

MAC Clauses in Commercial Loan Documents - Are They Effective?



by Richard S. Toder and Wendy S. Walker

Introduction

The “standard” borrower representations and warranties in commercial loan documents typically include a “no material adverse change” or “no material adverse effect” clause (MAC). Specifically, the borrower will represent and warrant that, since an agreed-upon date (e.g., the date of the latest audited financial statements delivered to the lender), no MAC has occurred. The representation and warranty must be true as of the date of any borrowing, and violation of the representation constitutes an event of default.

A common definition of a MAC in a commercial loan agreement is as follows:

“Material Adverse Effect” means a material adverse effect on (a) the business, assets, operations, prospects or condition, financial or otherwise, of the Borrower and the Subsidiaries taken as a whole, (b) the ability of the Borrower to perform any of its obligations under this Agreement or (c) the rights of or benefits available to the Lenders under this Agreement.

In commercial loan arrangements, a lender is not obligated to honor a borrowing request unless the borrower is in compliance with the terms of the loan agreement, including the representation

that no material adverse change or effect has occurred. For the reasons discussed below, however, lenders may face significant risks from refusals to fund based solely on a MAC.

Discussion

Two decisions regarding MACs and involving failed mergers are instructive: *Frontier Oil Corp. v. Holly Corp.*, 2005 WL 1039027 (Del. Ch. April 29, 2005), and *IBP v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001).

Frontier involved litigation between two petroleum refiners, Frontier Oil Corp. (Frontier) and Holly Corp. (Holly), under a merger agreement in which the parties represented and warranted to each other, among other things, that “there were no threatened legal proceeding other than those that would not have or would have or reasonably be expected to have a Frontier Material Adverse Effect.”¹ The term “Material Adverse Effect” (MAE) was defined in the merger agreement as follows:

“(d) ‘Material Adverse Effect’ with respect to Holly or Frontier shall mean a material adverse effect with respect to (A) the business, assets and liabilities (taken together), results of operations, condition (financial or otherwise) or prospects of a party and its Subsidiaries on a consolidated basis or (B) the ability of a party to consummate the transactions contemplated by this Agreement or fulfill the conditions to closing set forth in Article 6, except to the extent (in the case of either (A) or (B) above) that such adverse effect results from (i) general economic, regulatory or political conditions or changes therein in the United States or the other countries in

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editors

Menachem O. Zelmanovitz
mzelmanovitz@morganlewis.com

Jay Teitelbaum
jteitelbaum@morganlewis.com

Wendy S. Walker
wwalker@morganlewis.com

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NEWSFLASH

Oneida Ltd. Plan of Reorganization Confirmed

On August 30, 2006, Judge Gropper of the U.S. Bankruptcy Court for the Southern District of New York confirmed the plan of reorganization in the Oneida, Ltd. bankruptcy case. The Oneida plan provided for payment in full in cash to Oneida's tranche A secured lenders in the amount of approximately \$100 million and general unsecured creditors and for the distribution of 100% of the stock of the reorganized Oneida to the tranche B secured lenders, whose claims totalled approximately \$75 million. The plan was confirmed after a protracted confirmation hearing spearheaded by the Official Committee of Equity Security Holders. The Equity Committee plan objections, based upon allegations of bad faith and undervaluation of the reorganized debtors, were rejected by the Bankruptcy Court, which adopted the valuation testimony of the experts presented by Oneida, the Lenders and the Creditors Committee. The Bankruptcy Court decision is reported at 2006 WL 2506493 (Bankr. S.D.N.Y. 2006). Morgan, Lewis & Bockius LLP represented JPMorgan Chase Bank, N.A. as agent for the postpetition lenders and for the tranche A and B pre-petition secured lenders throughout the bankruptcy proceedings. The Morgan Lewis team consisted of Richard S. Toder, Wendy S. Walker, Jay Teitelbaum, Leonard Klingbaum, Mark C. Haut and Jay Baribeau. Alvarez & Marsal acted as financial advisors for the agent.

which such party operates; (ii) financial or securities market fluctuations or conditions; (iii) changes in, or events or conditions affecting, the petroleum refining industry generally; (iv) the announcement or pendency of the Mergers or compliance with the terms of Section 5.1 hereof; or (v) stockholder class action or other litigation arising from allegations of a breach of fiduciary duty relating to this Agreement.”²

Frontier sued Holly, claiming that it had repudiated the merger agreement. Holly counterclaimed, alleging that Frontier breached the MAE representation as a result of threatened environmental litigation involving a subsidiary of Frontier. The court first examined the terms of the MAE representation, stating that “the definition chosen by the parties emphasizes the need for forward-looking analysis; that is especially true because the parties . . . added the ‘would not reasonably be expected to have’ an MAE standard to the scope of the inquiry regarding threatened litigation and the term ‘prospects’ . . . in the definition of MAE.”³

