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Advising Businesses on Bankruptcy

Section 7

CHARTING THE ROAD FORWARD—REPRESENTING CREDITORS AND OTHER PARTIES IN INTEREST CONTRACT PARTY ISSUES

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I. EXECUTORY CONTRACTS IN BANKRUPTCY

The Bankruptcy Code ("Code") contains special provisions regarding executory contracts. Although there is no definition of an executory contract in the Code, it is generally regarded as a contract on which performance is due to some extent on both sides. A contract that has been terminated or that has expired before the commencement of a bankruptcy case is not executory.

Under section 365 of the Code and with court approval, a debtor may: (i) reject an executory contract; (ii) assume an executory contract; or (iii) in a Chapter 11 proceeding, if the debtor neither rejects nor assumes an contract, let the contract "ride through" the reorganization and leave the rights of the parties thereunder unchanged upon the emergence of the debtor from Chapter 11. With limited exceptions and subject to certain requirements, the debtor may assume any executory contract even though the debtor is, at the time, in default under such contract. Upon assumption, the agreement is in full force and effect and binding on the debtor as well as on the non debtor; a debtor who assumes a contract receives not only the benefits of the contract, but also must undertake any burden or obligations under the contract. Furthermore, after assumption the Code allows a debtor to assign the contract in certain instances.

A. Assumption

The Code provides no specific statutory requirements for assuming a contract where the debtor is not in default, other than the requirement of court approval. Where there is a default, however, the debtor must provide the non debtor with adequate assurance that it will (i) promptly cure the default; (ii) promptly compensate the non debtor for any actual pecuniary loss resulting from the default; and (iii) perform its future obligations to the non debtor under the contract. The adequacy of these assurances is governed by the standard of commercial reasonableness, and thus the debtor does not

have to make a showing of absolute certainty that its performance will always be satisfied to the non debtor.

1. Curing the Default

The debtor may cure defaults under an executory contract by rendering all performances then due under the contract. There are certain defaults, however, that the debtor need not cure for it to assume the contract. Defaults arising from a breach of a contractual provision relating to the commencement of a bankruptcy case, the appointment of a bankruptcy trustee or the insolvency or financial condition of the debtor at any time prior to the closing of the case need not be cured for the debtor to assume the contract or release. Although the Code does not specify the types of contract provisions which relate to the "financial condition" of the debtor, essentially default provisions based on a debtor's profits or revenues are likely to be considered provisions related to the debtor's financial condition. Contract provisions creating defaults solely because of the debtor's insolvency are unenforceable under the Code. Often, the financial circumstances leading to the bankruptcy preclude the debtor from being able to cure defaults by rendering performance. Consequently, the debtor may defer its cure but must provide adequate assurance of its future ability to effect the cure. The Code contains no standards for determining what constitutes adequate assurance of prompt cure, and therefore a "prompt cure" will depend on the circumstances of each case.

2. Compensate for Actual Pecuniary Loss

The debtor must also provide adequate assurance that it will compensate the non debtor for any actual pecuniary loss resulting from defaults under the contract in order to assume that contract. Generally, the case law suggests that the debtor's cure of defaults in most instances moot any claim for actual pecuniary loss.

3. Adequate Assurance of Future Performance

Finally, in order to assume a contact the debtor must provide adequate assurance of future performance thereunder. A court's determination of whether a debtor has complied with this requirement may be based upon, among other things, whether the debtor's financial data indicates its ability to generate an income stream sufficient to meet its obligations, the general economic outlook in the debtor's industry, and the presence of a third party guaranty. The words "adequate assurance" are to be given a practical construction and a determination of what consti-

tutes adequate assurance of future performance is determined under the facts of each particular case.

B. Assignment

Under the Code, the debtor has the authority to assume and then assign an executory contract. Generally, anti-assignment clauses in executory contracts are not enforceable. Except as discussed below, the debtor is free to assign a contract if it cures prior defaults and compensates the non debtor for pecuniary losses, and the assignee provides adequate assurance of future performance under the contract. Upon assignment, the debtor has no further obligation under the agreement.

