st. john's UNIVERSITY
SCHOOL OF LAW

St. John's Bankruptcy Research Library
A project of St. John's School of Law and the American Bankruptcy Institute Law Review

2012 Volume IV No. 14

# Assumption Under Section 365(c)(1) Creates Uncertainty for Debtors

**Heather Hili, J.D. Candidate 2013**

Cite as: *Assumption Under Section 365(c)(1) Creates Uncertainty for Debtors*, 4 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 14 (2012)

## Introduction

The assumption and assignment of executory contracts raises many issues in Chapter 11 bankruptcies. One issue is whether the trustee can assume an executory contract, thus forcing the non-debtor party to accept performance from the debtor-in-possession. Section 365(c)(1)[1] of the Bankruptcy Code ("Code") attempts to resolve this issue by providing that a trustee may not assume or assign an executory contract when applicable law would excuse the non-debtor party from accepting performance from someone other than the debtor-in-possession. But courts relying on Section 365(c)(1) to resolve this issue have interpreted it in different ways, creating a split among the circuits.

One interpretation of Section 365(c)(1) employs the "hypothetical" test. Under this test, a court will not allow a debtor-in-possession to assume an executory contract "if applicable law would bar assignment to a hypothetical third party, even where the debtor-in-possession has no

[1] 11 U.S.C. 365(c)(1) (2010) ("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--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 such party does not consent to such assumption or assignment").

intention of assigning the contract in question to any such third party."[2] The other interpretation employs the "actual" test, which disallows "assumption by the debtor-in-possession only where the reorganization in question results in the non-debtor *actually* having to accept performance from a third party."[3] The United States Supreme Court has yet to resolve this issue.

Part I of this memorandum explains the current circuit split on the issue and how courts decide which test to apply. Part II discusses the options a court has when presented this issue for the first time, drawing in guidance from a Supreme Court case that relates to the issue. Part III explains the effects of the circuit split and the impact it has on a debtor. The memorandum concludes that until the Supreme Court rules on the issue or Congress amends Section 365(c)(1), the ability of a debtor to assume an executory contract upon filing bankruptcy will remain uncertain.

## I. The Circuit Split

This part will explain various arguments the circuits have used in interpreting Section 365(c)(1) and deciding which test to employ.

A. Meaning of "or" in Section 365(c)(1)

One reason for the division between the circuits is the word "or."[4] Section 365(c)(1) states, "[t]he trustee may not assume *or* assign any executory contract . . . if . . . ."[5] Those courts applying the "hypothetical" test read the word "or" literally, concluding that unless applicable law allows assignment to a third party, the trustee may not simply assume the contract.[6] For instance, the Ninth Circuit in *In re Catapult* used the "hypothetical" test to determine if a

[2] *In re* Catapult Entertainment, Inc., 165 F.3d 747, 750 (9th Cir. 1999) (explaining "hypothetical" test).
[3] *Id.* at 751 (explaining application of "actual" test).
[4] *In re Footstar*, 323 B.R 566, 570 (S.D.N.Y. 2005).
[5] 11 U.S.C. 365(c)(1) (emphasis added).
[6] *In re* Catapult Entertainment, Inc., 165 F.3d 747, 751 (9th Cir. 1999).

Chapter 11 debtor-in-possession could assume a patent license as part of its reorganization plan.[7] The court held that the debtor could not assume the license because "applicable law" (federal patent law) would excuse the licensor from accepting performance from a third party, even though an actual third party was not involved.[8] Because the word "or" is read literally, the results of this test can "seem at odds with the basic objectives of the Bankruptcy Code."[9]

Those courts applying the "actual" test treat the "or" as an "and," therefore treating the acts of assumption and assignment as one. The First Circuit noted

> that a literal interpretation of the disjunctive "or" is utterly incongruent with the objectives of the Bankruptcy Code and would lead to the anomalous result that a debtor-in-possession would be deprived of its valuable but unassignable contract solely by reason of having sought the protection of the Bankruptcy Court, even though it did not intend to assign it.[10]

To prevent these "anomalous" results, the First Circuit adopted the "actual" test in *Institut Pasteur.*[11] The court found that federal patent law was the "applicable law," but that the law did not prevent the debtor from assuming the patent license because the licensor was not "*actually* . . . 'forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.'"[12]

