Case Note

Game Over

Perlman v. Catapult Entertainment (In re Catapult Entertainment), 165 F.3d 747 (9th Cir.), *cert. dismissed*, 120 S. Ct. 369 (1999).

Like ancient Babylonian decrees, the provisions of the current U.S. Bankruptcy Code are imbued with a wisdom few mortals can comprehend. Catapult Entertainment, an insolvent video-game developer, must have been made painfully aware of this by a recent Ninth Circuit opinion that analyzed the status of patent licenses in bankruptcy.[1] Having contracted for certain patent licenses, Catapult saw those licenses snatched away as a direct consequence of having filed for a Chapter 11 reorganization, despite the fact that the Bankruptcy Code normally prohibits solvent parties from terminating contracts merely because of a debtor's insolvency.[2] The explanation given was essentially the same as that offered for throwing Daniel into the lions' den: An established law cannot be altered, even when its consequences are unpleasant.[3] Whether Catapult and future technology firms in its situation will emerge unscathed remains to be seen.

Founded in 1994 "to create an online gaming network for 16-bit console videogames," Catapult had entered into two license agreements with Stephen Perlman that gave Catapult the right "to exploit certain relevant technologies."[4] Two years later, Catapult initiated reorganization

1. *See* Perlman v. Catapult Entertainment (*In re* Catapult Entertainment), 165 F.3d 747 (9th Cir.), *cert. dismissed*, 120 S. Ct. 369 (1999).

2. *See* 11 U.S.C. § 365(e) (1994) (nullifying so-called ipso facto clauses that terminate or modify the contract upon the insolvency or bankruptcy of a party).

3. *Compare Daniel* 6:15 ("[I]t is a law of the Medes and Persians that no interdict or ordinance that the king establishes can be changed."), *with Perlman*, 165 F.3d at 754 ("[T]hat the plain language of § 365(c)(1) may be bad policy does not justify a judicial rewrite."). Darius, the Persian ruler of Babylon, had been tricked by his satraps into signing a decree under which his distinguished chief minister, Daniel, was cast into the lions' den for worshipping the God of Israel. *See Daniel* 6:1-18.

4. *Perlman*, 165 F.3d. at 748.

proceedings.[5] As a solution to its financial problems, Catapult proposed a "reverse triangular merger" involving another company.[6] The Perlman licenses were to be assumed by Catapult under the plan, which was approved by the bankruptcy court over Perlman's objection,[7] but Perlman's argument that the patent licenses could not be assumed convinced the Ninth Circuit. The source of Catapult's torment in *Perlman* was 11 U.S.C. § 365(c), which constitutes an exception to the trustee's usually broad discretion to assume "executory contracts" in bankruptcy.[8] Section 365(c) prevents the trustee or debtor-in-possession from assuming executory contracts that could not be assigned outside of bankruptcy without the licensor's consent.[9] Since federal patent law allows the licensor to reject an assignment by the licensee to a third party,[10] and patent licenses are considered to be executory contracts, § 365(c) can be interpreted to render patents non-assumable in bankruptcy. Courts have disagreed, however, over whether the statute prohibits all assumptions of patent licenses in bankruptcy, or only an assumption combined with an actual intention to assign the licenses to a third party.

In an earlier case, the First Circuit had limited § 365(c) to cases in which the trustee or debtor-in-possession actually intended to assign the patent to a third party.[11] By contrast, in the Ninth Circuit's view, § 365(c) prevents a trustee from assuming a debtor's patent licenses without the licensor's consent, even when the trustee has *no actual intention of assigning them* to a third party.[12] The Ninth Circuit did not even reach the question of whether the trustee in *Perlman* actually intended to assign these licenses to a third party, holding that this issue was irrelevant under its

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5. *See id.* at 749.

6. *See id.* at 748-49.

7. *See id.* at 749.

8. According to the often cited "Countryman definition," an executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy* (pt. 1), 57 MINN. L. REV. 439, 460 (1973). The Ninth Circuit has held that patent licenses fall within this definition of executory contracts. *See* Everex Sys. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 677 (9th Cir. 1996).

9. Section 365(c) of the Bankruptcy Code reads as follows:

> The trustee may not assume or assign any executory contract . . . whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—
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> (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
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> (B) such party does not consent to such assumption or assignment . . . .

11 U.S.C. § 365(c) (1994).

10. Under federal law, patent licenses are "personal and assignable only with the consent of the licensor." *Everex Sys.*, 89 F.3d at 679-80 (citing a long line of federal appellate decisions).

