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Licensee Beware: How Bankruptcy Can Strip a Licensee of the Right to Use Its Software

In re Sunterra Corp.

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When intellectual property law intersects with the Bankruptcy Code, the results can be quite unpredictable. For a debtor, they can be harrowing. Suppose the following scenario: Acme Technology Corp. develops Super Software, which allows the user to keep track of and organize large amounts of data. Happy Times Inc., a worldwide operator of resorts, enters into a licensee agreement for Super Software with Acme Technology to maintain a master database of personal information regarding visitors to various Happy Times resorts. Happy Times pays Acme Technology $3 million for the license and then spends an additional $30 million to adapt Super Software so that it can be used for marketing by each of its resorts. The software is critically important to Happy Times' business. In a seemingly innocuous clause, the license agreement expressly provides that Acme Technology consents to any assignment of the Super Software license to a third party.

Several years later, Happy Times finds itself in financial dire straits due to cutthroat price wars raging in the tourism industry. Happy Times decides to use the reorganization process of chapter 11 of the Code to improve its balance sheet and emerge as a stronger competitor. During the course of the bankruptcy case, Happy Times seeks to assume (*i.e.,* keep) the Super Software licensing agreement through the process set forth in §365 of the Code. Acme Technology opposes the assumption, arguing that because it did not consent to an *assumption,* but only consented to an *assignment* of the Super Software license, the license agreement should be deemed rejected, meaning that Happy Times would lose the right to utilize Super Software. Happy Times responds by arguing that by consenting to the assignment, Acme Technology implicitly consented to the assumption. The bankruptcy court and the district court agree with Happy Times. However, the Circuit Court of Appeals reverses and holds that the literal reading of §365(c) requires consent to both assumption and assignment. Thus, having spent $33 million on acquiring and adapting Super Software, Happy Times is left with nothing.

While the outcome of the foregoing hypothetical seems surprising and harsh, that is precisely what happened in the case of *In re Sunterra Corp.,* 361 F.3d 257 (4th Cir. 2004).


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Sunterra Corp. was one of the world's largest resort management companies. Its business involved managing a timeshare club through which club members were allowed to trade their timeshare rights at Sunterra resorts for similar rights at other resorts. Sunterra needed to acquire an integrated computer system to enable it to manage the timeshare club. RCI Technology Corp. developed software for the resort and hospitality industry. Sunterra licensed RCI's software to enable its timeshare clients to trade their timeshare rights. Under the software license agreement, for which Sunterra paid RCI $3.5 million, Sunterra acquired a non-exclusive, worldwide, perpetual, irrevocable, royalty-free license to use, copy, modify and distribute a software program that RCI had registered with the U.S. Copyright Office. In the license agreement, RCI consented to a reasonable assignment of the license by Sunterra to a third party. Pursuant to the licensing agreement, Sunterra then spent $38 million to adapt the software to meet its particular needs. Under the license agreement, Sunterra owned the modifications and licensed them back to RCI. Each party was obligated to keep the source code confidential.

Subsequently, Sunterra filed for chapter 11 protection in the U.S. Bankruptcy Court for the District of Maryland. Approximately two years after Sunterra's bankruptcy filing, RCI filed a motion asking the bankruptcy court to deem the software license agreement rejected because it was an executory contract that could not be assumed without RCI's consent. RCI asserted that its consent was required by federal copyright law and §365(c) of the Code. Because RCI consented only to an *assignment* but not an *assumption* of the license agreement, RCI contended that the license must be deemed rejected. Sunterra successfully opposed RCI's motion in the bankruptcy court and on appeal to the district court. RCI then appealed to the Fourth Circuit Court of Appeals, which reversed the lower courts' decisions, holding that while the license agreement might be assigned by the debtor, the license could not be assumed by the debtor.

The key provision of the Code involved in the *Sunterra* case was 11 U.S.C. §365(c), which states, in relevant part:

> The trustee may not assume or assign any executory contract...of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—
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> > (1)(A) applicable law excuses a party, other than the debtor, to such contract... 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

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> restricts assignment of rights or delegation of duties; and
> (B) such party does not consent to such assumption or assignment.

The parties disagreed in the lower courts about whether the software license agreement was an executory contract. The bankruptcy court held that it was not. The district court disagreed and found that the software license agreement was an executory contract. The Fourth Circuit held that a contract was executory if obligations of both the bankrupt and the other party to the contract were so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other. The Fourth Circuit concluded that the software agreement at issue was executory because each party had a material ongoing obligation to keep confidential the software source code developed by the other.

