THE INTERACTION BETWEEN BANKRUPTCY LAW AND SPORTS AND ENTERTAINMENT LAW: SELECTED ISSUES

By

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Introduction

The entertainment industry is subject to many of the same economic problems confronting other industries, including bankruptcies. As businesses in the entertainment industry continue to merge or otherwise consolidate, various segments of the entertainment industry are likely to experience an increase in the number of bankruptcies. Some businesses may suffer from over-expansion or over-leverage. Others may experience a downturn in revenue as the newly merged companies increase market share. In either event, professionals involved in the entertainment industry will need to have an increased understanding and sensitivity to potential bankruptcy issues, both at the time agreements are negotiated and when the issues arise.

This article is intended to alert the non-bankruptcy lawyer to several issues which should be considered when drafting entertainment-related agreements such as licensing agreements, artist contracts, distribution agreements and the like. The issues dealt with in this article primarily resolve around the treatment of executory contracts in various bankruptcy scenarios, and a creditor's right to recoup in bankruptcy. The

treatment of executory contracts and the right to recoup is particularly important in an entertainment industry bankruptcy because of the contract-intensive nature of relationships in the entertainment world, as well as the common practice of making advances to artists, athletes, record labels and other players in the entertainment industry. Furthermore, a contract that is drafted properly at the outset with a sensitivity to potential bankruptcy issues may be treated far more favorably in a subsequent bankruptcy case than a contract drafted without this sensitivity. Through a thorough understanding of the Bankruptcy Code and the case law interpreting the Bankruptcy Code, the entertainment lawyer should, therefore, be able to better represent his client by drafting agreements to achieve a desired goal or obtain a more predictable result in the event of bankruptcy.

The Bankruptcy Basics

The United States Bankruptcy Code is designed to be rehabilitative in nature and to give the debtor a fresh start. The Bankruptcy Code is codified at 11 U.S.C. §§ 101 et seq.

1. Liquidation versus reorganization

The vast majority of bankruptcy cases in the entertainment

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industry are commenced under either Chapter 7 (liquidation) or Chapter 11 (reorganization). The Bankruptcy Code also provides for municipal bankruptcies (Chapter 9), family farmer bankruptcies (Chapter 12) and individual debt adjustment cases (Chapter 13).

Chapter 7 provides for the orderly liquidation and distribution of the debtor's assets. A trustee is appointed and the debtor's business is discontinued.

Chapter 11 provides the debtor with breathing room to reorganize its debts. The debtor's management typically continues to operate the debtor's business as a debtor in possession throughout the course of the bankruptcy case. The debtor in possession has most of the same rights and powers as a trustee. Therefore, whenever the Bankruptcy Code refers to the "trustee," it is also referring to the debtor in possession. See 11 U.S.C. § 1107(a) (rights, powers and duties of debtor in possession).

2. The automatic stay

The automatic stay of all litigation is one of the most important protections given to a debtor by the Bankruptcy Code. With certain narrowly tailored exceptions, the filing of a bankruptcy petition creates an automatic stay applicable to all

entities, including the government, of the commencement or continuation of all actions, enforcement of rights and attempts to perfect security interests against the debtor and property of the debtor's estate. 11 U.S.C. § 362(a). Thus, foreclosure actions, law suits and attempts to collect pre-bankruptcy debts are stayed. Any violation of the automatic stay may result in damages against the violating creditor. Certain types of actions are not stayed, including criminal actions, certain proceedings relating to the establishment of paternity, alimony, maintenance or support, and certain actions relating to the government's police and regulatory powers. 11 U.S.C. § 362(b).

3. Property of the estate

The filing of a bankruptcy petition creates an estate which consists of substantially all of the debtor's assets, including all legal or equitable interests of the debtor in property. 11 U.S.C. § 541(a). Earning from services performed by an individual debtor after the commencement of the case are not, however, property of the estate. 11 U.S.C. § 541(a)(6). Thus, money owing to an individual debtor under an artist or royalty agreement is property of the estate to the extent the services for which the money is owing were rendered before the commencement of the bankruptcy case. To the extent the services

were rendered after the commencement of the case, money paid for those services is not property of the debtor's estate, and the debtor is free to spend that money as he wishes.

4. Filing of proof of claim

A creditor or equity security holder is not required to file a proof of claim or interest unless its claim or interest is not contained on the debtor's schedule of liabilities, or is scheduled as disputed, contingent or unliquidated. Fed.R.Bankr.P. 3003(c)(2); 3002(a)(1). As a precaution, a creditor or equity security holder should always timely file a proof of claim or interest, even if properly scheduled.[1]

In a Chapter 7 case, with certain limited exceptions set forth in Bankruptcy Rule 3002(c), a proof of claim or interest must be filed within 90 days after the first date set for the meeting of creditors pursuant to Section 341 of the Bankruptcy Code. Fed.R.Bankr.P. 3002(c). In a Chapter 11 case, a proof of claim or interest must be filed within the time frame set by order of the bankruptcy court. Fed.R.Bankr.P. 3003(c)(3). Attorneys for creditors should be careful, however, because the local rules in many districts provide a fixed deadline for the

[1] One exception to this rule is if the creditor or equity security holder is concerned about subjecting itself to the jurisdiction of the bankruptcy court.

filing of proofs of claim and interest in a Chapter 11 case. Furthermore, a proof of claim or interest must actually be filed with the clerk of the court on the applicable date. It is not sufficient to mail the proof of claim or interest before the filing deadline. Whenever possible, proofs of claim and interest should be hand delivered to the court and the filing party should retain a file-stamped copy as proof of filing.

Executory Contracts

The most valuable assets of many entertainment companies are various types of contractual rights arising out of agreements such as recording agreements, distribution agreements and licensing agreements. Likewise, the most valuable assets of many individuals involved in the sports or entertainment industries are the contracts providing for their personal services. The ability of a bankruptcy debtor to reorganize may thus depend upon the debtor's ability to keep these valuable agreements in tact after the bankruptcy has terminated, or its ability to assign these contracts in the course of the bankruptcy. Similarly, burdensome provisions in many of these same types of contracts may have forced the debtor into bankruptcy in the first place. The debtor's ability to

reorganize may, therefore, be dependent on its ability to reject or terminate these contracts in the bankruptcy. Accordingly, whether it is the debtor determining whether to file a bankruptcy petition, or the creditor contemplating how to react to the filing of a bankruptcy petition, it is essential to understand how various types of executory contracts will be treated in the bankruptcy.

Section 365 of the Bankruptcy Code sets forth special rules that apply to "executory contracts," including rules that (i) permit the debtor to "assume" its obligations under the contract, (ii) permit the debtor to breach or "reject" the contract, (iii) permit the debtor to assign executory contracts, notwithstanding anti-assignment provisions in the contract, (iv) permit the non-debtor party to the contract to compel the debtor to assume or reject the executory contract, and (v) define the rights of a non-debtor licensee upon the rejection of a license by the debtor-licensor.

