INTELLECTUALLY BANKRUPT?: THE COMPREHENSIVE GUIDE TO NAVIGATING IP ISSUES IN CHAPTER 11

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INTRODUCTION

Under the Bankruptcy Code,[1] a debtor[2] generally enjoys nearly unfettered discretion to sell its assets and to assume, assign or reject its executory contracts notwithstanding contractual provisions that might otherwise restrict such rights.[3] These freedoms are designed to maximize the value of the debtor's assets, and bankruptcy courts appear to be increasingly focused on uncovering value within an estate for the benefit of the debtor's stakeholders. However, this regime is often at odds with the general goal of intellectual property ("IP") law, which is to vigorously protect a party's right to control access to its IP. To avoid the many pitfalls that await the unsuspecting and uninitiated, a sophisticated understanding of the interplay between IP laws and the bankruptcy system is key to a successful restructuring.

When an entity files for bankruptcy, all of its property rights, including its IP rights, become part of its estate.[4] IP that is wholly-owned by the debtor and that the debtor has not licensed to another party would be unaffected by a bankruptcy filing. Such IP rights may be retained by the debtor or sold.[5] The rules become far more complicated, and the debtor's options may be dramatically restricted, where the IP rights at issue are the subject of a license—which is the vehicle by which most IP rights are conveyed to third parties for their nonexclusive use. Where the debtor has licensed its IP to an unaffiliated third party pursuant to an executory contract, section 365(n) permits the licensee to retain certain of its rights under the license even after it has been rejected by the debtor-licensor if the licensee continues to pay all royalties required by the license.[6] If the debtor has licensed IP rights *from*

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1 Unless otherwise specified, all section references or references to the "Bankruptcy Code" are to title 11 of the United States Code (11 U.S.C. § 101 *et. seq.* (2006)), as amended.

2 In this article, the term "debtor" refers to the trustee or the debtor-in-possession who has the same rights and duties as a trustee under the Bankruptcy Code. *See* 11 U.S.C. § 1107(a) (2006).

3 *See id.* at §§ 363, 365(a).

4 *Id.* at § 544.

5 If title to IP is transferred from a debtor to a non-debtor party, or an exclusive license is granted by a debtor to a non-debtor party, within a short time prior to the filing of the bankruptcy petition, such transfers could be the subject of a preference or fraudulent conveyance action.

6 11 U.S.C. at § 365(n).

another party, IP laws may altogether prevent the debtor from assuming or assigning the underlying license absent the licensor's consent.

Under the Bankruptcy Code, executory contracts, including most licenses, may be assumed and assigned by a debtor without the consent of the non-debtor counterparty, unless "applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to an entity other than the debtor . . . ."[7] Unlike most other contractual relationships, IP laws typically require that IP licensing arrangements be treated like "personal" contracts and, unless the licensor consents, preclude performance by a party other than the original licensee. This clash of fundamental bankruptcy and IP law principles can create a formidable obstacle in bankruptcy cases for debtors holding (or buyers seeking to acquire) significant IP licenses in bankruptcy. Because these restrictions apply in most jurisdictions not only to prevent assignments to a third party non-debtor, but also assumptions of licenses by the debtor itself, parties who are not familiar with the nuances described herein may find themselves in a predicament that could threaten or derail a debtor's reorganization.

This article sets forth a comprehensive framework to analyze the treatment of IP in the bankruptcy process, including: (i) determining whether a given copyright, patent, trademark or other IP license is an executory contract; (ii) the instances in which executory IP licenses may be assumed, assumed and assigned, or rejected by a debtor; (iii) the effect of the assumption, assignment or rejection of an IP license; (iv) the effect and limitations of section 365(n) of the Bankruptcy Code; (v) the interplay between IP bankruptcy issues and section 363 and chapter 15 of the Bankruptcy Code; (vi) IP security interests; and (vii) other emerging IP bankruptcy issues.

I. IP LICENSES AS EXECUTORY CONTRACTS

When an IP owner decides to exploit its IP rights and make them available to be used by unaffiliated third parties, the owner will often enter into a license agreement with the third party licensee that establishes the terms of the relationship, including the duration and scope of the license. Ongoing IP licenses are generally considered to be executory contracts.[8] The Bankruptcy Code treats executory contracts differently than contracts that are not executory.[9] If a contract is executory, the debtor generally can (i) assume it, (ii) assume and then assign it to an unaffiliated

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[7] *Id.* at § 365(c)(1)(A).

[8] *See, e.g.*, *In re* Kmart Corp., 290 B.R. 614, 618 (Bankr. N.D. III. 2003) ("Generally speaking, a license agreement is an executory contract as such is contemplated in the Bankruptcy Code."); *In re* Buildnet, Inc., No. 01–82293, 01–82294, 01–82295, 01–82296, 01–82297, 01–82298, 01–82299, 2002 WL 31103235, at *3 (Bankr. M.D.N.C. Sept. 20, 2002) ("As a general rule, most patent, trademark, technology and other intellectual property licenses are executory contracts.").

[9] *See* 11 U.S.C. § 365 (concerning treatment of executory contracts in bankruptcy cases).

third party, or (iii) reject it.[10] If a contract is not executory, it is merely an asset or obligation of the estate, which would obviate the need for assumption. Thus, the threshold question when evaluating an IP license is whether it is an executory contract.[11]

The Bankruptcy Code does not define "executory contract," but bankruptcy courts typically use the "Countryman" definition,[12] which provides that an executory contract is one "under which the obligation[s] 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 performance of the other."[13] Under this standard, an IP license is executory when the lack of performance by either party would constitute a material breach of the license agreement.

The Countryman definition is relied upon in most jurisdictions, but some courts use a "functional analysis approach" to determine whether a contract is executory. Under this approach, a court may look more holistically to the nature of the parties, the goals of reorganization, and whether the acceptance or rejection of a contract will ultimately benefit the bankruptcy estate.[14] These external considerations make this approach broader and less rigid than the Countryman definition.

Under either of these approaches, a license is more likely to be considered an executory contract if the license agreement specifically provides that the lack of performance by either party under the agreement will constitute a *material breach*. Such contracts may specify events that would be considered a material breach of the

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[10] *See id.* at § 365(a). Courts generally review a debtor's decision to assign, assume, or reject an executory contract by applying the deferential "business judgment" test. *See, e.g.*, Orion Pictures Corp. v. Showtime Networks, Inc. (*In re* Orion Pictures Corp.), 4 F.3d 1095, 1099 (2d Cir. 1993) (adopting "business judgment" test).

[11] As discussed below, a separate but related threshold question to consider is whether the transaction at issue is actually an outright assignment or sale of the IP and not a true IP license.

[12] *See, e.g.*, *In re* Access Beyond Techs., Inc., 237 B.R. 32, 43 (Bankr. D. Del. 1999) (applying "Countryman" definition to license agreement); H.R. REP. NO. 95-595 at 347 (1977) (stating "there is no precise definition of what contracts are executory"); 3 COLLIER ON BANKRUPTCY, ¶ 365.02[2][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009) (explaining "Countryman" definition).

[13] Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 MINN. L. REV. 439, 460 (1973). *See also* Everex Sys, Inc. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 677 (9th Cir. 1996); Commercial Union Ins. Co. v. Texscan Corp. (*In re* Texscan Corp.), 976 F.2d 1269, 1272 (9th Cir. 1992).

[14] *See* Sipes v. Atl. Gulf Communities Corp. (*In re* Gen. Dev. Corp.), 84 F.3d 1364, 1374 (11th Cir. 1996) (noting that courts and commentators have consistently expanded definition of "executoriness" beyond static definition articulated by Professor Countryman in order to effectuate language and legislative purposes of section 365 and Bankruptcy Code); Tonry v. Hebert (*In re* Tonry), 724 F.2d 467, 468 (5th Cir. 1984) (holding contract can be executory even if only one party has remaining affirmative obligations); Fox v. Hill (*In re* Fox), 83 B.R. 290, 299 (Bankr. E.D. Pa. 1988) (finding contract is not executory where "[t]he estate has whatever benefit it can obtain from the other party's performance and the trustee's rejection would neither add to nor detract from the creditor's claim or the estate's liability."); *In re* Arrow Air, Inc., 60 B.R. 117, 121–22 (Bankr. S.D. Fla. 1986) (noting legislative history of section 365 shows that Congress "considered mutual obligation to be indicative of an executory contract in some, but not all, cases" and that "even though there may be material obligations outstanding on the part of only one of the parties to the contract, it may nevertheless be deemed executory under the functional approach if its assumption or rejection would ultimately benefit the estate and its creditors").

license. If the license merely conditions performance by one party on the performance of the other and does not indicate that the lack of performance by one party is a material breach, the contract may not establish the existence of ongoing obligations sufficient to render it executory.[15] In addition, a license may not be executory (and is more likely to be considered an assignment or sale) where it conveys some part of the exclusive right to exploit the rights in question.[16] If the license is deemed to be a sale or outright assignment of the IP, then it is not an executory contract and section 365(n), discussed below, will not apply.

Even if the license is deemed executory, section 365(c) of the Bankruptcy Code only prohibits assumption or assignment of the license if prohibited by applicable non-bankruptcy law.[17] This issue is addressed further below.

A. When is a Patent, Copyright, or Trademark License an Executory Contract?

Most types of IP licenses are treated as executory contracts in the bankruptcy context because the licensor and the licensee usually owe continuing material obligations to one another.[18] The key issues to consider in determining whether a license agreement is executory are (i) whether performance remains due on the part of both the licensee and the licensor such that the failure to perform by either party would constitute a material breach, and (ii) whether those remaining obligations are sufficient to show that the license is in fact an executory contract.[19] On the

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15 *See, e.g.*, *In re* Gencor Indus., 298 B.R. 902, 911–12 (Bankr. M.D. Fla. 2003) (finding licensing agreement's most favored nations clause and patent defense clause were mere conditions of payment by licensee (failure of which would excuse further payment) rather than material continuing obligations that if unperformed would result in material breach of contract).

16 *See, e.g.*, Otto Preminger Films, Ltd. v. Qintex Entm't, Inc. (*In re* Qintex Entm't, Inc.), 950 F.2d 1492, 1497 (9th Cir. 1991) (finding contracts were not executory where IP owners had "contractually given all of their future rights" to other contracting party); *In re Access Beyond Techs, Inc.*, 237 B.R. at 44 (holding license agreement was executory contract and not sale where it did not convey to licensee at least some part of exclusive right to practice invention and did not grant any right to exclude others from practicing patent).

17 *See* Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 750 (9th Cir. 1999) ("In other words, the statute by its terms bars a debtor in possession from assuming an executory contract without the nondebtor's consent where applicable law precludes assignment of the contract to a third party.").

18 *See, e.g.*, *In* re CFLC, Inc., 89 F.3d at 677 (discussing definition of executory contract); Encino Bus. Mgmt., Inc. v. Prize Frize, Inc. (*In re* Prize Frize, Inc.), 32 F.3d 426, 428 (9th Cir. 1994) (discussing balance between rights of bankrupt and rights of licensee) ("*In re* Prize Frize II"); *Qintex Entm't, Inc.*, 950 F.2d at 1496 ("The existence of substantial and unperformed obligations on both sides determines" whether contract is deemed executory); Lubrizol Enters., Inc. v. Richmond Metal Finishers Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1045–46 (4th Cir. 1985) (finding "[t]he unperformed, continuing core obligations of notice and forbearance in licensing" made license executory), *cert. denied*, 475 U.S. 1285 (1986); Fenix Cattle Co. v. Silver (*In re* Select-A-Seat Corp.), 625 F.2d 290, 292 (9th Cir. 1980) (adopting Countryman definition for executory contracts); *In re* Patient Educ. Media, Inc., 210 B.R. 237, 241 (Bankr. S.D.N.Y. 1997) ("Bankruptcy courts have generally treated nonexclusive copyright and patent licenses as executory contracts . . . .").

