

***PERLMAN V. CATAPULT
ENTERTAINMENT, INC.
(IN RE CATAPULT
ENTERTAINMENT, INC.):
NINTH CIRCUIT RESTRICTS DEBTOR'S
RIGHT TO ASSUME PATENT LICENSES***

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SUMMARY

On January 28, 1999, the Court of Appeals for the Ninth Circuit held that section 365(c)(1) of the Bankruptcy Code prevented a debtor in possession, Catapult Entertainment, Inc. ("Catapult"), from assuming patent licenses in connection with its reorganization plan over the licensor's objections.¹ The *Catapult* court concluded that, where applicable nonbankruptcy law excuses a party from accepting performance under a contract from, or rendering performance to, a party other than the debtor, the debtor may not assume the contract without the nondebtor party's consent whether or not the debtor intends to assign the contract to a third party.

For certain types of contracts, especially patent licenses, government contracts and personal services contracts, well-developed nonbankruptcy law excuses the licensor, the government, or service recipient, as the case may be, from having to deal with an assignee. The *Catapult* decision considerably strengthens such parties' positions in bankruptcy cases, while a debtor's ability to reorganize may in some instances be undermined or defeated.

BACKGROUND

Catapult was formed to create an online videogame network. In 1994, Catapult entered into patent license agreements with Stephen Perlman ("Perlman") granting Catapult the right to exploit certain technologies.

Catapult commenced its chapter 11 case in October 1996, shortly after having entered into a merger agreement with Mpath Interactive, Inc. ("Mpath"). The merger agreement

¹ *Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)*, 165 F.3d 747 (9th Cir. 1999).

contemplated the chapter 11 case and anticipated a reorganization plan pursuant to which Catapult would become a wholly owned subsidiary of Mpath and Catapult's creditors would receive approximately \$14 million in cash, notes and other securities. In connection with its proposed plan, Catapult filed a motion to assume 140 executory contracts and unexpired leases pursuant to section 365(a) of the Bankruptcy Code. Among the contracts to be assumed were the two Perlman licenses.

Perlman objected to the assumption of his licenses. The bankruptcy court overruled his objections, granted the assumption motion and confirmed the reorganization plan. The district court affirmed the bankruptcy court's decision, and Perlman appealed to the Ninth Circuit, which reversed.

SECTION 365 OF THE BANKRUPTCY CODE

When a debtor commences a bankruptcy case, it acquires the right to assume or reject its executory contracts and unexpired leases. Prior to assumption or rejection, the debtor's contracts and leases remain in place even if there are prepetition defaults that remain uncured. The automatic stay² prevents termination by the nondebtor party. If the debtor assumes a contract, that contract becomes a postpetition obligation of the debtor's estate: the debtor must cure prepetition defaults (including paying amounts that were due prepetition)³ and any claim for a subsequent breach by the debtor is entitled to administrative priority. If the debtor rejects a contract, the contract is not obliterated; rather, any claims arising out of its breach are accorded general unsecured status.⁴

Section 365 is the section of the Bankruptcy Code that governs assumption, rejection and assignment of contracts. Section 365(a) permits a debtor to assume or reject any executory contract or unexpired lease, subject to certain limited restrictions contained in sections 365(b), (c) and (d). Section 365(c) was at the heart of the decision.

Section 365(c)(1) provides that:

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 –

² 11 U.S.C. § 362.

³ 11 U.S.C. § 365(b).

⁴ 11 U.S.C. § 365(g). *See* 11 U.S.C. § 502. The Bankruptcy Code limits the debtor's rights respecting rejection of intellectual property license agreements under which the debtor is the licensor. *See* 11 U.S.C. § 365(n).

(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; and

(B) such party does not consent to such assumption or assignment; . . .

The Ninth Circuit interpreted this section to mean that if nonbankruptcy law would excuse the nondebtor party from accepting performance from or rendering performance to a third party (assignee) regardless of whether the contract itself restricts assignment, then the debtor cannot assume the contract without the nondebtor party's consent even if the debtor does not intend to assign the contract. Thus, in the Ninth Circuit's view, where nonbankruptcy law bars a party from assigning a contract, that party cannot assume the contract without the nondebtor's consent.