The court held that Holly had the burden of proving that Frontier had breached the MAE representation, but that Holly failed to demonstrate that the environmental litigation, which could be “catastrophic for Frontier”, was likely to occur.⁴ Holly did offer evidence that defense costs were estimated to be \$15 million to \$20 million, but failed to show that such costs could not be absorbed by Frontier without an MAE in light of Frontier's enterprise value of approximately \$338 million.⁵

In *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001), IBP, Inc. (IBP) sued Tyson Foods, Inc. (Tyson) seeking to compel it to acquire IBP under a merger agreement entered into by the parties. Tyson asserted that it was not obligated to proceed with the transaction, as a result of a breach by IBP of its representation that no MAE had occurred.⁶

Specifically, Tyson asserted that an impairment charge with respect to one of IBP's business lines and IBP's poor performance during the

fiscal quarter in which the transaction was being documented breached the representation and warranty under §5.10 of the merger agreement “that IBP had not suffered a material adverse effect since the ‘Balance Sheet Date’ of December 29, 1999, except as set forth in the Warranted Financials or Schedule 5.10 of this Agreement.”⁷ The term “material adverse effect” was defined in the merger agreement as “any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect . . . on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as a whole.”⁸

The court found that Tyson had the burden of showing that an MAE had occurred under New York law and that such burden was substantial. On the merits, the court held that (i) a general economic or industry downturn could not cause an MAE unless a material negative effect on the target was also proven, (ii) MAE clauses are to be interpreted in light of the relative positions of the parties such that a single quarter of poor performance would not constitute an MAE for a strategic buyer, but might for a short term speculator, and (iii) MAE clauses protect buyers against only unknown events. The court stated:

These negotiating realities bear on the interpretation of § 5.10 and suggest that the contractual language must be read in the larger context in which the parties were transacting. To a short-term speculator, the failure of a company to meet analysts' projected earnings for a quarter could be highly material. Such a failure is less important to an acquiror who seeks to purchase the company as part of a long-term strategy. To such an acquiror, the important thing is whether the company has suffered a Material Adverse Effect in its business or results of operations that is consequential to the company's earning power over a commercially reasonable period, which one would think would be measured in years rather than months.

It is odd to think that a strategic buyer would view a short term blip in earnings as material, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause.¹⁰

Since market analysts maintained a positive outlook for IBP notwithstanding its poor performance in the previous fiscal quarter, the court found that no MAE had occurred.¹¹ Rejecting Tyson's other arguments, the court ordered Tyson to proceed with the merger.¹²

Conclusion

Given the lack of reported decisions in the commercial loan context, the methodology and conclusions of courts in interpreting alleged MAC defaults in the context of mergers and acquisitions are instructive. First, courts will likely undertake a factual inquiry into what constitutes a material adverse change. Second, the inherent difficulties of such inquiry are heightened by the courts' desire and determination to discern the parties' overall intent within the context of the deal. Third, reliance on a MAC default, as opposed to a breach of a financial covenant or payment default, presents obvious lender liability risks if

it is determined that the circumstances relied upon by the lender did not result in a MAC. This is particularly true because a decision not to fund generally has dire consequences for the borrower. All of the above highlight the tension between the desire to structure broad MAC clauses to capture so-called "soft" defaults and

the need to adequately define the MAC. Those factors also underscore the need to focus commercial loan agreement negotiations on structuring tight financial covenants. Such "hard" defaults may be objectively assessed and relied upon by a lender seeking to terminate lending to a borrower.

endnotes

¹ 2005 WL 1039027 *33.

² *Id.* at *10.

³ *Id.* at *33. The court also noted that "[t]he notion of an MAE is imprecise and varies both with the context of the transaction and its parties and with the words chosen by the parties." *Id.* at *34.

⁴ *Id.* at *35-36.

⁵ *Id.* at *36-37.

⁶ 789 A.2d at 51-52.

⁷ *Id.* at 65.

⁸ *Id.* The court interpreted the MAE clause as requiring "the court to examine whether a MAE has occurred against the December 25, 1999 condition of IBP as adjusted by specific disclosures of the Warranted Financials and the Agreement itself." The court found that such an approach made "commercial sense because it

establishes a baseline that roughly reflects the status of IBP as Tyson indisputably knew it at the time of signing the Merger Agreement." *Id.* at 66.

⁹ *Id.* at 68.

¹⁰ *Id.* at 67 (emphasis in original)(footnotes omitted). The "negotiating realities" to which the court referred included IBP's financials and forward projections, which revealed (i) "a company that is consistently profitable, but subject to strong swings in EBIT and net earnings," (ii) a segment of IBP's business (Foodbrands) that was "hardly a stable source of earnings," and (iii) an expected "trough in the cattle cycle," which would not turn around until fiscal year 2004. *Id.*

¹¹ *Id.* at 71-72.

¹² *Id.* at 84.



Jurisdictional Power Play

bankruptcy court vs. federal energy regulatory commission

by William H. Schrag¹

Introduction

Does a bankruptcy court have the power to authorize rejection of a wholesale electrical power contract that is subject to the jurisdiction of the Federal Energy Regulatory Commission

(FERC)?² The answer is open and may depend on the forum deciding the issue.