19 Certain negative covenants have been deemed sufficient to make a contract executory. *See, e.g.*, Ozark-Mahoning Co. v. Am. Magnesium Co., 488 F.2d 147, 152 (5th Cir. 1974) ("An executory contract is one in which a party binds himself to do or not do a particular thing."); *In re* Golden Books Family Entm't, Inc., 269 B.R. 311, 314 (Bankr. D. Del. 2001) ("*In re* Golden Books II") (license found executory where each

licensee's side, the duty to pay royalties, provide updates, adhere to confidentiality provisions and indemnify the licensor have all been held to be material ongoing obligations.[20] A licensee will generally have at least the ongoing obligation to compensate the licensor for its use of the IP; however, an agreement is not executory "simply because one party is obligated to make payments of money to the other party."[21] The determinative factor in this analysis is usually whether the *licensor* has ongoing obligations.

If the licensor has no ongoing obligations, then the license is not executory. However, courts generally take a broad view of ongoing obligations. For instance, the grant of exclusivity in an exclusive license may be considered an unperformed, ongoing obligation of the licensor because it amounts to an affirmative covenant not to use or license the IP in violation of the license.[22] At a fundamental level, the grant of a license is intended to be a continuing obligation not to sue the licensee making any license executory.[23] However, some courts have resisted such broad propositions, finding that licenses are not executory contracts when one party has fully performed its material obligations.[24]

IP licenses are almost always viewed as executory contracts, unless the license constitutes an assignment or one side has completely performed its obligations. An IP license that is exclusive may be deemed an assignment in certain circumstances and not an executory contract.[25] While an IP license typically does not transfer ownership or control from the licensor to the licensee, bankruptcy courts will look beyond the language of an agreement to determine whether a licensee was granted an ownership interest in the IP at issue pursuant to a contract (even if labeled a license). Courts have found that where a license confers complete control to a licensee, the license is not an executory contract because at least one of the parties,

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party had material duty of "refraining from suing the other for infringement of any of the [intellectual property] covered by the license.").

[20] *See Lubrizol Enters., Inc.*, 756 F.2d at 1045 (finding licensee's obligations to give notice and to restrict its right to license its process at royalty rates it desired without lowering other royalty rates remained unperformed).

[21] *In re* Szombathy, Bankruptcy Nos. 94 B 15536, 95 A 01035, 1996 WL 417121, at *7 (Bankr. N.D. Ill. July 9, 1996), rev'd in part on other grounds, Szombathy v. Controlled Shredders, Inc., 1997 WL 189314 (N.D. Ill. Apr. 14, 1997).

[22] *See* Ron E. Meisler, et al., *Rejection of Intellectual Property License Agreements Under Section 365(n) of the Bankruptcy Code: Still Hazy After All These Years*, 19 NORTON J. OF BANKR. L. AND PRAC. 163, 164, (2010) (citing Marcelo Halpern, 950 Prac. L. Inst.: Patents 611, 625, Bankruptcy Issues in Intellectual Property Licensing (2008)).

[23] *See In re* HQ Global Holdings, Inc., 290 B.R. 507, 511 (Bankr. D. Del. 2003) ("As long as the royalty payments are made and the operation standards are met, the Debtors must permit the Franchisees' use of the marks. This is an executory contract.").

[24] *See* Gencor Indus., Inc. v. CMI Terex Corp. (*In re* Gencor Indus., Inc.), 298 B.R. 902, 913 (Bankr. M.D. Fla. 2003) (irrevocable license was not executory where no on-going duties remained that would cause material breach if unperformed).

[25] *See* Fawick v. Comm'r of Internal Revenue, 436 F.2d 655, 662 (6th Cir. 1971) (noting exclusive license agreements in some instances may constitute sale for tax purposes); *In re* Golden Books Family Entm't, Inc., 269 B.R. 300, 309 (Bankr. D. Del. 2001) ("*In re* Golden Books I").

if not both, has no further obligations under the sale or assignment agreement.[26] For this reason, pre-petition assignments of IP would generally not meet the definition of executory contracts. However, many exclusive licenses will be regarded as executory contracts.

Non-exclusive licenses do not convey any ownership interest in the IP from the licensor to the licensee because such licenses only grant permission to use the IP, which is considered a personal—not a property—right.[27] As a result, virtually all such licenses are considered executory contracts.

The determination of whether or not a license is executory is made based on the substance of the terms of the license itself. Regardless of how a license is depicted in a debtor's filings, a debtor cannot assume a non-executory contract.[28] Nor does a mere label of "non-executory," "executory," "license," or "assignment" contained within the contract itself affect whether a contract is in fact executory.

1. Patent Licenses

Courts typically find that patent licenses are executory in nature because both the licensees and the licensors generally have ongoing obligations. The obligation of a patent licensee to account for and pay royalties to the licensor for the term of the license agreement is typically enough to make the agreement executory on the licensee's side.[29] A patent licensee's duties (i) to mark all products sold under the license with the proper statutory patent notice, (ii) to share technology with the licensor, and (iii) to report any problems with the technology have also been found to constitute ongoing obligations sufficient to make a license executory.[30]

The following patent licensor obligations have been held to establish an

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[26] *See, e.g.*, Flanders v. United States, 172 F. Supp. 935, 950 (N.D. Cal. 1959) (holding "substantial rights" were transferred even where term license was used).

[27] "Unless the writing conveys some or all of the right to exclude others from practicing the invention, it will not convey an interest in the patent, but is a mere license." *In re* Access Beyond Techs., Inc., 237 B.R. 32, 44 (Bankr. D. Del. 1999) (citing Waterman v. Mackenzie, 138 U.S. 255, 256 (1891)). *See also* Madlyn G. Primoff & Erica G. Weinberger, *E-Commerce and Dot-Com Bankruptcies: Assumption, Assignment, and Rejection of Executory Contracts, Including Intellectual Property Agreements, and Related Issues under Sections 365(c), 365(e) and 365(n) of the Bankruptcy Code*, 8 AM. BANKR. INST. L. REV. 307, 317 (2000) (contrasting exclusive licenses and non-exclusive licenses).

[28] *See In re* Exide Techs., 378 B.R. 762, 765 (Bankr. D. Del. 2007) ("Section 365 allows debtors to assume or reject an executory contract, but provides no such option for a non-executory contract.").

[29] *See, e.g.*, Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1046 (4th Cir. 1985) (explaining promise to pay royalties "goes beyond a mere debt" making it enough to be considered executory); *See In re* Szombathy, Bankruptcy Nos. 94 B 15536, 95 A 01035, 1996 WL 417121, at *7 (Bankr. N.D. Ill. July 9, 1996) (contract found to be executory where unperformed, continuing duty was accounting for and paying royalties, but noting that agreement is not executory "simply because one party is obligated to make payments of money to the other party.").

[30] *See, e.g.*, Everex Sys., Inc. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 677 (9th Cir. 1996) (explaining because failure to mark deprives patent holder of damages in infringement action, licensee's performance of this duty is material).

executory contract on the licensor's side: (i) defending claims of infringement,[31] (ii) providing a non-exclusive licensee with notice of patent infringement suits or any other use or licensing of the IP,[32] (iii) refraining from licensing the IP to other parties at a lower royalty rate,[33] (iv) indemnifying the licensee for losses,[34] and (v) approving grants of sublicenses under reasonable standards.[35] A licensor's duty to refrain from issuing a license to other parties if the license is exclusive is also an ongoing duty.[36] Some courts have held that the duty of the licensor to forbear from suing a licensee for IP infringement is by itself an ongoing obligation that demonstrates the license's executory nature.[37] Other courts have held that this is not enough.[38]

In the patent context, an agreement is a sale of a patent right only if it conveys: (1) "the whole patent, comprising the exclusive right to make, use and vend the invention;" (2) "an undivided part or share of that exclusive right;" or (3) "the exclusive right under the patent within and throughout a specified" region.[39] For instance, in *Chesapeake Fiber Packaging Corporation. v. Sebro Packaging Corporation*, the Fourth Circuit held that an agreement, which stated that the patent holder "hereby sells, assigns, transfers and sets over to [patent assignee] its entire right, title and interest in, to, and under the aforesaid Inventions and any and all

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31 *See Lubrizol*, 756 F.2d at 1046 (finding contract to be executory because it required appellant to defend infringement suits).

32 *See id.* (finding contract to be executory because it required appellant to give notice of infringement suits); *see In re Szombathy*, 1996 WL 417121, at *8 (noting parties to contract had obligation to provide notice of possible infringement suits).

33 *See Lubrizol*, 756 F.2d at 1045 (licensing agreement was executory because by contract royalty rate was to be reduced "to meet any more favorable rates").

34 *See id.* at 1046 (contract also executory because it called for indemnification of certain losses).

35 *See* Univ. of Conn. Research & Dev. Corp. v. Germain (*In re* Biopolymers, Inc.), 136 B.R. 28, 30 (Bankr. D. Conn. 1992) (finding contract to be executory because contract called for reasonable standards in approving sublicenses).

36 *See, e.g.*, *In re* HQ Global Holdings, Inc., 290 B.R. 507, 510 (Bankr. D. Del. 2003) (holding that licensor who granted exclusive territorial license bore continuing material obligation not to engage in business in that territory).

37 *See* Jacob Maxwell, Inc. v. Veeck, 110 F.3d 749, 753 (11th Cir. 1997) (copyright); *In re* Spansion, Inc., Nos. 11–3323, 11–3324, 2012 WL 6634899, *3 (3d. Cir. Dec. 21, 2012) (finding covenant not to sue in settlement agreement constituted license); Everex Sys., Inc. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 677 (9th Cir. 1996) ("nonexclusive patent license is, in essence 'a mere waiver of the right to sue'"); Novon Int'l, Inc. v. Novamont S.P.A. (*In re* Novon Int'l, Inc.), Nos. 98-CV-0677E(F), 96-BK-15463B, 2000 WL 432848, at *4 (W.D.N.Y. Mar. 31, 2000) (stating both parties to contract are obligated to not sue other for infringement); *In re* Golden Books II, 269 B.R. 311, 314 (Bankr. D. Del. 2001) ("Applying the Countryman definition of executory contracts, courts generally have found intellectual property licenses to be 'executory' within the meaning of section 365(c) because each party to the license had the material duty of 'refraining from suing the other for infringement of any of the [intellectual property] covered by the license.'"); *In re* Access Beyond Techs, Inc., 237 B.R. 32, 43 (Bankr. D. Del 1999) (patent license).

38 *See, e.g.*, Gencor Indus., Inc. v. CMI Terex Corp., 298 B.R. 902, 912 (Bankr. M.D. Fla. 2003) ("the Court finds that the covenant not to sue, inherent in a licensing agreement, is not a material obligation").

39 Waterman v. Mackenzie, 138 U.S. 252, 255 (1891). *See* Wing v. Comm'r of Internal Revenue, 278 F.2d 656, 661 (8th Cir. 1960) ("exclusive licenses to manufacture, use, and sell for the life of the patent, are considered to be 'sales or exchanges' because, in substantive effect, all 'right, title, and interest' in the patent property is transferred"). *See also* Ortho Pharm. Corp. v. Genetics Inst., Inc. 52 F.3d 1026, 1032 (Fed. Cir. 1995) (recognizing exclusive licensee's right to sue for infringement under patent law).

Letters Patent," was an outright transfer of the IP, despite the fact that the patent assignee had to continue to make royalty payments to the patent holder.[40]

However, an exclusive license will be deemed executory if the licensee and the licensor both have material ongoing obligations under the license agreement. For example, in *In re Biopolymers, Inc.*, the licensor issued an exclusive license to a licensee "to make, use and sell" products for the life of the patent, and to grant sublicenses to third parties, subject to the approval of the licensor, not to be unreasonably withheld, and subject to certain federal restrictions.[41] The licensee agreed to make an initial cash and stock payment and to continue to pay royalties, provide quarterly business reports, and use its best efforts to produce and sell the products.[42] Despite the fact that the sole remaining obligation of the licensor was to approve third party licensees, the court held that this exclusive license was an executory contract.[43]

2. Copyright Licenses

A copyright license is not always considered an executory contract. A copyright licensee almost invariably has the ongoing obligation to publish or distribute the copyrighted work, and to account for and pay royalties for such distribution.[44] However, a copyright licensor, unlike a patent licensor, will often lack ongoing obligations under the license beyond the implied or explicit covenant not to sue the licensee.[45]

The question of whether a copyright license is executory may be more closely tied to whether the license is an exclusive or a non-exclusive license. Under an exclusive license, the licensee receives an interest in the underlying copyright and the licensor will often lack ongoing obligations.[46] On the other hand, if a copyright license was issued at a time when the work was expected to be revised or adapted, then the copyright owner and licensor may have ongoing obligations under the license agreement.[47] A licensor may also have ongoing

[40] *See* Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp.143 B.R. 360, 375 (D. Md. 1992), aff'd 8 F.3d 817 (4th Cir. 1993). *See also* Conde Nast Publ'ns, Inc. v. United States, 575 F.2d 400, 407 (2d Cir. 1978) (finding exclusive license to be "sale" for tax treatment purposes and restriction on assignability not inconsistent with completed sale).

