The Transactional Lawyer

A Publication of the Commercial Law Center

Preserving the Debtor's IP Licenses in Bankruptcy?

M. Alee Soleimanpour

A recent case reveals a significant trap for lenders with a security interest in intellectual property licensed to the debtor. This problematic scenario can arise in bankruptcy if the debtor is unable to assume the license, particularly if the license is one that the debtor needs to conduct its business. Fortunately, with due diligence and proper drafting, the secured party should be able to avoid this trap.

The Case

In *In re Trump Entertainment Resorts, Inc.*, **2015 WL 756873** (Bankr. D. Del. 2015), the debtors had entered into a prepetition licensing agreement that allowed them to use the Trump name in their hotels and casinos. On the same day, the debtors, the licensors, and the debtor's first-lien lenders entered into an ancillary agreement. Under the ancillary agreement, the licensors consented to the lenders' ability to transfer the debtors' license rights in connection with the enforcement of the lenders' security interest in those rights.

Four years later, the debtors sought Chapter 11 bankruptcy protection. Thereafter, the licensors sought relief from the stay in order to terminate the licensing agreement. The court granted the requested relief, concluding that the licensing agreement was an executory contract that the debtors could not assume under § 365(c)(1).

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Section 365(c)(1) denies a debtor-in-possession the right to assume an executory contract if applicable law would excuse the counterparty from accepting performance by someone else. Courts are split on how § 365(c)(1) applies if the debtor-in-possession wishes to assume, but not assign the contract. Some courts, including the Third Circuit, use the so-called "hypothetical test," which follows the text of the Code and prohibits assumption if the counterparty could not be forced to accept performance from someone other than the debtor. *See, e.g.*, *In re Sunterra Corp.*, **361 F.3d 257** (4th Cir. 2004); *In re Catapult Entm't, Inc.*, **165 F.3d 747** (9th Cir. 1999); *In re James Cable Partners, L.P.*, **27 F.3d 534** (11th Cir. 1994); *In re W. Elecs, Inc.*, **852 F.2d 79** (3d Cir. 1988). Other courts follow the "actual test," which focuses on whether the counterparty will in fact be asked to accept performance from or render performance to a party other than with whom it originally contracted. *See, e.g.*, *In re Mirant Corp.*, **440 F.3d 238** (5th Cir. 2006); *Summit Inv. & Dev. Corp v. Leroux*, **69 F.3d 608** (1st Cir. 1995). In other words, under the "actual test," if no *assignment* has occurred or is contemplated, *assumption* is permitted.

Because the *Trump* court was bound by Third Circuit precedent, it applied the "hypothetical test." The court then ruled that applicable non-bankruptcy law – federal trademark law – prohibited assignment of the trademark license agreement absent the licensors' consent. Since the debtors lacked the licensors' consent, the court permitted the licensors to seek termination of the license agreement in state court due to the debtors' alleged breach of the agreement. If the licensors are successful in this effort, it will leave the first-lien lenders without an enforceable security interest in the debtors' trademark licenses, property that is likely to be essential to the operation of the debtors' business and to the debtors' successful reorganization.

The Remedy

The case is all the more remarkable because the first-lien lenders were perceptive enough to obtain the licensors' consent to enforcement of the lenders' security interest. In other words, the lenders were probably aware that under U.C.C. § 9-408(a), the

licensors' consent was not necessary for them to obtain a security interest in the license. However, the lenders likely recognized that, under § 9-408(d), they could not compel the licensors to recognize the security interest. In effect, without the licensors' consent to enforcement, the lenders would not be entitled to use or assign the debtors' interest in that license.

Thus, the lenders bargained for and received the consent they needed to enforce their security interest. Nevertheless, the first-lien holders failed to bargain for the licensors' consent to the debtors' assumption of the license in event of bankruptcy – a provision that the *Trump* holding shows they needed. To avoid this problem, a creditor should include the following language:

If a petition for bankruptcy relief is filed by or against Debtor, Licensor shall not oppose or object to any motion to assume the Licensing Agreement pursuant to Section 365 of the Bankruptcy Code, and Licensor shall instead expressly consent to assumption of the Licensing Agreement.

