



**Delaware Bankruptcy Court Trumps an Automatic Stay by Allowing Suit to Terminate a
Trademark Licensing Agreement**

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Introduction

Trademark licensees that file for bankruptcy protection may encounter difficulties and uncertainties regarding their continued use of trademarks that are critical for their businesses. An issue that remains unsettled with courts is whether a licensee can assume a trademark license without the licensor's consent. Circuits are divided on whether Section 365(c)(1) of title 11 of the United States Code (the "Bankruptcy Code") prohibits a debtor from assuming an intellectual property license without the consent of the licensor. Courts on one side of the issue apply the "actual test," which permits a debtor to assume a license as long as the debtor does not intend to assign it. On the other side, courts apply the "hypothetical test,"¹ which prohibits a debtor from assuming a license regardless of the debtor's intent to assign it.

In *In re Trump Entertainment Resorts, Inc.*, the United States Bankruptcy Court for the District of Delaware held that trademark licenses are not assignable by a debtor licensee without

¹ *In re Catapult Entertainment, Inc.*, 165 F.3d 747, 750 (9th Cir. 1999) (establishing the hypothetical test as when "a debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession has no intention of assigning the contract in question to any such third party").

the consent of the licensor.² Section 365(c)(1) of the Bankruptcy Code limits a debtor's ability to assume or assign a contract where "applicable law" excuses a non-debtor counterparty from accepting performance from a third party.³ In interpreting applicable federal trademark law, the *Trump* court noted that exclusive or non-exclusive trademark licenses are precluded from assignment by a licensee without the licensor's consent, even if the original license agreement did not expressly prohibit such an assignment.⁴ The Court held that, under Section 365(c)(1) of the Bankruptcy Code, trademark license agreements are not assumable or assignable by a debtor licensee without the trademark owner's consent because they are not assignable under federal trademark law. The court in *Trump Entertainment* also discusses in detail what type of "applicable law" is relevant in the 365(c)(1) analysis.

I. Hypothetical Test vs. Actual Test

Circuit courts vary with respect to which test to use for interpreting Section 365(c)(1). When addressing the issue of whether a trustee can assume an executory contract, courts that rely on Section 365(c)(1) have interpreted it in many different ways, thus creating a split amongst the circuits.

a. Use of "or" instead of "and" in Section 365(c)(1)

Section 365(c)(1) prevents a trustee or debtor from assigning a contract without the nondebtor's consent if "applicable law" prevents the contract from being assigned outside

² *In re Trump Entertainment Resorts, Inc.*, 526 B.R. 116, 118 (Bankr. D. Del. 2015).

³ 11 U.S.C. 365(c)(1) ("The trustee may not assume or assign any executor 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--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 such party does not consent to such assumption or assignment").

⁴ *In re Trump Entertainment Resorts, Inc.*, 526 B.R. at 125.

bankruptcy without consent. Section 365(c)(1), however, uses the phrase “assume *or* assign,”⁵ as opposed to “assume *and* assign,” which seems to mean that a trustee or debtor cannot even assume such a contract and agree to perform under it, even if the trustee or debtor has no intention of assigning the contract to a third party. Courts that choose to apply the hypothetical test read the word “or” literally, and conclude that unless applicable law allows a third party to assume the contract, the trustee may not assume the assignment.⁶ Simply put, can the debtor hypothetically assign the license even though it doesn’t want to (“hypothetical test”) or what is the debtor actually proposing to do (“actual test”)?

The principal decision that utilizes the hypothetical test is from the Ninth Circuit in *In re Catapult Entertainment, Inc.*⁷ In *Catapult*, the court relied on an earlier decision holding that a non-exclusive patent license could not be assigned without the patent holder’s consent and, adopting the hypothetical test, held that such a patent license also could not be assumed over the patent holder’s objection. Most recently, the Nevada district court used the hypothetical test and held that this precluded assumption, or assumption and assignment, of an intellectual property license without the consent of the licensor, if the license is not assignable under non-bankruptcy law without consent of the licensor.⁸

The First Circuit used the actual test for its decision in *Institut Pasteur, et al. v. Cambridge Biotech Corporation*,⁹ which held that federal common-law and contractual restrictions against assignment of patents did not preclude assumption of a patent by a chapter 11

⁵ *In re Footstar*, 323 B.R. 566, 570 (S.D.N.Y. 2005) (questioning if the word “or” in the statutory language “assume or assign” must “be read literally, *i.e.*, as a disjunctive, or should it be construed in context as the functional equivalent of the conjunction “and”).

⁶ *In re Catapult Entertainment, Inc.*, 165 F.3d 747, 751 (9th Cir. 1999).

⁷ *Id.* (collecting bankruptcy court decisions favoring the actual test).

⁸ *N.C.P. Marketing Group v. BG Star Products*, 337 B.R. 230 (D. Nev. 2005).

⁹ *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 490 (1st Cir. 1997).

debtor. If the debtor in possession has no intent to assign an executory contract to a third party, the contract can be assumed if the debtor in possession meets requirements of section §365.¹⁰

Many courts have rejected the hypothetical test because it is inevitably contradictory to the goals of chapter 11, which permit licensees to benefit from the protections of bankruptcy law while encouraging maximization of the economic value of the estate. This unusual result allows the non-debtor to be free of contracts simply because of the debtor's bankruptcy filing.

