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Supreme Court Leaves Circuits Split on Whether Intellectual Property Licenses Can Be Assumed in Bankruptcy

On March 23, 2009, the United States Supreme Court denied *certiorari* in *N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc., et al.*, leaving unresolved the split of authority among the circuits regarding what test should be used to determine whether a bankruptcy debtor can assume an intellectual property license. In denying review, Justice Kennedy, joined by Justice Breyer, issued a three page statement urging the Court to consider granting *certiorari* in a future case raising this issue.

By way of background, in this case the United States District Court for the District of Nevada held that trademark licenses are personal and non-assignable absent a provision to the contrary in the trademark license. The licensee prior to its bankruptcy had entered into an agreement with Billy Blanks of Billy Blanks® Tae Bo® workout program. Specifically, Mr. Blanks had granted N.C.P. Marketing Group (NCP) a non-exclusive license to advertise and sell products bearing the Tae Bo® trademark.

The central issue in the case was the power of a debtor-in-possession to assume under Section 365 of the Bankruptcy Code executory contracts that were held by the debtor before bankruptcy. Section 365(a) of the Bankruptcy Code allows trustees and debtors in bankruptcy to assume—that is, to continue to receive the benefits of, while also continuing to perform its obligations under—the debtor's leases, ongoing performance contracts, and licenses to use the property of others. In effect, Section 365(a) offers trustees and debtors in possession the ability to reject financially-disadvantageous contracts and leases, the ability to assume financially-advantageous contracts and leases, and the ability to assign assumed contracts and leases to those better able to capitalize upon them.

Section 365(c)(1) of the Bankruptcy Code prevents trustees and debtors from assigning any executory contract if applicable non-bankruptcy law permits the non-debtor party to the contract to refuse performance from a third party. Many courts have read this section to prohibit the assumption or the assumption and assignment of

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nonexclusive intellectual property licenses over the licensor's objection because the free assignment of these licenses would violate the exclusive rights granted to intellectual property holders under federal law.

In this instance, the District Court granted Mr. Blank's motion for an order compelling rejection of the trademark license, which the Ninth Circuit affirmed. NCP was thus barred from making any economic use whatsoever of its license, arguably its most significant asset. A key reason for the District Court's decision in the *N.C.P. Marketing Group* case was the Ninth Circuit's interpretation of Section 365(c)(1) in prior cases and, specifically, the Ninth Circuit's treatment of whether a trustee or debtor-in-possession can assume an intellectual property license. The approach applied by the Ninth Circuit is known as the "hypothetical test."

Under the hypothetical test, a licensor can compel rejection of a license if the licensor could lawfully refuse performance from a "hypothetical" third party. In other words, if a debtor cannot assign an intellectual property license without licensor consent, the debtor is likewise barred from assuming it. If a debtor cannot assume the license without the consent of the licensor, then the license effectively terminates as a matter of law upon bankruptcy unless the licensor agrees otherwise. The majority of circuits, including the Third, Fourth, Ninth, and Eleventh Circuits, have adopted or commented favorably on the hypothetical test.

Under the contrary view, favored by the First and Fifth Circuits, as well as by lower courts in the Eighth and Tenth Circuits, the test used to determine whether an executory contract may be assumed pursuant to Section 365(c)(1) is the "actual test." Proponents of this approach argue that the otherwise applicable Bankruptcy Code provisions should be read by reference to the "actual" intent to assign the contract and, if there were no such intent, then Section 365(c) does not prevent assumption. Thus, under the actual test a bankruptcy court must conduct a case-by-case analysis of the performance that the debtor-in-possession will render with a view to ensuring that the non-debtor party will receive the full benefit of its bargain. Therefore, in the jurisdictions that apply the actual test, a licensor could not force a debtor in possession (such as NCP) to reject a trademark license if the debtor in possession merely intends to assume, but not assign, the license. Instead, to block the assumption under the actual test, the non-debtor party to the license must make an individualized showing that either (a) the debtor in possession proposes to assign its interest in the license to a third-party or (b) the debtor-in-possession cannot provide adequate assurance of its future performance under the license on a post-assumption basis—i.e., the non-debtor party to the license would not receive the full benefit of its bargain.

Justice Kennedy asserted that the Supreme Court should consider granting *certiorari* in a future case on the "significant question" of whether the hypothetical test or the actual test should be applied in interpreting Section 365(c)(1) of the Bankruptcy Code. Highlighting the problems associated with both approaches, Justice Kennedy noted that "[t]he division in the courts over the meaning of § 365(c)(1) is an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization."

Justice Kennedy noted that application of the hypothetical test might prevent a debtor-licensee from continuing to exercise its licensed intellectual property rights, thereby preventing the debtor-licensee from successfully reorganizing under Chapter 11. Justice Kennedy further opined that, under the hypothetical test, a non-debtor licensor has the power to reclaim its intellectual property during the debtor-licensee's bankruptcy case (as the



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result of the forced rejection of the license) and, subsequent to the bankruptcy reorganization, to resell or relicense that intellectual property to the reorganized debtor-licensee at a potentially higher market rate. According to Justice Kennedy, the hypothetical test “purchases fidelity to the Bankruptcy Code’s text by sacrificing sound bankruptcy policy.”

While the hypothetical test is much criticized, Justice Kennedy’s remarks do not signal the Court’s preference for the actual test. Indeed, Justice Kennedy expressed the view that, although the actual test comports with sound bankruptcy policy, it nevertheless presents “problems of its own” because the adoption of the actual test effectively rewrites Section 365(c)(1) of the Bankruptcy Code.

Intellectual property licenses are among the most valuable assets of many debtors, yet the Supreme Court is, at least for now, allowing the inter-circuit conflict to remain. Pending some resolution by Congress to address the divided statutory interpretation, in the majority of circuits intellectual property licensors have the practical ability to veto proposals by Chapter 11 debtors to assume or to assume and assign intellectual property licenses. For example, in Delaware—which is widely viewed as the most popular jurisdiction for significant Chapter 11 filings in the United States—if hypothetically the debtor can not assign a license of intellectual property without the non-debtor party’s consent, then absent such consent the reorganized debtor also cannot retain the license after Chapter 11. The bottom line is that, in bankruptcy, the jurisdiction of the debtor’s bankruptcy case dictates the disposition of an intellectual property license.

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