11. *See* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir. 1997).

12. *See Perlman*, 165 F.3d at 750-51.

reading of the Bankruptcy Code.[13] In effect, Catapult lost its licenses simply by going into bankruptcy. Unless future parties can evade the judicial controversy over § 365(c) by a felicitous change in the terms of the license—and such a *deus ex machina* may not be forthcoming in all cases[14]—small technology firms like Catapult may find it harder to secure financing under the *Perlman* rule, as lenders might raise the interest rate to compensate for a diminished expected return in the event of bankruptcy. *Perlman* may be superseded for corporate licensees by bankruptcy reform legislation pending in Congress, but it is not clear that *Perlman* will lose its effect in the case of a hybrid entity such as a limited liability company (LLC) under the amended § 365(c).[15]

I

After *Perlman*, technology firms in the Ninth Circuit's jurisdiction may find it difficult to propose a feasible Chapter 11 reorganization plan unless they own the full rights to key patents. When a licensee has filed under Chapter 11, the licensor can withhold its consent from the assumption of the license, keep whatever license fees have already been paid by the debtor, and find another licensee to take the debtor's place (perhaps for a higher fee). Unless the licensor has an independent interest in the survival of the bankrupt firm, any investment the licensee has made in developing the patent will become worthless. Such a result is antithetical to the policy of federal patent law that favors encouraging technological innovation, not to mention inconsistent with the principle that bankruptcy law should not unnecessarily disturb state-law property rights. This Case Note suggests a way to ameliorate the unfortunate effects that the Ninth Circuit's interpretation of the Code might otherwise have on technological investment. In future cases, given certain conditions, the trustee should bring an unjust-enrichment action against the licensor who does not consent

13. *See id.* at 749 n.1. Had the court reached this issue, it is possible that the proposed merger would have been considered a de facto assignment. In *Institut Pasteur*, however, the First Circuit had refused to treat a similar change in corporate control as an assignment, stating that Pasteur had chosen not to negotiate restrictions on the licensee's "rights under the cross-licenses based on changes in its stock ownership or corporate control." *Institut Pasteur*, 104 F.3d at 494. This decision was said to open the "back door" to "strategic acquisition of otherwise unaccessible patented technology by industry competitors." Gregory G. Hesse, *Ninth Circuit Slams Shut the "Back Door" Access to Patented Technology*, AM. BANKR. INST. J., Apr. 1999, at 18, 18 (citing Virginia P. Henschel, *"Back Door" Access to Patented Technology*, AM. BANKR. INST. J., Feb. 1998, at 40, 41). The Ninth Circuit's ruling, however, will apply not only to cases in which the assumption is part of a disguised assignment to a competitor, but also to cases in which the trustee or debtor-in-possession simply wishes to assume the license and continue to perform its obligations under it.

14. For reasons why changing the terms of the contract may not always solve the problem, see *infra* notes 28-30 and accompanying text.

15. *See infra* notes 32-33 and accompanying text.

to assumption under § 365(c). Provided that the parties had not made a valid agreement that the license fees would be nonrefundable,[16] restitution would compensate a licensee who had paid fees to the licensor without receiving fair value in return.

The proper reading of § 365(c) and its relationship to neighboring provisions have been contested issues in the courts since the Bankruptcy Code was enacted in 1978.[17] In particular, the "hypothetical test" adopted by some circuits has been criticized for preventing a "debtor in possession from being able to reorganize under circumstances that do not adversely affect the other party to the contract."[18] That this approach has been adopted in the Ninth Circuit is particularly disturbing since the Ninth Circuit includes the California region known as "Silicon Valley," where many American technology firms are created. Unless both circuits share the goal of encouraging new technology firms to make Boston their headquarters, it is undesirable for the First Circuit to adopt a more pro-debtor interpretation of § 365(c) than that of the Ninth Circuit.

The remedy suggested here does not require a judicial rewrite of § 365(c), but is instead grounded in the law of restitution and unjust enrichment. Although unjust enrichment has its roots in the civil law, the doctrine is accepted as a mature, albeit contorted, branch of Anglo-American jurisprudence.[19] Individuals and business firms that have not been protected by statutes like the U.S. Bankruptcy Code should not be afraid to assert their rights under the law of restitution. An unjust-enrichment remedy

16. Had Catapult brought a restitution claim in *Perlman*, its theory would have been that the operation of § 365(c) made its contract with Perlman impossible to perform. *See* 2 GEORGE E. PALMER, THE LAW OF RESTITUTION § 7.1, at 98-102 (1978). This theory would fail if the contract specifically provided that the fees were nonrefundable in such a contingency, unless that provision could be deemed void for reasons of public policy.

