BNA's

PATENT, TRADEMARK & COPYRIGHT

BNA Employee-Owned Since 1947

JOURNAL

BANKRUPTCY

It is critical that intellectual property lawyers drafting IP licenses have an understanding of the consequences that a bankruptcy filing may have on the rights and obligations of the respective parties to the licensing agreement. It is equally important for bankruptcy attorneys to have a basic understanding of IP law, or at a minimum to know when they should be consulting with their IP colleagues about a bankruptcy estate that includes a large amount of IP.

The Intersection of Intellectual Property and Bankruptcy Law

BY PETER J. TOREN, MONICA BHATTACHARYYA, AND JAMIE MCGLOIN-KING

Introduction

As the worldwide economy expanded over the past decade, intellectual property assets increased dramatically in value and became an ever increasing share of a company's balance sheet. Now, as the economy contracts and many companies face bankruptcy, a key question concerns the status of intellectual property rights that may have been assigned, transferred, sold or licensed when one of the parties to such a transaction declares bankruptcy.

Peter J. Toren, Monica Bhattacharyya, and Jamie McGloin-King are lawyers specializing in intellectual property litigation at Kasowitz, Benson, Torres & Friedman, New York. They regularly consult with the firm's bankruptcy counsel.

Federal bankruptcy law permits bankrupt parties (''debtors'') with limited exceptions to walk away from obligations or to sell their rights in certain kinds of contracts and licenses. Indeed, a trustee is permitted, even over the objections of the other party to the contract, ''to assign contract rights to third parties even in the face of contract provisions or applicable law prohibiting or restricting assignment. . . . This rather extensive power reflects the important consideration that the trustee should be able to abandon contracts that impose burdensome liabilities upon the bankruptcy estate, but

 ISSN 0148-7965

should also be allowed to retain favorable contracts that benefit the estate.''[1]

Critically important is whether the same freedoms apply to licenses that grant rights in a patent, trademark, or copyright. A company may risk losing rights, such as the right to manufacture a licensed product because the licensor declared bankruptcy. Or a licensor may be faced with a new competitive landscape because a debtor-licensee sold its rights to the licensor's primary competitor.

Complicating this issue is that the underlying goals of IP law and bankruptcy law are fundamentally different.

Bankruptcy law seeks to maximize the value of assets of a failing company by giving the bankruptcy trustee the right to sell or reject contracts if that benefits the estate, even where this is financially harmful to the non-debtor party. In comparison, IP law is more concerned with protecting the right to license and to assign IP assets freely. Law at the intersection of bankruptcy and IP matters has attempted with varying degrees of success to reconcile these sometimes mutually inconsistent goals.

While there are still open issues regarding the treatment of IP licenses by bankruptcy courts, including how licenses which bundle trademark and covered IP rights such as copyrights should be treated, there are a number of important conclusions that can be made about this: (1) bankruptcy courts generally look to federal IP law to determine whether licenses to patents, trademarks or copyrights can be assigned or rejected; (2) licenses to IP are almost always found to be ''executory'' for the purpose of determining whether a license can be assumed (and subsequently assigned) or rejected by a debtor because most IP licenses have ongoing obligations by or to the debtor; (3) a prospective licensee should consider whether an outright purchase of the IP to which it seeks a license (with or without a license back to the seller) would effectively resolve any uncertainty about the future status of the license should the licensor declare bankruptcy; (4) non-debtor trademark licensees receive less protection under bankruptcy law than non-debtor licensees of patents, copyright and trade secrets; and (5) licensors of IP who seek to maintain control over the identity of their licensees should structure licenses as not transferable and personal to the licensee, because courts will look at the intent of the parties, regardless of which of the available legal standards they apply to the question of whether a debtor licensee can sell its rights under a license.

Overview of Federal and State Intellectual Property Rights

Patents are government-issued grants of the right to exclude others from using or selling an invention, while copyrights protect expressive works from the time they are written down or recorded. Both are the subject of federal statutes[2] that are specifically authorized by the U.S. Constitution[3] and that provide remedies for the unauthorized use and sale of patented subject matter or copyrighted works.[4]

Trademarks are protected from third-party use if such use would confuse or mislead the consumers as to the origin of the trademarked product or service. The owner of a trademark can register it with the federal government and thereby qualify for more robust remedies.

Unlike patents and copyrights, the basis for federal protection of trademarks is the commerce clause of the U.S. Constitution rather than under the intellectual property clause of the Constitution. Unlike patents, trademarks (and, to a much lesser extent, copyrights) are also accorded some protection under state law.

The policies that underlie these three federal statutory regimes affect courts' treatment of the sale or license of the rights protected thereby, even though a license is ostensibly a contract governed by state contract law. State law provides protection against theft of trade secrets and, to a degree that varies widely by state, against a variety of related business torts such as misappropriation and unfair competition.

Overview of the Bankruptcy System

The modern bankruptcy system was created in 1978 with the enactment of the Bankruptcy Reform Act of 1978, with significant amendments since then.[5] The Bankruptcy Code is directly administered by the bankruptcy courts which are part of the district courts of the United States. Like the Patent and Copyright Acts, the Bankruptcy Code is specifically authorized by the U.S. Constitution.[6]

In most cases, a failing company initiates the bankruptcy process by filing a bankruptcy petition with the bankruptcy court.[7] Such a filing has two automatic effects.