Depending on the contracts involved, whether a bankruptcy court applies the hypothetical test or the actual test can greatly impact a debtor's ability to stay in business. Application of the hypothetical test can prevent a debtor from continuing to exercise its rights under a nonassignable contract, such as a patent, copyright, or trademark license, which generally cannot be assigned without the licensor's consent. The issue here is that some debtors may be incapable of reorganizing under Chapter 11 without such contracts.

b. Is “trustee” synonymous with the term “debtor-in-possession” in section 365(c)(1)?

The court in *In re Footstar, Inc.* adopted a different test that rested upon the distinctions between the debtor and the debtor-in-possession, and the bankruptcy trustee. The court reasoned that the term “trustee” in section 365(c)(1) should not automatically be assumed as synonymous with the term “debtor-in-possession,” such that the exclusion of assumption and assignment is limited to situations where a trustee, rather than the debtor-in-possession, seeks to assume an executory contract.¹¹ Under this approach, the debtor-in-possession would be precluded from assigning a contract because assignment would require the non-debtor to accept or perform the contractual obligations to someone other than the debtor. However, under this approach, the debtor-in-possession could assume the contract because the debtor-in-possession is not an entity

¹⁰ *Id.*

¹¹ *In re Footstar*, 323 B.R. at 571.

other than itself.

II. Whether “cause” to lift stay exists under section 362(d) of the Bankruptcy Code

An issue arises when a non-debtor party to an executory contract is subjected to a long period of uncertainty while the debtor determines whether to reject or assume the executory contract. Under Bankruptcy Code §362, the non-debtor party generally cannot terminate the contract unilaterally without moving for relief from the automatic stay. In *Trump Entertainment*, the bankruptcy court considered section 365(c)(1) in the context of a trademark licensor’s motion for relief from the automatic stay to continue state court litigation in which the licensor was seeking to terminate a trademark license agreement with the debtor. Following the precedent in *Izzarelli v. Rexene Prods. Co.*,¹² Delaware bankruptcy courts typically apply a balancing test in assessing whether “cause” to lift the stay exists under section 362(d) of the Bankruptcy Code. Under the three-pronged test, the court considers: (a) whether continuation of the nonbankruptcy litigation will cause great prejudice to either the estate or the debtor; (b) whether any hardship to the nondebtor arising from continuation of the stay considerably outweighs the hardship to the debtor; and (c) the probability that the nondebtor will prevail on the merits.¹³ Pursuant to the binding standard set forth in *West Electronics*, courts in the Third Circuit are obligated to use the hypothetical test when establishing whether a contract can be assumed.

In *Trump Entertainment*, the Delaware Bankruptcy Court adopted the “hypothetical test,” a strict interpretation of Section 365(c) of the Bankruptcy Code.¹⁴ The *Trump* court concluded that because the agreement was unassignable pursuant to non-bankruptcy law, the debtor could

¹² *Izzarelli v. Rexene Prods. Co.* 141 B.R. 574 (Bankr. D. Del. 1992).

¹³ *Int’l Bus. Machines v. Fernstrom Storage and Van Co. (Matter of Fernstrom Storage and Van Co.)*, 938 F.2d 731, 735 (7th Cir. 1991).

¹⁴ *In re Trump*, 526 B.R. at 125.

not assume it.¹⁵ Under the hypothetical test, pursuant to federal trademark law, a debtor may not assume an executory contract over the objection of the non-debtor even if the debtor does not have any intentions of assigning the contract.¹⁶ The Court determined that a debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would prohibit this assignment to a third party. However, the court noted that section 365(c)(1) must be interpreted simultaneously with section 365(f)(1): "Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection."¹⁷ Therefore, the bankruptcy court in *Trump Entertainment* concluded that, for section 365(c)(1) to apply, the applicable law must specifically provide that the nondebtor contract 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."¹⁸

This case exemplified the importance of choice of venue when companies that are licensees of intellectual property rights file for chapter 11.¹⁹ Many companies are incorporated under Delaware law, and this fact allows them to seek bankruptcy relief in Delaware's court system even if their principal place of business is in another jurisdiction.²⁰ One of the most valuable assets in a corporate bankruptcy filing is the right of a debtor as licensee to use intellectual property owned by a third party. Depending on the venue where the bankruptcy

¹⁵ *Id.* at 123.

¹⁶ *See id.* at 122.

¹⁷ 11 U.S.C. § 365(f)(1).

¹⁸ *In re Trump*, 526 B.R. at 125 (citing *In re ANC Rental Corp.*, 277 B.R. 226, 236 (Bankr. D. Del. 2002)).

¹⁹ *See id.*

²⁰ Mathews, Susan, *Corporate Chapter 11 Bankruptcies: The Case for Venue Reform*; October 2014; <http://www.abfjournal.com/articles/corporate-chapter-11-bankruptcies-the-case-for-venue-reform/>.

petition is filed, the value of the debtor's rights may vary greatly.

