual test have difficulty making sense of Congress' use of the phrase "assume or assign" in section 365(c)(1) of the Bankruptcy Code. Given the split in the courts on this issue, the plain language of section 365(c)(1) cannot provide the basis for resolving the controversy regarding the application of this section when the debtor merely seeks to assume an executory contract or unexpired lease. As stated above, the hypothetical test renders the words "or assume" mere surplusage, while the actual test transforms the phrase "assume or assign" into "assume and assign." Both tests are thus arguably inconsistent with the plain language of the statute.

Second, courts have found that the actual test is more consistent with the legislative history of section 365(c)(1).<sup>216</sup> Section 365(c)(1) of the Bankruptcy Code initially was enacted as a part of the Bankruptcy Reform Act of 1978.<sup>217</sup> Section 365(c)(1) originally provided that the trustee could not "assume or assign an

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(finding it makes no sense to prohibit the debtor in possession from assuming executory contract); *Texaco*, 136 B.R. at 670 (stating separate entity reasoning is directly contrary to *Bildisco*); *In re Ontario Locomotive*, 126 B.R. at 148 ("Congress did not intend to bar assumption of any contract as long as it will be performed by the debtor or debtor in possession."); *In re Fastrax Inc.*, 129 B.R. at 277 (rejecting proposition that debtor-in-possession is a different legal entity from a debtor); *In re Cardinal Indus. Inc.*, 116 B.R. at 981 (holding post-petition debtor is not different legal entity from its pre-petition entity); *In re Hartec Enters., Inc.*, 117 B.R. at 871 n.10 (stating debtor and debtor in possession are functionally same entity).

<sup>215</sup> See *In re Cardinal Indus. Inc.*, 116 B.R. at 977 ("[I]f non-assignability of a contract is sufficient as a matter of law to preclude assumption by the trustee, then there was no reason for Congress to provide that the trustee 'may not assume or assign' such contracts."); *In re Hartec Enters.*, 117 B.R. at 870 n.6 (interpreting section 365(c) in light of section 365(f)).

<sup>216</sup> *In re Nizny*, 175 B.R. at 937 (stating H.R. REP. NO. 1195, 96th Cong., 2d Sess. § 27(b) (1980) indicates Congress did not intend section 365(c)(1) to preclude assumption of an otherwise nonassignable personal service contract if performance to be given or received "will be the same as if no petition had been filed.") (quoting *In re Cardinal Indus. Inc.*, 116 B.R. at 979); *In re Cardinal Indus. Inc.*, 116 B.R. at 979 (finding no Congressional intent to preclude assumption); see also *In re Supernatural Foods, L.L.C.*, 268 B.R. 759, 773 (Bankr. M.D. La. 2001) (stating Congress intended to grant new rights to debtor in enacting section 365).

<sup>217</sup> Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 365(c), 92 Stat. 2549, 2575 (1978) (11 U.S.C. § 365(c) (1983)) (prior to 1984 and 1986 amendments); *Summit Inv. & Dev. Corp.*, 69 F.3d at 613 (detailing past language of section 365(c)).

executory contract" if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to *the trustee . . . whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties . . .*"<sup>218</sup> The legislative history indicates that "[s]ubsection (c) . . . only applies in the situation in which applicable law excuses the other party from performance independent of any restrictive language in the contract or lease itself."<sup>219</sup>

Congress subsequently amended section 365(c)(1) as a part of the Bankruptcy Amendments and Federal Judgeship Act of 1984,<sup>220</sup> which changed the language of section 365(c)(1)(A) of the Bankruptcy Code to provide that the trustee could not "assume or assign an executory contract" if "applicable bankruptcy 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 . . .*"<sup>221</sup> There is no authoritative legislative history of the Bankruptcy Amendments and Federal Judgeship Act of 1984. Courts, however, have looked to the legislative history of the Technical Amendments Act of 1980, which sought to make minor changes to the Bankruptcy Reform Act of 1978, for guidance.<sup>222</sup> Indeed, the language of a House amendment

<sup>218</sup> Bankruptcy Reform Act of 1978, § 365(c); see *Summit Inv. & Dev. Corp.*, 69 F.3d at 613 (explaining difference between old and revised statute).

<sup>219</sup> S. REP. NO. 95-598, at 59 (1978), reprinted in 1978 U.S.C.C.A.N. 4717, 5845.

<sup>220</sup> Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 362, 98 Stat. 333, 362 (1984) (prior to 1986 amendment) [hereinafter *BAFJA 1984*] (amending bankruptcy executory contract and lease provisions); see 3 COLLIER ON BANKRUPTCY ¶ 365.LH[2][a] (Lawrence P. King et al. eds., 15th ed. rev. 1997) (explaining section 365 1984 amendments); see also *Summit Inv. & Dev. Corp.*, 69 F.3d at 613 (finding Congress intended section 365 1984 amendment to clarify assumption power in executory contract situation where debtor continues to perform contract as debtor in possession).

Section 365(c)(1)(A) of the Bankruptcy Code was amended again in 1986. The 1986 amendment merely struck out "or an assignee of such contract or lease," and did not make any changes that could be considered helpful to resolving the conflict as to whether section 365(c)(1) of the Bankruptcy Code creates a hypothetical or an actual test. See Bankruptcy Judges, U.S. Trustees, & Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 283(e)(1), 100 Stat. 3088, 3117 (1986) (correcting technically title 11); 3 COLLIER ON BANKRUPTCY ¶ 365.LH[2][b] (Lawrence P. King et al. eds., 15th ed. rev. 1997) (reviewing section 365 1986 amendments).

<sup>221</sup> *BAFJA 1984*, supra note 220 (emphasis added); see also 3 COLLIER ON BANKRUPTCY ¶ 365.LH[2][a] (Lawrence P. King et al. eds., 15th ed. rev. 1997) (explaining section 365 1984 amendments); *Summit Inv. & Dev. Corp.*, 69 F.3d at 613 (finding congress intended section 365 1984 amendment to clarify trustee's assumption power in executory contract situation where debtor in possession, performance same as if no petition filed due to personal nature of contract).

<sup>222</sup> See *Summit Inv. & Dev. Corp.*, 69 F.3d at 613 (finding H.R. Rep. No. 1195, 96th Cong., 2d Sess. § 27(b) (1980) persuasive in rejecting hypothetical test); *Weaver v. Nizny* (*In re Nizny*), 175 B.R. 934, 937 (Bankr. S.D. Ohio 1994) (stating H.R. Rep. No. 1195, 96th Cong., 2d Sess. § 27(b) (1980) "clearly indicates" congressional intent against preclusion of nonassignable personal contract assumption if performance same as if no petition filed); *In re Fastrax*, 129 B.R. 274, 278 (Bankr. M.D. Fla. 1991) (finding section 365(c)(1) designed only to prevent debtor-in-possession executory contract assignment where nonassignable by law); *In re Cardinal Indus. Inc.*, 116 B.R. 964, 979 (Bankr. S.D. Ohio 1990) (finding section 365(c)(1) provides debtor-in-possession can assume personal service contract nonassignable under state law as long as performance same as if no petition filed). But see *In re Sunterra Corp.*, 361 F.3d 257,

to the Technical Amendments Act of 1980 eventually was adopted (in part) by the Bankruptcy Amendments and Federal Judgeship Act of 1984 as the amended version of section 365(c)(1)(A) of the Bankruptcy Code.<sup>223</sup>

The legislative history of the Technical Amendments Act of 1980 indicates:

This amendment makes clear that the prohibition against a trustee's power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition had been filed because of the personal service nature of the contract.<sup>224</sup>

Courts adopting the actual test view this statement as evidence that Congress did not intend to adopt the hypothetical test or the reasoning behind it when Congress amended section 365(c)(1) of the Bankruptcy Code in 1984.<sup>225</sup> The changes made by the Bankruptcy Amendments and Federal Judgeship Act of 1984, however, failed to change the words "assume or assign" in section 365(c)(1) to "assume *and* assign."

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270 (4th Cir. 2004) (finding H.R. 1195, 96th Cong., 2d Sess. § 27(b) (1980) inconclusive); *Perlman v. Catapult Entm't, Inc.* (*In re Catapult Entm't, Inc.*), 165 F.3d 747, 754 (9th Cir. 1999) (finding H.R. 1195, 96th Cong., 2d Sess. § 27(b) (1980) not dispositive).

<sup>223</sup> The House proposed the following changes to section 365(c)(1)(A) of the Bankruptcy Code:

(1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to [the trustee] *an entity other than the debtor in possession* or an assignee of such contract or lease *by virtue of the nature of such contract or lease*, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties . . . .

H.R. REP. NO. 1195, 96th Cong. 2d Sess. § 27 (b) at 57 (1980) [hereinafter *1980 Report*]. The language "by virtue of the nature of such contract or lease" was not adopted by the Bankruptcy Amendments and Federal Judgeship Act of 1984; however, the language "an entity other than the debtor in possession" was so adopted. See *BAFJA 1984*, *supra* note 220. For this reason, it is arguably appropriate to consider the legislative history behind the Technical Amendments Act of 1980 in light of the absence of such history behind the Bankruptcy Amendments and Federal Judgeship Act of 1984. See *In re Cardinal Indus. Inc.*, 116 B.R. at 979 ("[W]hile The Technical Amendments Act was originally drafted by the Senate, it was the language of the House amendment to the Act that eventually was adopted by BAFJA in 1984."); see also Bankruptcy Court And Federal Judgeship Act of 1983, S. REP. NO. 98-55, § 552(a) (1983) (revealing Senate approval of House amendment); Omnibus Bankruptcy Improvements Act of 1983, S. REP. NO. 98-65, § 252(a) (1983) (revealing Senate approval of House amendment).

<sup>224</sup> *1980 Report*, *supra* note 223.

<sup>225</sup> See *Summit Inv. & Dev. Corp.*, 69 F.3d at 613 (finding *1980 Report* persuasive in rejecting the hypothetical test); *In re Nizny*, 175 B.R. at 937 (interpreting *1980 Report* as clearly indicative of congressional intent against preclusion of assumption of nonassignable personal service contract if performance same as if no petition filed); *In re Fastrax*, 129 B.R. at 278 (finding section 365(c)(1) designed only to prevent debtor-in-possession executory contract *assignment* where nonassignable by law); *In re Cardinal Indus. Inc.*, 116 B.R. at 979 (finding section 365(c)(1) provides debtor-in-possession can assume personal service contract nonassignable under state law as long as performance same as if no petition filed).

Third, courts have found that the actual test is more compatible with the goal of maximizing the value of the bankruptcy estate.<sup>226</sup> If the ultimate goal of bankruptcy is the rehabilitation of a debtor's business, it makes little sense to prevent a debtor from assuming a potentially valuable asset.<sup>227</sup> Given the nature and number of contracts that courts have found to fall within the scope of section 365(c)(1), a court's decision to adopt either the actual or hypothetical test undoubtedly impacts the ability of a debtor to reorganize effectively.<sup>228</sup> Courts that (1) do not consider the nature of the contract or whether the identity of the original contracting party is material and (2) apply the hypothetical test are likely to apply section 365(c)(1) to prevent assumption whenever the contract in question is executory and there is some state or federal law that restricts assignment outside of bankruptcy, often to a debtor's estate's detriment.

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<sup>226</sup> See *Texaco Inc. v. La. Land & Exploration Co.*, 136 B.R. 658, 671 (M.D. La. 1992) ("The proposition tends to defeat the basic bankruptcy purpose of enhancement of the bankruptcy estate for benefit of rehabilitation and the general creditors upon a highly technical 'hypothetical' test which furthers no bankruptcy purpose at all."); *In re Cardinal Indus. Inc.*, 116 B.R. at 981 ("If the ultimate goal of Chapter 11 is the rehabilitation of a debtor's enterprise, the Trustee questions the wisdom of preventing the estate from assuming an executory contract which potentially is its most valuable asset, solely because the contract cannot be assigned to a hypothetical third party."); see also *In re TechDyn Sys. Corp.*, 235 B.R. 857, 864 (Bankr. E.D. Va. 1999) ("The court is sympathetic with such concerns and recognizes that a blanket refusal to permit a reorganizing debtor to assume valuable Government contracts over the Government's objection may well represent poor bankruptcy policy.").

<sup>227</sup> See *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1983) ("The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."); *Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 573 (3d Cir. 2003) ("The premise of a reorganization is to ensure that the debtor emerges from bankruptcy as a viable concern."); *In re FBI Distrib. Corp.*, 330 F.3d 36, 41 (1st Cir. 2003) ("The paramount objective of a Chapter 11 reorganization is to rehabilitate and preserve the value of the financially distressed business."); *In re Cedar Shore Resort, Inc.*, 235 F.3d 375, 379 (8th Cir. 2000) (holding purpose of chapter 11 reorganization "is to restructure a business's finances so that it may continue to operate, provide employees with jobs, pay its creditors, and produce a return for its stockholders.") (citing H.R. Rep. No. 595 (1975), *reprinted in* 1978 U.S.C.C.A.N. 6179); *In re Casse*, 198 F.3d 327, 334 (2d Cir. 1999) (concluding "object [of chapter 11] is to permit a potentially viable debtor to restructure and emerge from bankruptcy protection.") (citing *Kings Terrace Nursing Home & Health Related Facility v. N.Y. State Dep't of Social Servs. (In re Kings Terrace Nursing Home and Health Related Facility)*, 184 B.R. 200, 203 (S.D.N.Y. 1995)); *Canadian Pac. Forest Prods. Ltd. v. J.D. Irving, Ltd. (In re Gibson Group, Inc.)*, 66 F.3d 1436, 1442 (6th Cir. 1995) (stating chapter 11 purpose to provide debtor legal protection for reorganization, in turn providing creditors "going-concern value" rather than possibility of "more meager satisfaction through liquidation.").

<sup>228</sup> To avoid the consequences of the hypothetical test, at least one bankruptcy court has found that nonassumable executory contracts can "ride-through" bankruptcy if they are intentionally not assumed and not rejected when the contract is of significant important to the debtor's reorganization. See *In re Hernandez*, 287 B.R. 795, 806-07 (Bankr. D. Ariz. 2002) (finding nonassumable exclusive patent license could "ride-through" bankruptcy over licensor's motion to compel under section 365(d)(2) of the Bankruptcy Code because requiring the debtor to reject the license would significantly harm the debtor's attempted reorganization). Nevertheless, even if adopted by other courts, this approach is unlikely to be useful to debtors in hypothetical jurisdictions because, under the "ride-through" doctrine, the benefits afforded by section 365 of the Bankruptcy Code, such as insulation from *ipso facto* provisions and the ability to cure arrearages, are inapplicable. See *id.* 287 B.R. at 800 ("A contract that is not assumed is not entitled to the benefits afforded by 11 U.S.C. § 365 such as insulation from *ipso facto* provisions or the rights to cure arrearages within a reasonable period of time . . .").



#### IV. THE RIGHTS OF NONDEBTOR PARTIES TO SECTION 365(c)(1) CONTRACTS AND LEASES

A debtor's potential inability to assume an executory contract or unexpired lease draws into question the rights of nondebtor parties to contracts and leases that are subject to section 365(c)(1) of the Bankruptcy Code. In particular, a nondebtor party may desire to terminate the contract or lease upon the discovery of the debtor's bankruptcy, or the nondebtor party may seek to enforce a clause that provides for the termination of the contractual relationship upon the debtor's insolvency or filing for bankruptcy. A nondebtor party's ability to terminate an otherwise non-assumable contract or lease may be restricted or affected by the automatic stay imposed in a debtor's bankruptcy case under section 362 of the Bankruptcy Code. Pursuant to section 365(e)(1) of the Bankruptcy Code, courts also may be unwilling to enforce an *ipso facto* clause (e.g., a clause permitting termination upon the debtor's insolvency or bankruptcy) even if the contract or lease cannot be assumed under section 365(c)(1) of the Bankruptcy Code. Accordingly, nondebtor parties must consider the extent to which various provisions of the Bankruptcy Code other than section 365(c)(1) affect their rights under executory contracts or unexpired leases.

##### A. *Relief from the Automatic Stay*

At least one court has found that debtors can continue to exercise their rights under executory contracts or unexpired leases during the pendency of the case even when the contracts or leases in question cannot be assumed under section 365(c)(1) of the Bankruptcy Code.<sup>229</sup> The commencement of a case under the Bankruptcy Code creates an estate consisting of all of the property identified in section 541(a) of the Bankruptcy Code.<sup>230</sup> Section 541(a) defines "property of the estate" broadly as including "all legal or equitable interests of the debtor in property as of the

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<sup>229</sup> See *In re Valley Media, Inc.*, 279 B.R. 105, 137 (Bankr. D. Del. 2002) (opining debtor-in-possession exercise of rights under non-assumable contract during pendency of case does not conflict with federal law prohibiting assignment of non-exclusive licenses since debtor not assigning license to debtor-in-possession). But see *Tonry v. Hebert (In re Tonry)*, 724 F.2d 467, 469 (5th Cir. 1984) (finding "contingent fee contracts form no part of the . . . bankruptcy estate" where such contracts cannot be assumed because of section 365(c)(1)); *Spenciner v. Gettinger Assocs. (In re Brooklyn Overall Co.)*, 57 B.R. 999, 1002 n.2 (Bankr. E.D.N.Y. 1986) (commenting filing of petition does divest estate of personal service contracts which cannot be assumed by trustee under section 365(c)); *In re Noonan*, 17 B.R. 793, 797-98 (Bankr. S.D.N.Y. 1982) (holding "[w]here an executory contract between the debtor and another is of such a nature as to be based upon the debtor's personal skill, the trustee does not take title to the debtor's rights and cannot deal with the contract.").