C. Executory Contracts in Limbo

Until an executory contract is assumed or rejected, it is not enforceable against the debtor. The debtor may, however, elect to receive benefits under the agreement and require the non-debtor to perform contracts that are otherwise in limbo pending assumption or rejection. During this limbo period, the non-debtor is entitled to payment for the value of its performance to the debtor, and such claims for payment are entitled to administrative priority status (that is, such claims must be paid in full prior to any payment of prepetition unsecured claims).

The non-debtor can take several steps to ameliorate any adverse effects which might result during the period the contract is in limbo pending the debtor's decision to assume or reject. It can request that the court order the debtor to assume or reject the agreement within a specified time period. The general rule, however, is that the debtor should have a reasonable time in which to make its decision regarding assumption or rejection. Also, the nondebtor may ask the court to order the debtor to comply with parts of the agreement, the noncompliance of which would unfairly prejudice the non-debtor party.

II. SPECIAL RULES FOR IP LICENSES

The general rules regarding assumption and assignments are subject to one provision that has had significant importance to the determination of IP rights in bankruptcy. Specifically, Section 365(c)(1) of the Code recognizes that certain types of contracts should not be subject to assumption and assignment over a licensor's objection when applicable nonbankruptcy law excuses the nondebtor from accepting performance. The classic example of a contract that is not subject to assumption and assignment is a personal services contract. State law al-

lows a nondebtor to refuse acceptance of performance from anybody other than the original contracting party – and the Code honors that result. Litigation has occurred over what other type of law excuses acceptance of performance. The law seems well settled that a non-exclusive patent or copyright license agreement may not be assigned by the debtor licensee without the consent of the licensor unless the license itself permits such assignment. See Everex Systems, Inc. v. Cedtrak Corp., 89 F.3d 673 (9th Cir. 1996); In re Education Media, Inc., 210 B.R. 237 (Bankr. S.D.N.Y. 1997).

Special bankruptcy rules also apply to protect the rights of a licensee of a debtor licensor. Specifically, the application of the general rules of Section 365 had devastating consequences to an IP licensee in Lubrizol Enterprises v. Richmond Metal Finishers, 756 F.2d 1043 (4th Cir. 1985), cert. denied, 106 S.Ct. 1284 (1986). In that case, the debtor owned a unique metal coating process. Prepetition, it granted a non-exclusive license to Lubrizol Enterprises to use the process. One year after entering into the license agreement, the debtor filed for bankruptcy protection and sought to reject the license agreement. The Fourth Circuit concluded that the license agreement was executory as to both parties and could be rejected by the debtor. The rejection stripped Lubrizol of all of its rights to the licensed technology and left it with a claim for damages against the estate. In the concluding paragraph of its opinion, the Fourth Circuit noted that its decision would impose a serious burden on Lubrizol and could have a chilling effect upon the willingness of parties to enter into a licensing agreement with a business in possible financial difficulty. Nevertheless, the Fourth Circuit thought that it was up to Congress, not the judiciary, to remedy the situation.

In true democratic fashion, Lubrizol and other licensees appealed to Congress to remedy the situation. In response, Congress passed the Intellectual Property Bankruptcy Protection Act in 1988, which added a definition of "Intellectual Property" to Section 101 of the Bankruptcy Code and also a new section (n) to Section 365 governing executory contracts. "Intellectual property" is defined to mean the following:

- trade secret;
- invention, process, design, or plant protected under Title 35 [The Patent Act];
- patent application;
- plant variety;
- work of authorship under title 17 [The Copyright Act]; or

- mask work protected under Chapter 9 of Title 17; to the extent protected by applicable nonbankruptcy law.

11 U.S.C. § 101(35A).

Section 365(n) provides two options for a licensee under an IP license in the event that the licensor files for bankruptcy and rejects the license in its bankruptcy case. First, the licensee may treat the license as terminated and file a general unsecured claim against the bankruptcy estate for breach of contract damages, in which case it will forfeit all rights to continued use of the intellectual property relating to the license.

Alternatively, the licensee may opt to retain its rights under the license to the technology, including rights of exclusivity, and under any agreement supplementary to the license. The licensee may retain these rights for the initial term of the contract as well as for any optional extension periods available at the licensee's discretion, but must continue to pay all royalties due the licensor. The licensee is deemed to waive any rights of setoff it may have against the licensor as well as any administrative claims against the estate that it might have. Rejection relieves the debtor licensor of any burdens to take on any additional affirmative action pursuant to the license, such as training of licensee users or updating the intellectual property.