[41] *See In re* Biopolymers, Inc., 136 B.R. 28, 29 (Bankr. D. Conn. 1992).

[42] *Id.*

[43] *See id.* at 30.

[44] *See* Peer Int'l Corp. v. Pausa Records, Inc., 909 F.2d 1332, 1337 (9th Cir. 1990) (stating licensor is entitled to royalties each month, plus monthly statement of accounts for distributions by licensee).

[45] *Cf.* Aleta A. Mills, Comment, *The Impact of Bankruptcy on Patent and Copyright Licenses*, 17 BANKR. DEV. J. 575, 585 (2001) (declaring nonexclusive licensee of copyright does not have standing to sue for infringement of copyright).

[46] *But see id.* at 587 (noting under reasoning of one Ninth Circuit case, "an exclusive license will always be executory as to the licensor because it will necessarily include a continuing obligation not to sell to other parties, as well as an obligation not to sue the licensee for infringement").

[47] *See, e.g.*, Otto Preminger Films, Ltd. v. Qintex Entm't, Inc. (*In re* Qintex Entm't, Inc.), 950 F.2d 1492, 1496 (9th Cir. 1991) (agreement found to be executory where licensor must refrain from selling rights to

marketing or software updating obligations.[48]

Exclusive copyright licenses are transfers of copyright ownership pursuant to the Copyright Act,[49] which may not be treated as executory contracts.[50] However, there is some disagreement among the courts regarding the extent to which the granting of an exclusive license constitutes a full transfer of rights.[51] In the copyright context, "[t]he ownership of a copyright may be transferred in whole or in part by any means of conveyance."[52] As one court explained:

> Copyright assignments and [exclusive] licenses should not be treated as executory contracts . . . . According to the Copyright Act, assignments and [exclusive] licenses are transfers of copyright ownership; bankruptcy courts should treat them that way. If a debtor has granted an assignment or exclusive license of its copyright rights prior to filing bankruptcy, the assignment or exclusive license should be treated as a completed prebankruptcy transfer of property by the debtor, not as an executory contract . . . . Conversely, if a debtor enters bankruptcy with valid copyright assignments or exclusive licenses of copyright rights owned by others, those assignments or exclusive licenses are property of the estate, not executory contracts.[53]

3. Trademark Licenses

Trademark licenses are typically viewed as executory contracts because both

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sub-distribute movies, must indemnify licensee and exercises creative control over colorization and marketing of movies).

[48] *See* Bauhaus Software Inc. v. TVPaint Dev., No. SA-05-CA-1209 FB (NN), 2007 WL 2330999 at *14 (W.D. Tex. Aug. 14, 2007) (concluding that licensee's obligation to pay royalties depended on licensor "developing updated software products").

[49] *See* 17 U.S.C. § 101 (2006) (the "Copyright Act").

[50] *See id.* (defining "transfer of copyright ownership" to include "exclusive license"); Mills, *supra*, note 46, at 588 ("[I]f a license is an exclusive license, it is a transfer of ownership to the licensee and is therefore part of the debtor-licensee's estate. Exclusive copyright licenses should not be treated as executory contracts.").

[51] *Compare* Gardner v. Nike, Inc., 279 F.3d 774, 780 (9th Cir. 2002) (holding copyright licensee not allowed to transfer its rights under exclusive license without consent of original licensor), *with* Flanders v. United States, 172 F. Supp. 935, 950 (N.D. Cal. 1959) (noting exclusive license considered sale when agreement transfers all substantial rights to patent for particular industry to licensee). *See also* Traicoff v. Digital Media, Inc., 439 F. Supp. 2d 872, 877 (S.D. Ind. 2006) ("exclusive licensees, as copyright owners of their exclusive rights, are free under the [Copyright] Act to transfer those rights to third parties."); *In re* Hernandez, 285 B.R. 435, 439 (Bankr. D. Ariz. 2002) (holding exclusive patent license did not afford licensee right to assign patent); *In re* Supernatural Foods, L.L.C., 268 B.R. 759, 801–02 (Bankr. M.D. La. 2001) (excluding exclusive license to only subset of possible uses from definition of sale or assignment).

[52] 17 U.S.C. § 201(d)(1).

[53] *In re* AEG Acquisition Corp., 161 B.R. 50, 59–60 (B.A.P. 9th Cir. 1993) (citing J. Brinson, *The Copyright Act and Bankruptcy: Perfection, Priorities, and Transfers*, 1 J. BANKR. L. & PRAC. 337, 353 (1992) (footnotes omitted)), *overruled on other grounds by* Aerocon Eng'g, Inc. v. Silicon Valley Bank (*In re* World Aux. Power Co.), 303 F.3d. 1120 (9th Cir. 2002).

parties to the license agreement have ongoing obligations; were this not the case, the trademark would be invalidated for lack of quality control. The licensor has the continuing statutory obligation to monitor the quality of the trademark, notify licensees of any infringements, enforce the trademark for the benefit of the licensee, and indemnify the licensee for any damages, expenses, and attorneys' fees.[54] The licensee has the continuing obligation to adhere to the licensor's quality control specifications, to pay for the use of the trademark, to report to the licensor on the use of the trademark, and to market the trademark.[55]

II. ASSUMPTION

Under section 365 of the Bankruptcy Code, if a contract is executory, a debtor may proceed in one of three ways: (1) assume the contract and continue to perform its obligations during and after emerging from bankruptcy; (2) assume the contract and assign it to a third party; or (3) reject the contract.[56] A debtor's ability to assume, assume and assign, or reject an IP license is significantly more limited than with other executory contracts.

Under the Bankruptcy Code, "the trustee [or debtor in possession], subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[57] However, this broad right is restricted by section 365(c), which provides:

> The trustee may not assume or assign any executory contract or unexpired lease of the debtor, 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[58] excuses a party, other than the

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[54] *See In re* Chipwich, Inc., 54 B.R. 427, 430 (Bankr. S.D.N.Y. 1985) (explaining licensor's right to receive royalty payments must be examined in context of duties imposed upon licensor).

[55] *See, e.g.*, *In re* Superior Toy & Mfg. Co., 78 F.3d 1169, 1176 (7th Cir. 1996) (holding licensing agreement to be executory contract); *In re* HQ Global Holdings, Inc., 290 B.R. 507, 510 (Bankr. D. Del. 2003) (discussing licensee's obligations to maintain standards of operation, to pay monthly royalty payments, and to generate monthly operating reports); *In re* Blackstone Potato Chip Co., 109 B.R. 557, 560 (Bankr. D.R.I. 1990) (stating licensee and licensor have continuing obligations under agreement thus making it executory contract); *In re* Specialty Foods of Pittsburgh, Inc., 91 B.R. 364, 374 (Bankr. W.D. Pa. 1988) (indicating licensee has continuing obligation to permit licensor to inspect its premises and to use trademark only with certain items); *In re Chipwich, Inc.*, 54 B.R. at 430 (indicating licensee is required to protect licensor's rights in licensed trademarks).

[56] 11 U.S.C. § 365(a) (2006).

[57] *Id.*

[58] The term "applicable law" in this subsection refers to "applicable non-bankruptcy law." H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 348 (1977); S. REP. NO. 95-989, 95th Cong., 2d Sess. 59 (1978). An important question that arises in a section 365(c) analysis is whether federal or state law should apply. A choice of law discussion is beyond the scope of this article, but the answer to this question depends on the context. For example, state law is more likely to apply to whether an assignment of an IP license occurred and federal law is more likely to govern assignability. *See* ELAINE D. ZIFF & JOHN G. DEMING, IP LICENSES:

> 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
> (B) such party does not consent to such assumption or assignment . . . .[59]

Importantly, "applicable law" in this context does not include the enforceability of an anti-assignment provision in the contract, which provisions are disregarded under the Bankruptcy Code.[60] Extensive litigation regarding the meaning of this provision has led to jurisdictional splits in the test applied to determine whether a debtor-licensee may assume an IP license. Three approaches have emerged.

In the Third, Fourth, Ninth, and Eleventh Circuits, courts have interpreted section 365(c) to apply not only to the "trustee" but to the debtor as well. Additionally, these courts have read section 365(c) literally and held that this restriction bars both assumption and assignment if applicable law excuses performance to or from a party other than the debtor. For most contracts, this is a non-issue because (disregarding any contractual anti-assignment provision), applicable law provides that contracts may be freely assigned.[61] However, IP licenses are generally considered "personal" contracts and, where the licensee is the debtor, the principle of free assignability does not apply. This first approach is known as the "Hypothetical Test."[62]

The First and Fifth Circuits have held that section 365(c) does not apply to assumptions of executory contracts unless the debtor plans to assign the contract because, in the case of assumption without assignment, the non-debtor party would not actually have to accept performance from a party other than the debtor or debtor in possession. This test makes the restriction imposed by applicable law barring assignment irrelevant when the debtor is assuming, and *not* assigning, the license. This approach is known as the "Actual Test."[63]

Finally, some courts have held that the bar against assumption applies only to a trustee and does not prevent a debtor-in-possession from assuming a license. This third approach is known as the "Footstar Approach."[64]

RESTRICTIONS ON ASSIGNMENT AND CHANGE OF CONTROL 2–3 (Practical Law Company Intellectual Prop. & Tech. Practice Note, 2002).

[59] 11 U.S.C. § 365(c).

[60] *See, e.g.*, *id.* at §§ 365(f), 541(c)(1)(A).

[61] *See* RESTATEMENT (SECOND) OF CONTRACTS § 317(2). *See also* UCC § 2-210 (2012).

[62] *In re* W. Elecs. Inc., 852 F.2d 79, 83 (3d Cir.1988).

[63] Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir. 1997) (finding relevant inquiry is whether license has actually been assigned).

[64] *See In re* Footstar, Inc., 323 B.R. 566, 573–74 (Bankr. S.D.N.Y. 2005) (concluding that, as result of legislative history, Congress did not intend trustee and debtor in possession to be interchangeable, and thus, language of statute implies only trustee is barred from assumption). *See also In re* Aerobox Composite

Justice Kennedy has noted that this "division in the courts over the meaning of § 365(c)(1) is an important one to resolve for bankruptcy courts and for businesses that seek reorganization."[65] In denying certiorari on a case involving this jurisdictional split in 2009, Justice Kennedy opined that "[i]n a different case the Court should consider granting certiorari on this significant question."[66] Until this question is resolved, in the many jurisdictions following the Hypothetical Test, a debtor-licensee cannot assume an IP license (without the licensor's consent) unless it could also assign the license to an unaffiliated third party (and a debtor generally may not assign its rights as an IP licensee because applicable non-bankruptcy (IP) law treats IP licenses as "personal" to the contracting parties, which allows the non-debtor counterparty to refuse performance to or from anyone other than the original licensee). This limitation puts the debtor's right to continue to use licensed IP in significant jeopardy.

A. Hypothetical Test

The "Hypothetical Test" mandates that "a debtor in possession may not assume an executory contract over the non-debtor's objection if applicable law would bar assignment to a hypothetical party, even where the debtor in possession has no intention of assigning the contract to any such party."[67] This is the majority approach and it has been adopted in the Third, Fourth, Ninth, and Eleventh Circuits. The "Hypothetical Test" relies on a literal interpretation of section 365(c), which provides that the trustee (or debtor) may not assume *or* assign an executory contract if applicable law bars assignment.[68] In these jurisdictions, whether an IP license can be assumed is solely determined by whether it may be assigned (and in most instances, assignment is prohibited).[69] Under the "Hypothetical Test," it is irrelevant whether the debtor-licensee actually intends to assume the license for itself or to assume and assign the license to an unaffiliated third party. The determinative issue a court must resolve is whether the debtor may assign the license to an unaffiliated third party regardless of whether the debtor in fact intends to do so.[70]

The leading decision adopting the "Hypothetical Test" is *Perlman v. Catapult Entertainment, Inc.* from the Ninth Circuit. [71] In *Catapult*, the debtor sought to assume a non-exclusive patent license and the court held that the license could not be assumed because applicable law prevented the debtor from being able to assign it

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Structures, L.L.C., 373 B.R. 135, 142 (Bankr. D.N.M. 2007) (stating "it makes no sense to read 'trustee' to mean 'debtor in possession'").