In *In re Calpine*, 337 B.R. 27 (S.D.N.Y. 2006), appeal argued, (2d Cir. Apr. 10, 2006), Judge Casey of the United States District Court for the Southern District of New York held that the jurisdiction of the bankruptcy court was limited and vacated a temporary restraining order issued by the *Calpine* bankruptcy court to prevent FERC from determining the validity of certain power purchase agreements (PPAs).³ In doing so, Judge Casey rejected the holding

of *In re Mirant*, 378 F.3d 511 (5th Cir. 2004), that a bankruptcy court could authorize the rejection of PPAs under the Bankruptcy Code. In rejecting the *Mirant* ruling, the District Court reasoned that Congress intended FERC to have exclusive jurisdiction over the terms and conditions of wholesale energy contracts and, therefore, bankruptcy courts could not authorize the rejection of such contracts.

FERC

FERC is an independent agency that regulates the interstate transmission of electricity,

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natural gas and oil. It also reviews proposals to build liquified natural gas terminals and interstate natural gas pipelines, and licenses hydropower projects. Although energy contracts are privately negotiated, the contracts must be filed with FERC and certified as “just and reasonable” to be lawful under the FPA.⁴ The FPA mandate includes “the protection of electricity consumers through the ‘orderly development of plentiful supplies of electricity.’”⁵ FERC’s mission is to protect the integrity of the electrical supply in the United States, preventing, to the extent possible, unnecessary disruptions. In furtherance of that mission, FERC, under the FPA, has the exclusive authority to determine

its PPAs. Calpine also sought the rejection of certain PPAs⁶ because the prices fixed in the PPAs were significantly lower than prevailing electricity prices.⁷ If rejection were allowed, Calpine intended to enter into new PPAs at prevailing market rates for electricity it supplied. On December 21, 2005, in an administrative proceeding, following issuance of the TRO and prior to issuance of Judge Casey’s opinion, FERC issued an “order providing interim guidance” that adopted the policy position of the Fifth Circuit in *Mirant*, to wit, the FPA does not preempt Section 365 of the Bankruptcy Code and the Bankruptcy Court could authorize rejection of filed rate energy contracts. On December 30, 2005, the

authority over filed rate energy contracts;” and found “little evidence of [C]ongressional intent to limit FERC’s regulatory authority”¹⁰ in the Bankruptcy Code.¹¹ The District Court also found that it lacked a clear standard upon which to review a debtor’s rejection of an energy contract, which further militated toward leaving these disputes in the hands of the federal regulatory body.¹² The District Court cast the controversy as one of price approval, which could only be determined by action taken by FERC. Further justifying its split with Fifth Circuit precedent, the District Court stated: “The Court’s conclusion in this case is consistent with general policy considerations, including the proper allocation of power in our system of separated powers.”¹³ A filed rate transforms a PPA into the “equivalent of a Federal regulation,”¹⁴ which falls squarely within FERC’s administrative guidelines.

Analysis

In *Mirant*, the Fifth Circuit permitted rejection of certain PPAs. The District Court in *Calpine* did not permit rejection.¹⁵ Are the two decisions irreconcilable, or can they be harmonized? Key issues driving this question include (i) the scope of the mandate of FERC under the FPA, (ii) whether the rejection of a PPA represents a “collateral” or “indirect” attack on FERC’s jurisdiction over such contracts, (iii) whether Congress generally intended the FPA to supersede the provisions of the Bankruptcy Code and (iv) the proper forum and legal standard to resolve the “pricing” dispute.

If FERC’s policy mandate is the protection of the public interest, that purpose is not impaired by enabling rejection of an energy contract by an electricity purchaser-debtor. Notwithstanding the District Court’s observation that its holding conflicted with the Fifth Circuit, *Mirant* was not controlling because it relied heavily on Fifth Circuit precedent with no Second Circuit corollaries. Indeed, Judge Casey concluded that even if he adopted and applied *Mirant* faithfully, he would still find that FERC had exclusive jurisdiction over the fate of these PPAs. Judge Casey declared that,

Does a bankruptcy court have the power to authorize rejection of a wholesale electrical power contract that is subject to the jurisdiction of the Federal Energy Regulatory Commission?

the reasonableness of wholesale electricity rates, and its determinations are not subject to collateral attack in any other proceedings.

Factual Background of *Calpine*

Calpine is a federally regulated public utility that entered into long-term wholesale power agreements. In recent years, Calpine more than doubled the number of its power plants; it primarily funded its rapid expansion with debt. Service obligations, in addition to the sharp rise in natural gas prices, resulted in the filing of a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on December 20, 2005. On December 21, 2005, in the United States Bankruptcy Court for the Southern District of New York (the Bankruptcy Court), Calpine commenced an adversary proceeding against FERC, seeking a preliminary injunction, and obtained an ex parte temporary restraining order (TRO) prohibiting FERC from requiring Calpine’s compliance and continued performance under

Counter-Parties filed motions to withdraw the reference of Calpine’s motion to reject the energy contracts. On January 4, 2006, the District Court granted the motions and ordered the withdrawal of the reference to the Bankruptcy Court.