Two limitations on the scope of Section 365(n) must be emphasized: (1) the definition of "intellectual property" does not include trade marks and trade names and (2) the section does not address what happens when a licensee files for bankruptcy protection. In the latter case, the general rules concerning rejection, assumption and assignment will apply.

IP Licensors should protect themselves in two ways from pain caused by a bankruptcy license. Well ahead of any licensee bankruptcy filing, a licensor should ensure that the license agreement is drafted to provide maximum protection. If and when a bankruptcy occurs, the licensor should take immediate action.

Licensors should consider the following when drafting a license.

> Ensure that the license arrangement will be construed as an executory contract. As noted above, an executory contract is one in which performance remains due on both sides. If the licensee has no continuing obligation under the license, a bankruptcy court may conclude that the document created an absolute transfer or rights.
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> The licensee should contain an acknowledgment of the parties' intent that the license be considered executory and should

state the reasons why. Ongoing obligations such as maintenance of confidentiality and reporting will help prevent the licensee from claiming an outright ownership right, especially in an exclusive license. If an exclusive license must be granted, obtain a security interest in the licensee's interest.

Prohibit or limit assignment by the licensee to third parties. The Bankruptcy Code prohibits enforcement by the non-debtor of most so-called anti-assignment clauses in contracts. Yet these clauses in software licenses can be enforced by the non debtor licensor.

When drafting the license, prohibit assignment or limit it to specific conditions to demonstrate why a particular licensee was approved to receive the license. Include also a provision that upon an acquisition or change in control, the license is automatically terminated.

Expand termination rights. The right to terminate on account of bankruptcy filing is also generally unenforceable in bankruptcy. Licensors should enhance termination clauses to include other measures of impending financial difficulty such as the departure of key executives or the licensee's failure to meet certain milestones.

Limit term. A licensee is able to assume and assign only those executory contracts in effect as of the petition date. Annual automatic renewal clauses, unless notice of non-renewal has been given, are one way to limit term.

III. DOING BUSINESS WITH A CHAPTER 11 DEBTOR

A creditor that has entered into an ongoing contract or agreement with a customer that subsequently files for Chapter 11 relief may not elect to refuse to perform merely because of the customer's bankruptcy filing. As discussed above, the Bankruptcy Code contains provisions which give a Chapter 11 debtor or bankruptcy trustee the ability to exercise certain powers with respect to outstanding contracts that the debtor entered into before filing for bankruptcy. If a creditor unilaterally attempts to terminate the contract before the Chapter 11 debtor or trustee has had an opportunity to exercise its powers, the creditor may be deemed to have acted in violation of the automatic stay. Instead, a creditor

seeking to terminate or discontinue its performance under a contract may need to take appropriate steps to bring the matter before the bankruptcy court.

In some cases, a Chapter 11 debtor may be unable or unwilling to purchase goods on a "cash-on-delivery" basis and, instead, will request that the creditor continue selling goods or product to it on open credit. While a creditor is generally free to comply with such a request, it should do so only after carefully considering the risks involved in continuing to extend credit to a customer in bankruptcy. It is important to remember that the fact that a Chapter 11 debtor is operating under the supervision of the bankruptcy court does not in any way guarantee vendors and other parties transacting business with the debtor that they will ultimately receive payment.

If a Chapter 11 debtor fails to pay for goods supplied by a trade creditor during the Chapter 11 proceeding, the trade creditor will generally be entitled to an "administrative priority claim" for the price or value of the goods. Administrative priority claims have priority over unsecured, pre-petition claims and ordinarily must be paid in full in order for a Chapter 11 debtor to obtain confirmation of a Chapter 11 plan. The payment of administrative priority claims, however, is not required to occur until the "Effective Date" of the Chapter 11 plan. Some Chapter 11 cases end up "administratively insolvent," meaning that the assets remaining in the bankruptcy estate after taking into account the claims of the debtor's secured creditors are insufficient to pay administrative priority claims in full. Similarly, Chapter 11 cases are often converted to Chapter 7 when it becomes apparent that the debtor cannot reorganize. In such circumstances, administrative priority claims arising during the Chapter 7 proceeding have priority over and must be paid in full before there is any distribution to those parties holding Chapter 11 administrative priority claims.