If a contract is not "executory" on the date of the filing of the petition commencing a bankruptcy case, the non-debtor party to the contract will simply hold a general unsecured claim against the debtor's estate for any money owing by the debtor under the contract. This claim will be accorded a relatively

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low priority under the Bankruptcy Code, which will be paid after secured, administrative and priority claims are satisfied. If, however, the contract is executory on the date of the filing of the bankruptcy petition, the debtor will be required to assume, assume and assign, or reject the contract in the course of the bankruptcy case in accordance with Section 365 of the Bankruptcy Code. Because Section 365 of the Bankruptcy Code applies only to contracts that are executory, it is necessary to determine at the outset whether the particular contract at issue is executory.

A. Summary of Section 365

Section 365 of the Bankruptcy Code governs the treatment of executory contracts in bankruptcy. A contract is generally considered to be executory if there are sufficient unperformed obligations by both parties to the contract such that the failure of either party to perform would constitute a material breach of the contract, excusing performance of the other party.

With certain limited exceptions, Section 365 of the Bankruptcy Code permits the free assumption and assignment of executory contracts notwithstanding provisions in the contract or applicable law that prohibit assignment of the contract. To assume an executory contract, the debtor must cure all defaults

in the contract and provide the non-debtor party with adequate assurance of future performance. To assign an executory contract, the debtor must first assume the executory contract and the assignee must provide the non-debtor party to the contract with adequate assurance of future performance under the assigned contract. A contract cannot, however, be assumed or assigned if applicable nonbankruptcy law excuses the other party from accepting performance from, or rendering performance to, a party other than the debtor. The classic example of such a contract is a contract for personal services.

An executory contract, once assumed pursuant to Section 365, constitutes a fully enforceable obligation of the debtor. Any breach of that contract by the debtor will give rise to a claim with the priority of an expense of administration.

An executory contract, once rejected pursuant to Section 365 of the Bankruptcy Code, is treated as if it has been either breached or terminated. In either event, the non-debtor party to the contract will be given a general unsecured claim against the debtor's estate for any damages resulting from the rejection.

A licensee of "intellectual property" rights is given special protection upon the rejection of the intellectual

property license agreement; the licensee can choose to continue use of the license, subject to certain conditions, or to treat the license agreement as breached and assert a claim against the debtor's estate.

B. Determining whether a contract is executory

By its terms, Section 365 of the Bankruptcy Code applies only to contracts that are "executory." The Bankruptcy Code, however, does not define the term "executory contract." Whether or not a contract is executory is a matter of federal law. In re Qintex Entertainment, 950 F.2d 1492, 1495 (9th Cir. 1991). For purposes of Section 365 of the Bankruptcy Code, a contract is generally considered to be executory if the "obligations of both the bankrupt and the other party to contract are so far unperformed that the failure of either to complete the performance would constitute a material breach, excusing the performance of the other [party]." Lubrizol Enterprises v. Richmond Metal Finishers, 756 F.2d 1043, 1045 (4th Cir. 1985), quoting Countryman, "Executory contracts in Bankruptcy: Part I," 57 Minn. L. Rev. 439, 460 (1973). See also In re Stein and Day Inc., 81 B.R. 263, 266 (Bankr. S.D.N.Y. 1988) (citing Lubrizol: "A contract is not executory within the meaning of 11 U.S.C. § 365(a) unless it is executory as to both parties").

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For example, in Lubrizol, RMF, the debtor-licensor under a technology licensing agreement, moved to reject the licensing agreement. The Fourth Circuit found that the license agreement was executory, based on the following continuing obligations of the parties:

> RMF [licensor] owed the following duties to Lubrizol [licensee] under the agreement: (1) to notify Lubrizol of any patent infringement suit and to defend in such suit; (2) to notify Lubrizol of any other use or licensing of the process, and to reduce royalty payments if a lower royalty rate agreement was reached with another licensee; and (3) to indemnify Lubrizol for losses arising out of any misrepresentation or breach of warranty by RMF. Lubrizol owed RMF reciprocal duties of accounting for and paying royalties for use of the process and of canceling certain existing indebtedness. The contract provided that Lubrizol would defer use of the process until May 1, 1983 . . .

756 F.2d at 1045.

By contrast, in Stein and Day, the Court found a pre-bankruptcy publishing agreement to be non-executory and, therefore, not susceptible to rejection where the non-debtor author's obligations were limited to (i) holding harmless and defending the publisher in certain contingencies; (ii) notifying the publisher of certain claims and cooperating in the defense of such claims; and (iii) "furnish[ing] the publisher with a

manuscript that is libel-proof." 81 B.R. at 265. Despite the continuing performance required of the author, the bankruptcy court held that the publishing agreement was not an executory contract capable of assumption or rejection because "[t]he author has no further obligations to perform for the publisher under the agreements, which if not performed by the author would constitute a material breach which would excuse the publisher from its obligation to pay royalties." 81 B.R. at 266. In other words, although the author had some continuing obligations under the publishing agreement, those obligations simply were not significant enough to render the agreement executory and, therefore, rejectable.

For a contract to be executory, it is not necessary that the parties have affirmative obligations to act in a certain way, but it may be sufficient that the parties have an obligation to refrain from taking certain actions. See, e.g., Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.), 625 F.2d 290, 292 (9th Cir. 1980) (debtor's obligation under exclusive licensing agreement to refrain from selling software packages sufficient to render licensing agreement executory); In re American Magnesium Co., 488 F.2d 147, 152 (5th Cir. 1974) ("An executory contract is one in which a party binds himself to do

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or not do a particular thing, whereas an executed contract is one in which the object of the agreement is already performed"), reh'g den., 491 F.2d 1272. Because many non-bankruptcy courts have held that a license agreement is in the nature of a "covenant not to sue" (see, e.g., Spindelfabrik Suessen-Schurr v. Schubert & Salzer, 829 F.2d 1075, 1081 (Fed. Cir. 1987) ("a patent license agreement is in essence nothing more than a promise by the licensor not to sue the licensee"), cert. den., 484 U.S. 1063 (1988); Studiengellschaft Kohle m.b.H., 670 F.2d 1122, 1127 (D.C. Cir. 1981) (Same); Harris v. Emus Records Corp., 734 F.2d 1329, 1334 (9th Cir. 1984) (same with respect to copyright license)), it can be argued that a licensing agreement is presumptively executory as to the licensor. See, e.g., Tamietti, "Technology Licenses Under the Bankruptcy Code: A Licensee's Mine Field", 62 Amer. Bankr. L.J. 295, 300-01 (1988) (suggesting that any license agreement is presumptively executory because each day the licensor forebears its right to sue the licensee for conduct which, but for the license, would be an infringement).