B. Meaning of "trustee" in Section 365(c)(1)

Another reason for choosing to adopt one test over the other is the meaning of the word "trustee" in Section 365(c)(1). In deciding to apply the "actual" test, the Bankruptcy Court for

---

[7] *Id.* at 748.
[8] *Id.* at 750.
[9] *In re Footstar* 323 B.R. at 570 (stating that courts applying "hypothetical" test believe it is up to Congress to change language of statute and to prevent odd results).
[10] *Institut Pasteur v. Cambridge Biotech Corp.,* 104 F.3d 489, 493 (1st Cir.), *cert. denied*, 521 U.S. 1120 (1997).
[11] *Id.*
[12] *Id.* (citing *Summit Inv. & Dev. Corp. v. Leroux* (*In re* Leroux), 69 F.3d 608, 612 (1st Cir.1995)).

the Southern District of New York in *In re Footstar*, suggested that the focus should be on the plain meaning of "trustee" rather than "or."[13] The statute provides that "[t]he *trustee* may not assume or assign . . . ."[14] The issue is whether the word "trustee" is synonymous with the "debtor-in-possession." Courts applying the "hypothetical" test treat the two as synonymous, whereas those applying the "actual" test do not. By treating the two as synonymous, Section 365(c)(1) will apply regardless of whether it is the trustee or the debtor-in-possession wishing to assume the contract. On the other hand, by not treating the two as synonymous, Section 365(c)(1) will only apply when it is the trustee wishing to assume the contract.

For support in treating "trustee" as synonymous with "debtor-in-possession," courts applying the "hypothetical" test look to Section 1107(a) of the Code, which provides that "a debtor-in-possession shall have all the rights . . . and powers, and shall perform all the functions and duties, . . . of a trustee serving in a case . . . ."[15] In *In re West Electronics, Inc.*,[16] the Third Circuit, in applying the "hypothetical" test, substituted the term "debtor-in-possession" for "trustee." The court found that if "applicable law" provided that the non-debtor party to the case would have to consent to assignment to a third party, then the debtor, West, as the debtor-in-possession, could not assume the contract.[17]

Similarly, the Eleventh Circuit in *In re James Cable Partner*,[18] treated the two terms as synonymous and substituted "debtor-in-possession" for "trustee" in applying the "hypothetical" test. The party wishing to assume the contract in this case was James Cable, the debtor-in-

---

[13] *In re Footstar* 323 B.R. at 570
[14] 11 U.S.C. 365(c)(1).
[15] 11 U.S.C. 1107(a) (2010); *In re* West Elec., Inc., 852 F.2d 79 (3d Cir.1988) (citing 11 U.S.C. 1107(a); *In re* Pioneer Ford Sales, Inc., 729 F.2d 27, 28 (1st Cir.1984)); *see also In re* James Cable Partners, 27 F.3d 534, 537 (11th Cir. 1994) (using 11 U.S.C. 1106 (2010) for support).
[16] 852 F.2d 79 (3d Cir. 1988).
[17] *Id.* at 82–83.
[18] 27 F.3d 534, 537 (11th Cir. 1994).

possession. The court explained, "[a] debtor-in-possession generally has all the rights, powers, and duties of a trustee."[19] As a result, the court concluded that "debtor-in-possession" can be substituted for "trustee" and Section 365(c)(1) applied to James Cable.[20] In applying the "hypothetical" test, James Cable, as the debtor-in-possession, could not assume the contract if applicable law would excuse the City (the non-debtor party) from accepting performance from an entity other than the debtor or debtor-in-possession.[21] In this case, applicable law did not excuse the City from accepting performance from a third party, and James Cable was able to assume the contract.[22] However, had applicable law worked in the City's favor, James Cable, as the debtor-in-possession (substituted for "trustee") would have been prevented from assuming its own contract.