Without such a provision by a licensor, the debtor and the secured party will be vulnerable to losing the license if the debtor files bankruptcy in any jurisdiction that follows the "hypothetical test" when applying § 365.

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Waiving Suretyship Defenses

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A guarantor is a "favorite of the law," *e.g., JRG Capital Investors I, LLC v. Doppelt*, 580 F. App'x 242, 244 (5th Cir. 2014) (applying Texas law), with the result that guaranty agreements are strictly construed in favor of the guarantor, *id.*, and guarantors have an array of suretyship defenses. These defenses can be based on any of the following conduct by the creditor:

(a) Releasing the principal obligor from a duty to pay money or other obligation;
(b) Granting the principal obligor an extension of time to perform;
(c) Agreeing to a modification of the duties of the principal obligor;
(d) Impairing the value of an interest in collateral securing the underlying obligation;
(e) Allowing the statute of limitations on the underlying obligation to expire; or
(f) Any impairment of the guarantor's right of reimbursement or subrogation.

See Restatement (Third) of Suretyship and Guaranty § 37; *see also* Cal. Civ. Code §§ 2819–2825.

What Can Be Waived

A guarantor can waive such suretyship defenses at the outset of a transaction and many commercial lenders routinely include waiver language in their form guaranty agreements. Often, the language lists each suretyship defense waived, which lengthens the agreement and, more importantly, increases the risk that one or more suretyship defenses might be unintentionally omitted.

Fortunately, there is an alternative approach that is effective. Most suretyship defenses can be waived with a general statement that does not expressly list each defense and instead simply indicates that the guarantor is waiving all defenses based on suretyship. *See* Restatement (Third) of Suretyship and Guaranty § 48(1) & cmt. d; Cal. Civ. Code § 2856(b); *Pacifica L 39 LLC v. Ramy*, 2015 WL 394239 (Cal. Ct. App. 2015); *JPMorgan Chase Bank v. East-West Logistics, LLC*, 9 N.E.3d 104 (Ill. Ct. App. 2014); *Wells Fargo Bank v. Osprey Commerce Ctr., LLC*, 2014 WL 1271460 (M.D. Fla. 2014); *Moayedi v. Interstate 35/Chisam Road, L.P.*, 438 S.W.3d 1 (Tex. 2014); *Coop. Centrale Raiffeisen-Boerenleenbank, B.A. v. Navarro*, 978 N.Y.S.2d 186 (N.Y. Sup. Ct. App. Div. 2014). *See also Texas Capital Bank v. Dallas Roadster, Ltd.*, 2015 WL 1025207 (E.D. Tex. 2015) (a guarantor can release affirmative claims against the lender – whether known or unknown – and do so effectively using broad language that does not identify each cause of action).

Consequently, a single sentence such as the following should be sufficient to waive all the suretyship defenses referenced above.

Guarantor hereby waives all suretyship defenses.

What Perhaps Cannot Be Waived

At least in some jurisdictions, a surety might have additional defenses. For example, in *Sumitomo Bank v. Iwasaki*, **447 P.2d 956** (Cal. 1968), the California Supreme Court ruled that a creditor owes a surety a continuous duty of good faith. This means that, each time the creditor extends additional credit to the principal obligor, the creditor must disclose to a surety who has provided a continuing guaranty any fact – known to the creditor, but unknown to the surety – that materially increases the surety's risk. This ruling is now reflected in **§ 47** of the Restatement.

However, it is not clear whether a guarantor can waive this defense in advance in the guaranty agreement. **Section 48** of the Restatement of Suretyship and Guaranty, which deals with the waiver of defenses, conspicuously omits **§ 47** from its catalogue of defenses that a surety may waive. This implies that the defense cannot be waived in advance. *But cf. OneWest Bank v. Lorin*, **2012 WL 5266114** at *n.6 (Cal. Ct. App. 2012) (suggesting that a *Sumitomo* defense can be waived).