17. *See, e.g.*, Brett W. King, *Assuming and Assigning Executory Contracts: A History of Indeterminate "Applicable Law,"* 70 AM. BANKR. L.J. 95 (1996).

18. 3 LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY ¶ 365.06[1][d] (15th ed. rev. 1999) (discussing the adoption of the "hypothetical test" in *In re West Electronics*, 852 F.2d 79 (3d Cir. 1988), a case involving a defense contract).

19. *See* HANOCH DAGAN, UNJUST ENRICHMENT 1 (1997); REINHARD ZIMMERMANN, THE LAW OF OBLIGATIONS: ROMAN FOUNDATIONS OF THE CIVILIAN TRADITION 892-95 (1990). At least in its European guise, the concept of unjust enrichment can be traced back to the classical period of Roman law. *See* G. INST. 3.91. Liability for unjust enrichment was also accepted in Talmudic civil law, provided that the plaintiff sustained a sufficient loss. *See* DAGAN, *supra*, at 109-29 (reviewing the relevant sources). Restitution eventually made its way to the United States, where it was systematized in a *Restatement of Restitution*. The doctrine survives even in the forward-looking state of California. *See* Carolco Television v. National Broad. Co. (*In re* De Laurentiis Entertainment Group), 963 F.2d 1269 (9th Cir. 1992). Nevertheless, "[s]carcely anyone in the United States understands what restitution is about, to begin with, and the particular role of restitution in bankruptcy is further obscured by the way in which American commercial law has been codified." Andrew Kull, *Restitution in Bankruptcy: Reclamation and Constructive Trust*, 72 AM. BANKR. L.J. 265, 266 (1998). It is sometimes assumed, incorrectly, that the answer to any bankruptcy question can be found in the Bankruptcy Code, despite the fact that the Code is embedded in the common law. *See id.* at 266-67.

may not always make the debtor whole, but it would be better than no remedy at all.

II

As a matter of statutory interpretation, there are sound reasons to support the Ninth Circuit's adoption of the "hypothetical test." Holding that § 365(c) applies to the situation in *Perlman*, and that "its plain language does not produce a patently absurd result or contravene any clear legislative history," the Ninth Circuit refused to rewrite the statute to suit its own policy judgment.[20] Since it is clear that patents cannot be assigned under federal law, the Ninth Circuit reasoned, it made no difference under § 365(c) whether or not Catapult actually intended to assign them to a competitor of Perlman.[21] Despite its unpleasant consequences, the "hypothetical test" employed by the Ninth Circuit reflects the plain wording of the statute. Reliance upon legislative history and policy arguments to circumvent the apparent meaning of a statute has been frowned upon by leading scholars and judges.[22] Under our Constitution, it is the task of Congress, not the courts, to establish "uniform Laws on the subject of Bankruptcies throughout the United States."[23]

This approach to statutory interpretation, however, should not prevent debtors from making use of traditional remedies available to them under state law. The unjust-enrichment remedy proposed here is consistent with a narrow view of statutory construction. A plaintiff who has rendered services benefiting the defendant may "recover the reasonable value of those services when necessary to prevent unjust enrichment of the defendant."[24] As a general rule, property interests created by state law should not be "analyzed differently simply because an interested party is involved in a bankruptcy proceeding."[25] In bankruptcy, the trustee has the

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20. *Perlman*, 165 F.3d at 754.

21. *See id.* at 749 n.1. Although the Ninth Circuit did not mention it, hypothetical tests are often employed in bankruptcy. For example, the trustee has the right under § 544(a) to "avoid any transfer of property of the debtor or any obligation incurred by the debtor" that could have been avoided by a hypothetical creditor or hypothetical bona fide purchaser. 11 U.S.C. § 544(a) (1994). Section 365(c) can plausibly be read as establishing another hypothetical inquiry.

22. *See, e.g.*, ANTONIN SCALIA, A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW 16-18 (1997) (criticizing judicial efforts to discern legislative intent); Laurence H. Tribe, *Comment*, *in* SCALIA, *supra*, at 65, 74 (agreeing with Scalia where the object of construction is a federal statute rather than the Constitution).