[65] N.C.P. Mktg. Grp., Inc. v. BG Star Prods., Inc., 129 S. Ct. 1577, 1578 (2009).

[66] *Id.*

[67] *In re* Neuhoff Farms, Inc., 258 B.R. 343, 350 (Bankr. E.D.N.C. 2000).

[68] *In re* Jacobson, 465 B.R. 102, 105 (Bankr. N.D. Miss. 2011).

[69] Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 750 (9th Cir. 1999), *cert. denied*, 528 U.S. 924 (1999) (stating even absent intentions of assignment debtor in possession may not assume executory contract).

[70] *Id.*

[71] *See id.* at 754 (finding plain English of U.S.C. section 356 renders "hypothetical test" appropriate).

without the consent of the patent owner, who objected to the assumption.[72] The Ninth Circuit interpreted section 365(c) literally and found that the debtor's inability to *assign* the IP license under applicable law absent the licensor's consent prohibited the debtor from assuming it because section 365(c) applies to both assumption and assignment.[73] The court emphasized that under federal patent law, a non-exclusive patent license is "personal and assignable only with the consent of the licensor," and under the plain language of section 365(c)(1), the restrictions on assumption and assignment are linked.[74]

Following *Catapult*, the Fourth Circuit held in *RCI Tech. Corporation v. Sunterra Corporation* that a debtor could not assume a non-exclusive copyright license without the licensor's consent, even though it had no intention of assigning it, because under applicable copyright law, the licensor would not be required to render performance to or accept performance from a party other than the debtor.[75] Notably, the court found that while the debtor could not assume the non-exclusive copyright license, it could have assigned the license because the transfer provision in the license agreement permitted assignment under certain circumstances.[76]

Several other courts have adopted the "Hypothetical Test."[77] In these circuits, most IP licensors have the right to prevent the assumption of a license. This veto power can have enormous consequences for the licensee and can erect a significant roadblock to reorganization, making it considerably more difficult for a debtor-licensee to continue its business with a non-consenting licensor after emerging from bankruptcy. Justice Kennedy explained the consequences to debtors as follows: "the hypothetical test may prevent debtors-in-possession from continuing to exercise their rights under nonassignable contracts, such as patent and copyright licenses. Without these contracts, some debtors-in-possession may be unable to effect the successful reorganization that Chapter 11 was designed to promote."[78] He further noted the perverse incentives that this interpretation of section 365(c)(1) creates for the non-debtor licensor as follows:

> [T]he hypothetical test provides a windfall to nondebtor parties to valuable executory contracts: If the debtor is outside of bankruptcy, then the nondebtor does not have the option to renege on its agreement; but if the debtor seeks bankruptcy protection, then the

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72 *Id.* at 754–55.

73 *Id.* at 752.

74 *Id.* at 750–51.

75 RCI Tech. Corp. v. Sunterra Corp. (*In re* Sunterra Corp.), 361 F.3d 257, 271 (4th Cir. 2004).

76 *Id.*

77 *See, e.g.*, Cinicola v. Scharffenberger, 248 F.3d 110, 126 (3d Cir. 2001) (describing history of "hypothetical test" in jurisdiction and defining test); 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 re* W. Elecs. Inc., 852 F.2d 79, 83 (3d Cir. 1988); *In re* Catron, 158 B.R. 629, 635 (E.D. Va. 1993); *In re* Hernandez, 285 B.R. 435, 440 (Bankr. D. Ariz. 2002) (holding license not assignable under "hypothetical test"); *In re* Access Beyond Techs., Inc., 237 B.R. 32, 48 (Bankr. D. Del. 1999) (noting that majority of Circuit Courts have adopted "hypothetical test").

78 N.C.P. Mktg. Grp. v. BG Star Prod., Inc., 556 U.S. 1145, 1147 (2009).

> nondebtor obtains the power to reclaim—and resell at the prevailing, potentially higher market rate—the rights it sold to the debtor.[79]

Although a chapter 11 debtor-licensee may be able to continue to use an IP license until its chapter 11 plan becomes effective, the application of the "Hypothetical Test" could ensure that the debtor will not be able to continue to use an IP license following the confirmation of its plan if the licensor refuses to consent to the debtor-licensee's assumption.

B. Actual Test

The "Actual Test" rejects the literal approach applied in the "Hypothetical Test" and instead focuses on the actual intentions of the debtor-licensee seeking to assume an IP license because, unless the license will actually be assigned, the non-debtor licensor will not be required to accept or render performance "to an entity other than the debtor or the debtor in possession."[80] This minority approach has been adopted in the First and Fifth Circuits and involves a case-by-case inquiry into whether the non-debtor licensor is actually being forced to accept performance from an entity other than the debtor.[81] To determine whether a debtor may assume an executory IP license, the courts applying this test interpret section 365(c)(1) as a limit on the debtor-licensee's ability to assume a license only to the extent that the debtor proposes to *assume it for the purpose of assigning* it to an unaffiliated third party. Under this analysis, the court does not restrict the debtor's ability to assume an IP license if the license cannot be assigned unless the debtor *actually intends to assign* the license to a third party.[82]

In *Institut Pasteur v. Cambridge Biotech Corporation*, the First Circuit held that a debtor-in-possession may assume a non-exclusive patent license and transfer its stock to another entity without the consent of the licensor.[83] In that case, the debtor sought to assume a patent license and confirm a plan that purported to transfer the debtor's stock to a subsidiary of the licensor's direct competitor.[84] The licensor objected to the debtor's stock transfer on the grounds that its license effectively

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79 *Id.*

80 11 U.S.C. § 365(c)(1)(A) (2006).

81 *See In re* TechDyn Sys. Corp., 235 B.R. 857, 860–61 (Bankr. E.D. Va. 1999) (listing cases that have adopted "actual test").

82 *See* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir. 1997) (holding that court looks to whether non-debtor party was actually forced to accept performance from someone other than debtor). *But see* Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608, 614 (1st Cir. 1995) (noting that, in determining whether contract may be assumed by debtor, bankruptcy court is required to weigh any conflict of interest arising from proposed assumption that would prevent non-debtor licensee from receiving full benefit of its bargain).

83 *See Institut Pasteur*, 104 F.3d at 494.

84 *See id.* at 490.

would be assigned to the licensor's competitor.[85] However, the court rejected the licensor's objection and allowed the debtor-licensee to assume the license agreement and transfer its stock.[86] The court reasoned that the prohibition in the federal common law against the free assignability of patent licenses does not, in and of itself, prevent a debtor-licensee from assuming a patent license and transferring its stock to a third party.[87]

Several courts have held that a debtor is not automatically precluded from assuming a license which it otherwise cannot assign to a third party under applicable non-bankruptcy law.[88] For the debtor-licensee, the "Actual Test" can mean the difference between being able to retain a valuable license for the benefit of its reorganization and the complete loss of such license under the "Hypothetical Test."

C. Footstar Approach

The third approach, known as the "Footstar Approach," established by the bankruptcy court for the Southern District of New York, holds that the limitation of section 365(c)(1) bars only the trustee—not the debtor-in-possession—from assuming an IP license if applicable law would excuse the non-debtor counterparty from being bound by an assignment of the license.[89] The court reasoned that the debtor's "mere assumption (without assignment) would *not* compel the counterparty to accept performance from or render it to 'an entity other than' the debtor."[90] The court also emphasized that its decision was "entirely harmonious with both the objective sought to be obtained in section 365(c)(1) and the overall objectives of the Bankruptcy Code, without construing 'or' to mean 'and.'"[91] Adopting a new literal interpretation of section 365(c)(1), the court found that the word "trustee" does not

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[85] *See id.* at 490–91.
[86] *See id.* at 494.
[87] *See id.* at 493–94.
[88] *See, e.g.*, Texaco Inc. v. Louisiana Land & Exploration Co., 136 B.R. 658, 671 (M.D. La. 1992) (applying state law to prevent assumption of leases would be counterproductive to goals of bankruptcy); *In re* Cajun Elec. Power Co-op., Inc., 230 B.R. 693, 705 (Bankr. M.D. La. 1999) ("[T]he majority of cases . . . have rejected the 'hypothetical test' and have held that section 365(c) does not prohibit assumption by the debtor in possession."); *In re* Lil' Things, Inc., 220 B.R. 583, 587 (Bankr. N.D. Tex. 1998) ("[T]his Court also rejects the 'separate entity' theory and finds that a debtor may assume its own contracts and leases."); *In re* GP Express Airlines, Inc., 200 B.R. 222, 232 (Bankr. D. Neb. 1996) (explaining that completely baring debtors from assuming contracts would be contrary to bankruptcy code); *In re* LeRoux, 167 B.R. 318, 321 (Bankr. D. Mass. 1994) (noting debtors in possession can assume contracts notwithstanding applicable laws that say otherwise); *In re* Nizny, 175 B.R. 934, 939 (Bankr. S.D. Ohio 1994) (finding chapter 11 bankruptcy filing prevents debtor's dissolution under state law); *In re* Ontario Locomotive & Indus. Ry. Supplies (U.S.) Inc., 126 B.R. 146, 147–48 (Bankr. W.D.N.Y. 1991) (stating since separate entity doctrine has been struck down, prohibitions on assumption abilities of debtors in possession are not permitted); *In re* Cardinal Indus., Inc., 116 B.R. 964, 979–80 (Bankr. S.D. Ohio 1990) (holding debtors in possession can assume contracts otherwise un-assumable under state law).
[89] *In re* Footstar, Inc., 323 B.R. 566, 573–74 (Bankr. S.D.N.Y. 2005).
[90] *Id.* at 573 (emphasis in original).
[91] *Id.* at 570.

(as other courts have taken for granted) include the debtor or the debtor-in-possession.[92] Accordingly, the right of the non-debtor party to object to an assignment does not, by itself, affect the right of the debtor-in-possession (as opposed to a trustee) to assume an executory contract. The impact on a chapter 11 debtor is the same under the Actual Test and the Footstar Approach.

The same bankruptcy court followed the "Footstar Approach" in *In re Adelphia Communications Corporation*.[93] The court upheld the *Footstar* decision and described it as consistent with the outcomes of courts following the "Actual Test."[94] The court further noted:

> [W]here there is no controlling Second Circuit authority, [the Bankruptcy Court for the Southern District of New York] follows the decisions of other bankruptcy judges in this district in the absence of clear error. But to say that the Footstar decisions should be followed under that standard would be faint praise here. In this Court's view, Judge Hardin's analysis in those decisions was plainly correct.[95]

D. Section 365(e)(2)(A): Ipso Facto *Clauses*

A similar analysis as that set forth above likely applies to the question of whether an *ipso facto* clause (the Latin phrase meaning "by the fact itself") is enforceable to permit the termination if a license by the non-debtor counterparty upon the filing of a bankruptcy case by the debtor counterparty. Section 365(e)(1) of the Bankruptcy Code provides, in relevant part:

> Notwithstanding a provision in an executory contract . . . or in applicable law, an executory contract . . . *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 [bankruptcy] 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 . . . .[96]

Thus, under the Bankruptcy Code, *ipso facto* provisions in executory contracts are generally viewed as being rendered unenforceable. However, there is an

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[92] *Id.* at 573.

[93] *In re* Adelphia Commc'ns Corp., 359 B.R. 65, 72 (Bankr. S.D.N.Y. 2007).

[94] *Id.* ("The *Footstar* decisions also are consistent in outcome with the decisions of the First Circuit and the Fifth Circuit, and the great majority of the lower courts, which in this court's view reach the proper result.").

[95] *Id.* at 72 n.13.