Although the *Catapult* case arises in the context of a change in control of the licensee, the court did not confine its decision to any particular factual context.⁵ Rather, it held that the test of a contract's assumability is based on a strictly hypothetical assessment of whether it could be assigned.

THE ACTUAL TEST

The *Catapult* court rejected the interpretation of section 365(c)(1) adopted by other courts, which is referred to as the "actual test."⁶ Under the actual test, the court must determine whether the nondebtor party is actually being asked to deal with someone other than the debtor.⁷ If the debtor intends to assume the contract and continue to render (or accept) performance thereunder, then courts applying the actual test would find that section 365(c)(1) does not bar assumption. In other words, "where a debtor in possession simply wants to retain its prepetition executory contracts and to perform thereunder, the better reasoned result is to

⁵ This contextual approach is discussed in *Institute Pasteur v Cambridge Biotech Corp.* 104 F.3d 489 (1st Cir.), *cert. denied*, 117S. Ct. 2511 (1997). There, the debtor's plan called for the debtor/licensee's stock to be sold to a subsidiary of one of the licensor's direct competitors. *Id.* at 490. The court found that the licensor could have protected itself from a change in control of its licensee by including a restriction in its license agreement, but that it did not do so.

⁶ See, e.g., *Institute Pasteur*, 104 F.3d 489, *Texaco Inc. v. Louisiana Land & Exploration Co.*, 136 B.R. 658 (M.D. La. 1992); *In re GP Express Airlines, Inc.*, 200 B.R. 222 (Bankr. D. Neb. 1996); *In re American Ship Bldg. Co.* 164 B.R. 358 (Bankr. M.D. 1994); *In re Hartec Enters., Inc.*, 117 B.R. 865 (Bankr. W. D. Tex. 1990).

⁷ The Supreme Court has rejected the notion that the prepetition debtor and postpetition debtor in possession are different entities. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984).

permit assumption, regardless of whether the contract can be assumed and assigned to a third party under applicable law.”⁸

THE HYPOTHETICAL TEST

The test for assumability adopted by the Ninth Circuit is generally referred to as the “hypothetical test.”⁹ Under this approach, the court examines whether the debtor would have the right to assign the contract under applicable nonbankruptcy law. If so, it may assume the contract. If not, it may not assume the contract. Whether the debtor could effect a hypothetical assignment of the contract dictates whether it can assume it under this test.

ANALYSIS OF THE COMPETING VIEWS

In adopting the hypothetical test, the Ninth Circuit stated that it chose to “adhere to the plain statutory language” of section 365(c)(1), although it acknowledged that “the proper interpretation of [section] 365(c) has been the subject of considerable disagreement among courts and commentators.”¹⁰ The *Catapult* court specifically rejected three lines of argument normally cited in support of the actual test: “(1) the literal reading creates inconsistencies within [section] 365; (2) the literal reading is incompatible with the legislative history; and (3) the literal reading flies in the face of sound bankruptcy policy.”¹¹

COMPETING PROVISIONS OF THE CODE

Reconciling Sections 365(c) and 365(f)

Advocates of the actual test argue that the hypothetical test reading of section 365(c)(1) is incompatible with other subsections of section 365. Among those is section 365(f), which governs the debtor’s right to assign contracts. It provides, among other things, that “[e]xcept as provided in [section 365(c)], 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 under paragraph (2) of this

⁸ *G.P. Express*, 200 B.R. at 232.

⁹ *Catapult*, 165 F.3d at 750 (“a debtor in possession may not assume an executory contract over the nondebtor’s objection if applicable law would bar assignments 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”); see also *City of Jamestown v James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 537 (11th Cir. 1994); *In re West Elecs., Inc.* 852 F.2d 79, 83 (3d Cir. 1988).

¹⁰ 165 F.3d at 749.

