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Contracts That Cannot Be Assigned Under Section 365(C)(1) of the Bankruptcy Code: The List Is Expanding

Section 365(a) of the Bankruptcy Code (the Code) provides that a trustee in bankruptcy or a Debtor in Possession (DIP) has the power to assume or reject an executory contract or unexpired lease. Though the Code does not define "executory contract," the accepted definition is "a contract under which the obligations 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: Part I*, 57 Minn. L. Rev. 439, 460 (1973). Section 365(c)(1) of the Code carves out some exceptions to a debtor's general assumption and assignment authority. Though section 365(c)(1) is often referred to as the "personal service contracts exception," since courts initially limited the scope of section 365(c)(1) to contracts and leases that qualified as personal service contracts under state law, courts have since broadened the application of this section to include various other types of executory contracts and leases.

POSTED:

Dec 15, 2014

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Personal Service Contracts

Originally, courts that addressed section 365(c)(1) held that it applied only to personal service contracts. The most common example of the non-delegable or non-assignable nature of a personal service contract is that of a famous opera singer who has contracted with an opera to perform. She cannot assign her contractual duty to another singer because the nature of the services is unique and personal. Courts have characterized agreements to render professional services as a physician, lawyer or architect; options to purchase stock given to an employee; and agency agreements for the sale of land as personal service contracts. *See 6 Am. Jur. 2d Assignments* § 30 (2004).

Partnership Agreements

The Uniform Partnership Act of 1997 and the Uniform Partnership Act of 1914 (together, the "Uniform Partnership Acts") provide that a person can become a partner only with the consent of all of the existing partners, and that a partner's only transferrable interest in the partnership is the partner's share of the

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partnership's profits and losses, and the partner's right to receive distributions. Since the Uniform Partnership Acts restrict the assignment of a partner's full partnership interest, courts have given effect to these restrictions by invoking section 365(c)(1) of the Code. *See, e.g., Stumpf v. McGee (In re O'Connor)*, 258 F.3d 392, 402 (5th Cir. 2001).

Patent Licenses

Under the Patent Act, a party that "invents or discovers a new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent...." 35 U.S.C. § 101. The party holding the patent holds certain rights, including the right to exclude others from using, selling or importing the invention within the U.S. for a period of 20 years. License agreements do not transfer title in the patent, but rather are covenants not to sue between the licensor and licensee. Under federal common law, license agreements were considered personal in nature and could not be assigned to a third party without the licensor's consent. Accordingly, courts have given effect to these restrictions through section 365(c)(1) of the Code. *See, e.g., In re Alltech Plastics, Inc.*, 71 B.R. 686, 689 (Bankr. W.D. Tenn. 1987).

Copyright Licenses

Under the Copyright Act, a party that creates a work of authorship, including written work, motion pictures, sound recordings and architectural works has a copyright. There are two types of copyright licenses: exclusive and nonexclusive. Like patent licenses, nonexclusive copyright licenses are not considered a transfer of copyright ownership, are personal to the licensee, and are therefore not assignable by the licensee without consent of the licensor under federal law. *See In re Patient Educ. Media, Inc.*, 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997). Exclusive licenses are considered a transfer of copyright ownership. For this reason, courts generally will find that exclusive copyright licenses are freely assignable by the licensee under federal law. *See In re Golden Books Family Entm't, Inc.*, 269 B.R. 300, 309 (Bankr. D. Del. 2001). However, the Ninth Circuit has held otherwise, and has restricted the holder of an exclusive license from transferring its rights without the consent of the original licensor. *Gardner v. Nike, Inc.*, 279 F.3d 774, 780 (9th Cir. 2002). Accordingly, bankruptcy courts generally hold that section 365(c)(1) only restricts the transfer of nonexclusive licenses, though it is important to be aware of the Ninth Circuit split on this issue.

