

NATIONAL BANKRUPTCY CONFERENCE

*A Voluntary Organization Composed of Persons Interested in the
Improvement of the Bankruptcy Code and Its Administration*

March 11, 2010

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SHARJ A. BEDKER

The Honorable Steve King
Subcommittee on Commercial and Administrative Law
United States House of Representatives
Washington, DC 20515

Re: Proposal to Amend Section 365 of the Bankruptcy Code

Dear Mr. King:

Today, the ability of businesses to reorganize and preserve jobs and investments can be seriously impaired because, according to several federal Courts of Appeals and numerous lower courts, they are not permitted to assume, without the other party's consent, executory contracts that are not assignable as a matter of nonbankruptcy law. The most prominent instances of this problem occur when the debtor is the licensee of a non-exclusive intellectual property license that is a fundamental element of the debtor's business. For example, in *RCI Technology Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004), Sunterra was not permitted to assume – and therefore continue to use in accordance with its terms – its RCI software license, even though Sunterra had invested millions of dollars in permitted enhancements and modifications to the software and the software was critical to its operations.

Recognizing this problem, the National Bankruptcy Conference (NBC)¹ has studied the current situation and now recommends the amendments to sections 365(c) and (e) of the Bankruptcy Code set forth in the attached proposal.

Some general background may be helpful. Assumption is the process by which a debtor or bankruptcy trustee on behalf of a debtor accepts responsibility for full performance under a prepetition contract so that it binds the bankruptcy estate, the reorganized debtor and the non-debtor contracting party. By contrast, assignment is the process by which a debtor or bankruptcy trustee conveys to a third party all of the debtor's rights and obligations under a prepetition contract so that it becomes a contract between the assignee and the non-debtor contracting party. Both assumption and assignment require court approval, after a hearing on notice to the non-debtor contracting party and other parties in interest.

¹ The NBC is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and judges who are leading scholars and practitioners in the field of bankruptcy law. For approximately 70 years, the NBC's primary purpose has been and is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws. A fact sheet describing the Conference and a list of its current members is enclosed.

In general, section 365 of the Bankruptcy Code permits a debtor to retain (that is, assume) its contracts so that it can continue to operate, or to assign its contracts, for example, as part of a going-concern sale of the business to a new operator. Section 365(c)(1) imposes a limitation by providing, in substance, that a contract may not be either assumed or assigned, regardless of whether the contract prohibits the assignment of rights or delegation of duties, if: (i) “applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession”; and (ii) the non-debtor party to such a contract does not consent to the assumption or assignment. This limitation applies to contracts that, without regard to specific contractual anti-assignment provisions, cannot be assigned under applicable non-bankruptcy law to a party with which the non-debtor party did not contract, without the consent of the non-debtor party. Some examples are personal services contracts, non-exclusive copyright and patent licenses, trademark licenses, partnership agreements, limited liability company governance agreements and government contracts.

The problem that arises in the context of business reorganization cases is that section 365(c)(1) has been read to prevent not just assignment of such a contract to a third party, but also the assumption (or retention) of such a contract by the debtor itself – the very party with which the non-debtor party contracted. It is reasonable to protect the non-debtor party to such a contract from being forced to perform for or receive performance from a party with which it did not choose to contract, such as a third party assignee. The proposed amendments would not change the law in this regard. However, it is a very different matter – and inherently illogical – to excuse the non-debtor party to a contract from its contractual relationship with the debtor itself simply because the debtor has filed a bankruptcy case.²

In fact, section 365(c)(1) was amended in 1986, supposedly to address this problem. However, the language used was awkward and a number of courts, including the Third, Fourth and Ninth Circuit Courts of Appeals, have read section 365(c)(1) as prohibiting the debtor’s assumption of non-assignable contracts. See *In re Sunterra Corp.* (described above) (non-exclusive software license); *Perlman v. Catapult Entertainment (In re Catapult Entertainment)*, 165 F.3d 747 (9th Cir. 1999) (non-exclusive patent license); *In re West Electronics, Inc.*, 852 F.2d 79 (3d Cir. 1988) (government contract).³

² The Bankruptcy Code provides other protections to the non-debtor contracting party whose contract is assumed. For example, as set forth in section 365(b), if the contract to be assumed is in default, the default must be cured, actual pecuniary loss resulting from the default must be compensated, and adequate assurance of future performance must be provided.

³ Not all courts agree with this interpretation, including the First Circuit Court of Appeals (see *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 492 (1st Cir. 1997)) and a number of bankruptcy courts. Two Supreme Court Justices (Justice Anthony Kennedy and Justice Stephen Breyer) recently stated, in connection with the denial of a petition for certiorari, that the proper interpretation of section 365(c)(2) is ripe for review by the Supreme Court, although they concluded that the case before them did not adequately present the issue to the Court. See *N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc.*, 129 S. Ct. 1577 (2009).

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Thus, a business that seeks to reorganize through bankruptcy is currently at risk of losing valuable rights under intellectual property licenses, partnership and limited liability company agreements and other types of contracts that generally cannot be assigned under applicable non-bankruptcy law – simply because it filed a bankruptcy case – even if the debtor reorganizes under a plan and no attempt is made to assign the contract to a third party.