[96] 11 U.S.C. § 365(e)(1) (2006) (emphasis added).

exception to this rule that contains language similar, but not identical, to section 365(c)(1). Section 365(e)(2) provides, in relevant part:

> Paragraph (1) of this subsection does not apply to an executory contract . . . whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties, if . . . (A) (i) applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to the *trustee or to an assignee* of such contract . . . whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment . . . .[97]

In *Bonneville Power Administration v. Mirant Corporation*, a non-debtor counterparty sought to terminate its executory contract with the chapter 11 debtor based on an *ipso facto* clause after the debtor filed for bankruptcy.[98] In support of its argument, the non-debtor counterparty relied on section 365(e)(2) and asserted that under applicable law the Anti-Assignment Act, 41 U.S.C. § 15 (which generally prohibits the transfer of contracts to which the United States is a party) it was excused from accepting performance from or rendering performance to the trustee or an assignee.[99] Relying on cases analyzing section 365(c)(1), the court adopted the "Actual Test" to determine the availability of section 365(e)(2)(A).[100] As a result, in jurisdictions that have adopted the "Actual Test," the mere filing of a bankruptcy case by a debtor-in-possession will likely be insufficient to trigger the exception to the enforceability of *ipso facto* clauses in section 365(e)(2)(A). Instead, an actual assignment of the executory contract must be contemplated by the debtor.[101]

In addition, the analysis to be performed under sections 365(c)(1) and (e)(2)(A) may differ to some degree in that section 365(c)(1) refers to assignments "to an entity other than the debtor or the debtor in possession" while section 365(e)(2)(A) refers to assignments "to the trustee or to an assignee."[102] The conventional wisdom

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[97] *Id.* at § 365(e)(2) (emphasis added).

[98] Bonneville Power Admin. v. Mirant Corp., 440 F.3d 238, 240 (5th Cir. 2006).

[99] *See id.* at 244.

[100] *See id.* at 249 ("The plain text of § 365(e)(2)(A) requires an actual test for determining whether a law is 'applicable' under the exception"). *See also* Summit Inv. and Dev. Corp. v. Leroux, 69 F.3d 608, 612 (1st Cir. 1995) (declining to apply "hypothetical test" and determining section 365(e)(2)(A) does not apply where debtor has not yet attempted to assume or assign agreement to third party).

[101] *See Summit*, 69 F.3d at 612.

[102] *See id.* at 613 ("Before the 1984 amendment, the pivotal language in section 365(c) read precisely like the current version of section 365(e)(2); that is, it adverted to the 'applicable law excusing a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance *to the trustee or to an assignee of such contract or lease* . . . .' In replacing the highlighted language in section 365(c) with the phrase 'to an entity other than the debtor or the debtor in possession,' Congress intended to --make[] clear that the prohibition against the trustee's power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal

is that an *ipso facto* clause in an IP license does not allow the termination of the license by the non-debtor party during the pendency of a chapter 11 case in which the debtor remains in possession and no assignment of the IP license has been made.

E. Section 365(b): Cure of Defaults and Adequate Assurance

If a debtor-licensee is permitted to assume an IP license and elects to do so, and the debtor has defaulted under the license prior to its bankruptcy filing, then section 365(b) mandates that the debtor (i) cure all defaults or provide adequate assurance of a prompt cure, and (ii) provide adequate assurance of future performance.[103] Whether these conditions can be satisfied are questions of fact.

Generally, courts will not find that a default is incurable or that a non-monetary default may not be cured by a monetary payment.[104] In *In re Chapin Revenue Cycle Management, L.L.C.*, a debtor-licensee held a license to use software which prohibited the debtor from reproducing or distributing the software without the permission of the licensor.[105] The licensor subsequently gave notice that it could no longer provide maintenance services.[106] The debtor therefore interviewed potential replacement maintenance service providers and made portions of the source code available to the applicants.[107] The licensor contended that unauthorized disclosure of the source code by the licensee amounted to an incurable default under the license agreement and prevented the debtor-licensee from assuming the license.[108] The court disagreed and allowed the debtor to assume the license because the default was not deemed to be material and "did not cause a significant economic detriment" to the licensor.[109]

The Bankruptcy Code does not define the term "adequate assurance." Generally, courts look to the nature of the parties, their prior dealings and present circumstances, the present contract, and the character and feasibility of the debtor's plans for future performance.[110] Whether adequate assurance can be provided to the

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service contract will be the same as if no petition had been filed because of the personal nature of the contract. H.R. REP. NO. 1195, 96th Cong., 2d Sess. § 27(b) (1980).").

[103] *See* 11 U.S.C. § 365(b)(1) (2006).

[104] *See In re* Garcia, 276 B.R. 627, 638–39 (Bankr. D. Ariz. 2002).

[105] *See In re* Chapin Revenue Cycle Mgmt, 343 B.R. 728, 29 (Bankr. M.D. Fla. 2006).

[106] *See id.* at 730.

[107] *See id.*

[108] *See id.*

[109] *Id.* at 732.

[110] *See, e.g.*, *In re* Yardley, 77 B.R. 643, 646 (Bankr. M.D. Tenn. 1987) (discussing meaning of adequate assurance of future performance); *In re* Sapolin Paints, Inc., 5 B.R. 412, 421 (Bankr. E.D.N.Y. 1980) (defining adequate assurance of future performance). Courts also look to the express terms of the agreement. *See, e.g.*, *In re* Westview 74th Street Drug Corp., 59 B.R. 747, 754–55 (Bankr. S.D.N.Y. 1986) (focusing on whether it appears that contractual obligations will be met). However, the debtor is not obligated to assure performance of every facet of the original agreement. *See In re* U.L. Radio Corp., 19 B.R. 537, 543 (Bankr. S.D.N.Y. 1982) ("[B]y requiring provision of adequate assurance under section 365, i.e., 'the lessor's receipt

non-debtor-licensor depends on whether the debtor-licensee has established reasonable grounds to support a finding that the default will be cured and that all obligations will be performed as required under the agreement. However, courts tend to be practical and pragmatic in determining whether adequate assurance has been shown by the debtor.[111]

A licensor can take steps to prospectively protect itself by specifying in the license agreement that certain defaults are incurable and/or specifying the requirements for curing defaults relating to key provisions of the license. A licensor should also define what constitutes "adequate assurance of future performance" for the purposes of sections 365(b)(1)(C) or (f)(2). While in both instances enforcement will be up to the court, in the event that the licensee files for bankruptcy and seeks to assume its license, the bankruptcy court may adopt, or at least be influenced by, the parties' pre-negotiated definition.[112] For example, a licensee intending to assume an IP license may have to demonstrate a certain net worth or available capital.

F. Non-Payment for the Licensee's Use of the IP

Although section 365 may limit a debtor-licensee's ability to assume or assign an IP license without the licensor's consent, it does not compel the debtor to immediately determine whether it will assume or reject the license. Consequently, a licensee in bankruptcy can continue to use the IP without moving to assume, assign, or reject the IP license because, as an executory contract, an IP license remains effective during the "limbo period" while the debtor-licensee is determining how to proceed.[113] Although a debtor-licensee is statutorily required to compensate a licensor for the use of its IP, regardless of the debtor's ultimate intention to assume, assign, or reject it, licensors are still not guaranteed full payment pursuant to the license agreement for a debtor-licensee's use of their IP during the pendency of the debtor's bankruptcy case.

The cost of compensating the licensor for the post-petition use of IP during a

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of the 'full benefit of his bargain,' Congress did not require the Court to assure 'literal fulfillment by the lessee of each and every term of the bargain.'").

[111] *See, e.g.*, *In re* Rachels Indus., Inc., 109 B.R. 797, 803 (Bankr. W.D. Tenn. 1990) (analyzing meaning of adequate assurance); *In re* Great Nw. Recreation Ctr., Inc., 74 B.R. 846, 856 n.2 (Bankr. D. Mont. 1987) (listing provisions of § 365 and intended meaning of terms); *In re* Natco Indus., Inc., 54 B.R. 436, 440–41 (Bankr. S.D.N.Y. 1985) (looking at legislative history to determine meaning of adequate assurance).

[112] *See In re* Alltech Plastics, Inc., No. 86-23673-B, 1987 WL 123991, at *1812 (Bankr. W.D. Tenn. Dec. 30, 1987) ("The court finds that the license agreement in its entirety must be read to determine the definition of adequate assurance."). *See also In re* Luce Indus., Inc., 14 B.R. 529, 532 (S.D.N.Y. 1981) (finding adequate assurance absent in trademark assignment where assignment required "complete reworking of the procedures under the License Agreement" and there was no assurance that future performance would comply with specific provisions of license agreement).

[113] *See* Pub. Serv. Co. of New Hampshire v. New Hampshire Elec. Coop., Inc. (*In re* Pub. Serv. Co. of New Hampshire), 884 F.2d 11, 14 (1st Cir. 1989) (explaining Bankruptcy Code rules for executory contracts); *In re* Action Transit, Inc., No. 07–27904–pp, 2008 WL 533992, at *2 (Bankr. E.D. Wis. Jan. 10 2008) (stating debtor must abide by lease).

licensee's bankruptcy case is classified as a post-petition administrative claim that, unlike a pre-petition claim, must be paid in full in order for a chapter 11 plan to be confirmed.[114] Although administrative claims are typically paid in full at the end of the case upon the confirmation of a plan of reorganization, some cases end up being "administratively insolvent" when a debtor lacks sufficient assets to pay all administrative claims in full, in which case the debtor will not be able to fully compensate the licensor for the use of its IP.

Moreover, even when the debtor is administratively solvent, a licensor may not be awarded the contracted fee for the use of its IP as it is delineated in the license agreement. Courts determine the amount of an administrative claim by assessing the reasonable value of the services provided to the estate by the claimant. When determining the value of post-petition services, the Supreme Court announced that a debtor need not necessarily pay the contract fee, but instead "is obligated to pay for the reasonable value of those services . . . which, depending on the circumstances of a particular contract, may be what is specified in the contract."[115] The licensor further risks that a court will find that it did not provide valuable services to the estate.[116] To protect its payment rights under the license, the licensor may wish to perfect a security interest in the IP, as discussed below.

Given the uncertainty of receiving full or even partial compensation for the use of its IP, an IP licensor should move the bankruptcy court to compel a debtor-licensee to assume or reject the IP license or to lift the automatic stay to terminate a non-assumable license as early in the bankruptcy case as possible.[117] Upon assumption or rejection, the IP licensor should move the court to compel payment as a priority administrative claim.[118] However, an IP licensor should refrain from suspending performance owed under the license because the court may find that such unilateral suspension constitutes a violation of the automatic stay.[119]

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[114] *See In re* Boston Post Rd. Ltd. P'ship, 21 F.3d 477, 484 (2d Cir. 1994) (explaining post-petition administrative claims are considered priority claims and must be paid in full).

[118] N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 531 (1984). *See In re* Native Am. Sys., Inc., 368 B.R. 75, 80 (Bankr. D. Colo. 2006).

[116] *See* Microsoft Corp. v. DAK Indus. (*In re* DAK Indus.), 66 F.3d 1091, 1095–96 (9th Cir. 1995) (denying licensor administrative claim status because license agreement resembled sale and licensor provided no additional post-petition services to debtor); *In re* Kmart Corp., 290 B.R. 614, 621–22 (Bankr. N.D. Ill 2003) (denying licensor administrative claim status because licensor failed to show that it conferred benefit to bankruptcy estate).

[117] *See, e.g.*, *In re* Valley Media, Inc., 279 B.R. 105, 138 (Bankr. D. Del. 2002); *In re* Feyline Presents, Inc., 81 B.R. 623, 627 (Bankr. D. Colo. 1988) (noting that non-debtor could have forced debtor to assume or reject early on in case).

[118] *See In re* Collins & Aikman Corp., 384 B.R. 751, 763 (Bankr. E.D. Mich. 2008).

[119] *See* Interstate Gas Supply, Inc. v. Wheeling Pittsburgh Steel Corp. (*In re* Pittsburgh-Canfield Corp.), 283 B.R. 231, 238 (Bankr. N.D. Ohio 2002) (non-debtor party "cannot unilaterally elect to cease performance on an executory contract prior to its assumption or rejection"). *See also In re Feyline*, 81 B.R. at 626–27 (creditor exposed to suit for damages after post-petition unilateral suspension of agreement without seeking relief from automatic stay). *But see In re* Lucre, Inc., 339 B.R. 648, 662 (Bankr. W.D. Mich. 2006) ("[N]either Section 362 nor any other section of the Bankruptcy Code prohibits [a contracting party] from refusing to continue performance under . . . [an] agreement because of [the debtor contracting party's] alleged pre-petition breach of that agreement.").