First, it creates a separate legal entity, the ''bankruptcy estate,'' consisting of the debtor's property as of the filing, the proceeds of that property, and additional property that the estate may later acquire.[8] Tangible assets, such as real property or chattels, owned by the debtor automatically become part of the bankruptcy estate. In addition, a debtor may have been the owner, licensor or licensee of a wide range of IP interests involving patents, copyrights, trademarks, and trade secrets. The debtor's contractual IP rights and obligations also become property of the estate, subject to the counterparty's rights under section 365 of the Bankruptcy Code. Generally, assets sold via a transaction that is completed prior to the debtor filing for bankruptcy do not become part of the estate, unless the transaction is found to be fraudulent.[9]

Second, the filing of a bankruptcy petition also triggers an automatic stay to preserve the estate until the debtor's property and creditors can be brought together and the competing rights in the estate adjudicated. The automatic stay enjoins the initiation of any action by a creditor against the debtor or the estate or the continuation of any action by or against the debtor, including IP litigation.[10] Furthermore, a non-debtor counterparty

[1] *In re Quantegy Inc.*, 326 B.R. 467, 470 & n.4 (Bankr. M.D. Ala. 2005) (footnotes, quotations and citations omitted).
[2] 35 U.S.C. § 1 *et seq.* (patent); 17 U.S.C. § 101 *et seq.* (copyright).
[3] U.S. CONST. art. I, § 8, cl. 7.
[4] 35 U.S.C. §§ 283-285; 17 U.S.C. §§ 502-505.
[5] 11 U.S.C. § 101 *et seq.*
[6] U.S. CONST. art. I, § 8, cl. 3.
[7] 11 U.S.C. § 301.
[8] 11 U.S.C. § 541.
[9] 11 U.S.C. § 548.
[10] 11 U.S.C. § 362(a)(1).

  PTCJ ISSN 0148-7965

to a license must render performance if nonperformance would damage the debtor's estate.[11]

In a Chapter 7 proceeding, an estate simply liquidates all of its assets, with the exception of certain property that is exempted by statute, and distributes the proceeds to its creditors. The court appoints a trustee to collect the debtor's non-exempt assets and sell them in order to maximize the return to the creditors.

In a Chapter 11 proceeding, the debtor generally retains possession of the company's assets and continues operating the business while developing a plan for reorganizing itself in such a way as to emerge from the proceeding as a viable business, having resolved its obligations to its creditors. The ''debtor in possession'' serves in the role of the bankruptcy trustee, with a fiduciary duty to maximize value for the estate's creditors.[12] The exception is when a party in interest successfully moves for the appointment of a Chapter 11 trustee.[13]

Bankruptcy law establishes a tiered system that provides for the equitable distribution of a debtor's assets through equal sharing of losses by creditors of equal rank. Generally, secured creditors must be fully compensated by the collateral that secured their claims before any unsecured claimants can share in any recovery. Once the secured claims have been satisfied, unsecured creditors are entitled to receive payment from the remaining assets, including any assets that are not subject to the claims of the secured creditors. The Bankruptcy Code sets forth nine levels of priority, or classes, among the unsecured creditors.[14] Within each class, all members share on a pro rata basis and all senior priority classes must be paid in full before any money can be distributed to junior priority classes.

Adjudicating Intellectual Property Rights in Bankruptcy Court

Section 365 of the Bankruptcy Code Governs Intellectual Property Rights and Obligations

The Bankruptcy Code recognizes the unique nature of IP licenses and imposes limitations on the ability of the estate to sell or cancel most IP agreements. It affords additional protections to non-debtor parties to IP licenses and contracts.

However, a debtor can sometimes sell or cancel a license in order to benefit the estate, either as licensor or licensee. Or the debtor can continue in its role as a party to a license despite the objections of its non-debtor counterparty.

Section 365 Generally

Section 365 of the Bankruptcy Code gives the trustee or debtor in possession[15] the discretion to ''assume or reject'' a debtor's ''executory contracts'' notwithstanding any contrary provisions appearing in such contracts.[16] The bankruptcy court applies the relatively liberal ''business judgment rule'' in assessing whether it is in the best interests of the debtor to assume or reject such a contract. Under this test, the bankruptcy court will only overturn the decision by the trustee to assume or reject an executory contract if it is ''manifestly unreasonable.''[17]

The issue of whether a debtor in possession can assume an executory contract typically arises under one of two sets of circumstances. In the first, the debtor in possession is preparing to emerge from bankruptcy and seeks to assume the contracts to which it was a party before the bankruptcy filing, as part of its plan of reorganization. Under this scenario, the debtor in possession seeks to resume its pre-bankruptcy activities and have the benefit of its prebankruptcy contracts.

In the second scenario, the debtor in possession seeks to assume and immediately sell and assign its rights to the contract, either via an auction, a sale of assets, or a stock sale. In this scenario, the license represents a source of cash for the estate.[18]

Upon the court's approval of the debtor's assumption of an executory contract, the prepetition contract is reinstated and becomes fully binding. Generally, once the debtor assumes the contract, the debtor can then freely assign its rights under the contract so long as ''adequate assurance of future performance by the assignee of such contract or lease is provided,'' regardless of whether applicable law or the contract itself prohibits such an assignment.[19]

Upon the court's approval of the debtor's rejection of an executory contract, the pre-petition contract is typically considered breached by the debtor. This can give rise to a pre-petition claim for breach of contract, making the counterparty to the license an unsecured credi-

---

[11] *Id.*

[12] 11 U.S.C. § § 1107(a), 1106(a).

[13] 11 U.S.C. § 1104(a); *see also In re Sharon Steel Corp.,* 871 F.2d 1217, 1225 (3d Cir. 1989) (''It is settled that appointment of a trustee should be the exception, rather than the rule.''); *In re Marvel Entertainment Group Inc.,* 140 F.3d 463, 471 (3d Cir. 1998) (noting that ''[t]he party moving for appointment of a trustee . . . must prove the need for a trustee . . . by clear and convincing evidence.'')