<sup>230</sup> Section 541(a) of the Bankruptcy Code provides, in relevant part: "The commencement of a case under section 301, 302 or 303 of this title creates an estate." 11 U.S.C. § 541(a) (2000); see 5 COLLIER ON BANKRUPTCY ¶ 541.04 (Lawrence P. King et al. eds., 15th ed. rev. 1997) (annotating section 541(a)); 11 U.S.C. §§ 301-303 (providing for commencement of voluntary case, joint case, involuntary case, respectively).

commencement of the case."<sup>231</sup> A debtor's interest in an unassumed executory contract or unexpired lease generally is considered property of the debtor's estate under section 541(a).<sup>232</sup> Accordingly, although not adopted by all courts, an argument exists that a debtor in bankruptcy retains its rights under an executory contract or unexpired lease even if the contract or lease cannot be assumed by the debtor or trustee.

In *Valley Media*, the debtor, a full-line supplier of entertainment software products (primarily CDs, DVDs and VHS tapes), filed a motion to sell its inventory at an auction.<sup>233</sup> Various vendors that provided goods to the debtor under the terms of certain distribution agreements, which gave the debtor the authority to distribute the software products, objected to the proposed auction, asserting, among other things, that their distribution agreements with Valley Media contained nonexclusive licenses that could not be assumed or assigned pursuant to section 365(c)(1) of the Bankruptcy Code and controlling Third Circuit precedent. Since the nonexclusive licenses could not be assumed, the vendors reasoned that the contracts terminated

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<sup>231</sup> Section 541(a) of the Bankruptcy Code provides, in relevant part:

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsection (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

11 U.S.C. § 541(a); *see* *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204 (1983) ("Both the congressional goal of encouraging reorganizations and Congress' choice of methods to protect secured creditors suggest that Congress intended a broad range of property to be included in the estate."); 5 COLLIER ON BANKRUPTCY ¶ 541.04 (Lawrence P. King et al. eds., 15th ed. rev. 1997) (commenting on broadness of section 541(a)).

<sup>232</sup> *See* *Cinicola v. Scharffenberger*, 248 F.3d 110, 121 (3d Cir. 2001) (concluding executory contracts, leases, fall under section 541(a)(1) definition); *In re Rickel Home Ctrs., Inc.*, 209 F.3d 291, 302 n.12 (3d Cir. 2000) (validating leasehold interest as property interest under state law, encompassed by section 541); *Computer Communications, Inc. v. Codex Corp. (In re Computer Communications, Inc.)*, 824 F.2d 725, 730 (9th Cir. 1987) (holding 11 U.S.C. § 541 plainly states "contract" is within definition of section 541(a) "property of the estate."); 48th St. Steakhouse, Inc. v. Rockefeller Group, Inc. (*In re* 48th St. Steakhouse, Inc.), 835 F.2d 427, 430 (2d Cir. 1987) ("The courts are in agreement that unexpired leasehold interests, including subleases, constitute property of the bankrupt estate."); *In re Valley Media, Inc.*, 279 B.R. at 137 (concluding licenses are executory contracts, debtor license rights vested in debtor- in-possession as of petition date); *In re El Paso Refinery, L.P.*, 220 B.R. 37, 41 (Bankr. W.D. Tex. 1998) (stating its "inclination" was executory contracts were property of estate); *In re GP Express Airlines, Inc.*, 200 B.R. 222, 232 (finding property of bankruptcy estate includes debtor's contractual rights under section 541); *In re Daugherty Constr., Inc.*, 188 B.R. 607, 611 (Bankr. D. Neb. 1995) (finding debtor's interest in limited liability companies (L.L.C.s), rights under LLC contracts, constitute property of bankruptcy estate under section 541); *In re Chateaugay Corp.*, 116 B.R. 887, 898 (Bankr. S.D.N.Y. 1990) ("Contractual rights are intangible property which is included within the definition of the estate of the debtor."); *In re THW Enters., Inc.*, 89 B.R. 351, 354 (Bankr. S.D.N.Y. 1988) (stating "a lease not yet assumed is property protected by the automatic stay from any direct or indirect act which will interfere with the debtor's interest."); *In re Priestley*, 93 B.R. 253, 257 (Bankr. D.N.M. 1988) (finding limited partnership interests are estate property); *Varisco v. Oroweat Food Co. (In re Varisco)*, 16 B.R. 634, 637 (Bankr. M.D. Fla. 1981) (finding right created by franchise agreement property of estate under section 541).

<sup>233</sup> *In re Valley Media, Inc.*, 279 B.R. at 144 (describing debtor's business).

upon the commencement of the debtor's case. Accordingly, the vendors argued that the auction would constitute a first sale in violation of federal copyright law and give rise to actions for infringement if allowed by the bankruptcy court.<sup>234</sup>

The bankruptcy court disagreed and found that the debtor's rights under the distribution agreements did not terminate upon the commencement of the case but vested in the debtor and could be exercised by the debtor during the pendency of the bankruptcy.<sup>235</sup> The bankruptcy court first acknowledged that "[a] nonexclusive 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 common law since the license represents only a personal and not a property interest in the copyright."<sup>236</sup> The distribution agreements contained such nonexclusive licenses in that they gave the debtor the right to sell CDs, DVDs and VHS tapes without becoming an infringer.<sup>237</sup> Accordingly, under the Third Circuit's decision in *West Electronics* and section 365(c)(1), the debtor could not assume the distribution agreements.<sup>238</sup> The debtor, however, was "not seeking to either assume the licenses for the benefit of the post bankruptcy reorganized company or to assume and assign (*i.e.*, sell) the licenses for the benefit of the estate."<sup>239</sup> The debtor merely was seeking to exercise the rights it held under the distribution agreements to sell the goods as of the petition date. Thus, the debtor was permitted to exercise rights under the distribution agreements during the bankruptcy even though it could not assume the distribution agreements under *West Electronics*.

Taking this reasoning to its logical conclusion, if the debtor is viewed as retaining its rights under an executory contract or unexpired lease during the bankruptcy even if such rights cannot be assumed, then the nondebtor party must first obtain relief from the automatic stay before it attempts to extinguish the debtor's contractual rights.<sup>240</sup> Section 362(a) of the Bankruptcy Code provides for

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<sup>234</sup> *Id.* 133–34 (outlining vendors arguments).

<sup>235</sup> *Id.* at 137 ("Licenses are generally considered to be executory contracts and thus the rights of the debtor under such licenses are vested in the debtor in possession as of the petition date.").

<sup>236</sup> *See id.* at 135.

<sup>237</sup> *Id.* at 139 ("[T]he Debtor in Possession is not seeking to exercise any right that it did not already possess as of the commencement of the case and is not seeking to obtain additional performance from the Objecting Vendors.").

<sup>238</sup> *See id.* at 137 ("The debtor and the debtor in possession are indeed considered to be different entities. *In re W. Electronics, Inc.*, 852 F.2d at 83 . . .").

<sup>239</sup> *Id.* at 139.

<sup>240</sup> *See Computer Communications, Inc. v. Codex Corp. (In re Computer Communications, Inc.)*, 824 F.2d 725, 730 (9th Cir. 1987) (holding even if section 365(e)(2) allowed contract termination, section 362 automatically stayed termination); *In re Valley Media, Inc.*, 279 B.R. at 137 ("The automatic stay prevented the Objecting Vendors from terminating the agreements post-petition, despite any post-petition breach, without first seeking relief from the stay."); *Alert Holdings, Inc. v. Interstate Protective Servs., Inc. (In re Alert Holdings, Inc.)*, 148 B.R. 194, 202 (Bankr. S.D.N.Y. 1992) (noting courts consider executory contracts property of estate reaching the automatic stay); *In re THW Enters. Inc.*, 89 B.R. 351, 354 (Bankr. S.D.N.Y. 1988) ("[A] lease not yet assumed is property protected by the automatic stay from any direct or indirect act which will interfere with the debtor's interest.") (citing *48th St. Steakhouse, Inc. v. Rockefeller Group, Inc. (In re 48th Street Steakhouse, Inc.)*, 835 F.2d 427 (2d Cir. 1987)); *cf. In re W. Elecs. Inc.*, 852 F.2d at 84

an automatic stay of, among other things, any act to obtain possession of property of the estate or to exercise control over property of the estate upon the filing of a bankruptcy petition.<sup>241</sup> If a debtor's interest in an unassumed executory contract or unexpired lease is considered property of the debtor's estate under section 541(a) of the Bankruptcy Code, then an unauthorized attempt to terminate a debtor's rights arising under the contract or lease would violate the automatic stay. If a court takes this view, a nondebtor party must file a motion for relief from the automatic stay with the bankruptcy court before attempting to extinguish the debtor's rights under a non-assumable executory contract.