The Fourth Circuit affirmed an opinion in which the District Court for the Eastern District of Virginia discussed the substitution of "debtor-in-possession" for "trustee."[23] Like the cases from the Third and Eleventh Circuit, mentioned above, the court in *In re Catron*, relied on Section 1107(a) of the Code in determining that the two terms are synonymous.[24] Upon determining this, the court went on to decide that the debtor had legally obtained the status of a debtor-in-possession.[25] Then the court applied the "hypothetical" test and ruled that this debtor-in-possession was barred from assuming the contract at issue.[26] The Ninth Circuit in *In re*

[19] *Id.* at 537 (citing 11 U.S.C.A. § 1106 (West 1993)).
[20] *In re James Cable Partner*, 27 F.3d at 537.
[21] *Id.*
[22] *Id.* at 538.
[23] *In re* Catron, 158 B.R. 629 (E.D. Va. 1993), *aff'd without op.*, 25 F.3d 1038 (4th Cir. 1994).
[24] *In re Catron*, 158 B.R. at 632.
[25] *Id.* at 633.
[26] *Id.* at 635.

*Catapult*[27] cited these cases from the Fourth, Third, and Eleventh Circuits in forming a similar opinion.[28]

Those courts applying the "actual" test reason that treating the terms as synonymous "would render the provision a virtual oxymoron, since mere assumption [by the debtor-in-possession] (without assignment) would *not* compel the counterparty to accept performance from or render it to 'an entity other than' the debtor."[29] Therefore, the Bankruptcy Court for the District of New Mexico in *Aerobox* argued that Section 365(c)(1) does not prohibit assumption when the debtor-in-possession, as opposed to the "trustee," is the entity assuming the contract.[30]

Support for this reading of Section 365(c)(1) can be found in the legislative history. In *In re Cardinal Industries, Inc*,[31] the Bankruptcy Court for the Southern District of Ohio analyzed the legislative history of the statute in determining that the term "trustee" is not interchangeable with "debtor-in-possession."[32] The court relied on the Bankruptcy Amendments and Federal Judgeship Act of 1984.[33] This act "amended 11 U.S.C. § 365(c)(1)(A) by substituting the phrase 'an entity other than the debtor or the debtor-in-possession' for the words 'the trustee.'"[34] The legislative history behind this change states,

> [t]his amendment makes it clear that the prohibition against a trustee's power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service

[27] *See supra* Part I.A.
[28] *In re Catapult Entertainment, Inc.*, 165 F.3d at 750–51.
[29] *In re Aerobox*, 373 B.R. at 142 (citing *In re Footstar*, 323 B.R. at 573).
[30] *In re Aerobox*, 373 B.R. at 142.
[31] 116 B.R. 964 (S.D. Ohio 1990).
[32] *Id.* at 979.
[33] *Id.* (citing Pub. L. No. 98–353, 98 Stat. 333 (1984), reprinted in Appendix 1, L. King, Collier on Bankruptcy 1585 (15th ed. 1989)).
[34] *In re Cardinal Industries*, 161 B.R. at 979 (citing 11 U.S.C. § 365(c)(1)(A) (Supp. II 1985)).

> contract will be the same as if no petition had been filed because of the personal service nature of the contract.[35]

The court used this comment for support in deciding that the term "trustee" and "debtor-in-possession" are not synonymous, and in deciding to apply the "actual" rather than the "hypothetical" test.[36] The court concluded that this comment made it clear that a debtor-in-possession can assume a contract that is not assignable under applicable law, and therefore the "actual" test should apply.[37]

The Bankruptcy Court for the Northern District of Mississippi in *In re Jacobsen*[38] also relied on the change in the language of Section 365(c)(1)(A) in holding that "trustee" does not mean "debtor-in-possession."[39] In addition, the court cited to Collier on Bankruptcy to support its decision to apply the "actual" test. Collier described the *West Electronics* decision, discussed above, as "troubling" and approved of the First Circuit's decision in *Institut Pasteur*, also discussed above.[40] *Jacobsen* is one of the most recent cases dealing with this issue. The court in *Jacobsen* chose to apply the "actual" test based on Collier, the legislative history, and the "overwhelming majority of cases" that convinced the court the "hypothetical" test is erroneous.[41]

## II. The Current Status of Section 365(c)(1)

Part A of this section will discuss how the interpretations discussed in Part I have been used by the parties to a recent case in making their arguments to a court that has not decided the

---

[35] *In re Cardinal Industries*, 161 B.R. at 979 (citing H.R. Rep. No. 1195, 96th Cong., 2d Sess. § 27(b) (1980)).
[36] *In re Cardinal Industries*, 161 B.R. at 979.
[37] *Id.*
[38] 2011 WL 482828 (N.D. Miss. 2011).
[39] *Id.* at 4.
[40] *Id.* at 5 (citing 3 Collier on Bankruptcy, § 365.07[1][d]).
[41] *In re Jacobsen*, 2011 WL 482828, 5.

assumption issue. Part B will explain where the Supreme Court currently stands on the meaning of Section 365(c)(1).