[14] 11 U.S.C. § 507.

[15] *E.g.*, *In re Golden Books*, 269 B.R. 311, 313 (Bankr. D. Del. 2001) (''In this case, [debtor] is operating as the trustee because it is a debtor in possession pursuant to 11 U.S.C. § 1107(a).''); *but see In re Footstar Inc.*, 323 B.R. 566, 570-71 (Bankr. S.D.N.Y. 2005) (''The statute does not say that the debtor or debtor in possession may not assume or assign—the prohibition applies on its face to the 'trustee.' In this case there is no trustee. Here, it is the debtors who seek to assume the Agreements. Nothing in the Bankruptcy Code prohibits the debtors from assuming the Agreements.'').

[16] 11 U.S.C. § 365 (a), (c), (f).

[17] *See, e.g., In re Sandman Assocs. L.L.C.*, 251 B.R. 473, 481 (Bankr. W.D. Va. 2000).

[18] The debtor-in-possession does not need to assume the license to have the benefits of the license, except in these two scenarios, because the estate's interest in the license is protected by the automatic stay resulting from the bankruptcy filing as long as the debtor continues to perform its obligations. *See* 11 U.S.C. § 362(a) (''[A bankruptcy] petition . . . operates as a stay, applicable to all entities, of . . . (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate . . . .''); *see, e.g., In re Computer Communications Inc.*, 824 F.2d 725, 731 (9th Cir. 1987) (affirming a finding that non-debtor counterparty to a technology development agreement violated the automatic stay by unilaterally terminating the agreement and an award of compensatory and punitive damages); *accord In re Public Service Co. of New Hampshire,* 884 F.2d 11, 14 (1st Cir. 1989) (''Ordinarily, the debtor need not commit itself to assumption or rejection of such a contract until a reorganization plan is confirmed. In the meantime, the executory contract remains in effect and creditors are bound to honor it.'').

[19] 11 U.S.C. § 365 (f); *In re Hernandez*, 285 B.R. 435, 438 (Bankr. D. Ariz. 2002).

tor of the estate.[20] But that breach can amount to a cancellation of the license.[21]

The ability to assume or reject executory contracts is a powerful tool in the hands of a debtor in possession or trustee. However, this power is subject to certain key limitations.

First, the Section 365 power to assume or reject a license is limited, by its terms, to ''executory contracts.'' Under the widely accepted ''*Countryman* definition,'' a contract is executory if performance is still due from both parties to the contract.[22] The initial question, therefore, is whether the license or agreement is indeed an executory contract, or is instead a non-executory contract, sale or other transaction.[23] The answer to this question may be critical since it may determine whether a debtor may continue to use the IP without assuming the license or sell its rights under a license without complying with the conditions ''imposed'' on assignment. An IP agreement which is not executory or a sale is also not subject to rejection.

However, practitioners should be aware that the courts almost always find that IP licenses are executory contracts because most licenses have ongoing material obligations.[24] In the IP context, an ongoing obligation by the licensee to account for and to pay royalties for the life of the agreement meets the *Countryman* test for an executory contract. Other material ongoing licensee obligations include sharing technology with the licensor, reporting on problems with the technology and marking all products sold under the license with the proper statutory patent notice.

On the licensor's side, courts have held that contractual obligations to provide a nonexclusive licensee with notice of any patent infringement suit or any other use or licensing of the process, to refrain from licensing the technology to anyone else at a lower royalty rate, to approve grants of sublicenses under reasonable standards, to indemnify licensees for losses, and to defend claims of infringement are considerations in determining whether the agreement is executory. Several courts recognize the licensor's implicit or explicit duty to forbear from suing the licensee for infringement as, inherently, a material ongoing performance obligation that makes the agreement executory.[25]

Second, the debtor in possession's powers under Section 365 are limited by Section 365(c) in instances where ''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 or rights or delegation of duties and such party does not consent to such assumption or assignment . . . .''[26] Therefore, Section 365(c) establishes two conditions that must be satisfied before a debtor in possession is prohibited from assigning a license to which it was a party before it filed for bankruptcy: (i) ''applicable law'' must permit the non-debtor to refuse performance of the license from another party; and (ii) the non-debtor does not consent, or has not already consented, to an assignment. Unless a bankruptcy court finds that both conditions are satisfied, the debtor in possession can assign its rights under the license so long as ''adequate assurance of future performance by the assignee of such contract or lease is provided.''[27]

The first condition refers to applicable non-bankruptcy law that would prohibit the free assignment of the license by the debtor. The federal IP law policies that favor strong protection for the limited monopolies enjoyed by IP owners, via restrictions on the unauthorized use of that IP, constitute applicable law for purposes of Section 365(c).[28] State law, such as a prohibition on the assignment of personal service contracts, can also be applicable law under Section 365(c).[29]

The second condition acknowledges that parties can contract around such applicable law.[30] Courts will examine the license itself to determine whether the non-debtor has consented to the assignment of the license by the debtor.[31]

Courts have split, however, over whether both conditions must be satisfied when the debtor in possession

---

[20] *Medical Malpractice Insurance Association v. Hirsch (In re Lavigne)*, 114 F.3d 379, 387 (2d Cir. 1997).

[21] *E.g.*, *In re Exide Technologies*, 340 B.R. 222, 249-50 (Bankr. D. Del. 2006) (approving rejection of trademark license and holding that such rejection terminated the license).

[22] 3 Lawrence P. King, COLLIER ON BANKRUPTCY § 365.02[1] (15th ed. revised) (citing Very Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 446 (1973) (defining a contract as ''executory'' where the obligations ''of both the bankrupt and the other party . . . are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.'')).