At least one recent judicial decision seems to indicate the same. In *California Bank & Trust v. DelPonti*, **181 Cal. Rptr. 3d 216** (Cal. Ct. App. 2014), a bank that provided financing for a construction project materially breached the loan agreement by refusing to honor payment applications that had been approved, which caused the borrower to default and led to a foreclosure. The trial court ruled that the bank's action had exonerated the guarantors. The court of appeals affirmed. Although the guarantors had expressly waived suretyship defenses, the court concluded that the waiver applied only to the traditional defenses codified in the California Civil Code, not to equitable defenses such as unclean hands. To rule otherwise, the court concluded, would allow the lender to profit from its own improper conduct. ***Id.* at 219**. The court then added:

> [W]e apply a rule of strict construction to contractual pre-default waivers by the Guarantors. While broad in scope, such waivers are limited to those legal or statutory defenses particularly set forth in the guaranty agreement and do not constitute a waiver of all equitable defenses. In fact, the waiver provision of the guaranty agreement specifically states, "Except as prohibited by applicable law, Guarantor waives ...." This language contemplates the retention of defenses, the pre-default waiver of which would be contrary to public policy.
>
> In all suretyship and guaranty relations, the creditor owes the surety a duty of continuous good faith and fair dealing. (*Sumitomo Bank v. Iwasaki.*) This duty was not waived by the Guarantors in the agreement. The trial court found that public policy precluded an interpretation of the guaranty agreement that resulted in a waiver of *all* defenses. We agree. ***Id.* at 219-20**.

It is not entirely clear if the *DelPonti* court applied a rule of construction, so that a more specific waiver of such a defense could be effective, or a rule of law that regards an attempted waiver of such equitable defenses as against public policy and, therefore, void. However, it seems doubtful that a guarantor can waive in advance an equitable defense based on the lender's misconduct. *See Heartland Bank and Trust Co. v. Goers*, **2012 WL 7005595** (Ill. Ct. App. 2012) (a general waiver of defenses in a guaranty agreement does not waive defenses based upon a lender's breach of its duty to act in good faith).

That said, while parties cannot waive the duty of good faith, that duty merely supplements their agreement, it does not dictate the terms of an agreement or override express terms. *See, e.g.*, PEB Commentary #10 (Feb. 10, 1994) ("[O]ne acts in good faith relative to the agreement of the parties. To decide the question whether a party has acted in good faith, a court must first ascertain the substance of the parties' agreement."). Accordingly, a creditor should be able to avoid a defense based on the failure to disclose later-arising risks (*i.e.,* a *Sumitomo* defense) by having the guarantor agree that the creditor has no such duty.

Negating the creditor's continuing duty to inform the guarantor of risks requires language in addition to a general waiver of suretyship defenses. In sum, a general waiver of suretyship defenses should be effective to waive all the suretyship defenses listed at the beginning of this article. Additional language would be needed to waive equitable defenses based on creditor misconduct, but a waiver in advance of such defense is of doubtful efficacy. Finally, parties should be able to short-circuit a *Sumitomo* defense by including language that expressly negates the creditor's

duty to disclose risks. The following language should suffice:

Guarantor hereby waives all suretyship defenses.

Guarantor hereby waives any other defense arising in law or equity.

Guarantor represents and warrants that Guarantor has adequate means to obtain all relevant information, on a continuing basis, concerning Borrower's financial condition and Borrower's ability to perform its obligations under the Loan Documents. Guarantor bears responsibility for being and keeping informed of Borrower's financial condition and of all circumstances bearing upon the risk of nonpayment of the Guaranteed Obligations. Guarantor hereby waives any duty of Creditor to disclose any information, now or hereafter known by Creditor, which relates to the financial condition of Borrower or Guarantor's risk under this Guaranty.