Other courts that have found licensing, publishing or distribution agreements to be executory or non-executory include the following: In re Prize Frize, Inc., 32 F.3d 426, 428 (9th

Cir. 1994) (licensing and manufacturing agreement granting proprietary rights to french fry vending machine held to be executory); In re Qintex Entertainment, 950 F.2d 1492, 1496-97 (9th Cir. 1991) (holding that movie subdistribution and colorization agreement was executory but actor's television contracts were not executory when actor had performed all obligations); Delightful Music Ltd. v. James Taylor (In re James Taylor), 913 F.2d 102 (3d Cir. 1990) (holding that recording agreement was executory); In re Lubrizol Enterprises, 756 F.2d 1043, 1045 (4th Cir. 1985) (technology licensing agreement held to be executory contract); Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.), 625 F.2d 290, 292 (9th Cir. 1980) (per curiam) (software licensing agreement held to be executory); In re American Magnesium Co., 488 F.2d 147, 152 (5th Cir. 1974) (holding that mineral royalty agreement was executory); In re EI International, 123 B.R. 64 (Bankr. D. Idaho 1991) (assuming without discussion that software licensing agreement was executory); In re Matusalem & Matusa of Fla., Inc., 158 B.R. 514, 515 (Bankr. S.D. Fla. 1993) (holding that subfranchise agreement which included secret formula and trademark licenses was executory); In re Biopolymers, Inc., 136 B.R. 28, 30 (Bankr. D. Conn. 1992) (holding that patent license was executory

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contract); In re Learning Publications, Inc., 94 B.R. 763, 765 (Bankr. M.D. Fla. 1988) (publishing agreement held not executory when only remaining obligation was requirement to pay royalties); In re Alltech Plastics, Inc., 71 B.R. 686, 687 (Bankr. W.D. Tenn. 1987) (patent license held to be executory); In re Monument Record Corp., 61 B.R. 866, 867 (Bankr. W.D. Tenn. 1986) (holding that Ray Orbison's recording contract was not executory because it had been terminated prior to bankruptcy and only remaining obligation was to pay royalties); In re Chipwich, Inc., 54 B.R. 427 (Bankr. S.D.N.Y. 1985) (eggnog licensing and distribution agreement held to be executory); In re Noonan, 17 B.R. 793, 797 (Bankr. S.D.N.Y. 1982) (exclusive recording agreement held to be executory contract).

C. Assumption and rejection of executory contracts

The debtor may assume or reject an executory contract at any time before confirmation of a plan of reorganization in a Chapter 9, 11, 12 or 13 case. See 11 U.S.C. § 365(d)(2). The trustee must assume or reject an executory contract in a Chapter 7 case within 60 days after the order for relief,[1/] or within such additional time as the court directs within such 60 day

[2] The filing of a bankruptcy petition constitutes the order for relief in a voluntary case. 11 U.S.C. § 301. In an involuntary case, the court orders relief in accordance with Section 303(h) of the Bankruptcy Code.

period. See 11 U.S.C. § 365(d)(1). The debtor must assume or reject each executory contract in its entirety, and cannot assume or reject only a portion of a contract. In re Nitec Paper Corp., 43 B.R. 492 (S.D.N.Y. 1984). Furthermore, certain courts have held that the debtor can only assume an executory contract if the non-debtor party to the contract would be excused from accepting performance from, or rendering performance to, a party other than the debtor, as would typically be the case with a personal service contract. See 11 U.S.C. § 365(c).

A proceeding to assume or reject an executory contract is a "contested matter" governed by Federal Rule of Bankruptcy Procedure 9014. See Fed.R.Bankr.P. 6006(c). Accordingly, the debtor must seek authorization to assume or reject an executory contract by making a motion, on notice to the other party to the contract, such other parties as the court may direct, and the United States trustee. Fed.R.Bankr.P. 6006(c), 9014. As a contested matter, the federal discovery rules are applicable to a proceeding for authorization to assume or reject an executory contract. Fed.R.Bankr.P. 9014.

1. Assumption of executory contracts

Assumption of an executory contract is essentially a

ratification of the contract -- unless the non-debtor party to the contract agrees otherwise, the debtor must cure any defaults that exist under the contract, future obligations under the contract will be granted priority as an expense of administration, and the contract will be fully enforceable against the debtor as if it had been entered into after the filing of the bankruptcy case.

The debtor may assume any executory contract of the debtor if, in its business judgment, assumption of the executory contract would be in the best interest of the estate and creditors. See Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.), 4 F.3d 1095 (2d Cir. 1993). An executory contract, once assumed, is treated as if the contract was entered into post-bankruptcy. Accordingly, the non-debtor party can enforce the contract as if there was no bankruptcy. NLC Corp. v. Lone Star Building Centers (Eastern) Inc., 144 B.R. 170, 178 (S.D. Fla. 1992) (a debtor that assumes an executory contract "becomes liable for performance of the entire contract, as if bankruptcy had never intervened"). Any damages resulting from the debtor's post-assumption breach of an executory contract will be accorded priority as an expense of administration. In re Coast Trading Co., 744 F.2d 686-92-93

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(9th Cir. 1984); In re Sporting Way, Inc., 126 B.R. 110, 112 (Bankr. M.D. Fla. 1991).

In order to assume an executory contract in which there has been a breach, the debtor must (i) cure or provide adequate assurance that it will promptly cure such default, (ii) compensate or provide adequate assurance that it will promptly compensate a party other than the debtor to the contract for any actual pecuniary loss to such party resulting from such default, and (iii) provide adequate assurance of future performance under such contract. 11 U.S.C. § 365(b)(1). For purposes of Section 365(b)(1), however, a debtor is not required to cure a default that is a breach relating to (a) the insolvency or financial condition of the debtor at any time before the closing of the bankruptcy case, (b) the commencement of a bankruptcy case under title 11, (c) the appointment of a trustee, or (d) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the contract. 11 U.S.C. § 365(b)(2).

2. Assumption of nondelegable contracts[1/]

Section 365(c)(1) of the Bankruptcy Code has been

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[3] See § III(D)(2), infra, for a more detailed discussion of this issue.

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interpreted by a number of courts to preclude the assumption of any contract under which the non-debtor party to the contract would be excused from accepting performance from, or rendering performance to, an entity other than the debtor or debtor in possession. See, e.g., City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 534 (11th Cir. 1994); In re West Elecs. Inc., 852 F.2d 79 (3d Cir. 1988). But see In re Cardinal Industries, Inc., 116 B.R. 964, 979 (Bankr. S.D. Ohio 1990) (Section 365(c) does not preclude assumption of executory contracts). The classic example of a nondelegable contract is a personal service contract.