Holding

The District Court accused Calpine of seeking the TRO in order to avoid the authoritative exercise of FERC’s regulatory powers. The District Court held that the Bankruptcy Court could not interfere with the mandate of the federal agency acting in its regulatory capacity, since such interference would constitute an impermissible collateral attack upon FERC’s jurisdiction under the filed-rate doctrine. The District Court supported its interpretation by citing the applicable Bankruptcy Code provision,⁸ which “expressly exempts a federal agency, like FERC, from the automatic stay provision of the Bankruptcy Code.”⁹ Judge Casey observed that “FERC [had] vast

as opposed to *Mirant*, high price and excess capacity were not issues in *Calpine*.¹⁶ The debtor in *Mirant* gave two justifications for rejection of its purchase obligations: (i) above market rates and (ii) an overabundance of power supply contracts.¹⁷ *Calpine*'s only justification for rejection stemmed from the profitability concern of a supplier. In this context, the District Court determined that the FPA exclusively delegated to FERC both the authority to weigh the equity of a given electrical price and to regulate the terms and conditions that attach to a given filed rate.

In *Mirant*, the Fifth Circuit held: "The FPA does not preempt a district court's jurisdiction to authorize the rejection of a . . . contract subject to FERC regulation as part of a bankruptcy proceeding."¹⁸ The court distinguished the ultimate amount paid by *Mirant* in its bankruptcy proceedings to creditors, including on account of rejection damages, and the filed rate of its PPAs: "Any effect on the filed rates from a motion to reject would result not from the rejection itself, but from the application of the terms of a confirmed reorganization plan to the unsecured breach of contract claims."¹⁹ By allowing a bankruptcy court to reject a given PPA, the Fifth Circuit held that it was not permitting an

attack on the "reasonableness" of a filed rate; rather, it merely granted to the bankruptcy court jurisdiction over the terms and conditions of a contract that contained that rate. Because FERC retained the authority to approve or reject any new purchase contracts of a debtor, FERC's mission to protect the "public interest" was preserved.²⁰ At the same time, a bankruptcy court can authorize rejection of purchase obligations, which if not rejected might have prevented a debtor from surviving its Chapter 11 proceedings and undermined a central mandate of bankruptcy legislation: the restructuring and reorganization of faltering companies.²¹

Mirant and *Calpine* are at odds in regard to not only the scope of federal jurisdiction, but also the standard that a bankruptcy or district court should use when determining whether a PPA should be rejected. The District Court in *Calpine* ruled that it could not make either determination, as it lacked an objective rule to guide its decision on rejection. The Fifth Circuit remanded and recommended that the lower court use a balancing test that accounted for the respective roles of the debtor, the creditors, the employees and electricity consumers.²²

Conclusion

Jurisdictional disputes between FERC and bankruptcy courts go to the core of competing interests and policy considerations behind bankruptcy legislation and energy regulation. The business judgment rule is the legal standard employed by courts to protect debtors in bankruptcy proceedings, whereas the FPA protects the public interest of electricity consumers. The interaction of these conflicting standards and concerns is of critical importance, and as the turmoil in the energy industry continues, further precedent will develop. It will be necessary to monitor these disputes to determine the balance of power between FERC and the bankruptcy courts.

For now, it is difficult to predict what position other courts will take. However, the distinction between *Calpine*, as a supplier of electricity, and *Mirant*, as a purchaser, may help explain and harmonize the two decisions. The *Mirant* court's assumption of jurisdiction does not interfere with FERC's obligation under the FPA to protect the public from "unreasonable" energy prices. However, this reconciliation of competing interests under the FPA and the Bankruptcy Code does not apply where the debtor is a power supplier, as in *Calpine*, seeking to make a greater profit by rejecting contracts with below-market rates.

endnotes

- 1 The author gratefully acknowledges the assistance of A. Percy Ross, a 2006 summer associate at the firm and a 2007 J.D. candidate at New York University School of Law.
- 2 The jurisdiction of FERC is conferred by the Federal Power Act (FPA), 16 U.S.C.S. § 792.
- 3 Judge Casey heard and determined the jurisdictional dispute in the first instance, following the granting of the counterparties' motions for a withdrawal of the reference with respect to *Calpine*'s motion to reject certain energy contracts. *Calpine*, 337 B.R. at 30. The reference was withdrawn on the basis of the substantial overlap, requiring significant interpretation, of the FPA and the Bankruptcy Code, including determination of the forum with the authority to

approve or reject a debtor-company's proposed rejection of FERC-related wholesale energy contracts and the applicability of the business judgment or public interest standard.