Contrary to the holding in *Valley Media*, however, some courts have found that the filing of a bankruptcy petition automatically divests a debtor of its rights under an executory contract if that contract would be subject to section 365(c)(1) of the Bankruptcy Code.<sup>242</sup> Although most courts view a debtor's legal and equitable rights under an executory contract or unexpired lease as of the commencement of the case as constituting property of the estate under section 541(a)(1), some courts have stated that such rights do not become part of the estate until the debtor assumes the contract or lease.<sup>243</sup> This characterization of a debtor's rights under an executory contract prior to assumption has been widely criticized.<sup>244</sup> Nevertheless, under the

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(reversing judgment of district court remanding with instructions "lift stay imposed pursuant to 11 U.S.C. § 362 as relating to the [government contracts].").

<sup>241</sup> 11 U.S.C. § 362(a)(3) (2000).

<sup>242</sup> See *Tonry v. Hebert* (*In re Tonry*), 724 F.2d 467, 469 (5th Cir. 1984) (finding contingent fee contracts cannot be assumed under section 365(c)(1) of Bankruptcy Code); *Speciner v. Gettinger Assocs.* (*In re Brooklyn Overall Co.*), 57 B.R. 999, 1002 n.2 (Bankr. E.D.N.Y. 1986) ("The filing of the petition does divest the estate of those contracts which, pursuant to § 365(c), cannot be assumed by the trustee, e.g., certain personal service contracts."); *In re Noonan*, 17 B.R. 793, 797-98 (Bankr. S.D.N.Y. 1982) (asserting trustee cannot take title of debtor's rights where executory contract is based upon debtor's personal skill).

<sup>243</sup> See *Otto Preminger Films, Ltd v. Quintex Entm't, Inc.* (*In re Quintex Entm't, Inc.*), 950 F.2d 1492, 1495 (9th Cir. 1991) (noting executory contract does not become asset until assumed); *Turner v. Avery*, 947 F.2d 772, 774 (5th Cir. 1991) (stating executory contract becomes part of bankruptcy estate when trustee assumes contract); *Chbat v. Tleel* (*In re Tleel*), 876 F.2d 769, 770 (9th Cir. 1989) ("Unless rights under executory contract are timely and affirmatively assumed by the trustee, they do not become property of the debtor's estate."); *Cheadle v. Applechee Riders Assoc.* (*In re Lovitt*), 757 F.2d 1035, 1041 (9th Cir. 1985) (distinguishing executory contracts from other assets vesting on date trustee files bankruptcy petition); *In re Tonry*, 724 F.2d at 469 (stating interest in executory contract does not vest when bankruptcy petition is filed).

<sup>244</sup> See *Pub. Serv. Co. of N.H. v. N.H. Elec. Coop.* (*In re Pub. Serv. Co. of N.H.*), 884 F.2d 11, 14 (1st Cir. 1989) (stating during post-petition and pre-assumption or rejection, "the executory contract remains in effect and creditors are bound to honor it."); *In re Computer Communications, Inc.*, 824 F.2d at 730 ("The version of 11 U.S.C. § 541 in effect at the time plainly stated that a contract comes within the definition of 'property of the estate' despite non-assignability or the existence of a bankruptcy default clause."); *In re Nat'l Steel Corp.*, 316 B.R. 287, 311 (Bankr. N.D. Ill. 2004) (observing many courts holding property under section 541 includes executory contracts); *In re Mirant Corp.*, 303 B.R. 319, 328 (Bankr. N.D. Tex. 2003) (noting overwhelming authority holding debtor must perform under contract before deciding to assume or reject); *In re El Paso Refinery, L.P.*, 220 B.R. 37, 42 (Bankr. W.D. Tex. 1998) (reasoning executory contracts property of estate consonant with definition set out in section 541); *Cohen v. Drexel Burnham Lambert Group, Inc.* (*In re Drexel Burnham Lambert Group, Inc.*), 138 B.R. 687, 702 (Bankr. S.D.N.Y. 1992) ("[T]he plain language of § 541 sweeps in every kind of prepetition interest of the debtor in property not expressly excepted. Nothing in the Code suggests that some kinds of interests lurk in limbo outside the estate until assumed."); Douglas W. Bordewieck, *The Postpetition, Pre-Rejection, Pre-Assumption Status of an*

reasoning of these courts, and given the interaction between sections 541(a)(1) and 362(a) of the Bankruptcy Code, it is possible in some jurisdictions that the nondebtor party would not need to seek relief from the automatic stay before ceasing performance under a non-assumable contract.<sup>245</sup> Because more recent and arguably well-reasoned authority has rejected this position,<sup>246</sup> a nondebtor party should proceed cautiously and may be ill advised to proceed as if the bankruptcy filing automatically divested the debtor of its rights under a non-assumable contract.

### B. *Ipsa Facto* Clauses

It is not uncommon for contracts or leases to contain provisions providing for the termination of the contract or lease in the event of the insolvency or weakening financial condition of one of the parties. These provisions generally are referred to as "*ipso facto*" clauses.<sup>247</sup> Section 541(c)(1) of the Bankruptcy Code provides that a debtor's estate includes an interest of the debtor in property "notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law (A) that restricts or conditions transfer of such interest . . . or (B) that is conditioned on the insolvency or financial condition of the debtor . . ." <sup>248</sup> Accordingly, a

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*Executory Contract*, 59 AM. BANKR. L.J. 197, 200 n.18 (1985) (stating conclusion that executory contract does not become part of estate upon commencement of case "cannot easily be squared with § 541(a).").

<sup>245</sup> See *Fintel v. Oregon* (*In re Fintel*), 10 B.R. 50, 51 (Bankr. D. Or. 1981) (noting section 362(a) does not stay actions against property that is not part of estate); *Varisco v. Oroweat Food Co.* (*In re Varisco*), 16 B.R. 634, 637 (Bankr. M.D. Fla. 1981):

[W]hether or not the right granted by the Agreement is 'property of the Debtor's estate' under § 541 of the Bankruptcy Code is a threshold question. This is so because if it is not, the automatic stay provisions of § 362 of the Bankruptcy Code furnish no protection and no aid to the Debtor.

*Id.*; *Diamond Hill Inv. Co. v. Shelden*, 767 P.2d 1005, 1015 (Wyo. 1989) (automatic stay provisions apply to proceedings or acts against the property of estate but do not apply to acts against property which is neither the debtor's nor the estates).

<sup>246</sup> See cases cited *supra* note 244; see also *Edwards Mobile Home Sales, Inc. v. Ohio Cas. Ins. Co.* (*In re Edwards Mobile Home Sales, Inc.*), 119 B.R. 857, 859–60 (Bankr. M.D. Fla. 1990) (holding that a non-debtor could not terminate a non-assumable surety bond without first obtaining relief from automatic stay); *In re Coast Trading Co.*, 26 B.R. 737, 740–41 (Bankr. D. Or. 1982) (finding that non-debtor seeking termination of executory contract had to first seek relief from automatic stay pursuant to section 362).

<sup>247</sup> See 11 U.S.C. § 541(c)(1) (2000); see also *Mims v. Fid. Funding, Inc.*, 307 B.R. 849, 858 (N.D. Tex. 2002) (defining *ipso facto* clause as one that terminates debtor's rights in executory contract upon filing for bankruptcy); BLACK'S LAW DICTIONARY 847 (8th ed. 2004) (defining *ipso facto* clause as "[a]contract clause that specifies the consequences of a party's bankruptcy.").

<sup>248</sup> Section 541(c)(1) of the Bankruptcy Code provides:

(c)(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law —

(A) the restricts or conditions transfer of such interest by the debtor; or

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession

debtor's interest in an executory contract or unexpired lease becomes property of the debtor's estate notwithstanding an *ipso facto* clause in the agreement to the contrary.

Section 365(e)(1) of the Bankruptcy Code also makes *ipso facto* clauses unenforceable in bankruptcy. Section 365(e)(1) provides that, "at any time after the commencement of the case," a debtor's rights under an executory contract or unexpired lease "may not be terminated or modified" by a provision in such contract or lease or in "applicable law" that is conditioned on "(A) the insolvency or financial condition of the debtor . . . (B) the commencement of a case . . . or (C) the appointment of . . . a trustee . . . before such commencement."<sup>249</sup> Thus, section 365(e)(1) facially pre-empts contractual and statutory *ipso facto* provisions.

Section 365(e)(2) of the Bankruptcy Code, however, provides that the invalidation of *ipso facto* clauses does *not* apply to a contract or lease if "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[.]"<sup>250</sup> Thus, section 365(e)(2) of the

by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

11 U.S.C. § 541(c)(1).

<sup>249</sup> Section 365(e)(1) of the Bankruptcy Code provides:

(e)(1) *Notwithstanding* a provision in an executory contract or unexpired lease, or in *applicable law*, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on —

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

11 U.S.C. § 365(e)(1) (emphasis added).

<sup>250</sup> Section 365(e)(2) of the Bankruptcy Code provides:

(2) Paragraph (1) of this subsection does *not* apply to an 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 —

(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 such assumption or assignment; or

(B) such contract is a contract to make a loan, or extend other debt financing or financial accommodation, to or for the benefit of the debtor, or to issue a security of the debtor.