[23] *In re Exide Techs.*, 340 B.R. at 229 (analyzing trademark license under state contract law principles).

[24] *See id.* at 239 (collecting cases); *In re Kmart Corp.*, 290 B.R. 614, 618-19 (Bankr. N.D. Ill. 2003) (same); *but cf. In re Gencor Industries Inc.*, 298 B.R. 902, 910-13 (Bankr. M.D. Fla. 2003) (granting debtor's motion for summary judgment that a settlement agreement and patent license was not executory within the *Countryman* definition where the material obligations of the agreement and license were fulfilled upon execution and payment of the settlement, and citing cases).

[25] *In re Access Beyond Technologies Inc.*, 237 B.R. 32, 43 (Bankr. D. Del. 1999).

[26] 11 U.S.C. § 365(c).

[27] 11 U.S.C. § 365(f).

[28] *In re Travelot Co.*, 286 B.R. 447, 455 (Bankr. D. Ga. 2002) (in dictum); *see also RCI Technology Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 266 (4th Cir. 2004) (distinguishing the use of the term ''applicable law'' as used in Section 365(c) from the use of that same term in Section 365(f)).

[29] *E.g.*, *Summit Investment & Development Corp. v. Leroux*, 69 F.3d 608, 612 (1st Cir. 1995) (finding that ''the Massachusetts limited partnership statute'' is applicable law under Section 365(c) ''because it precludes general partners from assigning their general partnership 'participation' interests to a third party.''); *In re Rooster Inc.*, 100 B.R. 228, 232 (Bankr. E.D. Pa. 1989) (''Here the issue is narrowly framed by the parties: does the licensing agreement constitute a contract for personal services, which applicable Pennsylvania law holds as unassignable?'').

[30] *See In re Access Beyond Technologies Inc.*, 237 B.R. 32, 47 (Bankr. D. Del. 1999); *but see generally In re Valley Media, Inc.*, 279 B.R. 105, 140 (Bankr. D. Del. 2002) (''The contract law of the state governing the Distribution Agreements provides the rules of contractual construction of licenses to the extent that they do not interfere with the federal protection of intellectual property.'').

[31] *E.g.*, *In re Hernandez*, 285 B.R. 435, 440-41 (Bankr. D. Ariz. 2002).

  PTCJ ISSN 0148-7965

wants only to assume, but not assign, the license, and whether the non-debtor party to the license has to demonstrate that it would be forced to accept performance from another entity before a court will prevent a debtor in possession from assuming the license.[32]

A majority of the circuit courts rely on the literal language of the statute and have adopted what is termed the ''hypothetical test.''[33] Under this test, a debtor in possession cannot *assume* a license if applicable law would prohibit the debtor in possession from *assigning* its interest under the license. ''A debtor in possession *may not assume* an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party, *even where the debtor in possession has no intention of assigning* the contract in question to any such third party.''[34] The hypothetical test does not require an inquiry into whether or not the non-debtor party might fail to receive the benefit of the license.

In contrast, other courts[35] have favored an alternative approach, reasoning that Congress did not intend to bar a debtor in possession from assuming their own contracts where no assignment is contemplated and that, therefore, the non-bankruptcy ''applicable law'' policies against assignment are still satisfied.[36] This pragmatic ''actual test'' approach allows assumption of contracts that are non-assignable and non-delegable under applicable law. The test focuses on whether or not the nondebtor party would actually be forced to accept performance under the executory contract from someone other than the party, now a debtor in bankruptcy, with whom it originally contracted.[37]

Third, when the debtor is a licensor of a patent, copyright or trade secret, even if that license is executory and applicable law does not bar its rejection, and even if the debtor rejects the license, the licensee can still retain its rights under the license.[38]

Applying Section 365 to Specific Intellectual Property Licenses

Because technology and IP licenses frequently contemplate an ongoing relationship between the licensor and the licensee during the term of the agreement and the identity of the contracting parties is material to the agreement, serious problems can arise when an IP licensor or licensee enters bankruptcy. For example, the debtor-licensee may seek to assume the IP license and then to assign it to a third party, in exchange for economic benefit to the estate. Thus, a licensor could potentially find itself in a license agreement with a competitor, who has acquired the rights from the debtor-licensee and can use those rights to the detriment of the licensor.[39]

Further, a debtor-licensee who has acquired the exclusive rights to manufacture the licensor's product on a royalty basis may decide to reject the license and cease manufacturing the licensed product, which would deprive the licensor of the royalty payments. Such problems cannot simply be avoided by including a clause in the agreement which provides for the right of the nondefaulting party to terminate or modify an executory agreement upon the insolvency or filing of a bankruptcy petition by the other party.[40]

Specific considerations relating to patent licenses, copyright licenses, and trademark licenses are discussed below.

Patent Licenses

Whether deciding whether a patent license is assumable or assignable by a debtor, courts typically begin by determining whether the license is exclusive or nonexclusive.[41] The Supreme Court has recognized that free assignability of nonexclusive patent licenses would:

> undermine the [financial] reward that encourages invention because a party seeking to use the patented invention could either seek a license from the patent holder *or* seek an assignment of an existing patent license from a licensee. In essence, every licensee would become a potential competitor with the licensor-patent holder in the market for licenses under the patents . . . . Thus, any license a patent holder granted . . . would be fraught with the danger that the licensee would assign it to the patent holder's most serious competitor, a party whom the patent holder itself might be absolutely unwilling to license.[42]

---

[32] *In re Aerobox Composite Structures LLC*, 373 B.R. 135, 138, 140-42 (Bankr. D.N.M. 2007) (noting the circuit split and collecting cases); *In re Footstar Inc.*, 323 B.R. 566, 569 (Bankr. S.D.N.Y. 2005) (same).