Having found that the software license agreement was an executory contract, the Fourth Circuit turned to the issue of whether Sunterra could assume the agreement. The court acknowledged that while courts uniformly held that nonexclusive intellectual property licenses were not assignable under §365(c) without consent, a split existed among the circuits concerning whether a debtor could simply assume an executory contract that would not be assignable under nonbankruptcy law. The court noted that it was clear that the statute was drafted in the disjunctive, stating literally that a debtor may not assume or assign an executory contract without the consent of the nondebtor party if applicable nonbankruptcy law would prevent an assignment. The court observed that the majority view is that the statute must be given its plain meaning through what is referred to as a "literal test" or "hypothetical test." Under that standard, if the debtor could not assign the license under nonbankruptcy law without the nondebtor party's consent, then the debtor cannot assume it either, even if the debtor has no intention of assigning the license.

The Fourth Circuit concluded that §365(c) was not in conflict with §365(f)(1). Section 365(f)(1) generally invalidates anti-assignment provisions. It allows an assignment of a contract notwithstanding any applicable law that conditions, prohibits or restricts assignment. Section 365(c), on the other hand, bars assignment when applicable law prohibits assignment without the other party's consent. The Fourth Circuit reconciled these two provisions, however, by reasoning that the applicable law referenced in each section was distinct. According to the Fourth Circuit, whereas "applicable law" under §365(f)(1) refers to law that, as a general matter, prohibits or restricts the assignment of a contract, applicable law under §365(c) refers to law that does not only recite a general prohibition on assignment, but rather more specifically excuses a party from accepting performance from anyone other than the original counterparty.

Next, the court addressed the apparent inconsistency in §365(c)'s reference to "the debtor or the debtor-in-possession" in defining the persons to or from whom performance need not be rendered or accepted from under applicable law. According to the Fourth Circuit, if the directive of §365(c)(1) is to prohibit assumption whenever applicable law excuses performance with respect to any entity other than the debtor, why would Congress have added the words "or debtor-in-possession?" The Fourth Circuit found that the term "debtor-in-possession" refers to the assignment portion of the phrase "assume or assign" in §365(c). It reasoned that assumption and assignment are two distinct events. As a result, the court held that before a debtor assigns a contract that is not otherwise assignable under applicable law, it must obtain two separate consents from the nondebtor party: one upon assumption and one upon assignment. According to the Fourth Circuit, the term "debtor-in-possession" comes into play during the latter step where §365(c) forbids assignment, absent consent, if applicable law excuses the nondebtor party from rendering performance to or accepting performance from an entity other than the debtor-in-possession (DIP).

The Fourth Circuit rejected the argument that literal interpretation of §365(c) is inconsistent with the general bankruptcy law policy of fostering a successful reorganization and maximizing the value of the debtor's assets. Similarly, the court rejected the argument that Congress intended that the disjunctive "or" in "assume or assign" be interpreted as the conjunctive "and." While recognizing that such an interpretation would probably lead to a preferable policy outcome, the Fourth Circuit found that it was within Congress' discretion to reach such a result, not the courts. Based on the foregoing, the court concluded that since RCI did not consent to the *assumption* of the license agreement, Sunterra was precluded from assuming the agreement. Thus, Sunterra, having spent $38 million to modify the software, in addition to having paid RCI $3.5 million for the software license, was left to negotiate with RCI for a new software license in a very weak bargaining position.

To date, the Third, Fourth, Ninth and Eleventh Circuits have adopted or expressed approval of the "hypothetical" approach, while the First Circuit has rejected it in favor of the "actual test." Under the "actual test" approach, the court inquires as to whether the debtor is actually trying to assign the contract to a third party. If not, the court will not prevent an assumption.

Courts adopting the "hypothetical test" have generally done so because they believe they are bound by the plain, unambiguous language of the statute. Courts adopting the "actual test," however, find a variety of problems with this approach. They point to the conflict of the "hypothetical test" approach with the general goals of chapter 11 in allowing debtors to benefit from the protections of the Code and encouraging the maximization of the value of the debtor's estate. These courts suggest that the harsh result required by the "hypothetical test," where a nondebtor party obtains the ability to free itself from certain contracts simply because of its counterparty's bankruptcy filing, cannot be supported by any bankruptcy policy.

Unfortunately, the Code reform enacted by Congress and signed by the President earlier this year fails to clarify the meaning of §365(c). In light of the circuit split regarding the "hypothetical test" and the "actual test," it behooves licensees of intellectual property to rely on drafting contracts that would protect their investment in case they choose to reorganize their businesses through bankruptcy. In addition to the typical consent to an assignment of the license agreement outside of the bankruptcy context, a licensee should insist that the license agreement contain the licensor's consent to the licensee's assumption of the licensing agreement in the event of the licensee's bankruptcy filing.[2] ■

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[2] Such a clause might read as follows:
> If a petition for relief is filed by or with respect to the licensee under Title 11 of the U.S. Code, the licensor hereby consents to the assumption or assumption and assignment of the within license pursuant to 11 U.S.C. §365.