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Code to Code

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Monopoly Meets Marketplace: Section 365 and the Fate of IP Licenses in Chapter 11

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There is an enduring tension between two fundamental principles: the right of intellectual property (IP) owners to control and exclude others from their creations, and the principle that property interests should be freely transferable — a cornerstone of commercial law and vital in bankruptcy. This tension becomes especially acute when a troubled company, reliant on licensed IP, seeks to reorganize under chapter 11.

The stakes are enormous. Chapter 11 seeks to preserve going-concern value, often by enabling the assumption or assignment of contracts essential to the business. When the assumability of an IP license is uncertain, a debtor's restructuring strategy — and even its ability to continue operating — can hang in the balance. Balancing the exclusivity inherent in IP law with the transferability principles of bankruptcy law often produces a legal gray zone with significant economic consequences, shaping negotiations and reorganization outcomes.

Recent cases underscore the uncertainty. In *Crivella Holdings Ltd. v. Mesearch Media Techs. Ltd.*, courts within the Third Circuit allowed a debtor to assume a patent license over the licensor's objections, emphasizing continuity of operations and the chapter 11 goal of maximizing value.[1] By contrast, the Fourth Circuit in *In re Sunterra Corp.* barred assumption without the licensor's consent, underscoring the strength of the licensor's exclusionary rights under nonbankruptcy law.[2]

Crivella and *Sunterra* illustrate the unsettled law governing a debtor/licensee's ability to assume an IP license. The decisions reveal a deeper jurisprudential divide: whether § 365's reference to "assume or assign" allows assumption when the debtor intends to continue performing personally or instead prohibits assumption whenever assignment would be barred under nonbankruptcy law. This article explores this divide, reviews the statutory underpinnings of each approach, and provides practical strategies for drafting license agreements in the shadow of chapter 11.

Statutory Framework

Section 365(a) of the Bankruptcy Code is at the center of the tension between a debtor's reorganization objectives and the counterparty's contractual and property rights. It empowers a trustee or debtor-in-possession (DIP), with court approval, to assume or reject any executory contract. However, § 365(c) limits that broad power: The trustee

> may not assume or assign any executory contract ... if ... (A) applicable law excuses a party ... from accepting performance ... from an entity other than the debtor or the [DIP] ... and (B) such party does not consent.[3]

Two features of § 365(c) drive most of the litigation. First, the statute directs examination outside the Bankruptcy Code to determine whether "applicable law" would excuse a counterparty from accepting performance from someone other than the original contracting party. Second, the provi-

1 2025 U.S. Dist. LEXIS 164696 (W.D. Pa. Aug. 25, 2025), *aff'g In re Mesearch Media Techs. Ltd.* (Bankr. W.D. Pa. Feb. 28, 2025).
2 *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004).
3 11 U.S.C. § 365(c)(1). Congress separately enacted § 365(n) in 1988 to protect licensees where the licensor is the debtor and overrule decisions that construed § 365(a) to permit forfeiture. Section 365(n) gives certain rights to retain IP use after rejection by a licensor/debtor, but does not address situations in which the licensee — not the licensor — is the debtor. It signals a recognition by Congress that forfeiture of property interests in bankruptcy is not favored.

sion ties the result to the licensor's consent. Together, these clauses link bankruptcy policy to nonbankruptcy assignment principles, thus requiring courts to determine whether the debtor's *assumption* of a contract should be treated as a prohibited *assignment*.

Competing Approaches

Courts have been divided on how to apply § 365(c)'s phrase "assume or assign" and what it means for executory contracts that are nonassignable under "applicable law." The resulting split produces two distinct interpretive camps.

The "Hypothetical" (or Literal) Test

Under the hypothetical test, assumption is barred whenever the contract is nonassignable under applicable law — regardless of whether the debtor actually intends to assign it. The analysis asks a hypothetical question: Would applicable nonbankruptcy law permit *assignment* of the license to a third party? If the answer is "no," § 365(c) precludes *assumption* without the counterparty's consent. This is so even if the debtor has no present intention to transfer or assign the license.

This approach emphasizes fidelity to the statutory text and treats "assume or assign" disjunctively, giving each term independent effect. Courts applying the hypothetical test emphasize statutory literalism: The text contains no exception for cases where the debtor intends to continue performing itself. As a result, even a debtor seeking only to assume and fully perform might be barred if the underlying contract is nonassignable under nonbankruptcy law.[4] However, the hypothetical test provides a windfall to nondebtor counterparties to valuable executory contracts: If the debtor is not in bankruptcy, the licensor does not have the option to renege on its agreement, but if the licensee seeks bankruptcy protection, the licensor has the power to reclaim the property right by blocking assumption.