Most courts will not permit the debtor to assume a nondelegable contract unless the non-debtor party consents to the assumption. See 11 U.S.C. § 365(c)(1)(B) (requiring consent to assume or assign a nondelegable contract). Thus, a party to such a contract should seriously consider whether the filing of a bankruptcy petition would be in its best interest. For example, an individual debtor that is party to a valuable contract providing for his or her personal services may be forced to reject that contract which is quite likely one of its most valuable assets. Likewise, a recording company might be forced to reject each of its artist contracts if these

agreements do not contain consents to assignment. For this reason, an entity with a valuable personal service contract should consider negotiating a general consent to assignment or, at a minimum, a consent to assumption of the contract in the case of a bankruptcy.[1/] This consent can be placed in the contract itself or may be part of an amendment drafted immediately before the filing of a bankruptcy petition. In either event, such a consent should be sufficient to permit the assumption of the otherwise nondelegable contract. Likewise, a party entering into a contract that it does not wish to have assumed or assigned in a subsequent bankruptcy would be well-advised to consider adding a "key man" clause to the agreement to preserve the argument that the agreement is a non-assignable personal service contract.

3. Rejection of executory contracts

The debtor may "reject" or abandon any executory contract of the debtor if, in its business judgment, rejection of the executory contract would be in the best interest of the estate and creditors. Control Data Corp. v. Zelman (In re

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[4] See pages 31-32, infra, for a more detailed discussion of the type of consent that is necessary in the context of the assignment of an executory contract. The same standard is applicable in the context of both assumption and assignment of executory contracts.

Minges), 602 F.2d 38 (2d Cir. 1979); In re Chipwich, Inc., 54 B.R. 427 (Bankr. S.D.N.Y. 1985) ("In determining whether or not a debtor should be allowed to reject an executory contract, the courts have generally applied the business judgment test and the principle that the debtor's business judgment should not be interfered with, absent a showing of bad faith or abuse of business discretion"). See also N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 523 (1984) (implicitly adopting business judgment test for contracts other than collective bargaining agreements).

(a) Effect of rejection

The rejection of an executory contract renders it unenforceable and gives the non-debtor party to the contract a general unsecured claim for damages against the debtor's estate. There are two schools of thought on the effect of a rejection of an executory contract. Some courts hold that the rejection of an executory contract terminates the contract and renders it a nullity. See, e.g., In re Chicago, R.I. & P.R. Co., 604 F.2d 1002 (7th Cir. 1979); In re KMMCO, Inc., 40 B.R. 976 (E.D. Mich. 1984). The majority of courts, however, expressing the better reasoned view, hold that rejection of an executory contract merely constitutes a breach of the contract by the debtor; the

contract does not cease to exist. See, e.g., In re Dailey, 17 F.3d 394 (9th Cir. 1994) (unpublished opinion available on Westlaw) ("lease was merely breached, not rescinded or declared void ab initio"); In re Continental Airlines, 981 F.2d 1450, 1459 (5th Cir. 1993) ("[t]he statute does not invalidate the contract, or treat the contract as if it did not exist"); In re O.P.M. Leasing Services, Inc., 79 B.R. 161, 163 (S.D.N.Y. 1987). In either event, rejection of an executory contract constitutes a breach of such contract which is deemed to have occurred immediately before the date of the filing of the bankruptcy petition. 11 U.S.C. §§ 365(g); 502(g). Although the rejection claim would ordinarily be treated as a general unsecured claim, a creditor's claim will be treated as secured to the extent the creditor holds a properly perfected security interest in property belonging to the debtor. See Leasing Service Corp. v. First Tennessee Bank National Association, 826 F.2d 434, 436 (6th Cir. 1987) ("rejection of a lease obligation . . . does not affect the creditor's secured status").

4. Rejection of intellectual property licensing agreements

Section 365(n) of the Bankruptcy Code provides special protections for licensees of "intellectual property" rights.

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The Bankruptcy Code defines "intellectual property" in Section 101(35A) to include copyrights, patents, and trade secrets, but not trademarks.[1/] The Bankruptcy Code does not provide similar rights to licensors of intellectual property. These protections were enacted in 1988 by Pub.L. No. 100-506 (An Act to Keep Secure the Rights of Intellectual Property Licensors and Licensees Which Come Under the Protection of Title 11 of the United States Code, the Bankruptcy Code). The purpose of Section 365(n) was to overcome the harsh result of the Fourth Circuit's decision in Lubrizol Enterprises v. Richmond Metal Finishers, 756 F.2d 1043, 1045 (4th Cir. 1985), in which the Fourth Circuit permitted the debtor-licensor to reject an executory licensing agreement and thereby deprive the licensee of the benefit of the license.

Section 365(n) of the Bankruptcy Code provides as

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[5] "Intellectual property" is defined to include

(A) trade secret;

(B) invention, process, design, or plant protected under title 35;

(C) patent application;

(D) plant variety;

(E) work of authorship protected under title 17; or

(F) mask work protected under chapter 9 of title 17, to the extent protected by applicable nonbankruptcy law.

11 U.S.C. § 101(35A).

follows:

(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect --

(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for --

(i) the duration of such contract; and

(ii) any period for which such contract may be extended by the licensee as a right under applicable nonbankruptcy law.

(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract --

(A) the trustee shall allow the licensee to exercise such rights;

(B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the

licensee extends such contract; and

(C) the licensee shall be deemed to waive --

(i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and

(ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall --

(A) to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity.

(4) Unless and until the trustee rejects such contract, on the written request of the licensee the trustee shall --

(A) to the extent provided in such contract or any agreement supplementary to such contract --

(i) perform such contract; or

(ii) provide to the licensee such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law) held by the trustee; and

> (B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment), including any right to obtain such intellectual property (or such embodiment) from another entity.

11 U.S.C. § 365(n).

Pursuant to Section 365(n) of the Bankruptcy Code, upon the rejection of an executory licensing agreement for the provision of "intellectual property" rights, the licensee has the option to (i) treat the licensing agreement as terminated if rejection constitutes a breach under applicable non-bankruptcy law, pursuant to Bankruptcy Code Section 365(n)(1)(A), and become a general unsecured creditor of the debtor-licensor, or (ii) retain its rights under the licensing agreement (including any rights of exclusivity) for the remainder of the agreement's term (including extensions), pursuant to Bankruptcy Code Section 365(n)(1)(B).

Accordingly, if a licensee chooses to retain its intellectual property rights under a rejected licensing agreement pursuant to Section 365(n)(1)(B), it may continue to exercise its rights under the licensing agreement only in those aspects of the licensing agreement which constitute "intellectual property." The licensee will also be required to

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make all "royalty" payments due under the contract, will not be entitled to a claim for such rejection, and will be deemed to have waived its right to setoff. 11 U.S.C. § 365(n)(2).[1/] If the rejected licensing agreement covers items such as trademarks which fall outside the definition of "intellectual property" the licensee would merely have a general unsecured claim against the debtor-licensor for damages in accordance with Sections 365(g) and 502(g) of the Bankruptcy Code, as opposed to the right to continue use of such trademark rights.