- 4 The "filed rate" doctrine mandates that a utility's right to a reasonable rate under the FPA is the right to the rate, that FERC files or fixes.
- 5 *Calpine*, 337 B.R. at 32 (quoting N.A.A.C.P. v. Federal Power Comm'n, 425 U.S. 662, 670 (1976)).
- 6 The counterparties to the PPAs included Pacific Gas and Electric, Southern California Edison, Strategic Energy, the Northern California Power Agency, and the California State Parties (the latter consisting of the California Department of Water Resources, the California Electricity Oversight Board and the Attorney General of the State of

California) (collectively, the CounterParties).

- 7 *Calpine*'s disputed obligations were to supply electricity. *Mirant*'s disputed obligations were to purchase electricity.
- 8 11 U.S.C. § 362(b)(4).
- 9 *Calpine*, 337 B.R. at 35.
- 10 *Id.* *Calpine*, 337 B.R. at 33.
- 11 In *Mirant*, the Fifth Circuit also focused on the language of the Bankruptcy Code in its determination of the scope of bankruptcy court jurisdiction. It reasoned that Congress did not make an exception for the specific authority of FERC as a regulatory agency in the Bankruptcy Code, though it did provide for specific regulatory oversight in other proceedings. Thus, the Fifth Circuit concluded that a bankruptcy court retained

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its jurisdiction over these matters. *Mirant*, 378 F.3d at 522.

12 "Although the Court takes no formal position on what standard would apply were it to have jurisdiction, the Court does note that the standard issue may very well compel the Court's finding that it lacks jurisdiction altogether to authorize the rejection of these power agreements." *Calpine*, 337 B.R. at 39.

13 In the wake of recent spot market upheavals, this justification may reflect a desire for stability and predictability in the regulation of energy markets in the United States.

14 *Calpine*, 337 B.R. at 33 (quoting *CA ex rel.*

Lockyer v. Dynegy, Inc., 375 F.3d 831, 839 (9th Cir. 2004)).

15 *Calpine* filed an appeal to the Second Circuit on February 1, 2006. On April 10, 2006, Judges Winter, Calabresi and Pooler heard oral argument. A decision is pending.

16 *Mirant* stated that the company "may choose to reject [agreements] as unnecessary to its reorganized business because [they] represent excess capacity." *Mirant*, 378 F.3d at 520.

17 *Calpine*, 337 B.R. at 38.

18 *Mirant*, 378 B.R. at 522.

endnotes

19 *Mirant*, 378 B.R. at 521.

20 "The purpose of the power given to the Commission . . . is the protection of the public interest, as distinguished from the private interests of the utilities . . ." *Fed. Power Comm'n v. Sierra Pac. Power Co.*, 350 U.S. 348, 355 (1956).

21 Rejection is "vital to the basic purpose to a Chapter 11 reorganization, because rejection can release the debtor's estate from burdensome obligations that can impede a successful reorganization." *Calpine*, 337 B.R. at 34 (quoting *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984)).

22 *Mirant*, 388 B.R. at 525.

Trademark Licenses in Bankruptcy

can you assume or not assume, that is the question.

by Kristin C. Wigness and Lauren A. Scher

Introduction

Unlike patents and copyrights, trademarks are not defined as "intellectual property" under the Bankruptcy Code. Yet, whether a trademark license is assignable by a debtor-licensee under the Bankruptcy Code is to be a developing story – one that appears to be following the plot from the world of copyrights and patents. The Nevada District Court in *N.C.P. Marketing*¹ recently applied the same analysis developed in the areas of copyrights and patents to conclude that a trademark license was personal to the assignee and thus not freely assignable. The court further ruled that the license in question could not be assumed by the debtor under the "hypothetical test" that certain courts have used to interpret Section 365(c)(1) of the Bankruptcy Code.

Statutory Basis

Subject to Bankruptcy Court approval, a trustee or debtor-in-possession generally may assume or reject an executory contract under Bankruptcy Code §365(a) and may then assign such executory contract even if

the underlying contract prohibits or restricts assignment.² However, Section 365(c)(1) of the Bankruptcy Code sets forth an exception to the general rule. Under Section 365(c)(1):

"The trustee may not assume or assign any executory contract . . . of the debtor, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties, if –

(1)(A) 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 . . . prohibits or restricts assignment of rights or delegation of duties; and

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

When Section 365(c)(1) is applied to the trademark arena, the question at hand is whether applicable trademark law would bar assignment to a third party without consent of the assignor.³ Given the dearth of trademark

license bankruptcy cases on point, to answer that question, the *N.C.P. Marketing* court looked to the treatment of copyright and patent licenses in similar circumstances.