[33] *In re Aerobox,* 373 B.R. at 140 & n.7 (citing *In re Footstar*, 323 B.R. at 569 & n.2).

[34] *In re Access Beyond Technologies Inc.*, 237 B.R. 32, 48 (Bankr. D. Del. 1999) (quoting *Perlman v. Catapult Entertainment Inc. (In re Catapult Entertainment Inc.)*, 165 F.3d 747, 749-50 (9th Cir. 1999), and citing *City of Jamestown v. James Cable Partners L.P. (In re James Cable Partners L.P.)*, 27 F.3d 534, 537 (11th Cir. 1994)); *In West Electronics Inc.*, 853 F.2d 79, 83 (3d Cir. 1988); and *Breeden v. Catron (In re Catron)*, 158 B.R. 629, 633-38 (E.D. Va. 1993), *aff'd without op.*, 25 F.3d 1038 (4th Cir. 1994)) (alteration in original).

[35] *In re Footstar Inc.*, 323 B.R. 566, 569 & n.2 (Bankr. S.D.N.Y. 2005) (stating that ''the great majority of lower courts'' applied the ''actual test'').

[36] *In re Access Beyond Technologies Inc.*, 237 B.R. 32, 48 (Bankr. D. Del. 1999).

[37] *See, e.g.*, *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997); *Summit Investment & Development Corp. v. Leroux*, 69 F.3d 608, 612 (1st Cir. 1995).

[38] 11 U.S.C. § 365 (n). *See* discussion *infra*.

[39] *E.g.*, *Institut Pasteur*, 104 F.3d at 493 (competitor purchased stock of debtor and thereby obtained license rights).

[40] 11 U.S.C. § 365(e)(1) (''Notwithstanding a provision in an executory contract . . . or in applicable law, an executory contract . . . of the debtor may not be terminated or modified, and any right or obligation under such contract . . . may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract . . . that is conditioned on (A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title; or (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.'').

[41] *E.g.*, *In re Hernandez*, 285 B.R. 435, 438 (Bankr. D. Ariz. 2002) (''Under *[Perlman v. Catapult Entertainment Inc. (In re Catapult Entertainment Inc.)*, 165 F.3d 747, 749-50 (9th Cir. 1999)], the Section 365(c)(1) exception applies in cases where a patent license is nonexclusive. 165 F.3d at 750. The court must therefore determine if Section 365(c)(1) applies to this case if the court follows its tentative ruling that the License is exclusive'').

[42] *Everex Systems v. Cadtrak Corp. (In re CFLC Inc.)*, 89 F.3d 673, 679 (9th Cir. 1996) (emphasis original) (citing *Bonito Boats Inc. v. Thunder Craft Boats Inc.*, 489 U.S. 141, 148, 9 USPQ2d 1847(1989)(37 PTCJ 377, 391, 2/23/89); *Sola Electric Co. v. Jefferson Electric Co.*, 317 U.S. 173, 55 USPQ 379

Accordingly, federal law has long held that nonexclusive patent license agreements are personal to the licensor and are not assignable unless expressly made so in the agreement.[43]

Because patent law prohibits the assignment of nonexclusive patent licenses without the consent of the licensor, courts have unanimously applied Section 365(c) to prohibit the assignability of nonexclusive patent licenses without the consent of the non-debtor licensor.[44] However, courts applying the ''actual test'' have declined to prohibit the assumption of patent licenses by the debtor in possession,[45] even when the debtor in possession planned to then sell itself to a competitor of the nondebtor counterparty to the licenses.[46]

In contrast, exclusive patent licenses tend to be viewed as conferring property rights and not merely personal rights.[47] Thus, it might seem that the federal common law of patent licenses, applied via Section 365(c), should not preclude the assumption or assignment of an exclusive patent license by the debtor.

However, at least one court applied the ''hypothetical test'' to bar a debtor-licensee from assuming its interest under a patent license that the court characterized as ''some version of an exclusive license.''[48] The court reasoned that to permit the assignability of exclusive licenses

> would create a situation where a patent holder loses control over the identity of its license holders whenever the license agreement provides a licensee with an exclusive right. Such a result, which effectively treats the grant of an exclusive license as the equivalent of an outright assignment of the Patent, is inconsistent with federal case law.[49]

Thus the court determined that the key distinction for purposes of determining whether a license is assignable under Section 365(c) (and therefore assumable under the ''hypothetical test'') is between an exclusive license to a patent and the transfer of the patent, rather than between an exclusive license and a non-exclusive license. This reasoning parallels that of courts adjudicating the assignability of copyright licenses.

Copyright Licenses

As with patent licenses, courts look to federal law and policy to determine whether copyright licenses are assignable. Like patent licenses, non-exclusive copyright licenses lack the free assignability that courts focus on when determining whether a debtor can assign the license. However, courts split on whether an exclusive copyright license is assignable.