III. ASSIGNMENT

There are generally no restrictions on a debtor-licensor's assignment of an IP license since the identity of the licensor is usually not critical from the licensee's perspective.[120] The debtor-licensor is generally free to assume or assume and assign its IP rights and, after the bankruptcy case is commenced, the automatic stay prohibits a non-debtor licensee from terminating the license.

A licensee who files for bankruptcy, on the other hand, may want to assign valuable IP licenses to unaffiliated third parties. For instance, a debtor selling substantially all of its assets in a section 363 sale may want to assign its IP license to the purchaser if the license is needed for the full use of the assets sold and its exclusion would otherwise depress the value of the other assets. In some circumstances, a debtor's IP licenses may be its principal or only assets.

As a preliminary matter, if a license agreement includes a provision that allows a licensee to assign its rights in the license to a third party, then the license may be assigned. However, license agreements are often either silent on the issue of assignability or include provisions that specifically prohibit a licensee from assigning its interest in the license.

In the case of most executory contracts, section 365(f) enables a debtor to assign an executory contract despite clauses in the contract that would otherwise prevent the debtor from doing so in the non-bankruptcy context. Section 365(f) provides, in relevant part:

> Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, *the trustee may assign such contract* or lease under paragraph 2 of this subsection.[121]

Anti-assignment clauses in executory contracts that bar assignments or require that the counterparty consent to any assignments to third parties are generally unenforceable against the debtor if the debtor provides adequate assurance of future performance.[122] Courts have also held that provisions which effectively restrict assignments are also unenforceable under section 365(f).[123]

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[120] However, this may not be the case where the licensor is obligated to develop and deliver software updates or other new IP.

[121] 11 U.S.C. § 365(f)(1) (2006) (emphasis added).

[122] *See id.* at § 365(f)(2).

[123] *See, e.g.*, Crow Winthrop Dev. Ltd. P'ship. v. Jamboree L.L.C. (*In re* Crow Winthrop Operating P'ship.), 241 F.3d 1121, 1124 (9th Cir. Cal. 2001) (looking "beyond the literal wording of a contractual provision to see whether it operates as a de facto anti-assignment clause in violation of § 365(f)"); *In re* Standor Jewelers W., Inc., 129 B.R. 200, 201–02 (B.A.P. 9th Cir. 1991) (lease provision requiring remittance to lessor of proceeds of assignment deemed invalid under section 365(f)); *In re* Peaches Records & Tapes, Inc., 51 B.R. 583, 590 (B.A.P. 9th Cir. 1985).

The debtor's ability to assign an executory contract is subject to sections 365(b) and (c). As noted above, section 365(b) requires a debtor who seeks to assume a defaulted executory contract to (i) cure any defaults or provide adequate assurances of a prompt cure and (ii) provide adequate assurance of future performance. This provision applies equally to a debtor who seeks to assign an executory contract because section 365(f)(2)(A) provides that a debtor must first "assume[] such contract . . . in accordance with the provisions of this section" before an assignment can occur.[124] Thus, a debtor is ordinarily free to assign an executory contract, notwithstanding any anti-assignment provisions in the contract, so long as it cures any defaults and provides adequate assurance of future performance.

Section 365(c) limits a debtor's ability to assume and assign an executory contract when "applicable law" gives the non-debtor counterparty the right to refuse to deal with a party other than the debtor and the non-debtor counterparty does not consent to the assumption and assignment.[125] In the context of ordinary executory contracts, courts interpret "applicable law" as general common law doctrines that excuse a counterparty from accepting or rendering performance to a third party because public policy or principles of equity override the principle of contract law that favors free assignability.[126] For instance, contracts for personal services that involve unique skills and talent are not freely assignable without the consent of the party receiving the service.[127] Other courts have restricted assignments of executory contracts where the identity of the contracting parties is material to the contract.[128] Additionally, applicable non-bankruptcy law may prevent the assignment of executory contracts when government regulations bar the assignment of particular contracts.[129]

In the IP context, a license that is silent on assignability is generally not

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[124] *See* 11 U.S.C. § 365(f)(2)(A).

[125] *Id.* at § 365(c)(1).

[126] *See* 3 RESTATEMENT (SECOND) OF CONTRACTS § 317(2) ("A contractual right can be assigned unless (a) the substitution of a right of the assignee for the right of the assignor would materially change the duty of the obligor, or materially increase the burden or risk imposed on him by his contract, or materially impair his chance of obtaining return performance, or materially reduce its value to him, or (b) the assignment is forbidden by statute or is otherwise inoperative on grounds of public policy, or (c) assignment is validly precluded by contract."). *See also* UCC § 2-210 (2012).

[127] *See, e.g.*, Tonry v. Hebert (*In re* Tonry), 724 F.2d 467, 469 (5th Cir. 1984); *In re* Adelphia Commc'ns Corp., 359 B.R. 54, 73 (S.D.N.Y 2006); *In re* Taylor, 103 B.R. 511, 516 n.3 (D.N.J. 1989); *In re* Lil' Things, Inc., 220 B.R. 583, 587–88 (Bankr. N.D. Tex. 1998); *In re* McVay, 169 B.R. 49, 51 (Bankr. W.D. Tenn. 1994); *In re* Catron, 158 B.R. 629 (E.D. Virginia 1993); *In re* Rooster, Inc., 100 B.R. 228, 233 (Bankr. E.D. Pa. 1989) ("Generally speaking, nondelegable duties have been determined to be of a personal nature whenever the performance depends upon a special relationship, special knowledge, or a unique skill, upon which the other party is entitled to rely.").

[128] *See* Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 752 (9th Cir. 1999); Rieser v. The Dayton Country Club Co. (*In re* Magness), 972 F.2d 689, 696 (6th Cir. 1992).

[129] *See, e.g.*, *In re* W Elecs. Inc., 852 F.2d 79, 83 (3d Cir. 1988) (discussing non-assignable government contract); *In re* Pioneer Ford Sales, Inc., 729 F.2d 27, 28–30 (1st Cir. 1984) (discussing franchise agreement where state law prohibited transfer without manufacturer's consent); *In re* Nitec Paper Corp., 43 B.R. 492, 497–98 (S.D.N.Y. 1984) (electricity supply contract).

assignable[130] because the general principle of free assignability of contracts is subordinated to public policy interests in promoting creativity and innovation by protecting the IP owner's right to control its IP and ensuring that the owner is appropriately paid for the use of the IP. Most courts have interpreted "applicable law" to refer to non-bankruptcy patent, copyright, trade secret, and trademark law, and have found that IP licenses are, for the most part, inherently non-assignable without the consent of the licensor. Consequently, an IP licensor who does not consent to an assignment by the debtor-licensee can usually prevent a debtor from assigning an IP license to a third party during a bankruptcy case. This is true even in the event that there is no language in the contract that explicitly restricts assignment.[131]

Consent to the assignment (and assumption) of an IP license can come in one of three ways: (1) the licensor affirmatively consents to the assignment in writing after a bankruptcy case has been filed; (2) the licensor fails to object after a motion has

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[130] *See* ZIFF & DEMING, *supra* note 58, at p. 2 (collecting cases).

[131] Some corporate transactions will trigger a change of control which may, in turn, cause an assignment of a license. For example, in a stock sale, only the target company's equity interests are transferred. As a result, while a stock sale may trigger a change of control provision, it generally will not cause an assignment of the target's license rights. *See* White v. Hitachi, Ltd., 2007 WL 2725888, at *6 (E.D. Tenn. Sept. 17, 2007). *See also* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 494 (1st Cir. 1997) (patent); PPG Indus., Inc. v. Guardian Indus. Corp., 597 F.2d 1090, 1097 n.2 (6th Cir. 1979); Review Directories Inc. v. McLeodUSA Publ'g Co., 2001 WL 1946328, at *2 (W.D. Mich. July 7, 2001) (trademark). In addition, a seller that attempts to sell IP rights licensed from a third party as part of an asset sale will breach the related license agreement to the extent that it prohibits the assignment. *See, e.g.*, McCullough v. Dairy Queen of Mich., Inc., 121 U.S.P.Q. 302, 302–04 (W.D. Mich. 1959) (holding that franchise agreement, which contained prohibition against transfer without trademark holders' consent, was valid and franchisee's purported sale and assignment without such consent was null and void). If, however, the license agreement is silent as to assignability, whether the licensee can assign its rights without consent may depend on, among other things, the type of IP at issue, the exclusivity of the grant, the intent of the parties, rules of contract interpretation and policy considerations. *See, e.g.*, *In re* Access Beyond Techs., Inc., 237 B.R. 32, 46 (Bankr. D. Del. 1999) ("Where the provisions of a patent license are silent on the question of assignability, the license is nontransferable."). Finally, whether a merger will result in an assignment depends on the structure of the merger and state merger statutes. Regarding the former, it is more likely that a forward merger, *i.e.* a merger in which the target merges into the acquirer, will be found to result in the assignment of the target's IP license agreements because the target will cease to exist as a separate entity following the merger. *See* Cincom Sys., Inc. v. Novelis Corp., 581 F.3d 431, 439–40 (6th Cir. 2009) (holding non-exclusive "non-transferable" license breached by forward merger of the licensee); M.D. Mark, Inc. v. Kerr-McGee Corp., 565 F.3d 753, 762–63 (10th Cir. 2009) (holding that non-transferable license protected as trade secret was breached by forward merger); PPG Indus., Inc. v. Guardian Indus. Corp., 597 F.2d 1090, 1096 (6th Cir. 1979) (holding that forward merger violated anti-assignment clause in non-exclusive patent license because transfer by operation of law is still assignment); Council of Better Bus. Bureaus, Inc. v. Better Bus. Bureau, Inc., 1999 WL 288669, at *3 (N.D.N.Y. Mar. 30, 1999) (finding that forward merger resulted in impermissible assignment of non-exclusive trademark license). Because the target survives a reverse merger, this type of merger is generally assumed not to violate non-assignment provisions in the target's contracts. *See, e.g.*, Forry, Inc. v. Neundorfer, Inc., 837 F.2d 259, 262 (6th Cir. 1988) (finding no transfer of copyright where owner was survivor of reverse merger). *But see* SQL Solutions, Inc. v. Oracle Corp., 1991 WL 626458, at *6 (N.D. Cal. Dec. 18, 1991) (finding that reverse merger violated non-assignment provision in non-exclusive copyright license); Meso Scale Diagnostics, L.L.C. v. Roche Diagnostics GMBH, 2011 WL 1348438, at *13 (Del. Ch. Apr. 8, 2011) (denying motion to dismiss and holding that reverse triangular merger may violate non-assignment clause).

been filed seeking to assume and assign the license agreement; or (3) the license agreement expressly permits assignment under certain circumstances, such as pursuant to a provision that allows assignment in conjunction with a sale of all or substantially all of the assets of the licensee.[132]

A. Strategic Considerations Relating to Assignment

Whether applicable non-bankruptcy law would excuse a licensor from rendering performance to or accepting performance from a party other than the debtor under section 365(c) requires a separate analysis of the rules of assignability in patent, copyright, and trademark law. To indicate that the IP license is non-assignable, the license should include a provision that specifically references section 365(c)(1) and its restriction on assignments, such as:

> *This license is a license of the type described in section 365(c)(1) of the Bankruptcy Code and may not be assigned without the prior consent of the licensor.*

In the alternative, a licensor can generally prevent a licensee from freely assigning an IP license that is personal to the licensee. Thus, a licensor can include in the license services that are personal to the licensee and specific information about the parties that makes the license resemble a personal service contract.