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Recent Cases

Secured Transactions

Scope Issues

In re Heien,
2015 WL 1189968 (E.D. Mo. 2015)
Even if the Bailment Contract that a vehicle buyer signed and which provided that the purchase was conditioned on approval of the buyer's financing and, until then, the vehicle remained the seller's property, was contemporaneous with the purchase agreement, because the buyer obtained delivery of the vehicle and § 2-401 provides that retention of title by the seller of delivered goods is limited to a security interest, the vehicle was the buyer's property and came into the buyer's bankruptcy estate.

Attachment Issues

Royal Jewelers Inc. v. Light,
2015 WL 720559 (N.D. 2015)
Although the debtor must authenticate the security agreement, there is no requirement that the debtor separately authenticate or sign an exhibit that the security agreement references, even though that exhibit contains the description of the collateral.

In re 11 East 36th, LLC,
2015 WL 397799 (Bankr. S.D.N.Y. 2015)
Pledge agreement by which a limited liability company purported to grant a security interest in its "right, title, and interest . . . in and to its membership interest" in a subsidiary LLC that owned several condominium units did not give the secured party a security interest in the condominium units even though the security agreement purported to exclude some but, not all, of the subsidiary's condominium units and the secured party filed a financing statement against the debtor identifying the collateral as the other units owned by the subsidiary. The limited liability company that authenticated the security agreement did not have property rights in the condominium units owned by its subsidiary. The secured party therefore had merely an unperfected security interest in the debtor's interest in its subsidiary.

SEC v. Helms,
2015 WL 1040443 (W.D. Tex. 2015)
The investor in a Ponzi scheme partnership who had no knowledge of the fraud did not have a security interest to secure the investment because the Side Letter Agreement purporting to grant a security interest was void because it contradicted the Partnership Agreement and its execution was the a breach of the general partner's fiduciary duty to the partnership and the limited partners. Moreover, even if the security interest had attached, its creation was an avoidable fraudulent transfer because it was made with fraudulent intent and the investor's attorney failed to conduct adequate due diligence, preventing the investor from qualifying as a good faith transferee.

Priority Issues

Selective Ins. Co. of Am. v. Env., Safety & Health, Inc., **2015 WL 914824** (E.D. Tenn. 2015)
Because the indemnity agreement between a contractor and the surety that issued bonds for construction projects expressly provided that "all funds paid, due or to become due . . . under any contract in connection with which Surety shall have issued a Bond . . . shall be impressed with a trust in favor of and for the benefit of . . . Surety," the surety stated a cause of action against the contractor's secured lender for conversion based on the secured lender's receipt and retention of the proceeds of construction contracts. The surety was entitled to a preliminary injunction requiring the contractor to have all proceeds of its bonded contracts paid to the surety.

Enforcement Issues

Ross v. Rothstein, **2015 WL 1120086** (D. Kan. 2015)
The debtor was not entitled to notification of the sale of stock pledged as collateral because the debtor acknowledged his default and waived the right to notification in a superseding Pledge Agreement and even though the secured party agreed in the Forbearance Agreement not to take remedial action for a specified period of time, that did not eliminate the default by extending the time for payment. The secured party's sale of stock on the over-the-counter QB tier market ("OTCQB") was conducted in a commercially reasonable manner because the stock was sold at standardized prices that were not the subject of individual negotiation, and thus the OTCQB is a "recognized market" within the meaning of § 9-627(b). Although a sale a few hours later would have generated several thousand dollars more, the secured party had at the time no way of knowing that and the fact that a greater amount could have been obtained by disposition at a different time is not sufficient to show that the disposition was unreasonable.

Swift Energy Operating, L.L.C. v. Plemco-South, Inc., **2015 WL 446098** (La. Ct. App. 2015)
The factor that bought some accounts from the debtor and which obtained a security interest in the accounts that the debtor had not sold was an "assignee" of such unsold accounts within the meaning of § 9-406. Although the account debtor paid the debtor after receiving an e-mail message from the factor instructing the account debtor to pay the factor, the account debtor had no liability to the factor because the employee of the account debtor who received the message (along with contrary instructions from the debtor) informed the factor (and the debtor) that she was not the individual responsible for making payment decisions and informed the factor to whom it should send the assignment information. Consequently, the factor had not provided proper notification to the account debtor prior to the time the account debtor paid the debtor.

