ALERTS

Fifth Circuit Holds Asset Purchaser Unable To Acquire Rejected License Agreement

November 2, 2018

A license agreement "deemed rejected by operation of law" could not be acquired under a court-approved asset purchase agreement, held the U.S. Court of Appeals for the Fifth Circuit on Oct. 29, 2018. *In re Provider Meds LLC*, 2018 WL 5317445, *2 (5th Cir. Oct. 29, 2018). Although the acquirer claimed "that it purchased a patent license from [the] debtors in bankruptcy sales of their estates," the court explained that "a rejected executory contract … could not have been transferred by the bankruptcy sales in question … ." *Id.*, at *1. The court also declined to "approve of the use of a" bankruptcy court sale order "to avoid the requirement that an executory contract be assumed and assigned under" Bankruptcy Code ("Code") § 365. *Id.*, at *9.

Relevance

The Fifth Circuit first resolved "whether the License Agreement was an executory contract" because the Code "does not define the term … ." *Id.*, at *3. Second, the court dealt with the novel issue of whether the Code imposed a notice requirement on a Chapter 7 bankruptcy trustee's time to assume a contract. Finally, the court addressed the consequences of contract rejection, an issue about which the circuits are presently split in another context. In fact, to resolve a circuit split, the U.S. Supreme Court just granted a petition for certiorari to address the effect of rejection on a trademark license. *In re Tempnology LLC*, 879 F.3d 389 (1st Cir. 2018) (2-1), *cert. granted*, 2018 WL 2939184 (Oct. 26, 2018) (after licensor-debtor

rejects agreement, non-debtor licensee "left with only a pre-petition damages claim …"); *contra, Sunbeam Products Inc. v. Chicago Am. Mfg. LLC*, 686 F.3d 372, 377 (7th Cir. 2012) (non-debtor's right to use debtor's trademark continues post-rejection). *See* Michael L. Cook, "Split First Circuit Prevents Non-Debtor Licensee from Using Rejected Trademark License." *Pratt's J. Bankr., L*. 142 (April/May 2018).

Facts

Five corporate affiliates used remote pharmaceutical dispensing machines in violation of T's patent. T sued the entities for patent infringement in a Texas federal court, but the parties later settled, with the defendants gaining a "non-exclusive perpetual license" to use T's patent in exchange for "a one-time licensing fee of $4,000 for each … machine placed into operation after the execution of the agreement … ." 2018 WL 5317445, at *1. The defendants also had "to provide [T with] quarterly reports reflecting all new machines placed in service. The parties exchanged releases "except for the obligations specifically called for under" their settlement agreement. Due to the settlement, the federal court dismissed T's patent infringement suit in 2010. *Id.*

The defendants filed separate Chapter 11 petitions in 2012 and 2013, but each case was later converted to a Chapter 7 liquidation. Five debtors were "parties" to the license agreement, but never "listed the License Agreement or [T] on their schedules" of assets and liabilities. *Id.*

A lender, R, had a security interest in all of the debtors' assets, but, more than 60 days after the conversion of the cases' conversion to Chapter 7, agreed to purchase that collateral from three of the debtors' estates instead of litigating its liens. *Id.*, at *2. The bankruptcy court approved the asset sale in a separate sale order. No asset purchase agreement "explicitly referenced [T's] License; instead, each [agreement] covered certain categories of subject property." The sale orders entered by the bankruptcy court provided "that to the extent that any of the subject property was an executory contract it was 'hereby ASSUMED by the Estate and immediately ASSIGNED to [R] under the applicable provisions of … the … Code.'" R believed that it "had purchased the License under the terms of the" sale orders. *Id.*, at *2.

A year after the bankruptcy court approved the asset sale and related agreements, T sued the debtors, alleging that they had failed to comply

with their obligations under the Licensing Agreement "to provide quarterly reports and pay licensing fees … ." *Id.* As the asserted owner of the License, R "intervened and removed the proceeding to the bankruptcy court, arguing that the … debtor estates had assigned or otherwise transferred the License to [it]." *Id.*

The Lower Courts

The bankruptcy court held that R had no "rights under the License Agreement" because it "had not purchased the License under any of the" sale orders and, in any event, "the License Agreement was an executory contract that was rejected by operation of law [sixty days after the Chapter 7 order for relief,] prior to any alleged transfer." *Id.*, at *2. The district court affirmed.

The Fifth Circuit

License Agreement an Executory Contract. Under Fifth Circuit precedent, a contract is executory if "performance remains due to some extent on both sides" and if "at the time of the bankruptcy filing, the failure of either party to complete performance would constitute a material breach of the contract, thereby excusing the performance of the other party." *In re Murexco Petroleum*, 15 360, 62 (5th Cir. 1994). The issue in *Provider Meds*, said the court, was whether "both sides … owed additional performance under the License Agreement, and whether any party's failure to perform would constitute a material breach excusing the other side's performance." 2018 WL 5317445, at *3.