A. Undecided Circuit

The Seventh Circuit is one of the few circuits that have not ruled on the assumption issue. Recently, the court decided a case in which it was presented with, but failed to discuss this issue. In *In re XMH Corp.*,[42] the debtors wanted to assign a trademark license agreement to a third party rather than assume the contract as the debtors-in-possession.[43] As a result, the court simply held that the license was not assignable and did not consider whether the debtors could assume the license.[44]

Both parties to this case discussed the issue of assumption in their briefs to the circuit court and relied on the cases and interpretations discussed in Part I for support in their arguments. For example, in its brief, Western Glove Works ("WGW"), the licensor, argued that the "hypothetical" test should apply to determine whether the debtors have the right to assume the executory contract.[45] WGW argued that under the test the debtors could not assign the license agreement because trademark law does not allow assignment of a license to a third party without consent of the licensor, even if the debtor-in-possession has no intention to assign the license.[46] In addition, WGW argued that even under the "actual" test, as preferred by the purchasers of the debtors' assets, the result would be the same.[47] WGW based this conclusion on the court's

[42] 647 F.3d 690 (7th Cir. 2011).
[43] *In re XMH Corp.*, 647 F.3d at 692.
[44] *Id.* at 692.
[45] Reply Brief of Appellant Western Glove Works, *supra* note 6, at 13.
[46] Opening Brief of Appellant Western Glove Works at 42, *In re* XMH Corp., 647 F.3d 690 (7th Cir. 2011) (No. 10-2596–99), 2010 WL 6019694 (C.A.7).
[47] Reply Brief of Appellant Western Glove Works, *supra* note 6, at 15–16.

reasoning in *In re Aerobox*[48] that when applying the "actual" test, the debtor must be capable of operating its business in order to assume the contract.[49] Here, WGW asserted that, after bankruptcy, there would not be a business left for debtors to operate and therefore, no entity left to perform if the debtors assumed the contract.[50]

The purchasers of the debtors' assets argued that "[a]pplication of the hypothetical test as WGW advocates leads to the absurd result that certain agreements can *never* be assumed by a debtor-in-possession without the other party's consent -- even where the debtor-in-possession is ready, willing and able to *continue* performing the agreement just as it did prepetition."[51] Also, purchasers explained that debtors were able to continue performance, and under the "actual" test, debtors would be able to assume the contract as the debtors-in-possession.[52]

The purchasers relied heavily on the distinction between assumption by a trustee versus assumption by the debtor-in-possession.[53] They cited *In re Footstar*[54] in arguing that if the trustee is the entity assuming the contract, then it is essentially an assignment that applicable law may prohibit.[55] But, if the debtor-in-possession is assuming the contract, then there is not an assignment and it can assume.[56]

---

[48] *In re* Aerobox Composite Structures, LLC, 373 B.R. 135 (Bankr. D.N.M. 2007); *see* discussion *supra* Part I.
[49] Reply Brief of Appellant Western Glove Works, *supra* note 6, at 15.
[50] Reply Brief of Appellant Western Glove Works, *supra* note 6, at 16.
[51] Brief of Purchasers of Substantially all of Debtors' Assets, *supra* note 6, at 45.
[52] Brief of Purchasers of Substantially all of Debtors' Assets, *supra* note 6, at 44–46.
[53] Brief of Purchasers of Substantially all of Debtors' Assets, *supra* note 6, at 44 (citing *In re* Footstar, Inc., 323 B.R. 566, 573 (S.D.N.Y. 2005); *In re* Adelphia Commc'ns Corp., 359 B.R. 65 (Bankr. S.D.N.Y. 2007); *In re* Aerobox Composite Structures, LLC, 373 B.R. 135 (Bankr. D.N.M. 2007)).
[54] 323 B.R. 566 (S.D.N.Y. 2005); *see* discussion *supra* Part I.
[55] Brief of Purchasers of Substantially all of Debtors' Assets, *supra* note 6, at 44.
[56] Brief of Purchasers of Substantially all of Debtors' Assets, *supra* note 6, at 44.