Bankruptcy Code permits the enforcement of *ipso facto* clauses with respect to contracts or leases that, under section 365(c)(1), are not subject to assumption or assignment.

The language of section 365(e)(2) of the Bankruptcy Code closely tracks the language of section 365(c)(1). Thus, as a practical matter, to determine whether an *ipso facto* clause is enforceable under section 365(e)(2), a party must first determine whether the contract or lease falls within section 365(c)(1). As discussed above, this determination largely will depend upon the type of contract or lease and whether the particular court applies the hypothetical or actual test. Indeed, the same split of authority regarding the hypothetical<sup>251</sup> and actual<sup>252</sup> tests that exists in the context of section 365(c)(1) of the Bankruptcy Code also exists in the context of

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*Id.* § 365(e)(2) (emphasis added). The Bankruptcy Amendments and Federal Judgeship Act of 1984 did not make any changes to the language of section 365(e)(2)(A) of the Bankruptcy Code. Thus, the legislative history behind the Technical Amendments Act of 1980 arguably is not directly applicable to the conflict between sections 365(e)(1) and 365(e)(2) of the Bankruptcy Code. See *Calvin v. Siegal (In re Siegal)*, 190 B.R. 639, 644 (Bankr. D. Ariz. 1996) (remarking it was unclear what significance, if any, Congress attached to amending section 365(c)(1) but leaving section 365(e)(2) unchanged). The First Circuit, however, has found the legislative history behind the Technical Amendments Act of 1980 applicable given the interrelated concerns addressed by sections 365(c)(1) and 365(e)(2) of the Bankruptcy Code. See *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 613 (1st Cir. 1995) ("Congress contemplated in 1984 that section 365(e)(2) would permit a debtor or a debtor in possession to avoid automatic termination of his executory contract rights under the section 365(e)(2)(A) exemption.").

<sup>251</sup> See *Breeden v. Catron (In re Catron)*, 158 B.R. 629, 639 (E.D. Va. 1993):

[T]he court underscores that the language of the § 365(e)(2)(A)(i) exception tracks almost verbatim the language found in § 365(c)(1)(A). For this reason, the analysis used to dispose of appellant's argument with respect to § 365(c) applies with equal force to appellant's § 365(e) argument. Thus, the court finds that the Partnership Agreement comes within the exception recited in § 365(e)(2)(A) . . . .

*Id.*; *In re Sunset Developers*, 69 B.R. 710, 713 (Bankr. D. Idaho 1987) ("[S]ection 365(e) does not apply to the partnership agreement and the Debtor-in-Possession is not entitled to assign or assume the partnership contract."); see also *Skeen v. Harms (In re Harms)*, 10 B.R. 817, 821 (Bankr. D. Colo. 1981) ("It is obvious that the Trustee cannot assume the position of general partner of these limited partnerships, since he is not the person with whom the limited partners contracted. Thus, the partnerships dissolved when the Trustee was appointed.").

<sup>252</sup> See *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997) ("Given the pragmatic 'actual performance' test adopted in *Leroux*, the ultimate findings of fact and conclusions of law made by the bankruptcy court below did not constitute error."); *In re Summit Inv. & Dev. Corp.*, 69 F.3d at 612 ("According to *Summit*, therefore, the contract rights held by *Leroux* and *Curran* terminate without regard to whether they ever contemplated assigning their 'management' or 'participation' rights under the Agreement. We cannot agree with its interpretation, for several reasons."); *In re Siegal*, 190 B.R. at 646 ("[T]his Court is persuaded that Section 365(e)(2) permits state law mandated dissolution to occur only when actual substituted performance is contemplated."); *Weaver v. Nizny (In re Nizny)*, 175 B.R. 934, 938 (Bankr. S.D. Ohio 1994) (finding that the reasoning set forth in *In re Cardinal Industries* was persuasive, namely "[b]ecause assumption by a trustee on behalf of the estate results in the debtor's performance of the contract in a Chapter 11 case, invalidation of *ipso facto* clauses should be the rule, however, either under 11 U.S.C. § 365(e)(1) or by application of the Supremacy Clause . . . ."); *In re Cardinal Indus. Inc.*, 116 B.R. 964, 981 (Bankr. S.D. Ohio 1990) ("[A]ssumption of the contracts by the Trustee on behalf of the estate with performance by the Debtor would not constitute an assignment within the meaning intended by § 365(c)(1)(A) or § 365(e)(2)(A).").

section 365(e)(2).

The application and consequences of the hypothetical and actual tests under section 365(e)(2) is effectively illustrated in the context of state partnership statutes and partnership agreements. As previously discussed, the Uniform Partnership Acts restrict the assignment of a partner's full or entire partnership interest. In this respect, nonbankruptcy law excuses the nondebtor party from accepting performance from, or rendering performance to, a third party. On this basis, some courts have concluded that an *ipso facto* provision in a partnership agreement is valid in bankruptcy (or is not invalidated by section 365(e)(1) of the Bankruptcy Code).<sup>253</sup>

For example, in *Catron*, a partner in the Orchard Square Partnership, a partnership formed for the purpose of constructing and managing a shopping center, filed a bankruptcy case after failing to satisfy two capital calls required by the terms of the partnership agreement.<sup>254</sup> After the debtor filed its bankruptcy case and before the debtor sought to assume his partnership interest, the nondebtor partners sought relief from the automatic stay in order to exercise a buyout option contained in the partnership agreement that gave the nondebtor partners the right to buy out the bankrupt partner in the event that a partner filed a bankruptcy case.<sup>255</sup> The bankruptcy court first concluded that the partnership agreement was "essentially a personal services contract" that could not be assumed under section 365(c)(1) of the Bankruptcy Code<sup>256</sup> because "[f]undamentally a partnership is based upon the

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<sup>253</sup> See *In re Catron*, 158 B.R. at 639 (finding that an *ipso facto* clause was not invalidated by section 365(e)(1) of the Bankruptcy Code where section 365(c)(1) of the Bankruptcy Code barred assumption of the partnership agreement); *In re Sunset Developers*, 69 B.R. at 713 ("Section 365(c) prevents the Debtor-in-Possession from assuming or assigning the partnership other than such assignment as allowed by the Idaho Uniform Partnership Law. Therefore, section 365(e) does not apply to the partnership agreement . . ."); see also *In re Morgan Sangamon P'ship*, 269 B.R. 652, 654 (Bankr. N.D. Ill. 2001) (reasoning that under the Uniform Partnership Act general partner can not be compelled, without consent, to accept new partner and, therefore, *ipso facto* clauses in partnership agreements are enforceable).

<sup>254</sup> *In re Catron*, 158 B.R. at 631:

To meet the partnership's financial obligations, [the managing general partner] made two capital calls on the partners, one in 1990 and the other in 1991. On both occasions, Catron did not contribute his share as required by the Partnership Agreement. On October 17, 1991, Catron filed a petition for Chapter 11 Bankruptcy.

*Id.*

<sup>255</sup> *Id.* at 626:

Article 16 entitled "Continuation of the Partnership in Certain Events" provides that upon the bankruptcy of a partner, the partnership is to continue without the winding up of the partnership's affairs; the bankruptcy of a partner will trigger an option by the remaining partners to purchase that partner's interest for the fair market value of partnership assets as established by an independent appraiser.

*Id.*

<sup>256</sup> *Id.* at 628:

I find that Catron as debtor in possession is a separate entity from Catron as the



personal trust and confidence of the partners."<sup>257</sup> For the same reasons, the bankruptcy court also concluded that the buyout option that was triggered by the debtor's bankruptcy was not invalidated by section 365(e)(1) of the Bankruptcy Code, but rather was validated by section 365(e)(2).<sup>258</sup> Accordingly, the bankruptcy court granted the nondebtor parties' motion for relief from the automatic stay,<sup>259</sup> and the debtor appealed.

The district court affirmed the bankruptcy court's decision to lift the automatic stay. After concluding that sections 365(c)(1) and 365(f) of the Bankruptcy Code simply cannot be reconciled, the district court adopted the hypothetical test set forth by the Third Circuit in *West Electronics*.<sup>260</sup> Since the debtor could not assume the contract under section 365(c)(1) of the Bankruptcy Code, the district court also found that the buyout option that was triggered by the debtor's bankruptcy was not invalidated by section 365(e)(1) of the Bankruptcy Code. According to the district court: "[T]he language of the § 365(e)(2)(A)(i) exception tracks almost verbatim the language found in § 365(c)(1)(A). For this reason, the analysis used to dispose of appellant's arguments with respect to § 365(c) applies with equal force to appellant's § 365(e) argument."<sup>261</sup> On this basis, the district court affirmed the decision to lift the automatic stay.