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Trademark Licenses

Under the Lanham Act, a trademark is defined as "any word, name, symbol, or device or any combination thereof ... [used by a person] to identify and distinguish his or her goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods...." 22 U.S.C. § 1127. Because a trademark is used, by definition, to identify goods with a person or business, the trademark is personal in nature and cannot be assigned. See 4 J. Thomas McCarthy, McCarthy on Trademarks and Unfair Competition § 25:33 (4th ed. 2011). A grant of a trademark license that allows a licensee to use a trademark is also generally considered personal to the licensee and cannot be freely transferred to third parties under federal common law.

Government Contracts

The Federal Anti-Assignment Act prohibits a party that enters into an executory contract or unexpired lease with the federal government from transferring the contract to a third party outside of bankruptcy. The purpose of the Anti-Assignment Act is to prevent third parties from obtaining claims against the federal government and using them as a means of influencing government officials. Bankruptcy courts have given effect to these restrictions within the bankruptcy context by generally holding that executory contracts and unexpired leases between a debtor and the federal government fall within section 365(c)(1). *See, e.g., In re W. Elecs. Inc.*, 852 F.2d 79, 83 (3d Cir. 1988).

Franchise Agreements

Various state laws prevent the assignment, transfer or sale of a franchise or interest in a franchise without the consent of the franchisor; these laws typically focus on automobile franchises. State statutes will generally require the franchisee to give written notice to the franchisor and allow the franchisor to approve or notify the franchisee of the unacceptability of the proposed transferee in writing. See, *e.g.*, N.J. Stat. § 56:10-6; Fla. Stat. § 320.643(1)(a). Though the franchisor's rejection of the proposed transfer cannot be done in bad faith or without material reasons, the franchisee's ability to assign or transfer its interest is restricted in certain circumstances. Some courts have found that, because of this, section 365(c) (1) of the Code applies to restrict the assignment of franchise agreements in bankruptcy as well. *See, e.g., In re Pioneer Ford Sales, Inc.*, 729 F.2d 27, 31 (1st Cir. 1984). Other courts, however, have declined to restrict the

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assignment of these agreements after the franchisee argued that the contract was not personal in nature. *See, e.g., In re Sunrise Rests. Inc.*, 135 B.R. 149, 153 (Bankr. M.D. Fla. 1991). In the context of franchise agreements, courts seem to be swayed by this argument, even after the application of section 365(c)(1) has been broadened.

Limited Liability Company Agreements and Joint Venture Agreements

Courts that focus on the identity of the contracting parties when deciding whether a contract falls within the purview of section 365(c)(1) have restricted the transfer of operating agreements for limited liability companies and joint venture agreements under that section. State limited liability statutes are largely patterned after state partnership statutes, discussed above. Because of this similarity, courts reach the same result when dealing with an LLC as they would when dealing with a partnership: a debtor or trustee may only assign his or her financial interests to a third party, but assignment of governance rights is restricted by section 365(c)(1). See Del. Code tit. 6 § 18-702 and 15 Pa. Stat. § 8924. Joint venture agreements, which courts consider to be executory contracts, are similarly governed by the same rules as partnerships. Based on state partnership law anti-assignment provisions, debtors may lack the ability to assign joint venture agreements without the consent of their joint venture partners.

Even If a Contract Cannot Be Assigned, Can It Be Assumed?

Circuits are split over whether a DIP can assume an executory contract or unexpired lease if the contract falls within the scope of section 365(c)(1), and therefore cannot be assigned to a third party. The Third, Fourth, Ninth, Tenth and Eleventh Circuits apply a "Hypothetical Test" which restricts a DIP from assuming an executory contract over an objection if applicable law would bar assignment to a *hypothetical third party*, even if the DIP has no intention of assigning the contract to a third party. Alternatively, the First, Fifth, Sixth and Eighth Circuits use an "Actual Test" or an "As Applied" approach, whereby the court will limit assumption under 365(c)(1) only when the DIP intends to subsequently assign the assumed contract, and the non-debtor would actually have to accept performance from a third party. This approach must be applied on a case-by-case basis. A few circuits, including the Seventh Circuit, have declined to adopt either test.

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If you have any questions about contracts that cannot be assigned under the Code, please contact your Reinhart attorney or any member of Reinhart's Business Reorganization group."

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