Copyrights and Patents

Copyrights

In determining whether copyright law precludes the free assignment of copyright licenses, courts have generally found that a nonexclusive license gives rise to only a personal and not a property interest, and therefore cannot be assigned by the licensee over the objection of the licensor.⁴ By contrast, some courts have found that an exclusive licensee does acquire property rights and "may freely transfer his rights, and moreover, the licensor cannot transfer the same rights to anyone else."⁵ The court in *Patient Education Media* reasoned that "[o]wnership is the *sine qua non* of the right to transfer, and the copyright law distinguishes between exclusive and nonexclusive licenses. . . . The holder of the exclusive license is entitled to all of the rights and protections of the copyright owner to the extent of the license."⁶

Patents

In determining whether a patent license is assignable, many courts have followed the same reasoning with respect to nonexclusive licenses. The court in *In re CFLC, Inc.*⁷ stated that nonexclusive patent licenses are “personal and assignable only with the consent of the licensor.”⁸

While there is case law to support the proposition that nonexclusive patent licenses are not freely assignable by the licensee, there is no strong line of authority with respect to the assignability of exclusive patent licenses. The Ninth Circuit in *In re Catapult* specifically stated that “we express no opinion regarding the assignability of *exclusive* patent licenses under federal law, and note that we expressed no opinion on this subject in *Everex*.”⁹ The court in *In re Hernandez*,¹⁰ however, held that an exclusive patent license is not freely assignable and requires the consent of the licensor because free assignability of an *exclusive* license “would create a situation where a patent holder loses control over the identity of its license holders,” which result is “inconsistent with federal case law...”¹¹

Assumption of Licenses

Even where there is no attempt to assign the license to a third party, most courts hold that the trustee or debtor-in-possession may not assume a nonexclusive license. The United States Courts of Appeal for the Third, Fourth, Fifth, Ninth and Eleventh Circuits have adopted the “hypothetical test”, which focuses on the strict statutory language of Section 365(c)(1), which states that the trustee “may not assume or assign” if applicable nonbankruptcy law prohibits assignment.¹² In other words, under the hypothetical test, if applicable law prevents the debtor from assigning the license, the debtor will not be allowed to assume the license even for its own use. Accordingly, these circuits have held that intellectual property licenses may not be assumed by a debtor, even if the debtor did not intend to assign the license to a

third party.¹³ In contrast, the “actual test” adopted by the First Circuit looks at the circumstances of the individual case to determine if the licensor will be “forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.”¹⁴

The N.C.P. Marketing Decision

In *N.C.P. Marketing*, the District Court was squarely faced with how Section 365(c)(1) would be applied to trademark licenses. The debtor in *N.C.P. Marketing* was the nonexclusive licensee of the “Tae Bo” trademark, with certain rights to use the trademark in marketing and selling products. The creators of Tae Bo disputed the debtor’s ability to assume the trademark license in its bankruptcy case, and sought to compel the rejection of the nonexclusive license.

The debtor argued that trademarks raise unique concerns not found in patents and copyrights. Specifically, the debtor argued that the underlying purpose of trademarks was the protection of consumers from product confusion and not the protection of the trademark holder, and that the purpose was not frustrated provided that the licensee (or assignee) adhered to the terms of the license. The District Court disagreed, holding trademarks “are also used by trademark owners to protect themselves from unauthorized use of their mark, and... to preserve the value of their business name and products.”¹⁵

Having decided that trademarks raise similar concerns for licensors as do patents and copyrights, the District Court analyzed case law interpreting the Lanham Act and trademarks in general. The District Court recognized that the value of a trademark is largely dependent on the goodwill of the company utilizing the mark, necessitating the trademark owner’s interest in controlling the party to whom the mark is transferred.¹⁶ Consequently, the District Court held that “[b]ecause the owner of the trademark has an interest in the party to whom the trademark is assigned so that it can maintain

the good will, quality, and value of its products and thereby its trademark, trademark rights are personal to the assignee and not freely assignable to a third party.”¹⁷ The District Court thereupon applied the “hypothetical test” and held that the debtor could not assume the license.

The Next Chapter?

Based on the District Court’s ruling in *N.C.P. Marketing*, the story line with respect to copyright and patent licenses may well be extended to trademark licenses: namely, (1) the focus on whether the trademark license is exclusive or nonexclusive in deciding whether a trademark license may be assigned under applicable

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non-bankruptcy law and (2) the adoption of the “hypothetical test” or the “actual test” – depending on the applicable circuit - in determining whether or not a trademark license may be assumed. And while the *N.C.P. Marketing* ruling was the first major reported bankruptcy decision with respect to the assignability of nonexclusive trademark licenses, several nonbankruptcy courts have also held that nonexclusive trademark licenses are personal and not freely assignable without the consent of the licensor under applicable trademark law.¹⁸

As is the case with exclusive patent licenses, there is very little authority on the treatment of exclusive trademark licenses. In a recent unreported decision, however, the Delaware

Bankruptcy Court held that an exclusive trademark license is assignable by the licensee without the consent of the licensor.¹⁹ The Bankruptcy Court relied on the District Court's decision in *Golden Books* that, with respect to a

freely assignable “in that it does not constitute a personal services contract.”²²

It is too soon to say whether the law as applied to trademark licenses will routinely follow the

It is too soon to say whether the law as applied to trademark licenses will routinely follow the law under copyrights and patents.

copyright license, an exclusive licensee acquires property rights and may freely transfer its rights in such license.²⁰ It also cited *In re Rooster*²¹, whereby an exclusive trademark license was held

law under copyrights and patents. There may be twists and turns along the way as the story unfolds. But no one should be surprised if the ending looks quite familiar.