In contrast, courts that have determined that section 365(c)(1) of the Bankruptcy Code creates an actual test have invalidated *ipso facto* clauses in partnership agreements under section 365(e)(1).<sup>262</sup> For example, in *Summit*

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prepetition partner. Furthermore, since the partnership agreement is essentially a personal services contract I am persuaded that § 365(c)(1), in conjunction with other applicable law, prevents the debtor from assuming the partnership agreement over the objection of the nondebtor partners.

*Id.* Since the partnership was created pursuant to Virginia law, the bankruptcy court looked to the Uniform Partnership Act as adopted by the State of Virginia in order to determine whether applicable law would excuse the nondebtor parties from exception performance from a party other than Catron. *Id.*

<sup>257</sup> *Id.* at 627 (citing VA. CODE ANN. § 50-21 (Michie 1989), UNIF. P'SHIP ACT § 404, U.L.A. (1992), and BLACK'S LAW DICTIONARY 626 (6th ed. 1990)).

<sup>258</sup> *Id.* at 629 ("[Section] 365(e)(2)(A) provides that in certain circumstances § 365(e)(1) will not apply. I find for the reasons expressed above that the conditions triggering § 365(e)(2)(A) exist in this case; therefore, the purchase option in this case will not be invalidated.").

<sup>259</sup> *See id.* at 640 (finding "the burden left upon the remaining partners sufficiently establishes cause under § 365(d)(1) for lifting the automatic stay.").

<sup>260</sup> *See id.* at 638 (affirming "the bankruptcy court's conclusion of law that the Partnership Agreement was the 'type' of executory contract that § 365(c)(1) barred Catron as a debtor in possession from assuming." (emphasis added)).

<sup>261</sup> *Id.* at 639.

<sup>262</sup> *See, e.g., Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 614 (1st Cir. 1995) (holding "section 365(e) . . . preempts enforcement of the *ipso facto* termination provisions in Section 7.5E of the [Partnership] Agreement."); *Calvin v. Siegal (In re Siegal)*, 190 B.R. 639, 646 (Bankr. D. Ariz. 1996) (ordering "[s]ection 365(e)(1) of the Bankruptcy Code preempts the Arizona U[niform] P[artnership] A[greement]."); *Weaver v. Nizny (In re Nizny)*, 175 B.R. 934, 939 (Bankr. S.D. Ohio 1994) (declaring "upon the filing of a partner's chapter 11 petition in reorganization § 365(e)(1) prevents an *ipso facto* dissolution of a partnership under state law."); *In re Cardinal Indus., Inc.*, 116 B.R. 964, 981-82 (Bankr. S.D. Ohio 1990) (deciding section 365(e)(1) invalidated *ipso facto* clause because section 365(c)(1) did not prohibit assumption of partnership agreement).

*Investment*, two general partners in the Belle Isle Limited Partnership, a limited partnership formed pursuant to Massachusetts law, filed cases under chapter 11 of the Bankruptcy Code.<sup>263</sup> After the debtors filed their bankruptcy cases and before the debtors sought to assume their partnership interests, the nondebtor partners sought injunctive and declaratory relief to remove the debtors as general partners pursuant to a provision in the partnership agreement. Under the partnership agreement, a general partner ceased to be a general partner if it filed a voluntary petition for bankruptcy.<sup>264</sup> The bankruptcy court, however, found the provision unenforceable under section 365(e)(1) of the Bankruptcy Code.

The bankruptcy court first held that section 365(c)(1) of the Bankruptcy Code did not apply or would not apply in the event that the debtors sought to assume their interests because "the non-debtor parties would be dealing with the same persons with whom they had originally contracted."<sup>265</sup> For the same reason, the bankruptcy court also found that the *ipso facto* provision triggered by the debtors' bankruptcy was invalidated by section 365(e)(1) of the Bankruptcy Code, as the section 365(e)(2)(A) exception was inapplicable. According to the bankruptcy court: "The language of § 365(e)(2)(A) mirrors, in all significant respects, the language found in § 365(c). For the reasons stated above with regard to § 365(c), the Court finds the § 365(e)(2)(A) exception inapplicable in the instant case."<sup>266</sup> Accordingly, the bankruptcy court denied the nondebtor parties' motion for injunctive and declaratory relief, and the nondebtor parties appealed.

The district court and the First Circuit both affirmed the bankruptcy court's decision. The First Circuit rejected the hypothetical test and adopted the actual test, whereby assumption is not precluded by section 365(c)(1) of the Bankruptcy Code when the identity of the contracting party remains unchanged.<sup>267</sup> The First Circuit observed that the legislative history of the Technical Amendments Act of 1980 is not directly applicable to the conflict between sections 365(e)(1) and 365(e)(2) of

<sup>263</sup> *Summit Inv. & Dev. Corp.*, 69 F.3d at 609 (describing background of bankruptcy filing by two of three partners in Belle Isle Limited Partnership).

<sup>264</sup> *Id.* at 609 n.2 (defining pertinent part of MLPA § 23(4)):

Except as approved by the specific written consent of all partners at the time, a person ceases to be a general partner of a limited partnership upon the happening of any of the following events: . . . (4) Unless otherwise provided in writing in the partnership agreement the general partner . . . (ii) files a voluntary petition in bankruptcy; (iii) is adjudicated bankrupt or insolvent; [or] (iv) files a petition or answer seeking for himself any reorganization . . . or similar relief under any statute, law or regulation . . .

*Id.*

<sup>265</sup> *Summit Inv. & Dev. Corp. v. Leroux (In re LeRoux)*, 167 B.R. 318, 321 (Bankr. D. Mass. 1994), *aff'd*, 69 F.3d 608 (1st Cir. 1995) (explaining "*Curran* and *LeRoux's* status as debtors in possession exempts them from the restrictions of [section 365(c)(1)]. A debtor in possession can assume and perform a personal service contract notwithstanding that such contract is otherwise barred from assumption and assignment by a trustee under applicable law.").

<sup>266</sup> *In re LeRoux*, 167 B.R. at 322 (paralleling section 365(e)(2)(A) analysis with section 365(c) analysis).

<sup>267</sup> *Summit Inv. & Dev. Corp.*, 69 F.3d at 613 ("[S]ection 365(c)[1] presents no bar to [the] assumption of the Agreement.").

the Bankruptcy Code because the Bankruptcy Amendments and Federal Judgeship Act of 1984 did not make any changes to the language of section 365(e)(2)(A) of the Bankruptcy Code.<sup>268</sup> Given the interrelated concerns addressed by sections 365(c)(1) and 365(e)(2), however, the First Circuit found that "Congress contemplated in 1984 that section 365(e)(2) would permit a debtor or a debtor in possession to avoid automatic termination of his executory contract rights under the section 365(e)(2)(A) exemption."<sup>269</sup> Accordingly, the First Circuit adopted the actual test and found the *ipso facto* clause invalid under section 365(e)(1).<sup>270</sup>

The extent to which a court will enforce an *ipso facto* provision under section 365(e)(2) of the Bankruptcy Code largely depends upon whether the court would permit the debtor to assume the contract notwithstanding the existence of applicable nonbankruptcy law restricting the assignment of the contract. If a nondebtor is confident that binding precedent requires the application of the hypothetical test under section 365(c)(1) of the Bankruptcy Code, then the nondebtor also should be fairly confident that an *ipso facto* clause in the contract in question will be given effect under section 365(e)(2) of the Bankruptcy Code. This conclusion, however, does not relieve the nondebtor of its obligation to seek relief from the automatic stay because even the enforcement of a valid *ipso facto* clause generally requires such relief.<sup>271</sup>

#### V. PRACTICE TIPS RELATING TO SECTION 365(c)(1) OF THE BANKRUPTCY CODE

Given the importance that a particular contract or lease may have to a debtor's or a nondebtor party's business, it is crucial for parties to consider the implications and consequences of section 365(c)(1) of the Bankruptcy Code early in the process—perhaps even as early as the initial negotiating and drafting stage of the contractual relationship. Depending upon the particular party's perspective and

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<sup>268</sup> *Id.* (recognizing implications of legislative history by noting "Congress inexplicably chose, in 1984, not to alter the corresponding language in section 365(e)(2)(A)."); see 3 COLLIER ON BANKRUPTCY ¶ 365.07[2], at 69 (Lawrence P. King et al. eds., 15th ed. Rev. 1997) ("[W]hen the language of section 365(c) was amended to describe contracts under which the other party would not be required to accept performance from an entity other than 'the debtor or the debtor in possession,' section 365(e)(2) was not similarly amended.").

<sup>269</sup> *Summit Inv. & Dev. Corp.*, 69 F.3d at 613.