Because Section 365(n)(2)(B) requires a licensee that elects to retain its intellectual property rights to make all "royalty" payments due under the contract, parties negotiating a licensing agreement should consider allocating a portion of the fees paid by the licensee as something other than royalties. Such an allocation will give the licensee of a rejected licensing agreement an argument that it may make reduced payments to the licensor on the rejection of the licensing agreement. The parties's characterization, however, will not

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[6] There are no published decisions discussing whether the licensee will also be deemed to have waived its right of recoupment. To the extent the licensee owes the licensor money under the rejected licensing agreement, the licensee would likely have a right of recoupment. The licensee should nevertheless expressly provide for a right of recoupment in the licensing agreement. <u>See</u> <u>generally</u> § IV, <u>infra</u>, for a discussion of recoupment.

necessarily be binding in bankruptcy. See generally In re Prize Frize, Inc., 32 F.3d 426 (9th Cir. 1994).

In Prize Frize, the non-debtor licensee under a rejected technology licensing agreement chose to retain its intellectual property rights pursuant to Section 365(n)(1)(B). It was, therefore, required to make all royalty payments due under the license agreement. The license agreement provided for the payment of a "license fee" of $1,250,000, the balance of which was to be paid in $50,000 monthly installments. The Ninth Circuit was faced with the issue whether these "license fees" were "royalties" within the meaning of Section 365(n)(2)(B). In rejecting the licensee's argument that the license fees were not royalty payments, the Ninth Circuit reasoned that:

> the parties by their choice of names cannot alter the underlying reality nor change the balance that the Bankruptcy Code has struck. Despite the nomenclature used in the agreement, the license fees to be paid by [the licensee] are royalties in the sense of section 365(n).

32 F.3d at 429.

The Prize Frize court did, however, raise the question whether all of the license fee should be deemed a "royalty," or whether some portion of the license fee should be allocated as payment for the "non-intellectual property" obligations of the

debtor which the debtor was no longer required to perform as a result of the rejection. 32 F.3d at 429. Although the Ninth Circuit refused to decide the allocation issue on the basis that it had not been argued before the lower courts, practitioners should nevertheless consider expressly allocating a portion of the fees payable under a license agreement in such a way that they will be determined not to be royalties upon the rejection of the licensing agreement. Although not binding on a bankruptcy court, such an allocation at the outset will help to obtain a more predictable result in the event of a subsequent bankruptcy.

In the event of rejection of a licensing agreement, the licensee's sublicensees can have no greater rights in the licensed property than the licensee. In re Yachthaven Rest. Corp., 103 B.R. 68, 75 (Bankr. E.D.N.Y. 1989) (when licensee defaults as to licensor, sublicense falls). Thus, if a licensee loses its rights in the licensed property because of rejection, then the licensee's sublicensees will lose the rights derived from the licensee, possibly subjecting the licensee to a claim for damages from its sublicensees. Likewise, the sublicensees will retain their rights in the licensed property to the extent that the licensee elects to retain its rights to such

intellectual property.

D. Assignment of executory contracts

The assignment of executory contracts is governed by Section 365(f) of the Bankruptcy Code. Section 365(f) gives the debtor greater rights to assign executory contracts than those which might exist outside of bankruptcy. See, e.g., 11 U.S.C. § 365(f)(1) (permitting assignment of executory contracts notwithstanding non-assignment provisions). The debtor cannot, however, assign a contract such as a personal service contract in which, under applicable law, the non-debtor party would be excused from accepting performance from, or rendering performance to, a party other than the debtor. Neither the debtor nor the debtor's estate is liable for a breach of a properly assigned executory contract after assignment. See 11 U.S.C. § 365(k) ("Assignment by the trustee to an entity of a contract or lease assumed under this section relieves the trustee and the estate from any liability for any breach of such contract or lease occurring after such assignment").

9. Mechanics of assignment

Section 365(f)(2) of the Bankruptcy Code provides that the debtor may assign an executory contract only if (i) it assumes such contract in accordance with Section 365(a) of the

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Bankruptcy Code, and (ii) the assignee of the contract provides adequate assurance of future performance under the assigned contract.[1/] Congress did not define adequate assurance of future performance. What constitutes "adequate assurance" is decided on a case-by-case basis. See Seacoast Prods., Inc., v. Spring Valley Farms, Inc., 34 B.R. 379 (M.D.N.C. 1983). It has generally been held, however, that

> [a]dequate assurance of future performance . . . means that the proposed assignee has the ability to satisfy the financial obligations imposed by the [contract] . . . . An absolute guarantee, such as a letter of credit, is not required to meet this standard.

In re Tech Hifi, Inc., 49 B.R. 876, 879 (Bankr. D.Mass. 1985). For specific examples of when adequate assurance of future performance has been found to be sufficient, see, e.g., In re Sea Harvest Corp., 868 F.2d 1077, 1080 (9th Cir. 1989) (statement that debtor-in-possession recognizes ongoing obligation to pay is insufficient to provide adequate assurance; In re Taylor Mfg., Inc., 6 B.R. 370, 372-73 (Bankr. N.D.Ga. 1980) (adequate assurance found when proposed assignee of lease had substantial net worth and record of paying its debts); In re Belize Airways Ltd., 5 B.R. 152, 156 (Bankr. S.D. Fla. 1980)

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[7] See § III(C)(1), supra, for a discussion of the requirements to assume an executory contract pursuant to Section 365(a) of the Bankruptcy Code.

(posting of a three-month security deposit found to be adequate assurance).

1. Enforcement of anti-assignment provisions

Section 365 of the Bankruptcy Code permits the free assignment of most contracts, except contracts such as personal service contracts which are nondelegable under applicable nonbankruptcy law. Such nondelegable contracts can be assigned only if the non-debtor party consents to the assignment.

Section 365(f)(1) of the Bankruptcy Code states the general rule that

> notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.

11 U.S.C. § 365(f)(1). _See generally In re Rooster, Inc._, 100 B.R. 228 (Bankr. E.D. Pa. 1989) (purpose of provision is to prevent assignment of contracts ordinarily made unassignable by law). Section 365(c)(1), however, is an exception to the general rules that a debtor may freely assume and assign executory contracts:

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> (c) The trustee may not assume or assign an 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 -
>
> > (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 or lease prohibits or restricts assignment of rights or delegation of duties; and
> >
> > (B) such party does not consent to such assumption or assignment;

11 U.S.C. § 365 (c)(1).

Courts have interpreted the exception contained in Section 365(c)(1) in a variety of ways. For example, in In re West Elecs. Inc., 852 F.2d 79 (3d Cir. 1988), the Third Circuit was faced with the issue whether the debtor, a defense contractor, could assume a defense contract with the government despite a federal law requiring the government's consent before such a contract can be assigned. In resolving this issue in the negative, the Third Circuit devised what has become known as the "hypothetical test:"

> . . . 11 U.S.C. § 365(c)(1) creates a hypothetical test--i.e., under the applicable law, could the government refuse performance from "an entity other than the debtor or debtor in possession." Thus, the relevant inquiry is not whether 41 U.S.C. § 15 would preclude an assignment from West as a debtor to West

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> as a debtor in possession, but whether it would foreclose an assignment by West to another defense contractor.