The "Actual" (or Conjunctive) Test

Other courts apply a more pragmatic "actual" or "no-harm" test, asking whether the nondebtor will be required to accept performance from someone other than the debtor.[5] Under this reading, if the debtor intends merely to *assume* and continue performing itself (so the counterparty will continue to receive performance from the same entity as prebankruptcy), § 365(c) should not bar assumption.

This approach furthers the principle that bankruptcy law does not displace contractual entitlements or result in forfeiture in the absence of a clear statutory command. The interpretation construes "assume or assign" conjunctively rather than disjunctively, reasoning that assumption should be permitted when no actual assignment is contemplated. Courts adopting the actual test emphasize chapter 11's rehabilitative purpose and the distinction between maintaining existing performance and transferring contractual rights to a stranger.

A minority of courts have taken a more precise approach, finding that the statute's reference to "trustee" does not include the "debtor" or the "DIP." Under this view, the licensor's right to object to assumption applies only to a trustee, allowing a DIP to assume the contract without consent.[6]

Practical Consequences

The choice between these tests has major implications for technology companies. Under the hypothetical test, a nonexclusive patent license — ordinarily nonassignable under federal law — cannot be assumed without consent, even if the debtor merely seeks to continue using the technology as agreed. Under the actual test, the debtor may assume the license as long as no transfer occurs. The difference can determine whether a debtor preserves or forfeits its core operating asset.

In re Sunterra: The Literal Approach

The Fourth Circuit's decision in *In re Sunterra* remains the touchstone for the "hypothetical" or literal interpretation of § 365(c). The case arose from a chapter 11 debtor/licensee seeking to assume a nonexclusive software license over the licensor's objection. The licensor argued that under federal copyright law, such a license was personal and nonassignable without the licensor's consent, and that § 365(c) barred assumption.

The lower courts permitted assumption, reasoning that the debtor intended only to continue using software — not to assign the license. The Fourth Circuit reversed. The court rejected the contrary "actual" approach and held that § 365(c) must be given its plain meaning: If applicable nonbankruptcy law would excuse the nondebtor from accepting performance from a *hypothetical* third party, then the statute bars assumption absent consent —regardless of whether any actual assignment is contemplated.

The court rejected policy-based arguments favoring reorganization, concluding that the statute means what it says. Because copyright law would have excused the licensor from accepting performance from a different licensee, the debtor could not assume the license without consent. Therefore, the Fourth Circuit found that the debtor could not assume the license over the licensor's objection.

Key Takeaways

- The Fourth Circuit gave full effect to the disjunctive "or" in "assume or assign" as written, declining to read the phrase as the conjunctive "and."
- The decision gives deference to the nonbankruptcy IP doctrines (copyright/trademark/patent law) that may permit the counterparty to refuse third-party performance.
- *Sunterra* is protective of licensors and limits the universe of licenses a debtor can preserve unilaterally — even if no assignment to a third party is contemplated.

4 The Third, Ninth and Eleventh Circuits have often historically been associated with versions of this analysis. *See, e.g., In re Catapult Entm't Inc.*, 165 F.3d 747 (9th Cir. 1999); *In re James Cable Partners, LP*, 27 F.3d 534 (11th Cir. 1994); *In re West Electronics Inc.*, 852 F.2d 79 (3d Cir. 1988).

5 *See, e.g., Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1996); *In re Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006).

6 *See, e.g., In re Footstar*, 323 B.R. 566 (Bankr. S.D.N.Y. 2005); *In re Aerobox Composite Structures LLC*, 373 B.R. 135 (Bankr. D.N.M. 2007).

• Under *Sunterra*, even the mere act of assumption — without any proposed transfer or alteration of contractual entitlements — can be treated as functionally equivalent to an impermissible assignment if applicable law would prohibit assignment to a third party.

The consequence of the hypothetical test can be severe for debtors whose business depends on IP licenses. By virtue of entering bankruptcy, a debtor might lose the ability to retain the rights that enable it to operate. In other words, the practical impact of *Sunterra* is as follows: The happenstance of bankruptcy can operate to divest a licensee of contracted-for rights, a result that critics argue is at odds with the general framework and rehabilitative goals of chapter 11.[7]

Crivella: The Practical Approach

In *Crivella*, the debtor acquired IP rights covered by patents in a license agreement. The license granted the debtor/licensee a "perpetual, non-transferable, limited-exclusive license" but included language restricting transfers without consent, although notably it permitted assignment "to a successor in interest."

After creditors filed an involuntary petition and a chapter 11 trustee had been appointed, the licensor sought relief from the automatic stay, arguing that the license was not assignable and could not be assumed without its consent. The bankruptcy court denied the motion, finding that the contract allowed assignment to a successor-in-interest and therefore found no cause to modify the automatic stay.