<sup>270</sup> *Id.* at 614 ("[W]e hold that section 365(e), in the circumstances of this case, preempts enforcement of the *ipso facto* termination provisions in Section 7.5E of the Agreement and in MLPA section 23(4).").

<sup>271</sup> See, e.g., *Computer Communications v. Codex Corp.* (*In re Computer Communications, Inc.*), 824 F.2d 725, 730 (9th Cir. 1987) ("[W]e hold that even if § 365(e)(2) allowed Codex to terminate the contract, § 362 automatically stayed termination."); *Wegner Farms Co. v. Merchants Bonding Co.* (*In re Wegner Farms Co.*), 49 B.R. 440, 444 (Bankr. N.D. Iowa 1985) ("Having accepted Merchants 365(e) argument, the Court must nonetheless reject its contention that right of termination necessarily propels cancellation of the bonding agreement outside the orbit of the automatic stay."); see also *Edwards Mobile Home Sales, Inc. v. Ohio Cas. Ins. Co.* (*In re Edwards Mobile Home Sales, Inc.*), 119 B.R. 857, 860 (Bankr. M.D. Fla. 1990) (agreeing with *Computer Communications* and *Wegner* holdings, finding "Ohio Casualty may not terminate the surety bond without first obtaining relief from the automatic stay," and concluding section 365(e)(2) does not exempt non-assumable executory contracts from scope of automatic stay).

goals, as well as the nature of the relationship, this may mean requesting or resisting language in a contract or lease reflecting the personal nature of the contract or specifically acknowledging that the contract or lease is subject to section 365(c)(1) of the Bankruptcy Code. If a potential debtor cannot successfully resist this type of language, this also may mean a request by the potential debtor to include an acknowledgment in the contract or lease that the nondebtor contract party expressly consents to the assumption of the contract by the potential debtor in any bankruptcy or insolvency proceeding. These and a few additional tips for mitigating the effects of, or utilizing, section 365(c)(1) of the Bankruptcy Code are set forth below.

### A. *Tips for Potential Debtors*

Perhaps the most important tip for a potential debtor is to be proactive regarding any issues relating to section 365(c)(1) of the Bankruptcy Code. Specifically, any entity considering filing for bankruptcy protection should, prior to making such decision, take an inventory of, and evaluate, its material executory contracts and unexpired leases. Through this review process, a potential debtor should (1) identify any material executory contracts or unexpired leases that arguably qualify as section 365(c)(1) contracts and (2) develop a game plan for addressing these contracts and leases. Depending upon, among other things, the importance of the contract or lease and the relationship between the contracting parties, a potential debtor's game plan may vary. For example, if the potential debtor's business hinges on the continued performance of the particular contract or lease, the debtor may choose to be proactive with the nondebtor contract party. Proactive steps may include: (1) executing a confidentiality agreement with the nondebtor contract party (if the contract or lease itself does not contain a satisfactory confidentiality provision); (2) explaining the debtor's potential need to file a bankruptcy case; (3) outlining the debtor's intentions with respect to the particular contract or lease in any such bankruptcy case; and (4) requesting the nondebtor contract party's consent to the assumption or assumption and assignment of the contract or lease in any such bankruptcy case.<sup>272</sup> The nondebtor contract party most likely will want something in exchange for any pre-bankruptcy consent, and it may be easier to obtain consent only to assumption, rather than to assumption and assignment, of the contract or lease.<sup>273</sup> Nevertheless, if the potential debtor truly is dealing with a contract or lease

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<sup>272</sup> At least two courts have held that such consent in the contract or lease itself prohibits the nondebtor contract party from later using section 365(c)(1) of the Bankruptcy Code to block a debtor's assumption or assignment of the contract or lease. See *Metro. Airports Comm'n v. Northwest Airlines, Inc.* (*In re Midway Airlines, Inc.*), 6 F.3d 492, 496 (7th Cir. 1993) (upholding contract provision, in light of section 365, allowing lease to be assigned if Midway enters bankruptcy); *In re Supernatural Foods, L.L.C.*, 268 B.R. 759, 804 (Bankr. M.D. La. 2001) (finding section 365(c)(1) of Bankruptcy Code inapplicable where license agreement permitted assignment incident to liquidation or sale of substantially all of debtor's assets); see also *In re Sunterra Corp.*, 361 F.3d 257, 271 (4th Cir. 2004) (stating language of agreement is relevant to whether section 365(c)(1) of Bankruptcy Code precludes debtor from assuming and assigning agreement).

<sup>273</sup> One such request may be an acknowledgment in the contract or lease that the debtor will assume the contract or lease in any bankruptcy case. As a general rule, however, prebankruptcy waivers of bankruptcy

critical to its business operations, this pre-bankruptcy negotiation and agreement may be an extremely worthwhile exercise.

If, on the other hand, the contracts or leases arguably subject to section 365(c)(1) of the Bankruptcy Code are not critical to the debtor's business operations or the relationship between the contracting parties makes it difficult to approach the nondebtor party prior to any bankruptcy filing, the potential debtor's game plan should include a thorough legal evaluation of these contracts or leases so that the debtor is prepared for (and not surprised by) any issues relating to section 365(c)(1) of the Bankruptcy Code raised in the bankruptcy case. For example, if a potential debtor is contemplating a straight reorganization under chapter 11 of the Bankruptcy Code and does not anticipate a sale of assets, determining that the debtor is filing in a jurisdiction applying the actual test (as opposed to the hypothetical test) under section 365(c)(1) of the Bankruptcy Code may give the debtor sufficient comfort.<sup>274</sup> Likewise, determining that the debtor has arguments against the characterization of the particular contracts or leases as nondelegable or nonassignable under "applicable law" (as that phrase is used in section 365(c)(1) and interpreted in the particular filing jurisdiction) may arm the debtor with sufficient ammunition to eliminate or at least mitigate any concerns relating to section 365(c)(1).<sup>275</sup> A contract or lease arguably is subject to

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rights are unenforceable. See *Hayhoe v. Cole (In re Cole)*, 226 B.R. 647, 652 n.7 (B.A.P. 9th Cir. 1998) ("[C]ourts have held that prepetition waivers of other bankruptcy benefits are also enforceable."); *Fallick v. Kehr*, 369 F.2d 899, 904 (2d Cir. 1966) (stating in dictum advance agreements to waive benefits of bankruptcy are void); *In re Trans World Airlines, Inc.*, 261 B.R. 103, 114 (Bankr. D. Del. 2001) (finding debtor's pre-petition agreement not to reject or to assume executory contract violates public policy for binding debtors in possession without regard to third parties and bankruptcy estate); *In re Am. Sweeteners, Inc.*, 248 B.R. 271, 276 n.6 (Bankr. E.D. Pa. 2000) ("I note that many courts have held that prepetition a debtor cannot waive the rights bestowed upon it by the Bankruptcy Code."); *In re Heward Bros.*, 210 B.R. 475, 479 (Bankr. D. Idaho 1997) ("Generally, a prepetition agreement to waive a benefit of bankruptcy is void as against public policy."); *In re Pease*, 195 B.R. 431, 433 (Bankr. D. Neb. 1996) ("[B]efore the bankruptcy case is filed, the debtor does not have the capacity to waive the rights bestowed by the Bankruptcy Code upon a Chapter 11 debtor in possession."); *In re Tru Block Concrete Prods., Inc.*, 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983) ("It is a well settled principal that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy."). *But see, e.g., In re S. E. Fin. Assocs.*, 212 B.R. 1003, 1005 (Bankr. M.D. Fla. 1997) ("A prepetition waiver of bankruptcy benefits may be binding unless the agreement was obtained by coercion, fraud or mutual mistake of material fact."); *In re Atrium High Point Ltd. P'ship*, 189 B.R. 599, 607 (Bankr. M.D.N.C. 1995) ("[T]his court elieves that such prepetition waivers enforceable in appropriate cases."); *In re Powers*, 170 B.R. 480, 483 (Bankr. D. Mass. 1994) ("I agree that pre-petition agreements waiving opposition to relief from the automatic stay may be enforceable in appropriate cases."); *In re Citadel Props., Inc.*, 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988) (enforcing settlement agreement entered into pre-petition which gave creditor immediate relief from automatic stay if debtor filed for bankruptcy). In addition, debtors generally resist such requests in order to maintain maximum flexibility regarding the treatment of their contracts and leases in any bankruptcy case. Alternatively, the nondebtor party may request substantive changes to the contract terms—particularly, payment or default terms (e.g., cash in advance, shortened grace periods upon default, right to suspend performance or to terminate upon default, etc.)—to obtain additional protection in any bankruptcy case.

<sup>274</sup> See cases cited *supra* note 196.