23. U.S. CONST. art. I, § 8, cl. 4.

24. *Carolco Television*, 963 F.2d at 1272 (discussing the remedy of quasi-contract or quantum meruit under California law); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 272 cmt. b (1981) ("A party whose duty has never arisen or has been discharged because of impracticability of performance or frustration of purpose . . . [generally has] a claim for restitution to the extent that his performance has benefited the other.").

25. Butner v. United States, 440 U.S. 48, 55 (1979).

"capacity to sue and be sued" under 11 U.S.C. § 323, and may assert causes of action possessed by the debtor.[26] Quasi-contractual claims for unjust enrichment are thus recoverable by the bankruptcy trustee.[27] Trustees who are denied the right to assume patent licenses under a literal reading of § 365(c) are therefore allowed to sue the licensor for unjust enrichment. Assuming there was no agreement that the license fees were nonrefundable, to the extent that Perlman was paid any license fees for which Catapult did not receive fair value, Catapult should have brought an unjust-enrichment action against Perlman to recover their value.

III

Perlman did not offer the debtor any remedy for its lost investment in developing the license. Without such a remedy, the Ninth Circuit's holding could have unfortunate consequences for small technology firms. To compensate for a smaller expected return on insolvency, banks will charge a higher interest rate to finance projects that depend on key patent licenses that are not owned by the debtor and hence, under *Perlman*, would not produce revenue in the event of a Chapter 11 reorganization. This would make already risky start-up ventures like Catapult more expensive to finance, reducing technology investment and shifting the balance in favor of large, well-capitalized manufacturers able to buy multiple licenses without additional financing. Furthermore, technology firms whose going concern value would exceed their liquidation value only if they retained their patent licenses will often be forced to liquidate under Chapter 7 rather than reorganize under Chapter 11. This outcome is to be avoided if at all possible, since the preservation of firms whose going concern value exceeds their liquidation value is a central purpose of bankruptcy law.

It might be possible for some licensees to protect themselves against the effects of the Ninth Circuit's test ex ante by offering a lower price for the patent license or altering the payment schedule for the license fees.[28] The

26. *See* 3 KING ET AL., *supra* note 18, § 323.03[2].

27. *See* Wedtech Corp. v. London (*In re* Wedtech Sec. Litig.), 161 B.R. 345, 348 (S.D.N.Y. 1993); Crews v. Delta Concrete (*In re* Moulton), 113 B.R. 732, 733 (Bankr. M.D. Fla. 1990); *cf.* Deemer Steel Casting Co. v. Lebanon Foundry & Mach. Co. (*In re* Deemer Steel Casting Co.), 117 B.R. 103, 108 (Bankr. D. Del. 1990) (noting that the Chapter 11 debtor could have recovered under "the quasi-contractual doctrine of unjust enrichment . . . if no contract in fact had been found").

28. The Coase Theorem predicts that parties will contract around mandatory rules so as to achieve the most efficient outcome. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2-8 (1960); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1809 (1998). The Coase Theorem, however, applies only when the costs of carrying out market transactions are low, *see* Coase, *supra*, at 15, an assumption that may not hold here. Even if the debtor does not mind discussing bankruptcy during the negotiations, calculating the likelihood of insolvency could involve paying substantial fees to accountants and lawyers.

transaction costs that would be involved in such negotiations, however, are difficult to calculate. The debtor may not wish to endanger the deal by raising the specter of a bankruptcy at the bargaining table.[29] If, on the other hand, the parties tried to stipulate that the license was assumable in bankruptcy despite § 365(c), such a provision could either run afoul of the Bankruptcy Code's ban on clauses that allow an executory contract to be modified on the insolvency of the debtor[30] or encourage a court to treat the license as *assignable* as well as assumable, regardless of the licensor's wishes. In some cases, the parties might be able to agree to certain restrictions on the license, and the licensor might consent in advance to the free assignment of the license, subject to the same restrictions, by the licensee, but this might not be the preferred arrangement.

The proposed remedy avoids these problems without violating canons of statutory interpretation. Admittedly, the licensor might defend against an action for unjust enrichment by arguing that the debtor's right to use the patent (even if unexercised) constituted value received in return for its license fees. Since patent licenses can be effectively incorporated into a product only after a period of research and development, however, the right to use the patent is not valuable at the beginning. Only when revenues are actually being received on account of the patent does the debtor begin to recoup the license fee payments. Unless the parties have made an enforceable agreement to the contrary, therefore, the trustee should be allowed to recover restitution to the extent that the fees already paid to the licensor exceed the benefit the debtor has derived from the patent.[31] In effect, the bankruptcy court would offer licensors who did not earn the fees they received a choice: Either consent to assumption of the license under § 365(c) and continue to deal with the trustee or debtor-in-possession, or pay restitution to the bankruptcy estate.