The NBC believes that this is a serious and unnecessary impediment to the reorganization process. It penalizes other stakeholders for the unwarranted benefit of non-debtor parties to such contracts, which can extract unjustifiable compensation for consenting to the assumption of their contracts by the very party (the debtor) with which they chose to contract.

We encourage you to review the attached statutory amendments the NBC proposes to section 365(c)(1) and to its companion, section 365(e)(2), which include explanatory notes. The members of our Committee on Chapter 11 and the members of our Drafting Committee are available and would be pleased to discuss this proposal with you or members of your staff. Please contact me by telephone at (213) 896-6024 or by email at sneely@sidley.com if you would like any further information.

Sincerely,

Sally S. Neely
Chair, Committee on Legislation

Attachment and Enclosure

National Bankruptcy Conference

Proposed Amendments to Section 365(c) and (e)
of the Bankruptcy Code

(c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if –

- (1) (A) with respect to a proposed assignment under subsection (f) or under a plan, or, in a case in which the debtor is an individual, a proposed assumption by the trustee and not by a debtor in possession, applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
- (B) such party does not consent to such assumption or assignment; or

* * *

(e) (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) in a chapter 7 case in which the debtor is an individual, or a chapter 11 case in which the debtor is an individual and is not a debtor in possession, 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

....

Explanation of Proposed Amendments to Section 365(c)

- (1) The National Bankruptcy Conference voted to amend section 365 to overrule cases such as *Perlman v. Catapult Entertainment (In re Catapult Entertainment)*, 165 F.3d 747 (9th Cir.), cert. dismissed, 120 S. Ct. 369 (1999), in which the Ninth Circuit applied the “hypothetical” test under section 365(c) to preclude a debtor in possession from assuming its own patent license.
- (2) The reason for adding “and not by a debtor in possession” after “trustee” is to make sure that the courts do not interpret “trustee” to include a “debtor in possession” (which would take us back to *Catapult*), and so that an individual who is a debtor in possession in a chapter 12 case may assume (but not assign) the contract, even though a trustee is serving in the case. (Note that in chapter 12 a trustee is always appointed but the debtor stays in possession and has the powers of a trustee; *see* section 1203.)
- (3) The draft of the proposed amendment to section 365(c) would continue to prohibit, in any type of case, any assignments of contracts that are nonassignable as a matter of law (such as personal service contracts, certain intellectual property licenses, and government contracts).
- (4) However, under the proposed amendments, such nonassignable contracts could be assumed (but not assigned) in a number of situations, such as when a trustee is serving in a corporate chapter 11 case (the rationale being that outside of bankruptcy corporate management is always subject to change, which does not relieve contracting parties from obligations under a nonassignable contract). In particular, assumption of nonassignable contracts would be permitted in the following situations:
 - a. In a corporate or partnership chapter 7 case, though it would be rare, a trustee may wish to assume a short-term contract if it preserves the value of the estate (such as a patent license that is coming to an end soon but which preserves value);
 - b. In a chapter 11 case of a corporation or partnership, where the debtor in possession or a trustee assumes the contract;
 - c. In a chapter 12 case of a corporation or partnership, the contract could be assumed by the debtor in possession under section 365 or under a plan. If the debtor is an individual in chapter 12, and the debtor files a plan that provides for the assumption of a personal service contract, the contract could be assumed (because it is not being assumed by the trustee);
 - d. In a chapter 13 case (where trustees are always appointed), the debtor could file a plan that provides for assumption of a personal services contract, in which case it should be assumable because it will not be assumed by a trustee. The contract will then be performed by the debtor.

Explanation of Proposed Amendments to Section 365(e)

- (1) Presently, section 365(e)(2) is harsher than the current version of 365(c)(1)(A) because it allows the nondebtor party to terminate a contract based on the debtor's insolvency, filing of a bankruptcy petition, etc. Section 365(e)(2) should not apply if there remains a possibility that the personal services contract would be assumed by a debtor or debtor in possession (but not a trustee), as would be permitted by the proposed amendment to section 365(c)(1)(A).
- (2) For that reason, the nondebtor party should be able to terminate a personal services contract based on an ipso facto clause only if the debtor is an individual in chapter 7, or is an individual in a chapter 11 case in which a trustee has been appointed or elected.
- (3) If the debtor is a corporation or partnership in any type of case, termination under an ipso facto clause would deprive the trustee or debtor in possession of the opportunity to later assume (but not assign) the contract. As stated above, even in a chapter 7 case in which the debtor is a corporation or partnership, the trustee may wish to assume a personal services contract for a short time period to preserve the value of the estate (including the going concern value of the assets of the debtor).
- (4) In a chapter 12 or 13 case involving a debtor who is an individual, termination of the contract could deprive the debtor of the ability to assume the contract under a plan.
- (5) In any event, the nondebtor party to a nonassignable contract is protected by section 365(c) as amended, which prohibits assignment of such contracts regardless of the chapter or type of debtor involved in the case. Further protection than that provided in the draft of proposed amendments to section 365(e)(2) should not be necessary.

March 5, 2010
National Bankruptcy Conference