On the other hand, a licensee can seek a provision in the license agreement that specifically entitles the licensee to assign its interest in the IP license to third parties without the licensor's consent. The provision should specifically exempt the license from the restrictions imposed by section 365(c)(1), for instance:

> *If either party becomes a debtor or debtor-in-possession under the Bankruptcy Code, notwithstanding section 365(c) of the Bankruptcy Code or applicable non-bankruptcy law which prohibits, restricts or conditions the assignment of the Agreement or any of the rights therein, the debtor-in-possession or trustee in bankruptcy for such party may assume and assign this Agreement (upon cure of all monetary defaults and demonstration of adequate assurance of future performance).*

If the licensor does not agree to a broad assignability provision, the licensee should negotiate provisions that allow the licensee to freely assign its license to its affiliates and successors and in conjunction with a transfer of substantially all of its

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[132] *See* Robert L. Eisenbach III, Assumption of Intellectual Property Licenses in Bankruptcy: Are Recent Cases Tilting Toward Debtors? (2007), *available at* http://bankruptcy.cooley.com/2007/04/articles/business-bankruptcy-issues/assumption-of-intellectual-property-licenses-in-bankruptcy-are-recent-cases-tilting-toward-debtors/ (discussing ways licensor can consent to assignment of IP license).

assets. The licensee could also request a provision preventing the licensor from unreasonably withholding its consent to an assignment of the license.

B. Assignment of Patent Licenses

Patent rights are governed by title 35 of the United States Code (the "Patent Act").[133] The Patent Act governs three types of patents obtainable from the U.S. Patent and Trademark Office: utility patents,[134] plant patents,[135] and design patents[136] and generally provides a patent holder with a monopoly to exploit (or choose not to exploit) its patent for a fixed period of time.

The Patent Act does not explicitly prohibit or restrict the assignment of patent licenses. Upon the successful prosecution of a patent, the patent owner holds all rights in the patent.[137] This bundle of rights includes "the right to exclude others from making, using, offering for sale or selling" the patented invention.[138] A patent owner may issue a license for some or all of these rights or assign some or all of the patent to a third party.[139] The difference between a patent assignment and a patent license is that "an assignment of a patent is a transfer of an ownership interest in the patent and is specifically authorized and regulated by 35 U.S.C. § 261 [while a] license is an agreement allowing the licensee to use the patent but not transferring any ownership interest in the patent."[140]

A patent license is considered to be a form of personal property granted specifically to the licensee for the purpose of using the patent for a specified period of time without being liable to the patent owner for patent infringement within the scope of the license.[141] Courts have generally held that patent licenses are inherently non-assignable by the licensee under federal common law absent consent to the assignment by the patent owner,[142] and are deemed to be non-assignable unless there is an express provision in the license agreement that permits assignment.[143]

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[133] *See* 35 U.S.C. §§ 101 *et. seq.* (2006).
[134] *See id.* at §§ 101–105.
[135] *See id.* at §§ 161–164.
[136] *See id.* at §§ 171–173.
[137] *See id.* at § 261.
[138] *Id.* at § 154.
[139] *See id.* at § 261.
[140] Everex Sys., Inc. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 676 n.2. (9th Cir. 1996).
[141] *See id.* at 677 (citing De Forest Radio Tel. & Tel. Co. v. United States, 273 U.S. 236, 242 (1927)).
[142] *See In re* Alltech Plastics, Inc., 71 B.R. 686, 689 (Bankr. W.D. Tenn. 1987).
[143] *See* Lane & Bodley Co. v. Locke, 150 U.S. 193, 195–96 (1893); Hapgood v. Hewitt, 119 U.S. 226, 233–34 (1886); Oliver v. Rumford Chem. Works, 109 U.S. 75, 82 (1883) (declaring that "the instrument of [a patent] license is not one which will carry the right conferred to any one but the licensee personally, unless there are express words to show an intent to extend the right to an executor, administrator, or assignee, voluntary or involuntary"); Troy Iron & Nail Factory v. Corning, 55 U.S. 193, 216 (1852) (declaring that patent licenses are not assignable without owner's consent); *In re CFLC, Inc.*, 89 F.3d at 679–80 (holding that federal law governs assignability of non-exclusive patent licenses and that patent licenses are personal and assignable only with licensor's consent); Unarco Indus., Inc. v. Kelley Co., Inc., 465 F.2d 1303, 1306 (7th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973) (concluding that patent "monopoly conferred by federal statute as well as the policy perpetuating this monopoly, so affects the licensing of patents, and

The general prohibition against free assignability by licensees of patent licenses is consistent with the overarching policy inherent in federal patent law to provide patent owners with maximum control over their patents in an effort to promote invention and innovation. Allowing a patent owner the right to approve or refuse the assignment of a license to use the patent owner's IP enhances this control and limits the risk that the patent owner's license will be assigned to a competitor without the owner's consent.

1. Non-Exclusive Patent Licenses

Non-exclusive patent licenses are "personal" in nature and may not be assigned by a licensee unless permitted by the license.[144] A non-exclusive license provides the licensee with a limited right to use the patented technology and protects the licensee from being held liable for infringement of the patent; it does not confer on the licensee the right to distribute or sell the IP itself to third parties. Courts have almost uniformly held that non-exclusive licenses are not assignable in bankruptcy without the express consent of the licensor.[145]

In *Everex Systems, Inc. v. Cadtrak Corp.,* the Ninth Circuit explained the rationale for limiting the assignability of non-exclusive patent licenses as follows:

> The fundamental policy of the patent system is to "encourage the creation and disclosure of new, useful, and non-obvious advances in technology and design" by granting the inventor the reward of "the exclusive right to practice the invention for a period of years." . . . Allowing free assignability—or, more accurately, allowing states to allow free assignability—of non-exclusive patent licenses would undermine the reward that encourages invention because a

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the policy behind such licensing is so intertwined with the sweep of federal statutes, that any question with respect thereto must be governed by federal law" and upholding federal common law rule relating to non-assignability of patent licenses); *In re* Access Beyond Techs., Inc., 237 B.R. 32, 45 (Bankr. D. Del. 1999) (recognizing that "long standing federal rule of law with respect to the assignability of patent license agreements provides that these agreements are personal to the licensee *and not assignable unless expressly made so in the agreement*.") (emphasis added).

[144] *See* Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 750 (9th Cir. 1999), *cert. denied*, 528 U.S. 924 (1999); *In re CFLC, Inc.*, 89 F.3d at 679 (*quoting* Gilson v. Republic of Ireland, 787 F.2d 655, 658 (D.C. Cir. 1986) ("It is well settled that a non-exclusive licensee of a patent has only a personal and not a property interest in the patent and that this personal right cannot be assigned unless the patent owner authorizes the assignment or the license itself permits assignment."); PPG Indus., Inc. v. Guardian Indus. Corp., 597 F.2d 1090, 1093 (6th Cir. 1979); Murray v. Franke-Misal Techs Grp., (*In re* Supernatural Foods, L.L.C.), 268 B.R. 759, 804 (Bankr. M.D. La. 2001) (holding where license "is pro-assignment, applicable law must be such that performance or acceptance of performance would be excused regardless of the consent to transfer in the contract for the provisions of § 365(c) to apply"); *In re Access Beyond Techs., Inc.*, 237 B.R. at 45; *In re Alltech Plastics*, 71 B.R. at 689 ("Given that the rights pursuant to a patent license are personal and nonassignable, it seems logical to conclude that the duties thereunder are also personal and nondelegable.").

[145] *See, e.g.*, *Perlman*, 165 F.3d at 754–55; *In re CFLC, Inc.*, 89 F.3d at 680 (non-exclusive pre-paid patent license not assignable in bankruptcy).

> 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. And while the patent holder could presumably control the absolute *number* of licenses in existence under a free-assignability regime, it would lose the very important ability to control the *identity* of its licensees. Thus, any license a patent holder granted—even to the smallest firm in the product market most remote from its own—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.[146]

2. Exclusive Patent Licenses

Exclusive patent licenses typically confer both property rights and personal rights on the licensee. Whether a patent license is exclusive depends on the nature and the extent of the rights that the licensee is granted under the license and the ownership rights retained by the licensor. A patent license is considered exclusive if it grants the licensee "rights which go beyond the rights granted in a non-exclusive patent license."[147] While an exclusive license generally grants the licensee full ownership and control of an undivided share of the patent, exclusivity can also be limited in terms of geography, time, or type of use.[148]

Both bankruptcy and non-bankruptcy courts have been inconsistent regarding whether to allow the assumption and assignment of exclusive patent licenses.[149] Certain bankruptcy courts have been somewhat liberal in permitting the assignment of exclusive licenses. For instance, one bankruptcy court has held an exclusive license agreement that prevented the licensor from withholding consent under certain conditions allowed the licensee to assign the license under those conditions without seeking further consent from the licensor.[150] Other courts have interpreted a

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[146] *In re CFLC, Inc.*, 89 F.3d at 679.

[147] *In re* Hernandez, 285 B.R. 435, 439 (Bankr. D. Ariz. 2002) ("A nonexclusive license simply grants the licensee the privilege of being protected from an infringement claim by the licensor.").

[148] *See* Amgen, Inc. v. Chugai Pharm. Co., 808 F. Supp. 894, 899–900 (D. Mass. 1992) (indicating limits on exclusivity).

[149] *See, e.g.*, *In re Hernandez*, 285 B.R. at 439 (holding that exclusive license does not give licensee freely transferable equitable ownership interest).

[150] *See* Murray v. Franke-Misal Techs. Grp., (*In re* Supernatural Foods, L.L.C.), 268 B.R. 759, 805 (Bankr. M.D. La. 2001) (upholding transfer of exclusive license rights under asset purchase agreement where licensor's express written consent was not required for transfers incident to sale of substantial portion of licensee's assets: "[t]he requirement that applicable law can be analyzed without regard to, or independent of, the language in the contract does not apply to language that allows assignment or provides the consent to assignment").

license that is silent on the issue as permitting assignment.[151] For example, in *Superbrace, Inc. v. Tidwell*, the court held that state law, not federal common law, should be applied when deciding whether a patent license is assignable and concluded that "the contractually obtained right to mass-produce and sell aluminum motorcycle parts is not of a personal nature" and therefore the license to practice the patent was assignable.[152]

Other courts have taken a more restrictive approach and have held that exclusive patent licenses are not assignable without the licensor's consent.[153] As one court explained, the exclusivity of a patent license does not necessarily make it freely assignable because "[s]uch 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 which carefully distinguishes between the two."[154] In *In re Hernandez*, the bankruptcy court construed three license agreements, which granted three different entities the rights to manufacture and sell products produced using the patented technology, to be exclusive licenses.[155] The court concluded that because the licensees had the right to issue sublicenses to third parties, the licenses were exclusive (even though the agreements prohibited outright assignment).[156] The court also noted that while an exclusive license confers to a licensee standing to enforce the patent, it does not alone afford the right to assign the patent, as licensors have a vested interest in determining the identity of their licensees.[157] The justification for allowing the free transferability of an exclusive patent license is that such a license confers rights akin to those conferred through an

[151] *See* Superbrace, Inc. v. Tidwell, 124 Cal. App. 4th 388, 405 (Cal.App. 4 Dist. 2004) (applying California contract law and finding contractual rights of exclusive patent licensee were not of personal nature and were therefore assignable without licensor's consent); Farmland Irrigation Co. v. Dopplmaier, 308 P.2d 732, 740 (Cal. 1957) (holding rights under contract (including those associated with patent licenses) are freely transferable absent terms or purpose in contract showing that it was meant to be non-assignable). *But see In re CFLC, Inc.*, 89 F.3d at 679 ("[F]ederal law governs the assignability of patent licenses because of the conflict between federal patent policy and state laws, such as California's, that would allow assignability."); Verson Corp. v. Verson Int'l Grp., 899 F. Supp. 358, 363 (N.D. Ill. 1995) ("We seriously doubt whether these decisions [including the Farmland decision] survive the later developed line of cases refusing to imply a right of assignability of patent licenses. Even if some vestige of Farmland and Bowers remains, we cannot overlook decades of precedent to the contrary. . . . Therefore, we feel bound to require compelling evidence of the parties' intent before implying a right to assign.").

[152] *Superbrace*, 124 Cal. App. 4th at 404–05.