Section 101 of the Copyright Act specifically identifies an exclusive license as a transfer of copyright ownership.[50]

> The holder of an exclusive license is entitled to all the rights and protections of the copyright owner to the extent of the license . . . the licensor cannot transfer the same rights to anyone else. By contrast, the nonexclusive license does not transfer any rights of ownership [and] ownership remains with the licensor.[51]

After granting a nonexclusive license, the copyright licensor still retains the exclusive right to use or authorize the use of the copyrighted work. Therefore, as in patent law, a nonexclusive copyright license is personal to the licensee and cannot be assigned without the consent of the licensor. Section 365(c) prohibits a debtor licensee from assigning a non-exclusive copyright license without the consent of the non-debtor licensor because federal copyright policy prohibits a licensor from being forced to accept performance from or render performance to another party.[52]

Courts are split, however, on the assignability of exclusive licenses where the contract is silent on the issue of assignability. The Ninth Circuit has held that the Copyright Act does not allow a copyright licensee to transfer its rights under an exclusive license without the consent of the original licensor.[53] The court reasoned:

> It is easy to imagine the troublesome and potentially litigious situations that could arise from allowing the original licensor to be excluded from the negotiations with a sublicensee. For example, what if the sublicensee was on the verge of bankruptcy or what if the original licensor did not agree that the sublicensee's material use of the copyright fell within the original exclusive license?[54]

On the other hand, a number of courts have expressly disagreed with the Ninth Circuit and taken the position that the holder of an exclusive license is entitled to all the rights and protections of the copyright owner to the extent of the license and the right to transfer such rights

---

(1942); *Oliver v. Rumford Chemical Works*, 109 U.S. 75, 3 S.Ct. 61, 27 L.Ed. 862 (1883), and *Hapgood v. Hewitt*, 119 U.S. 226, 7 S.Ct. 193, 30 L.Ed. 369 (1886)).

[43] *See, e.g.*, *PPG Industries Inc. v. Guardian Industries Corp.*, 597 F.2d 1090, 1093, 202 USPQ 95 (6th Cir. 1979) (citing *Troy Iron & Nail v. Corning*, 55 U.S. (14 How.) 193, 14 L. Ed. 383 (1852) and *Unarco Industries Inc. v. Kelley Co.*, 465 F.2d 1303, 1306, 175 USPQ 199 (7th Cir. 1972)).

[44] *See, e.g.*, *Everex Systems Inc. v. Cadtrack Corp. (In re CFLC Inc.)*, 89 F.3d 673, 679 (9th Cir. 1996); *Perlman v. Catapult Entertainment Inc. (In re Catapult Entertainment Inc.)*, 165 F.3d 747, 754-55 (9th Cir. 1999).

[45] *E.g.*, *In re Aerobox Composite Structures LLC*, 373 B.R. 135, 138, 140-42 (Bankr. D.N.M. 2007).

[46] *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493-94 & n.11 (1st Cir. 1997) (''Notwithstanding [the nondebtor counterparty's] reliance on the important policy goals animating the federal common law of patents, the productinnovation theme promoted under patent law may well be accommodated by allowing patent holders to control sublicensing through *negotiated contract restrictions*.'') (emphasis original).

[47] *In re Hernandez*, 285 B.R. 435, 439 (Bankr. D. Ariz. 2002).

[48] *Id.* at 438 (internal quotations omitted).

[49] *Id.* at 439 (citing *Waterman v. Mackenzie*, 138 U.S. 252, 255, 11 S. Ct. 334, 34 L. Ed. 923 (1891)); *see also id.* at 438 (distinguishing between a nonexclusive patent license, an exclusive patent license, and a freely assignable interest in a patent).

[50] 17 U.S.C. § 101.

[51] *In re Patient Education Media Inc.*, 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997) (citing 17 U.S.C. §§ 101, 201(d)(2)) (citations and quotation marks omitted).

[52] *E.g.*, *id.* at 242-43 (Bankr. S.D.N.Y. 1997); *see also Harris v. Emus Records Corp.*, 734 F.2d 1329, 1333-34, 222 USPQ 466 (9th Cir. 1984) (broadly stating that all copyright licenses are non-assignable without the authorization of the licensor).

[53] *Gardner v. Nike*, 279 F.3d 774, 780-81, 61 USPQ2d 1529 (9th Cir. 2002)(63 PTCJ 304, 2/8/02).

[54] *Id.* at 781.

   ISSN 0148-7965

and, accordingly, an exclusive licensee may freely transfer his rights.[55] According to these courts, therefore, section 365(c) does not prohibit a debtor-licensee from assigning an exclusive copyright license.[56]

Trademark Licenses

The basis for trademark law is fundamentally different from patent and copyright law. Rather than encouraging invention or creation, the goals of trademark law are to prevent consumer confusion and unfair competition and to encourage the creation of good will in a mark. Achieving this may take a long time. Unauthorized use of a trademark without consent of the owner will constitute infringement only if such use is likely to confuse, cause mistake or deceive.

Although it is generally not in the interest of the trademark owner to have the license transferred to a third party without consent, Section 365(c) will not necessarily excuse a trademark holder, in the absence of a contract provision barring assignment of the trademark, from accepting performance from or rendering performance to a party other than the debtor in accordance with the terms of a license. Thus, one would expect courts to permit trademark licenses to be assumed and/or assigned by debtor licensees.[57] However, at least one court has agreed that, as with patent and copyright licenses, a trademark licensor has a significant interest in a licensee's identity, which flows from the trademark owner's need to protect its mark's good will, value and distinctiveness.[58]

Rights of a Non-Debtor Licensee Upon Rejection

Prior to the passage of the Intellectual Property Bankruptcy Protection Act of 1988 (''IPBPA''), which amended Section 365 of the Bankruptcy Code,[59] licensees faced the real possibility that where the debtor-licensor rejected an IP license, the licensee would lose its right to continue to use that IP and would be left with only a pre-petition claim for contract damages, even where the licensee may have built a business or product line upon use of the licensor's IP. This was the harsh result in *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*, a case in which the bankruptcy court approved, under the business judgment rule, the rejection of a non-exclusive license the debtor-licensor's patented metal coating process.[60] The court acknowledged that allowing rejection of such contracts ''imposes serious burdens upon contracting parties . . . [and] could have a general chilling effect upon the willingness of [potential IP licensees] to contract at all with businesses in possible financial difficulty.''[61] The court nevertheless concluded that ''under bankruptcy law such equitable considerations may not be indulged by courts in respect of the type of contract here in issue.'' [62]