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29. Ex post bargaining might also be possible: Faced with a revocation under § 365(c), a patent licensee could attempt to bribe the licensor to consent to assumption. In cases where the patent is valuable to other parties, however, the licensor might hold out for a high bribe and thus obstruct the debtor's attempt to reorganize. The licensee's bankruptcy, moreover, might suggest to the licensor that a greater return could be obtained by contracting with a solvent party. Acrimony from a deal gone sour may also impede some otherwise rational bargaining. *Cf.* Ward Farnsworth, *Do Parties to Nuisance Cases Bargain After Judgment? A Glimpse Inside the Cathedral*, 66 U. CHI. L. REV. 373 (1999) (demonstrating that feuding neighbors often dislike each other too much to engage in economically efficient ex post bargaining).

30. *See* 11 U.S.C. § 365(e) (1994). This ban usually applies to clauses that work to the detriment of the debtor, but its language could be invoked here as well.

31. In order to bring a successful action for unjust enrichment, the licensee must first restore to the licensor the value of any benefits received by the licensee under the license. *See* RESTATEMENT OF RESTITUTION §§ 65-66 (1937).

IV

Without doing violence to the text of the Bankruptcy Code, the proposed solution would give some licensors a proper incentive to consent to assumption of patent licenses and would thereby facilitate investment in smaller U.S. technology ventures. Congress is currently considering major bankruptcy reform legislation, and the House bill would eliminate the prohibition on assumption of executory contracts under § 365(c) in cases in which the debtor is a corporation.[32] Assuming that the House amendment becomes part of the new Code, courts will still face the core *Perlman* issue when the debtor-licensee is not a corporation. Some technology startups might be structured as LLCs, and a court might not consider such ventures to constitute "corporations" under the Code.[33] In any event, *Perlman* offers a general lesson for the future. Rather than arguing over whether the wording of a statute should be twisted to meet a policy goal, courts and litigants should consider whether the law of restitution, neglected cousin of contract and tort, might bring about the desired result.

—*Joshua C. Tate*

32. *See* H.R. 833, 106th Cong. § 305 (1999). Had this been the law when the Ninth Circuit decided *Perlman*, the question would probably never have been litigated. This is not the first time that Congress has been forced to resolve a problem involving patent licenses under § 365. In the 1980s, federal courts interpreted an earlier version of § 365 as allowing patent licensors to declare bankruptcy and subsequently reject their licenses. *See, e.g.*, Lubrizol Enters. v. Richmond Metal Finishers, 756 F.2d 1043 (4th Cir. 1985). Congress amended the Bankruptcy Code to relieve this burden on American technological development. *See* S. REP. NO. 100-505 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3200 (discussing the current 11 U.S.C. § 365(n)). The pending changes to § 365(c) may solve another discrete problem, but new questions are certain to arise.

33. Although the Bankruptcy Code's definition of "corporation" would seem to include most startup technology ventures, *see* 11 U.S.C. § 101(9), it would be possible for a licensor to argue that an LLC is a partnership and therefore excluded under § 101(9)(B). An LLC is an unincorporated venture that can be treated as a partnership for tax purposes. "Since LLCs have a number of characteristics in common with general and limited partnerships, it is arguable that a LLC should be treated under the Code as a corporation for some purposes and as a partnership for others . . . ." Sally S. Neely, *Partnerships and Partners and Limited Liability Companies and Members in Bankruptcy: Proposals for Reform*, 71 AM. BANKR. L.J. 271, 286 (1997); *cf.* Broyhill v. DeLuca (*In re* DeLuca), 194 B.R. 65, 74 (Bankr. E.D. Va. 1996) (treating the relationship among LLC members as analogous to that among the partners of a partnership). Whether this interpretation would be correct is another story. *See* Thomas F. Blakemore, *Limited Liability Companies and the Bankruptcy Code: A Technical Review*, AM. BANKR. INST. J., June 1994, at 12, 12 (arguing that "courts should not find an exclusion [of LLCs in the Bankruptcy Code's definition of corporation] unless it is explicit").