852 F.2d at 83 (emphasis in original and citations omitted).

Although the Eleventh Circuit appears to have adopted the hypothetical test espoused by the Third Circuit, it has interpreted "applicable law" somewhat differently. See City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 534 (11th Cir. 1994). In James Cable, the City of Jamestown, Tennessee had enacted a city ordinance granting a cable television franchise to James Cable. The ordinance provided that the franchise agreement could not be assigned in bankruptcy. 27 F.3d at 536. James Cable went into bankruptcy and sought to assume the cable franchise agreement over the City's objection. The Eleventh Circuit permitted the debtor to assume the franchise agreement, reasoning that the city ordinance was not the type of "applicable law" referred to in Sections 365(c) and (f):

> A general prohibition against assignment does not excuse the City from accepting performance from a third party within the meaning of § 365(c)(1). In order to be excused from accepting performance, the City would need to point to applicable law such as Tennessee law that renders performance under the cable franchise agreement nondelegable. A classic example of a contract under which performance is nondelegable is a personal service contract. The City proffers no

> Tennessee law, other than the general prohibition against assignment found in section 12 of the Ordinance and laws validating such a prohibition, that would excuse the City from accepting performance from a third party. Accordingly, we conclude that applicable Tennessee law does not excuse the City from accepting performance from an entity other than James Cable, that the § 365(c)(1) exception does not apply in this case, and that James Cable as debtor in possession may therefore assume the cable franchise agreement from itself as a debtor under 11 U.S.C. § 365(a).

27 F.3d at 538 (footnotes omitted). Regardless of which law is applied, the debtor cannot assume or assign an executory contract under which the non-debtor party would be excused from accepting substituted performance under "applicable law."

2. Assignment of personal service contracts

Section 365(c)(1) of the Bankruptcy Code prohibits the assumption or assignment of executory contracts under which the debtor cannot delegate its duties. See generally James Cable. Although typically applied to personal service contracts, courts have held that Section 365(c) applies more broadly to contracts that cannot be assigned under applicable non-bankruptcy law. See, e.g., In re West Electronics, Inc., 852 F.2d 79, 83 (3rd Cir. 1988); In re Pioneer Ford Sales, Inc., 729 F.2d 27, 29 (1st Cir. 1984); In re Braniff Airways, Inc., 700 F.2d 935, 943 (5th Cir. 1983).

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Although a personal service contract cannot be assumed or assigned, the debtor can reject a contract for personal services. See, e.g., Delightful Music Ltd. v. James Taylor (In re James Taylor), 913 F.2d 102, 107 (3d Cir. 1990) (authorizing rejection of personal service contract); In re Noonan, 17 B.R. 793, 798 (Bankr. S.D.N.Y. 1982) (holding that contract for debtor's personal services cannot be assumed absent consent of the debtor). But see In re Carrere, 64 B.R. 156, 159 (Bankr. C.D.Cal. 1986) (holding that trustee has no standing to reject contract for debtor's personal services).[1/]

Whether a contract is a contract for personal services is a question of state law. In re Headquarters Dodge, Inc., 13 F.3d 674, 683 (3rd Cir. 1994). In discussing whether an automobile franchise agreement is a personal service contract and therefore non-assignable under Section 365(c), the Third Circuit stated that

> Whether a contract is personal in nature depends `upon the nature of the subject of the contract, the circumstances of the case and the intent of the parties to the contract.' . . . [C]lauses in the contract . . . attesting to a personal relationship will not be dispositive. Among the circumstances to be considered and weighed are the extent of the

[8] The Carrere decision is of questionable validity due to its lack of statutory support. See James Taylor, 913 F.2d at 107 (criticizing Carrere decision).

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> franchisee's ownership interest in the specific franchise, the extent to which the nature of the dealership permitted personal service of the franchisee, the multi-franchise character of the operation, the number of employees in the entire dealership operation, and other relevant factors. Under this standard, the determination is one of fact . . .

Headquarters Dodge, 13 F.3d at 682-83 (quoting from West Electronics, 852 F.2d at 83) (citations omitted). Similarly, the Fifth Circuit held that

> The important inquiry is into the nature of the contract itself, to determine if it calls for the exercise of some personal skill and judgment on the part of the bankrupt, or rests upon the other party's placing trust and confidence in the reputation of the bankrupt for skill and integrity.

Ford, Bacon & Davis, Inc. v. Holahan, 311 F.2d 901, 904 (5th Cir. 1962). Furthermore, although most personal service contracts require the services of an individual, a contract calling for the services of a corporation can also be a personal service contract. See Ford, Bacon & Davis, 311 F.2d at 903-04. For this reason, parties entering into contracts that they do not wish to have assumed or assigned in a subsequent bankruptcy would be well-advised to consider adding a "key man" clause to the agreement to preserve the argument that the agreement is a non-assignable personal service contract.

Section 365(c)(1) and non-bankruptcy law generally permit

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the assignment of personal service contracts if the non-debtor party to the contract consents to such assignment. See 11 U.S.C. § 365(c)(1)(B). This consent does not necessarily have to be given in connection with the bankruptcy case. Rather, to the extent there is a consent to assignment contained in the agreement to be assigned, the agreement will generally be assignable under applicable law and therefore pursuant to Section 365(f), without regard to Section 365(c). For example, in Pino v. Spanish Broadcasting System of Florida, 564 So.2d 186, 187-89 (Fla. 3d D.C.A. 1990), the District Court of Appeals enforced the assignment of an employee's employment contract, including a covenant not to compete, on the basis that the employment contract contained a consent to its assignment. In Pino, a radio disk jockey signed an employment agreement which contained an agreement not to compete for 12 months after the termination of her employment. The employment agreement also provided that it was assignable by the employer. The employer subsequently sold its assets and assigned the employment agreement to SBS. After the termination of her employment with SBS, Ms. Pino began work as a disk jockey for another Miami radio station in violation of her covenant not to compete. In holding that SBS, the assignee of the employment contract, had

the right to enforce the covenant not to compete, the court held that "it is a well settled principle of contract law that contracts for personal services are assignable by consent of the parties." 564 So.2d at 187-88. The court went on to state that

> Because the contract containing the covenant not to compete included a provision permitting assignment, Pino's covenant not to compete was assignable and, therefore, enforceable by SBS . . . Our holding conforms with the policy of preserving the sanctity of contract and providing uniformity and certainty in commercial transactions . . . Pino agreed that her employment contract, including the one-year prohibition against competition, was assignable. She must be held to that obligation.