<sup>275</sup> For example, as discussed in Sections III.B.4 and III.B.5 above, neither the Anti-Assignment Act nor state laws that restrict the ability of a franchisee to assign a franchise or interest therein are based upon the "personal" nature of the contract or the materiality of the identity of the performing party. Accordingly, in

section 365(c)(1) only if the debtor otherwise seeks to assume or assume and assign the contract or lease under sections 365(a) and 365(f) of the Bankruptcy Code or if the nondebtor contract party seeks to force rejection of the contract or lease under section 365(c)(1).<sup>276</sup>

In addition, a startup entity or any entity that anticipates future financial issues should be diligent in the negotiation and drafting of any new (or amendments to existing) material contracts or leases. Particularly in the context of intellectual property licenses, it is not uncommon for a party to request language in the contract acknowledging that the contract is "personal" in nature, dependent upon the identity of the contracting parties or, even more directly, subject to section 365(c)(1) of the Bankruptcy Code. More subtle language requests intended to address section 365(c)(1) may include a reference to a particular federal or state law intended to govern the contract or lease, which law arguably draws the contract or lease under section 365(c)(1). If the potential debtor does not have a concern regarding the other party's financial condition,<sup>277</sup> the potential debtor should resist this type of language or, at a minimum, request the other party's consent to the assumption of the contract or lease by the debtor itself and, perhaps, even the assumption and assignment of the contract or lease to a third party. In addition, if the contract or lease is not or is not intended by the parties to be personal in nature, the potential debtor should include language in the contract reflecting this reality. For example, the contract should contain objective performance targets and expressly provide (in the recitals or covenants) that the contract is a standard supply contract for widgets and that, if the potential debtor is unable to perform, it may substitute the performance of another widget supplier, delegate its obligations or otherwise assign the contract.<sup>278</sup>

Finally, if appropriate, based upon the nature of the contract or lease, a potential debtor could seek to take a security interest in the subject matter of the contract or lease.<sup>279</sup> This security interest should be established to secure the other party's

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jurisdictions that consider whether the identity of the performing party is material in determining whether section 365(c)(1) of the Bankruptcy Code applies, a debtor may have arguments against the characterization of, at least, government contracts and franchise agreements as being subject to section 365(c)(1) of the Bankruptcy Code.

<sup>276</sup> As discussed above in Section V.A, the debtor in *Valley Media* was permitted to retain its rights under distribution agreements during the pendency of the bankruptcy even though the debtor could not assume or assign the distribution agreements.

<sup>277</sup> If the potential debtor does have concerns regarding the other party's financial condition and desires to protect its section 365(c)(1) rights in any bankruptcy of such party, the potential debtor should consider negotiating a mutual version of the contract provisions suggested below for nondebtor contract parties. See *infra* text accompanying note 279 (offering ways nondebtor parties can protect interests when contracting with entities in precarious financial situations).

<sup>278</sup> See *infra* text accompanying note 279 (noting, after suggesting ways nondebtor can protect its interests, courts may decline to give weight to contract language).

<sup>279</sup> This strategy may be particularly effective in the context of intellectual property licenses. For a general discussion of the mechanics for taking a security interest in intellectual property subject to a license agreement and some related issues, see generally Cieri & Morgan, *supra* note 99, at 1691-97 (reviewing ways to enhance leverage in bankruptcy, to structure security agreements, to draft covenants and to perfect security interests). In addition, rather than taking a security interest in the subject matter of the contract or

performance under the contract or lease, and the potential debtor should obtain rights to exercise and foreclose on the security interest in the event that, among other things, the nondebtor party refuses performance, including through the unreasonable withholding of consent to any continued performance by the debtor (and potentially the assignment by the debtor to a third party). This, of course, may be the most challenging provision for a potential debtor to negotiate; however, if obtained, it may act as an effective deterrent to the nondebtor contract party raising any issues relating to section 365(c)(1) in any subsequent bankruptcy case because the nondebtor contract party may risk losing all of its rights in the subject matter of the contract or lease.

### *B. Tips for Nondebtor Contract Parties*

Similar to the discussion above for a potential debtor, nondebtor parties that are party to (or considering becoming party to) contracts with financially troubled entities (*i.e.*, potential debtors) should be proactive in the protection and utilization of their rights under section 365(c)(1) of the Bankruptcy Code. For example, prior to a bankruptcy filing, nondebtor parties should carefully consider the language of their contracts and, if the contract is or is intended by the parties to be personal in nature, the contract language should reflect this reality. For example, the contract should describe (in the recitals or covenants) the subjective factors considered by the parties in entering into the agreement (*e.g.*, the particular qualifications of the potential debtor, the nondebtor party's reliance on the potential debtor's qualifications, the nondebtor party's need for a specialized service or widget and the potential debtor's unique ability to provide such service or widget, etc.) and expressly provide that the potential debtor may not substitute the services or product of a third party and, of course, may not assign or delegate its obligations under the contract to a third party. There is no "magic" language in this context, and a bankruptcy court, being a court of equity, may decline to give substantial weight to the contract language (for example, finding such language to be an impermissible prebankruptcy waiver or as elevating form over substance).<sup>280</sup> If nothing else, however, tailoring the language of the contract to reflect the true nature of the contractual relationship may assist the nondebtor party in satisfying its evidentiary burden at any hearing before the bankruptcy court or, at least, enhance the nondebtor party's leverage in any negotiations with the debtor (or its creditors' committee) regarding treatment of the contract or lease in the bankruptcy.

In addition, the contract or lease should give the nondebtor party the specific right to terminate the contract or lease upon the filing of a voluntary or involuntary

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lease, the potential debtor could attempt to secure the nondebtor party's continued performance and/or consent through a guarantee or letter of credit. As with the grant of a security interest, the potential debtor must be careful in drafting the events triggering its collection rights under any guarantee or letter of credit, and such events should include a refusal by the nondebtor party to consent or perform under the contract or lease.

<sup>280</sup> See general discussion and cases cited *supra* note 273.

bankruptcy by or against the potential debtor, the insolvency of the potential debtor or any other material adverse change with respect to the potential debtor's financial condition. As discussed above, these "*ipso facto*" clauses generally are enforceable if the contract or lease is subject to section 365(c)(1) of the Bankruptcy Code.<sup>281</sup> Moreover, the nondebtor party may want to include financial reporting or notice provisions in the contract or lease, which would require the potential debtor to provide the nondebtor party with periodic financial reports or notice of any material adverse change, such as a bankruptcy filing. These types of provisions will allow the nondebtor party to monitor the potential debtor's financial condition and take immediate action when necessary or appropriate.

Once a bankruptcy case is filed by or against the potential debtor, the nondebtor party should be proactive in the enforcement of its rights under the contract or lease and sections 365(c)(1) and 365(e)(2) of the Bankruptcy Code. Specifically, if the nondebtor party desires to terminate the contract or lease because of the bankruptcy filing (and based upon an *ipso facto* clause in the contract or lease), the nondebtor party should file a motion for relief from the automatic stay to exercise its rights under section 365(e)(2) of the Bankruptcy Code as soon as it receives notice of the bankruptcy filing.<sup>282</sup> Any delay in taking such action may be argued as a waiver or estoppel by the debtor, since the termination right arguably is linked to the filing of the bankruptcy case itself. Likewise, if the nondebtor party elects not to terminate the contract or lease immediately upon the bankruptcy filing, it should stay apprised of events in the bankruptcy case to ensure that the debtor does not seek to assume or assume and assign the contract or lease pursuant to sections 365(a) and 365(f) of the Bankruptcy Code. Absent a timely objection to any such treatment by the nondebtor party under section 365(c)(1) of the Bankruptcy Code, the bankruptcy court may enter an order authorizing the assumption or assumption and assignment of the contract or lease.

Finally, the nondebtor party should resist any attempt by the debtor to take a security interest in the subject matter of the contract or lease, to obtain consent to the assignment (even limited assignment) of the contract or lease and, depending upon the goals of the nondebtor party, perhaps even to obtain consent to the assumption or continued performance of the contract or lease by the debtor itself.<sup>283</sup> As discussed above, these types of contract provisions may eliminate or restrict the nondebtor party's rights under section 365(c)(1) (and, in turn, section 365(e)(2)) of the Bankruptcy Code.

## CONCLUSION

Although not a new provision in the Bankruptcy Code, the impact of section 365(c)(1) of the Bankruptcy Code clearly is gaining momentum vis-à-vis

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<sup>281</sup> See *supra* Section IV.B.

<sup>282</sup> See *supra* Section IV.A.

<sup>283</sup> See *supra* notes 271–72 and accompanying text.



protection of nondebtor contract parties, and the expanding application of the section therefore may have unexpected and adverse consequences for debtors. Accordingly, contracting parties need to be aware of the current scope and application of section 365(c)(1) of the Bankruptcy Code and to plan accordingly. In fact, the best advice for either the potential debtor or the nondebtor contract party is to be proactive—make sure you understand your rights under section 365(c)(1) (and section 365(e)(2)) of the Bankruptcy Code and take timely steps to protect those rights.