*In re XMH Corp.* came down in 2011; the same year the Northern District of Mississippi decided *In re Jacobsen*.[57] Interestingly, the court in *Jacobsen* chose to apply the "actual" test for many of the same reasons given by the purchasers in *XMH*. A decision on this issue from the Seventh Circuit in favor of the purchasers would have potentially identified a new trend among the courts. However, we are instead left without a decision in the Seventh Circuit and remain uncertain if employment of the "actual" test is gaining popularity.

B. Opinion from the Supreme Court

The only contribution the Supreme Court has offered on the issue thus far has come from an opinion denying a petition for writ of certiorari.[58] *N.C.P. Marketing Group, Inc.* came to the Supreme Court from the Ninth Circuit, a circuit that has adopted the "hypothetical" test.[59] Justice Kennedy, joined by Justice Breyer, explained the two tests and the problems that each presents. Regarding the "hypothetical" test, Justice Kennedy discussed the sacrifice that is made by adhering to the text of the statute rather than bankruptcy policy.[60] "[T]he hypothetical test may prevent debtors-in-possession from continuing to exercise their rights under nonassignable contracts . . . . Without these contracts, some debtors-in-possession may be unable to effect the successful reorganization that Chapter 11 was designed to promote."[61] In discussing the "actual" test, the only criticism Justice Kennedy discussed was the departure from the plain text in order to conform to sound bankruptcy policy.[62] Justice Kennedy stressed that this is an important issue

[57] 2011 WL 482828 (N.D. Miss. 2011); see *supra* Part I.
[58] *N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc.*, 125 S. Ct. 1577 (2009).
[59] *In re Catapult Entertainment, Inc.*, 165 F.3d at 751.
[60] *N.C.P. Marketing Group, Inc.*, 125 S. Ct. at 1577.
[61] *Id.*
[62] *Id.*

that the court must resolve; however he explained that this was not the most suitable case for that purpose.[63]

**III. Effects of the Circuit Split**

The ability of a debtor-in-possession to assume an executory contract upon filing for bankruptcy in circuits that have not ruled on this issue is uncertain. This uncertainty will cause a debtor to think twice before filing bankruptcy because of the risk that it will not be able to assume its executory contracts as a debtor-in-possession.

This issue arises in Chapter 11 cases in which the debtor is an entity conducting a business. As a business entity, the debtor may have a choice in determining where to file for bankruptcy. As a result, forum shopping may become an issue because a debtor will want to file in a forum that applies the test most suitable for its purposes. For instance, two cases discussed in Part I, *In re Catapult Entertainment, Inc.*[64] in the Ninth Circuit and *Institut Pasteur*[65] in the First Circuit, concerned the assumption of patent licenses. Both courts found that federal patent law was the "applicable law" for the purposes of Section 365(c)(1), but the results of the cases were not the same.[66] When the "actual" test was applied in the First Circuit, the debtor-in-possession was able to assume the license, however, when the "hypothetical" test was applied in the Ninth Circuit, the debtor-in-possession was barred from assuming the license.[67] If a debtor had the choice to file in either the First Circuit or the Ninth Circuit, it would be in its best interest to choose the former. If the debtor did not have a choice in forum it may, if possible, chose not to

[63] *Id.*
[64] 165 F.3d 747 (9th Cir. 1999).
[65] 104 F.3d 489 (1st Cir.), *cert. denied*, 521 U.S. 1120 (1997).
[66] *See supra* Part I.A.
[67] *See supra* Part I.A.

file bankruptcy altogether if it knew it would not be able to assume an essential business contract as the debtor-in-possession.

**IV. Conclusion**

The circuits that have ruled on the assumption of executory contracts under Section 365(c)(1) are split. For various reasons, some courts employ the "hypothetical" test while others employ the "actual" test. This split has caused similar cases to have different outcomes, depending on where the debtor filed for bankruptcy. In order to prevent different rulings on similar cases, either the Supreme Court needs to decide the issue, or Congress has to amend Section 365(c)(1) to clarify the discrepancy.