¹¹ *Id.* at 751

subsection .” A debtor cannot assign a contract without first assuming it. If section 365(c) prevents assumption because of the very same nonbankruptcy antiassignment law that section 365(f) renders inoperative, then section 365(c) renders section 365(f) a nullity.¹²

The *Catapult* court rejected this argument, reasoning that the scope of the reference to “applicable law” is different in section 365(c) from that of the reference in section 365(f). It stated that:

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 rendering performance to an entity” different from the one with which the party originally contracted, the applicable law prevails over subsection (f)(1). In other words, in determining whether an “applicable law” stands or falls under [section] 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.¹³

Conflicts Within Section 365(c)

The *Catapult* court also addressed briefly arguments that adoption of the hypothetical test produces conflicts within section 365(c). First, it rejected the debtor’s argument that section 365(c)(1) was intended to address only those situations in which the prohibited assumption was in connection with an assignment to a third party.¹⁴ The *Catapult* court stated that it was possible that assumption and assignment could be bifurcated and that the nondebtor entity’s consent would have to be obtained twice: once for assumption and once for assignment.¹⁵ The nondebtor party could conceivably consent to the assumption, but not the assignment.

The *Catapult* court also rejected the argument that its reading of section 365(c)(1) would render section 365(c)(2) (which bars assumption of contracts to provide loans and other financial accommodation) superfluous because such contracts are already nonassignable under nonbankruptcy law. The *Catapult* court found “Congress by enacting subsection (c)(2)

¹² *Id.*

¹³ *Id.* at 752 (citations omitted).

¹⁴ See *In re American Ship Bldg. Co.*, 164 B.R. 358, 363 (Bankr. M.D. Fla. 1994).

¹⁵ 165 F.3d at 752.

cemented uniformity in the bankruptcy context.”¹⁶ Moreover, section 365(c)(1) would still permit assumption with the nondebtor party’s consent; the *Catapult* court read section 365(c)(2), however, to Prohibit Such Assumption Regardless Of Consent.¹⁷

LEGISLATIVE HISTORY

The debtor had argued that the legislative history surrounding a 1984 amendment of Section 365 indicated Congress’s intent to enable a debtor in possession to assume its own contract without the nondebtor party’s consent. It cited a 1980 House of Representatives report as support for its proposition.¹⁸

The *Catapult* court rejected this argument. First, it stated that reference to the legislative history was unnecessary because it found the plain language of the statute unambiguous. Second, because the House Report to which the debtor referred “relates to a different proposed bill, predates enactment of [section] 365(c)(1) by several years, and expresses at most the thoughts of only one committee in the House,” the court deemed it insufficient to overcome what it viewed as the unambiguous language of the statute.

BANKRUPTCY POLICY

Finally, the *Catapult* court rejected the argument that a reading of section 365(c)(1) that would prevent a debtor in possession from assuming its own contract is contrary to bankruptcy policy, stating that “[p]olicy arguments cannot displace the plain language of the statute; that the plain language of [section] 365(c)(1) may be bad policy does not justify a judicial rewrite.”¹⁹

SCOPE OF THE DECISION

The *Catapult* decision deepens the split among the Circuits as to whether a debtor in possession can assume a contract without the nondebtor party’s consent where nonbankruptcy law would otherwise prohibit its assignment. Compare *Catapult*, 165 F.3d 747; *James Cable*, 27 F.3d 534; and *West Electronics*, 852 F.2d 79 with *Institute Pasteur*, 104 F.3d 489. If the hypothetical test prevails, a debtor’s right to assume certain types of contracts such as intellectual property licenses, governmental contracts and personal services contracts will be limited to situations in which the nondebtor party consents to the assumption.

¹⁶ *Id.* at 753.

¹⁷ *Id.*

¹⁸ 165 F.3d at 754.

¹⁹ *Id.*

The proper interpretation of section 365(c)(1) will likely continue to be litigated unless it is resolved by the Supreme Court²⁰ or Congress.²¹ Indeed, as increasing numbers of high technology companies seek relief under Chapter 11, this issue is likely to become increasingly prominent.

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If you have any questions or comments concerning the *Catapult* decision, please do not hesitate to contact Mark Thompson (at 212-455-7355), Kerry Konrad (at 212-455-2663) or Shari Siegel (at 212-455-3875).

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²⁰ As of the date of this memorandum, the time for filing a petition for certiorari in the *Catapult* case has not yet expired.

²¹ The National Bankruptcy Review Commission has, in fact, recommended amendments to section 365 that include distinguishing between a debtor in possession electing to perform its own contract and assignment to a third party. National Bankruptcy Review Commission Section 365 Working Group Proposal No. 4 (1997).