¹ *In re N.C.P. Mktg. Group, Inc.*, 337 B.R. 230 (D. Nev. 2005).

² 11 U.S.C. §365(f)(1).

³ *N.C.P. Mktg. Group*, 337 B.R. at 235.

⁴ *In re Golden Books Family Entm't, Inc.*, 269 B.R. 311, 314, 316 (Bankr. D.Del. 2001); see also *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997) (the nonexclusive license is personal to the transferee and the licensee cannot assign it to a third party without the consent of the copyright owner).

⁵ *Patient Educ. Media*, 210 B.R. at 240.

⁶ *Id.* In *Gardner v. Nike*, 110 F. Supp. 2d 1282 (C.D. Cal. 2000) *aff'd* 279 F.3d 774 (9th Cir. 2002), the court held that exclusive licensees do not have the right to assign under copyright law. However, many courts find “the reasoning of Gardner to be unpersuasive” since the “Copyright Act clearly states that there is a key distinction between exclusive and nonexclusive licenses.” *Golden Books*, 269 B.R. at 318.

⁷ 89 F.3d 673 (9th Cir. 1996).

⁸ *Id.* at 680; see also *In re Access Beyond Tech Inc.*, 237 B.R. 32, 44 (Bankr. D.Del.1999) (holding patent license agreement at issue was nonexclusive because it did not convey the exclusive right or some part of the exclusive right to practice the invention and did not grant any right to exclude others from practicing the patents and holding that nonexclusive license is not assignable); *In re Catapult Entm't*, 165 F.3d

747, 750 n.3 (9th Cir. 1999), *cert. denied*, 528 U.S. 924 (1999) (nonexclusive licenses do not give rise to ownership rights and are not assignable over the objection of the licensor); *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986) (a “non-exclusive licensee of a patent has *only* a personal and not a property interest in the patent and that this personal right cannot be assigned unless the patent owner authorizes the assignment or the license itself permits assignment”).

⁹ *Catapult*, 165 F.3d at 750.

¹⁰ 285 B.R. 435 (Bankr. D. Ariz. 2002).

¹¹ *Id.* at 439-40.

¹² See *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004); *In re Catapult Entm't*, 165 F.3d 747 (9th Cir. 1999); *In re James Cable Partners L.P.*, 27 F.3d 534 (11th Cir. 1994); *Turner v. Avery*, 947 F.2d 772 (5th Cir. 1991) *cert. denied*, 504 U.S. 985 (1992); *In re West Elecs. Inc.*, 852 F.2d 79 (3d Cir. 1988).

¹³ *N.C.P. Mktg. Group*, 337 B.R. at 234-35.

¹⁴ *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 494 (1st Cir. 1997) (citations omitted).

¹⁵ *N.C.P. Mktg. Group*, 337 B.R. at 236. .

¹⁶ The District Court also emphasized the Lanham Act's requirement that the owner of the trademark monitor the quality of the goods that are sold bearing the mark.

endnotes

¹⁷ *Id.*

¹⁸ See *Miller v. Glen Miller Prods.*, 318 F. Supp. 2d 923, 938 (C.D. Cal. 2004) *aff'd*. 454 F.3d 975 (9th Cir. 2006) (holding that a non-exclusive trademark licensee cannot sublicense without consent of original licensor); see also *In re Travelot Co.*, 286 B.R. 447, 455 (Bankr. S.D. GA 2002) (stating that a non-exclusive trademark license is personal to licensee and not freely assignable to a third party); *Tap Publ'ns, Inc. v. Chinese Yellow Pages (New York), Inc.*, 925 F. Supp 212, 218 (S.D.N.Y. 1996) (same).

¹⁹ Transcript of Hearing at 284, *In re Global Home Prods., LLC, et al.*, Case No. 06-10340 (Bankr. D. Del. Aug. 8, 2006).

²⁰ *Id.*

²¹ 100 B.R. 228 (Bankr. E.D. Pa. 1989).

²² Transcript of Hearing, *Global Home Prods.* at 284. It should be noted, however, that the court in *In re Rooster* specifically stated that the issue at hand was “narrowly framed by the parties: does the licensing agreement constitute a contract for personal services, which applicable Pennsylvania law holds as unassignable?” 100 B.R. at 232. There was neither mention nor discussion of federal trademark law.