The district court affirmed, holding that *Sunterra*'s rigid hypothetical test did not automatically bar assumption where the contract's language allowed assignments. The court found that *Sunterra* erroneously held that a license agreement "must expressly provide for assumption in addition to assignment to satisfy the Hypothetical Test and § 365(c)."[8]

Key Takeaways

• Courts may prioritize the explicit language of the contract rather than apply a rigid hypothetical/assignment bar, but this would not impose a requirement that there must be language consenting to assumption to satisfy the requirements of § 365(c).

• If a license allows transfers to successors-in-interest and includes reasonable consent standards, a court might find that the language satisfies § 365(c)'s concerns. When the agreement can be fairly read to permit assignment consistent with the parties' original expectations, it may be assumed.

• *Crivella* illustrates that careful drafting can influence whether § 365(c) bars assumption; courts need not apply *Sunterra*'s literal test when the contract language supports a different result This approach aligns with principles of freedom of contract[9] and chapter 11's rehabilitative purposes.

Reconciling the Cases

At first glance, *Sunterra* and *Crivella* appear to represent diametrically opposed outcomes. However, the divergence reflects the interaction of two distinct legal questions: (1) the assignability of IP licenses under federal law; and (2) the effect of contract language on the assumption of executory contracts under § 365(c). Courts look to federal patent law and contract language.

Under long-established federal law, patent license agreements are generally considered personal to the license and not assignable unless the agreement expressly permits assignment.[10] Is the license a property interest capable of transfer, or does it instead create personal covenants and restrictions tied to the licensee's identity?

For contract language, the parties' written agreement can alter the outcome. License provisions that expressly authorize transfers to successors, permit sublicenses, or condition consent on reasonable standards can enable a court to allow assumption despite *Sunterra*'s concerns. *Crivella* illustrates that clear language may satisfy the statute's requirements and permit assumption.

Where patent law or the contract allows transfers to a successor-in-interest, a court applying *Crivella*-style analysis may permit assumption — or at least deny immediate termination. By contrast, where the law or the agreement (tying performance to the licensee's identity without successor language) precludes third-party performance, *Sunterra*'s approach forecloses assumption without consent.

Practical Implications

For IP licensees, draft assignment/successor clauses. Be sure to include clear successor-in-interest language and express consent standards that permit assumption without licensor veto (or at least constrain "consent" to be reasonable). In addition, plan for adequate protection and cure. If assumption is contemplated, be prepared to satisfy cure obligations and provide assurances of continued performance. Present a plan that keeps the licensor whole.

For IP licensors, preserve contractual anti-assignment protections. If restricting successor transfers is commercially important, make the prohibitions explicit and limit provisions that could be read to permit assignment. Act early in bankruptcy cases. Seek relief from stay or object to assumption motions promptly, and litigate whether § 365(c) literally bars assumption where applicable.

For deal counsel (both licensees and licensors), negotiate "bankruptcy" clauses. Consider any express language addressing assumption/rejection consequences, permissible transfers, and defined circumstances for deemed consent. Use choice-of-law and governing-law clauses strategically. Federal patent law will trump contract words that attempt to violate assignability limits, but the agreement's substance and the parties' expectations remain powerful evidence for courts. In addition, monitor legal developments and consider

7 Defenders, by contrast, maintain that the hypothetical test respects the licensor's statutorily protected exclusivity and control — a difficult position, it seems, to maintain when no alteration of performance or party will occur upon assumption.

8 *Crivella Holdings Ltd. v. Mesearch Media Techs., Ltd.*, 2025 U.S. Dist. LEXIS 164696 *12 (W.D. Pa. Aug. 25, 2025).

9 *Id.* at *14 (opining that one cannot be heard to complain about consequences of its own contract).

10 *Unarco Indus. Inc. v. Kelley Co. Inc.*, 465 F.2d 1303, 1306 (7th Cir. 1972). The federal rule favors allowing the holder of a patent to choose who, if anyone, may use the patented invention, which in turn promotes federal policy underlying patent law: to reward invention.

forum strategy. Circuit authority matters, as outcomes differ materially depending on whether the court favors the hypothetical or actual test.

Conclusion

The outcomes in *Sunterra* and *Crivella* highlight how contract drafting and judicial interpretation can have decisive consequences in bankruptcy. Technology companies operating under licenses face high-stakes decisions. Precise drafting, clear successor and assignment provisions, and early engagement in bankruptcy proceedings can mean the difference between retaining or losing critical licenses.

For licensors, safeguarding identity-linked elements of their IP is crucial. For licensees, ensuring that contracts permit assumption in a restructuring context is essential. While the law remains unsettled at the margins, careful transactional planning and protective litigation strategy are the most reliable tools for navigating the intersection of bankruptcy and intellectual property law. abi

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