III. Is an intellectual property license an executory contract?

Only contracts which are executory may be assumed, assigned, or rejected under Section 365 of the Bankruptcy Code. The Bankruptcy Code does not define the term "executory." Bankruptcy courts often cite the definition put forth by Professor Vern Countryman. Under the Countryman definition, a contract is executory where both the debtor and the non-debtor party have obligations that so unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other.²¹ As a general rule, non-exclusive licenses of intellectual property are considered executory contracts, whereas exclusive licenses are not.²² Whether sufficient performance remains due on both sides for the contract to be executory is frequently a difficult question. Negative covenants (promise to not conduct certain activities) have been determined to be sufficient to make a contract executory.²³ Even the common license agreement provision prohibiting the parties from suing for infringement has been interpreted as sufficient for a license agreement to be considered as executory.²⁴

IV. Effects of the split among the Circuits

The uncertainty among the circuits causes a debtor to question whether or not to file for

²¹ Countryman, *Executory Contracts and Bankruptcy*, 57 Minn. L. Rev. 439 (1973). See *In re Texscan*, 976 F.2d 1269; *In re Select-A-Seat Corp.*, 625 F.2d 290 (9th Cir. 1980); *In re Coast Trading Company, Inc.*, 744 F.2d 686, 692 (9th Cir. 1984).

²² *In re Golden Books Family Entert.*, 269 B.R. 300 (Bankr. D. Del. 2001).

²³ See, e.g., *In re Rovine Corp.*, 5 B.R. 402 (Bankr. W.D. Tenn. 1980) (covenant not to compete sufficient); *Lubrizol Enters. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985) (technology licensor's duty to defend intellectual property rights, indemnify licensee and maintain confidentiality sufficient); *In re Select-A-Seat Corp.*, 625 F.2d 290 (exclusive licensor's duty not to further license held sufficient). But see *In re Stein & Day, Inc.*, 81 B.R. 263 (Bankr. S.D.N.Y. 1988) (non-debtor author's duty to indemnify publisher and offer future books for publication insufficient); see also *In re Monument Record Corp.*, 61 B.R. 866 (Bankr. M.D. Tenn. 1986) (employment contract in which non-debtor artists had no further obligation to record).

²⁴ *In re Access Beyond Technologies, Inc.*, 237 B.R. 32, 43-44 (Bankr. D. Del. 1999) (citing *Everex Systems, Inc. v. Cad Trak Corp.* (In re FLC, Inc.), 89 F.3d 673, 677 (9th Circuit 1996)).

bankruptcy with the risk of not being able to assume an executory contract as a debtor in possession. Particularly, this becomes important when the debtor is an entity or corporation. As a business, the choice of venue is critical because the debtor would want to choose the court that applies the test most suitable for its purposes. As mentioned above, the debtor in possession was able to assume the license when the First Circuit applied the actual test. However, the debtor in possession was barred from assuming the license when the Ninth Circuit applied the hypothetical test.²⁵ Depending on whether or not the debtor would want to assume the license, and depending upon whether a debtor has multiple options as to where it can file a bankruptcy case, it would serve its best interest to choose a venue that would apply the test most beneficial to its outcome of choice.

Conclusion

According to the court in *Trump Entertainment*, the “applicable law” (in this case, federal trademark law) states that licenses are not assignable without the licensor’s express authorization. This general bar exists because trademarks are meant to identify a good or service of a particular, consistent quality, making the distinctiveness of licensees vital to licensors. The parties clearly did not intend to contract around this rule in the Trademark License Agreement. Additionally, the licensor’s consent to assignment to the first lien lender was not enough to overrule the default rule of non-assignability because it was only effective with respect to an “isolated assignee” in the context of a state enforcement action that was unlikely to ever occur once the bankruptcy case was commenced. The section 365(c)(1) hypothetical test was therefore satisfied, and the court held that Trump AC was entitled to relief from the automatic stay using the *West Electronics* case as precedent.

²⁵ *Id.*

Trump Entertainment exemplified the importance of choice of venue when companies that are licensees of intellectual property rights file for chapter 11.²⁶ There are many companies incorporated under Delaware law and are able to seek bankruptcy relief in that state's court system even if their principal place of business is in another jurisdiction.²⁷ If this case was filed in a jurisdiction that did not follow the hypothetical test, then Section 365(c) would not have prevented the assumption of the trademark license, and there would have been no relief from the automatic stay.²⁸ The circuits that have ruled on the assumption of executory contracts under Section 365(c)(1) are split. For various reasons, some courts employ the "hypothetical" test while others employ the "actual" test. This split has caused similar cases to have different outcomes, depending on where the debtor filed for bankruptcy. In order to prevent different rulings on similar cases, either the Supreme Court needs to decide the issue, or Congress has to amend Section 365(c)(1) to clarify the discrepancy.

²⁶ *See id.*

²⁷ Mathews, Susan, *Corporate Chapter 11 Bankruptcies: The Case for Venue Reform*; October 2014; <http://www.abfjournal.com/articles/corporate-chapter-11-bankruptcies-the-case-for-venue-reform/>.

²⁸ *In re Trump*, 526 B.R. at 120–21.