564 So.2d at 189. Because the employment agreement in Pino could be assigned under applicable nonbankruptcy law, it presumably could have been assigned under Section 365(f), without regard to the prohibition contained in Section 365(c)(1).

The Right of Recoupment

A wide range of contracts in the sports and entertainment industries typically provide for the payment of advances at the beginning of the contractual relationship, and the "recoupment" of those advances throughout the contract term. Many of these same contracts also provide for payments between the parties

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based on varying types of formulas, and adjustments to those payments as the components of those formulas subsequently change. In these situations, it is important that the non-debtor party has a valid right of recoupment in bankruptcy.

The right of recoupment is different than the right of setoff in several important respects. Most important for bankruptcy purposes is that setoff requires relief from the automatic stay and "mutuality of obligations." In contrast, many courts have held that (i) recoupment does not require relief from the automatic stay and (ii) a creditor may recoup post-bankruptcy obligations owing to the debtor against pre-bankruptcy obligations owing from the creditor. Therefore, to the extent a creditor has a valid right to recoup under applicable nonbankruptcy law, it may be able to continue to recoup as if no bankruptcy case had been commenced. The advantages of recouping are obvious -- the creditor can continue to pay down its pre-bankruptcy claim against the debtor in 100 cent dollars despite the automatic stay and other rules that prohibit the payment of pre-bankruptcy debts by the debtor.

A. Requirements for recoupment

Except as otherwise agreed, a creditor can exercise a common law right of recoupment if each of the following

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conditions are satisfied:

1. Debts are owing from the creditor to the debtor, and from the debtor to the creditor;

2. The debtor and creditor are standing in the same capacity; and

3. The debts arise out of the same transaction.

The majority of courts have held that the Bankruptcy Code does not affect the substantive right of recoupment. See, e.g., In re University Medical Center, 973 F.2d 1065, 1079-80 (3d Cir. 1992) (stating in dicta that recoupment is an equitable exception to the automatic stay); In re Newbery Corp., 145 B.R. 998 (Bankr. 9th Cir. 1992); In re St. Johns Home Health Agency, Inc., 173 B.R. 238 (Bankr. S.D. Fla. 1994). But see Quittner v. Los Angeles Steel Casting Co., 202 F.2d 814 (9th Cir. 1953) (not permitting recoupment in bankruptcy).[1/] Thus, as a general rule, creditors enjoy the same right to recoup inside of bankruptcy as outside of bankruptcy, in accordance with

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[9] It is questionable whether Quittner is still good law. See, e.g., Newbery (permitting recoupment in bankruptcy without discussion of Quittner); In re California Canners and Growers, 62 B.R. 18, 19 (Bankr. 9th Cir. 1986) (stating in dicta that "a creditor properly invoking the recoupment doctrine can receive preferred treatment even though setoff would not be permitted"). But see In re Pacoima Memorial Hospital, 1990 W.L. 282, *5 (Bankr. C.D. Cal. 1990) (citing Quittner for the proposition that "the law in the Ninth Circuit appears to leave little, if any room for the application of recoupment in bankruptcy").

applicable state law. In re Public Service Co. of New Hampshire, 107 B.R. 441, 444 (Bankr. D.N.H. 1989).

Although courts universally require relief from the automatic stay to set off a claim against a bankruptcy debtor, most courts that have addressed the issue have held that no such relief is required to recoup a debt owing to a bankruptcy debtor. See, e.g., St. Johns Home Health Agency, 173 B.R. at 241, in which the bankruptcy court held that the right of recoupment "is not subject to the automatic stay nor appropriately enjoined under 11 U.S.C. § 105." But see In re Heafitz, 85 B.R. 274, 280 (Bankr. S.D.N.Y. 1988) ("a party seeking to exercise a proper recoupment must first seek relief from the automatic stay").

In discussing the right of recoupment in a bankruptcy scenario, the Ninth Circuit Bankruptcy Appellate Panel stated that

> the purpose of asserting a claim in recoupment is to determine the just liability on the plaintiff's claim and since both claims arise out of the same transaction, recoupment should be allowed regardless of whether one claim arose pre-petition and the other post-petition. Indeed, to allow a debtor to cut off a creditor's defense simply because the defense arose pre-petition and the claim arose post-petition would be inequitable.

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> Accordingly, [the creditor] may recoup its pre-petition damages against the debtor's claim for post-petition rents.

Newbery, 145 B.R. 1001 (citations and footnote omitted).

1. Existence of debts

A creditor may only exercise its right of recoupment to the extent (i) it holds a claim against debtor, and (ii) the debtor holds a claim against the creditor. Wolf v. Aero Factors Corp. (In re Regent Case Co.), 126 F.Supp. 872, 883 (S.D.N.Y. 1954) (holding that existence of a debt is required for setoff), aff'd, 221 F.2d 901 (2d Cir. 1955). Thus, to the extent the creditor is merely holding money or property that is property of the debtor's bankruptcy estate pursuant to Section 541 of the Bankruptcy Code, no debt exists. To the extent there is no debt, there is no right to recoup.

For example, in In re Allbrand Appliance & Television Co., Inc., 16 B.R. 10 (Bankr. S.D.N.Y. 1980), the debtor employed a truck driver to make deliveries of the debtor's products, and to collect COD payments from the debtor's customers. Within a week of delivery, the driver would turn over the COD receipts to the debtor. On these facts, the bankruptcy court held that the driver and debtor had created a debtor-creditor relationship as to the COD payments and the driver, therefore, had the right to

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retain those payments in his possession as a setoff of amounts owed to the driver from the debtor. See also In re W & A Bacon Co., 261 F. 109 (D.Mass. 1919) (holding that debtor-creditor relationship existed on similar facts). And see Interstate Record Distributors, Inc. v. Columbia Broadcasting System, Inc. (In re Interstate Record Distributors, Inc.), 307 F.Supp. 1142, 1144 (S.D.N.Y. 1970) (citing W & A Bacon and holding CBS (manufacturer) stood in debtor-creditor relationship rather than trustee relationship as to money collected on behalf of debtor, dealer), aff'd, 430 F.2d 1017 (2d Cir. 1970) (per curiam)).

2. Capacity of parties

Parties must stand in the identical capacity to recoup. Thus, for example, a creditor that is owed money in its capacity as a trustee cannot recoup against a debt owing in its individual capacity. See, e.g., In re Warren, 93 B.R. 710, 712 (Bankr. C.D. Cal. 1988) (individual acting as executor of estate is not acting in same capacity as individual acting on own behalf).