Congress passed the IPBPA to overturn the *Lubrizol* case, and addressed the issue by providing a non-debtor IP licensee with two options in the event that a debtor-licensor rejects a license that falls within the Bankruptcy Code's definition of ''intellectual property.''[63] The licensee can treat the debtor's rejection as a breach of contract.[64] Such a breach would then give rise to a potential claim for money damages under Section 365(g), but the non-debtor licensee would then be in the same position as any other party whose contract was rejected and treated as a general unsecured creditor.[65]

Alternatively, the licensee could elect to retain the rights to the IP covered by the license. The licensee must continue to pay royalties due under the licensing agreement and must waive all rights to set off or any claim for administrative expenses.[66]

The debtor-licensor is required to provide the licensee with access to the subject IP;[67] not interfere with the exercise of licensee's rights under the license;[68] and, in the case of an exclusive license, not licensing

---

[55] *In re Golden Books*, 269 B.R. 300, 309 (Bankr. D. Del. 2001) (in dictum); *In re Patient Education Media Inc.*, 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997) (same).

[56] *See, e.g.*, *I.A.E. v. Shaver*, 74 F.3d 768, 775 (7th Cir. 1996); *In re Golden Books*, 269 B.R. 311, 318 (Bankr. D. Del. 2001).

[57] *See, e.g.*, *In re Rooster Inc.*, 100 B.R. 228, 232-35 (Bankr. E.D. Pa. 1989) (analyzing a trademark sublicense as a personal services contract under Pennsylvania law and finding that the control over the debtor sublicensee's product exercised by the non-debtor sublicensor prohibited a finding that the sublicense was personal and allowing the debtor to assume and assign it); *see generally In re Luce Industries Inc.*, 14 B.R. 529, 530-32 (Bankr. S.D.N.Y. 1981) (analyzing trademark license under section 365(b)(1), which governs executory contracts in default and reversing decision to allow the license to be assumed with the intent to assign it); *In re Sunrise Restaurants*, 135 B.R. 149, 153 (Bankr. M.D. Fla. 1991) (applying the ''actual test'' and finding that a Burger King franchise agreement is not a personal service contract and can be assumed and assigned for the benefit of the estate).

[58] *In re N.C.P. Marketing Groups*, 337 B.R. 230, 236 (D. Nev. 2005) (affirming order granting motion to compel rejection of trademark license under the hypothetical test by emphasizing the exclusive-rights aspect of trademarks and analogizing to patent and copyright law), *aff'd without op.*, 279 Fed. Appx. 561 (9th Cir. May 23, 2008), *cert. denied*, *N.C.P. Marketing Group Inc. v. BG Star Productions Inc.*, 129 S. Ct. 1577, 2008 WL 4522334 (Oct. 6, 2008).

[59] *See* 11 U.S.C. §§ 365(n), 101(35A); *see also In re Centura Software Corp.*, 281 B.R. 660, 668 (Bankr. N.D. Cal. 2002) (''The critical provisions of IPLBA were codified as § 365(n) and § 101(35A) . . . .'').

[60] 756 F.2d 1043, 226 USPQ 961 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986).

[61] *Id.* at 1048.

[62] *Id.*

[63] ''[I]ntellectual property'' means ''(A) trade secret; (B) invention, process, design or plant protected under title 35 [the Patent Act]; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17 [the Copyright Act]; or (F) mask work protected under chapter 9 of title 17 [semiconductor chip products].'' 11 U.S.C. § 101(35A).

[64] 11 U.S.C. § 365(n)(1)(A).

[65] *See In re Centura Software Corp.*, 281 B.R. 660, 668 (Bankr. N.D. Cal. 2002); *see also Medical Malpractice Insurance Association v. Hirsch (In re Lavigne)*, 114 F.3d 379, 387 (2d Cir. 1997) (''Rejection gives rise to a remedy for breach of contract in the non-debtor party. The claim is treated as a pre-petition claim, affording creditors their proper priority.'').

[66] 11 U.S.C. § 365(n)(2)(B)-(C). Royalty payments are not defined in the Bankruptcy Code, but the legislative history and case law suggests that whether the payment should be considered a ''royalty'' should depend on the substance of the transaction and not on the label. *Encino Business Mangement Inc. v. Prize Frize Inc. (In re Prize Frize)*, 150 B.R. 456, 459-60 (B.A.P. 9th Cir. 1993) (regardless of the characterization of the payments used in the license agreement, ''royalty payments'' as referred to in the statute, encompassed all license fees to be paid by the licensee to retain its rights to use the intellectual property), *aff'd*, 32 F.3d 426 (9th Cir. 1994).

[67] 11 U.S.C. § 365(n)(2)(A), (3)(A).

[68] 11 U.S.C. § 365(n)(3)(B).

the technology to others.[69] These are only passive obligations on the part of the licensor, necessary for the licensee to enjoy the continued use and exploitation of licensed IP. Section 356(n) does not mandate that the debtor perform any affirmative duties under the license.

Thus, while Section 365(n) permits a licensee to retain its pre-petition rights to that IP as of the time of the bankruptcy, it does not allow the licensee to enforce the debtor-licensor's obligations to update or improve such IP contemplated by the license.[70] The parties cannot contract around this situation.[71] The most a licensee can retain under section 365(n) is ''the property rights in existence at the time of the bankruptcy filing.''[72] This can create problems for the licensee who may be left with no means to gain access to critical technological updates and thereby left with outdated or obsolete technology.

