

The § 365(C)(1) Dilemma: What Ability Does A Debtor Have To Assume Or Assign Executory Agreements?

By Matthew V. Spero

Bankruptcy Code § 365(c)(1), which addresses the right to assume and assign contracts while in bankruptcy, has long confounded courts. A recent decision emanating from the United States District Court of Nevada indicates that the confusion may not subside soon.

Section 365(c)(1) states:

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

(A) applicable law excuses a party, other than the debtor, to such contract or unexpired 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 unexpired lease prohibits or restricts assignment of rights or delegation of duties; and

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

The November 2005 decision *In re NCP Marketing Group, Inc.*, - - - B.R. - - - -, 2005 WL 3253268 (D.Nev.) illustrates the dilemma faced when a debtor wishes to either assume or assume and assign an executory agreement. In *NCP*, appellees filed a motion in NCP's bankruptcy for an order compelling the rejection of a non-exclusive trademark license after NCP claimed in its

disclosure statement in support of its plan of reorganization that it owned the subject trademarks. In determining whether NCP could assume and assign its rights under the license agreement, the court examined the “hypothetical” and “actual” tests developed by other courts addressing the right to assume and assign agreements under the Bankruptcy Code. Under the “hypothetical test”, which has been adopted by the Third, Fourth, and Ninth Circuits, the court would look to the plain language of § 365(c)(1) to determine whether NCP, as a debtor, could assume the license agreement over the licensor’s objection. If applicable non-bankruptcy law (in this case, trademark law) would bar assignment to a hypothetical third party, regardless of whether NCP actually had any intention of assigning the license agreement to a third party, NCP could not assume it. *In re Catapult Entertainment, Inc.*, 165 F.3d 747 (9th Cir.1999); *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir.2004); *In re West Elecs., Inc.*, 852 F.2d 79 (3d Cir.1988). On the other hand, if the court were to apply the “actual test”, which has been adopted by the First Circuit and a majority of lower bankruptcy courts, it would examine whether the license agreement in actuality could be assumed, as long as no assignment was contemplated, and whether the non-debtor counterparty actually could be forced to accept performance under the license agreement from a third party with whom it did not originally contract. *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir.), cert. denied, 521 U.S. 1120, 117 S.Ct. 2511, 138 L.Ed.2d 1014 (1997).

The NCP court ultimately applied the “hypothetical” test and the “plain language” of § 365(c)(1) to determine the assumability of the trademark license agreement. Since § 365(c)(1) states that the trustee (in this case, NCP) cannot assume the license agreement if applicable non-bankruptcy law (trademark law) excuses the non-debtor party (licensor) from accepting performance from a third party it did not originally contract with (here, trademark law states that the grant of a non-exclusive license is personal to the assignee and thus not freely assignable to a third party, see, e.g. *Tap Publ'ns, Inc. v. Chinese Yellow Pages [New York], Inc.*, 925 F.Supp. 212, 218 [S.D.N.Y.1996]), the trademarks would be assignable only with the consent of the licensor and therefore could not be assumed.

Although *In re NCP* concerned a debtor seeking to assume *and* assign a trademark license agreement, since the court utilized the hypothetical test to determine the debtor’s ability to assume the contract under § 365(c)(1), it

should have arrived at the same holding even if the debtor wished to assume, but not assign, the license agreement. *In re NCP* widens the chasm between courts applying the hypothetical and actual tests, especially when contrasted with *In re Footstar, Inc.*, decided by the Southern District of New York Bankruptcy Court nine months prior to *In re NCP*, wherein the Bankruptcy Court concluded that § 365(c)(1) was, in fact, not even applicable to a debtor seeking to assume, but not assign, a non-assignable contract. 323 B.R. 566 (Bankr. S.D.N.Y.2005). In *Footstar*, the debtors sought to assume, but not assign, certain agreements with K-Mart granting the debtors the exclusive right to operate footwear departments in certain K-Mart stores. K-Mart opposed the debtors' motion to assume the contracts. Bankruptcy Judge Hardin, while using the "actual test" to determine that *Footstar* could assume and continue performing the agreements notwithstanding K-Mart's objections, utilized a different focus in analyzing § 365(c)(1). While agreeing that a debtor or debtor-in-possession could not assign an agreement under § 365(c)(1) if the non-debtor party opposed the assignment and applicable law excused the non-debtor party from accepting performance from a third party, the Bankruptcy Court remarked upon the faulty premise underlying the entire "hypothetical" test, in that the statute states that the trustee may not assume or assign the executory contract, not that a debtor or debtor-in-possession may not assume or assign it. *Id.* at 570. Since in *Footstar* it was the debtors who sought to assume the executory agreements, the Court held that, according to the plain language of § 365(c)(1), nothing prevented the debtors from assuming the agreements. The Court reasoned that the objective of § 365(c)(1) is to, in accordance with applicable non-bankruptcy law, preserve the right of the non-debtor party to a contract to refuse performance from a party "other than the debtor or debtor-in-possession" with whom it did not contract. *Id.* at 573. Since a trustee is an entity other than the debtor or debtor-in-possession with whom the non-debtor party did not contract, it logically follows that a trustee should not be permitted to assume and perform the contract and that § 365(c)(1) therefore places no such restriction on a debtor or debtor-in-possession. *Id.*

Since the recent amendments to the Bankruptcy Code failed to resolve the different interpretations of § 365(c)(1), the issue is likely to continue until the Supreme Court decides to resolve the conflict between the circuits.



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