- 1 ***In re Kmart Corp.***, 434 F.3d 536 (7th Cir. 2006) Court of Appeals held that under Bankruptcy Code §365(a), where debtor was not in default under an executory contract, it could assume the contract without cure and without providing adequate assurance of future performance.
- 2 ***In re North Am. Energy Conservation, Inc.***, 339 B.R. 75 (Bankr. S.D.N.Y. 2006) Payments made by debtor to supplier during preference period when debtor was in the process of winding-down, but which were consistent with all the debtor's payments to the supplier and with industry practice, were within the "ordinary course of business" exception to the trustee's preference-avoiding power.
- 3 ***In re Rocor Int'l, Inc.***, 339 B.R. 508 (Bankr. W.D. Okla. 2006) For purposes of determining whether a payment of insurance premiums was on account of antecedent debt or a contemporaneous exchange for new value under Bankruptcy Code §547, the date of delivery of the check, and not the date the check cleared the drawer bank, was the date of transfer. The obligation to pay premiums and the payment were deemed to occur simultaneously, because under Oklahoma law, the obligation was held in abeyance until the check was paid.
- 4 ***In re Delta Air Lines***, 341 B.R. 439 (Bankr. S.D.N.Y. 2006) Disagreeing with two leading treatises and several other court decisions, court held that rejection damages claim could not be set off against creditor's own alleged prepetition obligation to the debtor where such set off rights did not exist under nonbankruptcy law.
- 5 ***In re Oakwood Homes Corp.***, 340 B.R. 510 (Bankr. D. Del. 2006) Court upheld deepening insolvency claims against lenders and others to the extent that such claims were based on fraudulent rather than negligent conduct.
- 6 ***In re Enron Corp.***, 341 B.R. 141 (Bankr. S.D.N.Y. 2006) Claims for damages related to employee stock options that were allegedly rendered worthless by debtor's fraudulent conduct must be subordinated under Bankruptcy Code §510(b). Whether for fraudulent inducement, fraudulent retention or breach of contract, such claims derived from the ownership of a security and thus were claims "arising from the purchase . . . of a security."
- 7 ***In re United Air Lines, Inc.***, 447 F.3d 504 (7th Cir. 2006) Under California law, debtor-airline's assignment and leaseback of airport facilities with public entity that issued bonds to finance the improvement of the facilities was a disguised secured financing, and not a true lease subject to assumption or rejection, where, among other things, debtor was required to pay rent even if premises were destroyed, leaseback terminated on prepayment of bonds, and bonding entity had no reversionary interest.
- 8 ***In re Eagle-Picher Indus., Inc.***, 447 F.3d 461 (6th Cir. 2006) Where confirmed plan provided that ordinary course of business liabilities would be paid by the reorganized debtor, postpetition patent infringement, and contract claims were not discharged by confirmation of the plan.
- 9 ***In re CitX Corp., Inc.***, 448 F.3d 672 (3d Cir. 2006) Court refused to extend the scope of deepening insolvency claim beyond one based on fraudulent conduct, rejecting such claim against an accountant based on negligence.
- 10 ***Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co.***, 126 S. Ct. 2105 (2006) Resolving a split in circuits, the Supreme Court held that insurance carriers' claims for unpaid workers' compensation premiums owed by a debtor-employer were not priority claims for unpaid contributions to "an employee benefit plan" under Bankruptcy Code §507(a)(5).
- 11 ***In re Oakwood Homes Corp.***, 449 F.3d 588 (3d Cir. 2006) Court could disallow postpetition interest on claim or discount the entire claim to present value, but not both.
- 12 ***In re Cooper Mfg. Corp.***, 344 B.R. 496 (Bankr. S.D. Tex. 2006) Letter of credit proceeds that were assigned by the debtor to creditors outside of the 90-day preference period could not be recovered by the trustee as a preferential transfer, even where the creditors actually received the proceeds within the 90-day period.
- 13 ***In re Asia Global Crossing, Ltd.***, 344 B.R. 247 (Bankr. S.D.N.Y. 2006) Debtor's guarantee of related entity's performance under a contract was supported by sufficient consideration in the form of payment to the related entity, even where the debtor was insolvent and did not receive "fair consideration" under New York fraudulent conveyance law, and thus, claim based thereon could not be disallowed.
- 14 ***In re Official Committee of Unsecured for Dornier Aviation (North America), Inc.***, 453 F.3d 225 (4th Cir. 2006) The court's authority to recharacterize claims as equity is within the powers granted to the court under Bankruptcy Code §105(a) and is independent of its powers of disallowance and equitable subordination.
- 15 ***In re Scott Acquisition Corp.***, 344 B.R. 283 (Bankr. D. Del. 2006) Under Delaware law, directors and officers of an insolvent wholly owned subsidiary owe fiduciary duties to the subsidiary and its creditors.
- 16 ***In re Tom's Foods, Inc.***, 345 B.R. 795 (Bankr. M.D. Ga. 2006) Emails from CEO to an attorney serving on the corporation's board, allegedly seeking legal advice regarding threatened suits against the corporation's officers and directors, were not protected by the attorney-client privilege because the emails were distributed widely to persons affiliated with another corporate entity and their substance concerned matters within the debtor's business affairs.