Thus, companies that are considering entering into a licensing agreement with financially strapped but technology-rich companies should weigh the advantages of access to the existing technology with the risk that they may not have continued access to the latest technology should the licensor declare bankruptcy. One solution under such circumstances would be for the licensee to acquire the technology outright from the licensor, with the means to improve upon it.

The IPBPA's solution is limited in other ways as well. While it specifically includes patents, copyrights, and trade secrets, Congress intentionally omitted trademark licenses from its coverage.[73] Thus, the rejection by a debtor-licensor of a trademark license would extinguish the licensee's right to use the mark and would leave the licensee with only a claim for breach of contract. At least one court has confirmed the rejection by the debtor-licensor of a trademark license agreement over objections of the licensee that rejection would result in damages of $67 million.[74] Such an amount ''will not diminish the dividend to unsecured creditors sufficiently to render [debtor's] decision to reject unreasonable.''[75]

An important unresolved question is how to treat licenses which bundle trademark rights along with other IP such as copyrights. According to one court, the answer may depend on whether the licensee raised the issue prior to court approval of a rejection of the license agreement.[76] ''While, pre-rejection, § 365(n) is only used as a guide or a factor in the determination of whether a contract should be rejected, it controls the adjudication of the licensee's rights once rejection is approved.''[77] Therefore, according to the court, if the licensee had invoked its rights to the bundled IP under the license pre-rejection, the licensee could have sought to ''persuade the bankruptcy court to weigh the equities and not to reject the agreement because its trademarks are integrally linked to other intellectual property.''[78] But since the licensee invoked its rights after the court approved the debtor's rejection, Section 365(n) controlled those rights and because trademarks are excluded from the scope of IP to which Section 365(n) applies, the court could not ''weigh the equities'' in assessing whether to allow the licensee to retain the trademark rights. The court also expressly disagreed with an earlier decision that interpreted the IPBPA to authorize courts to develop equitable standards for determining the treatment of trademark licenses in bankruptcy cases.[79]

Finally, companies must act expeditiously in protecting their rights. In a notable example, IBM lost the right under Section 365(n) to force a debtor-licensor to assume a license between a subsidiary of IBM, that was created as part of a $2 billion sale to Hitachi of its disk drive business, and the licensor, because there was no valid contract between the subsidiary and the licensor at the time the licensor had declared bankruptcy.[80]

Conclusion

The intersection of IP and bankruptcy law presents real challenges to both IP and bankruptcy lawyers. The potential problems are exacerbated because under bankruptcy law, the parties often cannot simply address the issues through contract.

While Congress has enacted amendments to the Bankruptcy Code, such as Section 365(n), that have clarified certain areas and provided increased protection to licensees and licensors in the event of a bankruptcy, several areas remain open to questions. Particularly, the law concerning the effect of bankruptcy on trademark license remains.

Trademark owners must, therefore, seek to protect themselves through careful drafting of the license. The rights conferred under a trademark should be narrowly drawn and clearly delineated and must incorporate quality control provisions and mechanisms for enforcing such standards.

Accordingly, it is critical that IP lawyers involved in drafting IP licenses have an understanding of the consequences that a bankruptcy filing would have on the rights and obligations of the respective parties to the licensing agreement. It is equally important for bankruptcy attorneys to have a basic understanding of IP law, or at a minimum to know when they should be con-

---

[69] 11 U.S.C. § 365(n)(1)(B), (2)(A).

[70] *Biosafe International v. Controlled Shredders (In re Szombathy)*, Case Nos. 94 B 15536, 95 A 01035, 1996 Bankr. Lexis 888, at *28-31 (Bankr. N.D. Ill. July 9, 1996), *aff'd in part, rev'd in part*, 1997 US Dist Lexis 5168 (N.D. Ill. Apr. 10, 1997)).

[71] *See, e.g.*, *In re Computer Communications Inc.*, 824 F.2d 725, 731 (9th Cir. 1987) (''Section 365(e) generally prohibits exercise of bankruptcy termination clauses in [executory contracts].'').

[72] *Biosafe International*, 1996 Bankr. Lexis 888, at *29.

[73] *In re Centura Software Corp.*, 281 B.R. 660, 669-670 (Bankr. N.D. Cal. 2002) (''Congress has deliberately limited § 365(n) protection only to the intellectual property enumerated by the statute. It has expressly withheld § 365(n) protection from rejected executory trademark licenses.'').

[74] *In re Exide Technologies*, 340 B.R. 222, 249-50 (Bankr. D. Del. 2006).

[75] *Id.* at 247.

[76] *In re Centura Software Corp.*, 281 B.R. 660, 671-73 (Bankr. N.D. Cal. 2002)

[77] *Id.* at 671 (citing William L. Norton Jr., 6A NORTON BANKR. L. & PRAC. 2D § 150:18 (2002)).

[78] *Id.* at 671-72; *see also id.* at 671 n.19.

[79] *In re Centura*, 281 B.R. at 671-73 (rejecting the licensee's reliance on *In re Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993)).

[80] *In re Read-Rite Corp.*, Case No. 03-43576RN, 2006 WL 2241107, at *4-5 (Bankr. N.D. Cal. June 19, 2006) (finding that IBM ''had ample inquiry notice that required it to do something to protect whatever rights the unexecuted license afforded it. By not doing something [within the proper time limits, IBM] relinquished any rights it had under the unexecuted agreement and § 365(n).'').

  PTCJ ISSN 0148-7965

sulting with their IP colleagues about a bankruptcy estate that includes a large amount of IP.