3. Same transaction

The claims of both the creditor and debtor must arise out of the same "transaction" if the creditor is to have a valid right of recoupment. The majority of cases has held that the

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creditor's claim for recoupment arises out of the "same transaction" as the debtor's claim for payment when both claims arise from the same contract and the creditor's claim is based upon monies advanced to the debtor. As set forth in Waldschmidt v. CBS, Inc., 14 B.R. 309, 314 (M.D. Tenn. 1981):

> the advances and royalties involved in this case unquestionably arise from the same transaction. Both grow out of the recording contract between [the debtor] and CBS. In fact, no dispute over the royalties would exist but for the express provision in the contract calling for advances and their recoupment from royalties.

14 B.R. at 314. See also In re B & L Oil Co., 782 F.2d 155, 157 (10th Cir. 1986) (citing case law which "emphasized that most recoupment cases involved single contracts that provided for advance payments based on estimates of what ultimately would be owed, subject to later correction"); Public Service Co. of New Hampshire, 107 B.R. at 445 (equitable recoupment usually applied when there is a single contract, and there is some contractual overpayment or advance); In re Denby Stores, Inc., 86 B.R. 768, 782 (Bankr. S.D.N.Y. 1988) (same). But see United States v. Dewey Freight System, Inc. (In re Dewey Freight System, Inc.), 31 F.3d 620, 623 (8th Cir. 1994) (questioning whether obligations at issue, which arose out of same contract, arose out of same "transaction").

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For example, in B & L Oil, the parties had a supply contract providing for multiple purchases of oil. The contract allowed either party to recoup billing errors on one purchase against amounts owing on a subsequent purchase. Even though the contract had not been assumed, the court held that the overall equities of the situation warranted that the creditor be permitted to continue exercising its right of recoupment, pending assumption or rejection of the supply contract.

B. Recoupment at different stages of a bankruptcy case

Some courts have treated the right to recoup differently, depending on whether the contract giving rise to the recoupment right has been assumed, rejected, or neither assumed nor rejected.

1. Recoupment upon assumption of contract.

A debtor that assumes an executory contract "becomes liable for performance of the entire contract, as if bankruptcy had never intervened." NLC Corp. v. Lone Star Building Centers (Eastern) Inc., 144 B.R. 170, 178 (S.D. Fla. 1992). This obligation includes the obligation to permit the other party to the contract to recoup in accordance with the terms of the contract. See, e.g., St. Johns Home Health Agency, 173 B.R. at 246 (holding that assumption of a provider agreement by a debtor

health care provider would subject it to contractual and statutory recoupment by the government). If the debtor assumes an executory contract, the creditor will be entitled to recoup in accordance with the terms of the assumed agreement and applicable nonbankruptcy law.

2. Recoupment upon rejection of contract.

A debtor, with bankruptcy court approval, can reject an executory contract pursuant to Section 365 of the Bankruptcy Code. Upon rejection of the contract, the other party to the contract is given a damage claim against the debtor, which claim is deemed to have arisen immediately before the filing of the petition. 11 U.S.C. § 365(g). *See generally* § III(C)(3)(a), *supra*. Some courts that treat contract rejection as a breach rather than as a termination would allow the creditor its contractual termination remedy of recoupment. *See, e.g.*, *In re Dailey*, 17 F.3d 394 (9th Cir. 1994) ("bankruptcy court committed error by ignoring the lease's damage calculation formula"). Other courts would presumably permit the creditor to exercise equitable recoupment. *See, e.g.*, *In re Blevins Concession Supply Co.*, 1994 WL 634425 (E.D. Pa. 1994) (suggesting that the equitable remedy of recoupment would survive rejection of an executory contract). If followed, however, the Eighth Circuit's

recent decision in Dewey Freight may limit severely a creditor's right of recoupment. Although the facts and holding of Dewey Freight are somewhat unclear, this case could arguably be read to hold that a non-debtor party to an executory contract cannot exercise a right of recoupment in the post-bankruptcy, pre-rejection period. The case also holds that a creditor cannot exercise a right of recoupment against its claim for damages resulting from the debtor's rejection of the contract. If a bankruptcy or appellate court were to follow Dewey Freight, a creditor would not be able to exercise either an equitable or contractual right of recoupment for its rejection damages, and might not even have a right to recoup during the post-bankruptcy, pre-rejection period.

3. Recoupment pending assumption or rejection of contract.

Courts have the most difficulty with the scenario in which the debtor neither assumes nor rejects the executory contract, but continues to operate under its terms. Some courts have held that contractual recoupment still applies without assumption by the debtor. See St. Johns Home Health Agency, 173 B.R. at 246 ("This Court has held that a debtor provider is subject to recoupment even prior to formal assumption of a Provider

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Agreement, at least where the debtor continues to operate under the terms of the executory contract and seeks to receive its benefits"). See also In re Midwest Service and Supply Co., 44 B.R. 262, 265 (D. Utah 1983) ("having sought the benefit of post-petition performance under the contracts, the debtor must also accept the burden of the liquidation portion of the progress payment contract clause"); In re Yonkers Hamilton Sanitarium, 22 B.R. 427, 434-35 (Bankr. S.D.N.Y. 1982) ("[a]s long as the debtor continues to receive benefits under such contract it must also bear the burdens or obligations imposed under the contract"), aff'd, 34 B.R. 385 (1983). But see N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 532 (1984) (until assumed, executory contracts remain enforceable by debtor but not other party to contract).

If a court does not permit contractual recoupment absent assumption of the executory contract by the debtor, the creditor would likely still be entitled to exercise its equitable (common law) right to recoupment. See, e.g., In re Consumer Health Services of America, Inc., 171 B.R. 917, 921 (Bankr. D.D.C. 1994) ("a finding that there is no contractual right to recoupment does not necessarily mean that another basis for recoupment does not lie"). Most courts allow equitable

recoupment when the debtor operates under the contract without assuming it. See, e.g., B & L Oil, 782 F.2d at 157 ("a debtor who assumes the favorable aspects of the contract . . . also must take the unfavorable aspects of the same contract").

A minority of courts, however, allow the debtor "to have its cake and eat it too" in such situations, ruling that the debtor may accept the benefits of the contract, but not the burdens, reasoning that court approval is required for any assumption. See, e.g., Dewey Freight, 31 F.3d at 624-25 (arguably holding that a non-debtor party to an executory contract cannot exercise a right of recoupment in the post-bankruptcy, pre-rejection period).

Conclusion

Professionals involved in negotiating and drafting licensing, distribution, artist and other agreements in the sports and entertainment industries should be mindful of the future bankruptcy ramifications of those contracts. This article discusses in a summary format some of the issues which may arise in connection with a bankruptcy case. Parties entering into contracts should consider inserting language to take advantage of various provisions in the Bankruptcy Code.

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For example, they may wish to insert consents to the assignment of nondelegable contracts, create disincentives for the rejection of contracts, allocate payments to be made in licensing agreements between "royalty" and non-royalty payments, and expressly provide for a right of recoupment. Upon the occurrence of a bankruptcy, professionals should be careful to act quickly to protect their clients' rights, but be careful not to take any action that might have the affect of violating the automatic stay.

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