

The Southern District of New York Adds Its Two Cents to the Catapult Debate

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The debate over whether nonexclusive licenses can be assumed in the face of applicable nonbankruptcy law prohibiting assignment rages on. The battle lines are clearly drawn. Some circuits follow the so-called “hypothetical test” and prohibit assumption if applicable nonbankruptcy law would prohibit assignment of the contract to a hypothetical third party. Other circuits adhere to the so-called “actual test” and reach the opposite conclusion. A recent ruling of the U.S. Bankruptcy Court for the Southern District of New York illustrates that this debate has important implications in telecommunications and technology bankruptcy cases as well.

The Ninth Circuit in *Catapult* and the Fourth Circuit in *Sunterra* have adopted the “hypothetical test.” Both ruled that a debtor licensee cannot assume executory contracts, such as nonexclusive licenses, over an objecting licensor, even if the debtor does not seek to assign the license. *In re Catapult Entm’t Inc.*, 165 F.3d 747 (9th Cir. 1999); *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004).

As first articulated in *Catapult*, the rationale behind the “hypothetical test” is that Bankruptcy Code §365(c)(1) requires an examination of whether or not applicable nonbankruptcy law would excuse a hypothetical third party assignee from accepting performance from someone other than the debtor. Section 365(c)(1) reads:

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

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

11 U.S.C. §365(c)(1).

Because nonexclusive patent licenses are deemed personal in nature and are incapable of assignment without the consent of the licensor under applicable nonbankruptcy law, even the licensee itself would not be able to assume the license in bankruptcy. The Fourth Circuit in *Sunterra* followed suit in the context of a nonexclusive license of copyrighted software.

On the other hand, the First and Fifth Circuits have adopted the “actual test” or the “as-applied approach.” *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997); *Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238 (5th Cir. 2006). If the debtor only seeks to assume an executory contract, such assumption is permissible even if applicable nonbankruptcy law would prohibit an assignment of such contract. In order to prohibit assumption, there must be a showing that the executory contract

will actually be assigned to a third party and that applicable nonbankruptcy law would prohibit the assignment.

Although the Second Circuit has not weighed in on the issue, a recent ruling by the Bankruptcy Court for the Southern District of New York makes abundantly clear on which side of the debate the Southern District of New York falls—the “actual test” proponents. In *In re Adelphia Communications Corp.*, 359 B.R. 65 (Bankr. S.D.N.Y. 2007), Judge Gerber held that “the law in this district, and by far the better view, is that where the assumption is to be effected by a debtor in possession (as contrasted to a trustee), the right to object to *assignment* does not by itself affect the right to *assume*.” *Id.* at 72 (emphasis in original). The court also agreed wholeheartedly with previous decisions by Judge Hardin and ruled that it would not deviate with the law of a sister court in the Southern District of New York. *Id.* (citing *In re Footstar Inc.*, 323 B.R. 566, 573-574 (Bankr. S.D.N.Y. 2005) and *In re Footstar Inc.*, 337 B.R. 785, 788 (Bankr. S.D.N.Y. 2005) (holding the same)). The court went on to criticize the courts that follow the hypothetical approach:

Cases to the contrary, including some Circuit Court decisions that apply a species of “plain meaning” analysis to §365(c)(1), are in this Court’s view incorrectly decided. They give insufficient attention to other provisions of §365, link concepts that have no relation to each other, and yield results demonstrably at odds with the purposes of the statute.

Id. (footnotes omitted). In particular, the court noted that §365(f), which sets forth the requirements for assignment, makes the right to assign expressly subject to §365(c)(1). “If §365(c)(1) made it impossible even to assume the contract to be assigned, there would be no reason for having a §365(c)(1) exception in §365(f).” *Id.* at n.17.

While the court ultimately ruled that the cable operator franchise agreements in question were not capable of assignment under the applicable nonbankruptcy local ordinances restricting assignment of such contracts, it did clearly rule in favor of the debtor on the threshold question of whether or not such executory contracts could be assumed notwithstanding objection.