The Fifth Circuit rejected R's argument that T's settlement obligation to refrain from suing the debtors was "illusory." *Id.*, at *4. Despite the earlier stipulated dismissal of T's patent infringement suit, "principles of claim preclusion … would not have barred" T from suing the debtors. *Id.*, at *6. Therefore, T "had an ongoing material obligation under the License Agreement to refrain from suing the debtors." *Id.*, at *6. Similarly, the debtors "also had corresponding material obligations under the License Agreement" requiring them "to take certain ongoing actions, such as filing quarterly reports and not discussing the settled lawsuit." *Id.*

The court further rejected R's unsupported argument "that a license [which] is *only* 'perpetual' and not 'perpetual and irrevocable,' is irrevocable in the face of material breach … ." *Id.*, at *7. The License here

was "perpetual," and thus "not revocable at will." *Id.* "[B]oth sides [thus] had ongoing material obligations under the … License Agreement, making it an executory contract." *Id.*

Agreement Rejected by Operation of Law. Code § "365(d)(1) imposes a *sixty*-day deadline for a bankruptcy trustee to assume an executory contract, starting here with the cases' conversion from Chapter 11 to Chapter 7. After that deadline passes, the contract will be deemed rejected by operation of law." *Id.* Because the License Agreement here was executory, "it was deemed rejected when each of the bankruptcy estates failed to assume it prior to the expiration of the sixty-day period." *Id.* This statutory deadline applies only in Chapter 7 liquidation cases, for, as the court noted, a trustee or a Chapter 11 debtor-in-possession "may assume or reject an executory contract at any point before the plan is confirmed." *Id.*, at *3, citing Code § 365(d)(2) and *In re O'Connor*, 258 F.3d 392, 400 (5th Cir. 2001). *See NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 529 (1984) (reorganizing debtor needs more time to decide on rejection).

No Notice Requirement. The court rejected R's argument for avoiding the Code's 60-day deadline because the debtors had failed to schedule the License Agreement and because the trustees were "unaware of the contract within the sixty-day period." 2018 WL 5317445, at *7. "Like most circuits," the Fifth Circuit had not addressed this issue "directly," but stressed that the License Agreement "was a matter of public record" in the 2010 district court patent litigation. *Id.*, at *8. Nor was there any evidence of "intentional concealment." *Id.* Because Code § 365(d)(1) imposes no "actual or constructive notice requirement for when the sixty-day deadline applies," the Fifth Circuit refused to "read such a requirement into the statute when doing so is not supported by the statutory text." *Id.*

The Effect of Rejection. The court also dismissed R's argument that the trustees could sell the License Agreement even when it had been rejected. "The rejection of an executory contract places that contract outside of the bankruptcy estate … [and] cannot be sold under a provision that authorizes a trustee to sell 'property of the estate.'" *Id.* For a contract to be sold under Code § 363, it must be "assumed and assigned under section 365." *Id.*

In sum, "the License Agreement was deemed rejected by operation of law when each trustee failed to assume it within the sixty-day period." Moreover, "the statutory presumption of rejection after sixty days is

conclusive where there is no suggestion that the Debtor intentionally concealed a contract from the estate's trustee." *Id.*

Comments

- *Provider Meds* shows inadequate pre-acquisition diligence by a prospective buyer. A little digging would have disclosed the rejection of the License Agreement. Within the past year, a Chapter 11 debtor-in-possession lender made a similar mistake. *Banco Panamericano Inc. v. City of Peoria Inc.*, 880 F.3d 329 (7th Cir. 2018) (lender with lien on all of Chapter 11 debtor's assets failed to discover that lease, thought to be its collateral, had been terminated prior to financing). *See SRZ Alert*.

- Aside from the previously noted *Tempnology* and *Sunbeam* circuit splits to be resolved by the U.S. Supreme Court in the next year, the Connecticut Supreme Court defined the effect of bankruptcy on contracts last year: Bankruptcy "does not constitute a per se breach of contract and does not excuse performance by the other party in the absence of some further indication that the [debtor] either cannot, or does not, intend to perform," held the Connecticut court in a lengthy opinion on Nov. 21, 2017. *CCT Communications Inc. v. Zone Telecom Inc.*, 2017 WL 54777540, *13 (Ct. Nov. 21, 2017) (en banc), superseding 324 Conn. 654, 153 A.3d 1249 (2017).

The Supreme Court rejected the trial courts' erroneous finding that the plaintiff debtor's bankruptcy petition "constituted a breach of [contract, permitting] the defendant to terminate that agreement." *Id.* at *2. Because the trial court never found that the debtor (CCT) "either could not or did not intend to perform its obligations as a result of its bankruptcy filing," it had not "breached the … agreement by filing for bankruptcy protection." *Id.* at *13. Nothing in the contract itself supported the trial court's "conclusion that filing the [bankruptcy] petition constituted a breach by [CCT]." *Id.*

Equally important, the Connecticut court rejected the lower court's enforcement of an *"ipso-facto"* bankruptcy termination clause, reasoning that the contractual language in this case "only" gave the non-debtor defendant "the option to terminate." *Id.* at *12. Nor, on the facts of the case, could the non-debtor rely on the so-called judicially created "ride-through" exception to evade the Bankruptcy Code's invalidation of *ipso-facto* termination clauses (§ 365(e)(1)). *See* Michael L. Cook "Connecticut

Supreme Court Defines Bankruptcy Effect on Contracts," 35 *Bankr. Strategist* No. 3 (Jan. 2018).

Authored by Michael L. Cook.

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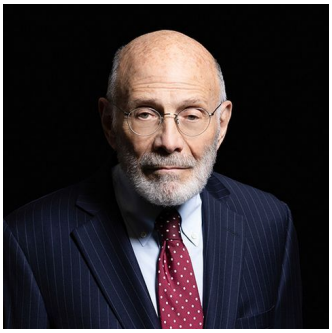

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