Lexel Imaging Systems, Inc. v. Video Display Corp., **2015 WL 403140** (E.D. Ky. 2015)
Even though the buyer and seller of all the stock in a corporate entity agreed to arbitrate disputes, the buyer was not entitled to a preliminary injunction ordering the seller to restore control of the entity to the buyer pending resolution of the arbitration because the seller retained a security interest in the stock and had an irrevocable power of attorney permitting it to exercise "any and all powers which may be exercised by the owners of said stock."

Moutopoulis v. 2075-2081 Wallace Ave. Owners Corp., **2015 WL 1243706** (N.Y. City Civ. Ct. 2015)
A secured party disposing of shares in two cooperative apartments makes no warranty about the financial status of or liens against the cooperative – as distinguished from the shares of the apartments involved – and even if it such a warranty would normally arise, it was properly disclaimed by language in the Terms of Sale providing that there was "no representation about either the title or any underlying mortgages on the premises or other obligations of the cooperative corporation." Accordingly, the high bidder who refused to consummate the purchase was not entitled to return of the deposits paid.

GUARANTIES & RELATED MATTERS

JPMorgan Chase Bank v. Winget, **2015 WL 728060** (6th Cir. 2015)
A guaranty agreement that defined an individual and a trust as "guarantor," and provided that the individual would be released upon a specified condition, could not be reformed due to mutual mistake to release both parties upon the occurrence of that condition. The guaranty was unambiguous, there was no mistake of fact, and reformation due to a scrivener's error is limited to situations in which the writing omits or mistakenly describes an agreed-to term, but here there was no agreement prior to the execution of the guaranty, a point supported by the integration clause in the guaranty.

GECC v. Anderson,
2015 WL 575159 (D. Conn. 2015)
Because the forbearance agreement among borrowers, guarantors, and lender provided that "Lender has entered into this Agreement in good faith and, in accordance with the present policies and procedures of Lender," and the meaning of that phrase was unclear, guarantor was entitled to admit parol evidence that the lender's representative had stated, when the loan was first made, that the lender's policy was not to chase guarantors unless there was evidence of fraud or wrongdoing in connection with the loan, and that the forbearance agreement incorporated that policy. Accordingly, the lender was not entitled to summary judgment on its claim against the guarantor.

LENDING & CONTRACTING

Brandt v. Lee,
2015 WL 506443 (Minn. Ct. App. 2015)
Because the letter, sent by the holder of a purchase option, stating "please take this as formal notification of my intent to exercise the option" was unclear as to whether it actually exercised the option or merely provided notification of the intent to exercise, a factual issue remained about whether a later assignee of the option holder's rights was obligated to consummate the purchase.

Notices

ACCESSING DRAFTS OF THE U.C.C.

Until recently, the preliminary drafts of the various Articles of the U.C.C., along with memoranda and other documents relating to each revision project, were available on the University of Pennsylvania School of Law web site. That web site no longer maintains these materials. Fortunately, the materials are accessible in other ways.

First, materials relating to the most recent revision of each Article are now available on the web site of the Uniform Law Commission. For example, materials relating to the 2010 amendments to Article 9 are available here:

http://uniformlaws.org/Committee.aspx?title=Commercial%20Code%20Article%209

Unfortunately, the ULC web site does not contain older materials, such as those relating to the 1998 revision to Article 9.

Second, the materials can be accessed using the so-called "way-back machine," a technique for accessing archived versions of the web. The following address and link is to an archived version of the web from a time when the U. Penn. library maintained the documents:

https://web.archive.org/web/20110617053353/http:/www.law.upenn.edu/bll/archives/ulc/ulc.htm#drafts

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The file synopsizes more than 400 judicial decisions

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