[153] *See, e.g.*, Rhone-Poulenc Agro, S.A. v. DeKalb Genetics Corp., 284 F.3d 1323, 1328 (Fed. Cir. 2002) ("[C]ourts generally have acknowledged the need for a uniform national rule that patent licenses are personal and non-transferable in the absence of an agreement authorizing assignment, contrary to the state common law rule that contractual rights are assignable unless forbidden by an agreement."); *In re Hernandez*, 285 B.R. at 439–40 (applying federal patent law and distinguishing between assignments and licenses and holding that exclusive licenses do not give licensees equitable ownership interest that is freely transferable); *In re* Access Beyond Techs., Inc., 237 B.R. 32, 46 (Bankr. D. Del. 1999) ("Where the provisions of a patent license are silent on the question of assignability, the license is nontransferable.").

[154] *In re Hernandez*, 285 B.R. at 439–40.

[155] *See id.*

[156] *See id.* at 437.

[157] *See id.* at 439–40.

assignment of the patent.[158] However, the Federal Circuit has held that "an exclusive patent license may be tantamount to an assignment of title to the patent . . . only when 'the licensee holds "all substantial rights" under the patent.'"[159] Thus, any limits on the assignability of rights in a patent license weigh in favor of finding that a licensee holding an exclusive license has less than "all substantial rights."[160] If the license is tantamount to an assignment, the license is unlikely to be executory.

In many jurisdictions, however, the issue of the assignability of exclusive patent licenses has yet to be decided.[161]

C. Assignment of Copyright Licenses

The Copyright Act[162] governs copyrights and aims to protect "original works of authorship fixed in any tangible medium of expression," which can include literary works, musical works, dramatic works, pantomimes and choreographic works, pictorial, graphic, and sculptural works, motion pictures and other audiovisual works, sound recordings, architectural works, and software.[163] A copyright grants the copyright owner the exclusive right to reproduce, distribute, publicly perform, publicly display, and prepare derivative works based on the copyrighted material.[164] The copyright owner may issue licenses to third parties to use the copyrighted material.[165]

1. Non-Exclusive Copyright Licenses

Several courts have generally imported the principle of non-assignability absent

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[158] *See* Ortho Pharm. Corp. v. Genetics Inst., Inc., 52 F.3d 1026, 1031 (Fed. Cir. 1995) ("To have co-plaintiff standing in an infringement suit, a licensee must hold some of the proprietary sticks from the bundle of patent rights, albeit a lesser share of rights in the patent than for an assignment and standing to sue alone.").

[159] *Rhone Poulenc Agro, S.A.*, 284 F.3d at 1334 (quoting Textile Prods., Inc. v. Mead Corp., 134 F.3d 1481, 1484 (Fed. Cir. 1998)). *See* Intellectual Prop. Dev., Inc. v. TCI Cablevision of Cal., Inc., 248 F.3d 1333, 1345 (Fed. Cir. 2001) (observing exclusive licensee receives more substantial rights in patent than non-exclusive licensee, but receives fewer rights than assignee of all substantial patent rights).

[160] *See* Prima Tek II, L.L.C. v. A-Roo Co., 222 F.3d 1372, 1379–80 (Fed. Cir. 2000). *See also* Pfizer Inc. v. Elan Pharm. Research Corp., 812 F. Supp. 1352, 1373 (D. Del. 1993) (express prohibition on assignment of patent license without patent holder's consent, among other factors, precluded finding that agreement was "assignment"); Raber v. Pittway Corp., No. C–91–2399–JPV, 1992 WL 219016, at *3 (N.D. Cal. May 4 1992) (same). *But see* Aluminum Co. of Am. v. Norton Co., Civ.A. No. 91–547, 1993 WL 330628, at *2 (W.D. Pa. May 21 1993) (express prohibition on assignment of exclusive patent license without consent does not prevent finding of grant of "all substantial rights" in subject patent thus allowing licensee to sue infringers without licensor as co-party).

[161] *See, e.g.*, Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 750 n.3 (9th Cir. 1999), *cert. denied*, 528 U.S. 924 (1999) ("[W]e express no opinion regarding the assignability of *exclusive* patent licenses under federal law . . . .").

[162] *See* 17 U.S.C. §§ 101–122 (2006).

[163] *See id.* at § 102(a).

[164] *See id.* at § 106.

[165] *See id.* at § 201(d).

the licensor's consent from patent law to the copyright context,[166] holding that a non-exclusive copyright license "is personal to the transferee . . . and the licensee cannot assign it to a third party without the consent of the copyright owner."[167] Like a non-exclusive patent license, a non-exclusive copyright license does not grant the licensee any ownership interest in the copyrighted work and thus may not be assigned.[168] Similar to the policy of protecting the rights of the patent owner, the prohibition against the free assignment of copyright licenses is intended to preserve the full scope of rights granted by the Copyright Act to copyright owners, including controlling the identity of their licensees without fearing that, in the event that a licensee files for bankruptcy, their copyrighted work could be sold to the highest bidder.

2. Exclusive Copyright Licenses

Unlike the Patent Act, the Copyright Act specifically defines "transfer of copyright ownership" to include an exclusive copyright license. "Transfer of copyright ownership" is defined as "an assignment, mortgage, exclusive license, or any other conveyance, alienation, or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license."[169]

Rights in a copyright are divisible. Section 201(d)(2) of the Copyright Act provides that "[a]ny of the exclusive rights comprised in a copyright, including any subdivision of any of the rights specified by section 106 [of the Copyright Act], may be transferred . . . and owned separately."[170] A copyright license is deemed to be exclusive where the licensor cannot issue additional licenses and does not retain the right to control the copyrighted material.[171] For instance, in *In re Golden Books II*, the licensor was prohibited from transferring any rights in the copyrighted material to any other parties.[172] The licensee had (1) "the sole, full, and complete

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[166] *See* Harris v. Emus Records Corp., 734 F.2d 1329, 1333 (9th Cir. 1984) (quoting Sony Corp. of Am. v. Universal City Studios, Inc., 464 U.S. 417, 439 (1984)) ("Where precedent in copyright cases is lacking, it is appropriate to look for guidance to patent law 'because of the historic kinship between patent law and copyright law.'"); *In re* Patient Educ. Media, Inc., 210 B.R. 237, 243 (Bankr. S.D.N.Y. 1997) (holding that "conclusion [in Everex dealing with patent licenses] applies with equal force in the analogous area of copyright law").

[167] *In re Patient Educ. Media, Inc.*, 210 B.R. at 240. *See Harris*, 734 F.2d at 1333–34 (based on 1909 Copyright Act); Michaels v. Internet Entm't Grp., 5 F. Supp. 2d 823, 834 (C.D. Cal. 1998); SQL Solutions, Inc. v. Oracle Corp., No. C-91-1079, 1991 WL 626458, at *6 (N.D. Cal. Dec. 18, 1991); *In re* Golden Books I, 269 B.R. 300, 311 (Bankr. D. Del. 2001) (debtor may not assume or assign non-exclusive copyright licenses without licensor's consent).

[168] *See In re Patient Educ. Media, Inc.*, 210 B.R. at 240–41 (noting licensee may not assign to third party without consent of copyright owner).

[169] 17 U.S.C. § 101.

[170] *Id.* at § 201(d)(2).

[171] *See In re Golden Books II*, 269 B.R. at 314–16. ("[T]he licensor cannot transfer the same rights to anyone else.").

[172] *See id.* at 315.

discretion concerning the manufacture, distribution, marketing, and other exploitation of [the copyrighted material]," (2) "the sole and exclusive right to negotiate and enter into contracts with respect to [the copyrighted material]," and (3) "the right to use and authorize others to use [the copyrighted material]."[173]

Although the plain language of the Copyright Act suggests that exclusive copyright licenses convey an ownership interest of the licensed copyright and, consequently, licensees should be able to transfer such licenses, courts are split on whether exclusive copyright licenses may be assigned.[174] Some courts have held that a licensee holding an exclusive copyright license may transfer the license without the consent of the copyright owner because the provisions of the Copyright Act grant the holder of an exclusive license all the rights and protections of the copyright owner.[175] In *In re Golden Books II*, the court explained that the assignability of a copyright license turns on whether it is exclusive or non-exclusive, and held that an exclusive copyright license of a children's book character was assignable by the debtor.[176] The court in *In re Patient Education Media, Inc.* further suggested that an exclusive license may be assignable without the licensor's consent, even if there is an express restriction on assignments in the license agreement.[177]

Other courts have disagreed, holding that even an exclusive copyright license is not assignable without the licensor's consent unless there is an express provision in the agreement to the contrary.[178] In *Gardner v. Nike*, the Ninth Circuit held that all

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[173] *Id.*

[174] *Compare* Gardner v. Nike Inc., 279 F.3d 774, 779–80 (9th Cir. 2002) (refusing, under federal common law, to allow copyright licensee to transfer its rights under exclusive copyright license without consent), *with In re* Golden Books II, 269 B.R. at 311, 314 ("[A]n exclusive licensee does acquire property rights and 'may freely transfer his rights . . . .'").

[175] *See In re Golden Books II*, 269 B.R. at 314; *In re* Patient Educ. Media, Inc., 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997).

[176] *See In re Golden Books II*, 269 B.R. at 314.

[177] *See In re Patient Educ. Media, Inc.*, 210 B.R. at 240 (holding exclusive licensee is entitled to "all the rights and protections of the copyright owner to the extent of the license" and may therefore freely transfer license). *See also* Traicoff v. Digital Media, Inc., 439 F. Supp. 2d 872, 878–89 (S.D. Ind. 2006) (holding exclusive copyright license freely assignable, stating court's interpretation in *Gardner* of "protection and remedies" inconsistently encompasses some, but not all, of owner's rights under Copyright Act); *In re Golden Books II*, 269 B.R. at 317–19 (holding exclusive copyright license freely assignable and declining to follow Gardner v. Nike, Inc., 110 F. Supp. 2d 1282 (C.D. Cal. 2000), because "protections and remedies" includes all rights of owner that are transferred, including right to assign); *In re* GT Brands Holding L.L.C., No. 05–15167 (PCB), 2005 WL 3763535, *2–3 (Bankr. S.D.N.Y. Sept. 2, 2005) (stating "[t]he case law states that in a bankruptcy case, nonexclusive licenses may not be assigned but exclusive licenses [sic] can be assigned. The definition of exclusive and non-exclusive seem somewhat paradoxical. However, an exclusive license is one which gives exclusive right in any aspect of the copyright. In this case, the agreements . . . give an exclusive right to use the films in a specified territory for a specified period of time. That is sufficient to constitute and [sic] exclusive license. Therefore the court concludes that both license [sic] are exclusive and can be assigned.") (citations omitted).

[178] *See, e.g.*, Gardner v. Nike, Inc., 279 F.3d 774, 780 (9th Cir. 2002) (holding that Copyright Act grants exclusive licensees "protections and remedies" of copyright owners, not rights to assign). *See also* Cadsoft Corp. v. Riverdeep, L.L.C., 2007 WL 1462394, *5–6 (N.D. Cal. May 18, 2007) (finding licensor's consent must be "explicit, or express"; implied consent is not sufficient to make license assignable).

"copyright licenses (whether exclusive or not) were 'not transferable as a matter of law.'"[179] The court read the Copyright Act narrowly and held that only the owner of the copyright could apportion and subdivide its interest in the copyright, while an exclusive licensee was granted only the "protection and remedies" of the Copyright Act.[180] The court further emphasized that the policy of protecting the copyright owner mandated this interpretation because free assignability by a copyright licensee would undermine the copyright holder's ability to control its IP and would counteract the policy of promoting continued creativity.[181] The *Gardner* court viewed the issue of assignability as one of federal, not state, law.[182]

D. Trademark Licenses

The Lanham Act[183] governs and protects trademarks, which are defined as "any word, name, symbol or device, or any combination thereof."[184] Unlike patent and copyright laws, trademarks laws are consumer protection statutes. A trademark is an indicator of the source of goods and services. It represents the goodwill of that source without which it has no significance for its underlying use in commerce.[185] Thus, a trademark cannot be sold or assigned apart from the goodwill it symbolizes.[186] The Lanham Act does not address the assignability of trademark licenses, and a direct analogy to patent and copyright law is inappropriate in light of the different policies behind patent and copyright law on the one hand, and trademark law on the other.

As discussed above, the protection of patents and copyrights stems from an effort to promote innovation. The protection of trademarks, however, is rooted in the need to ensure the integrity of the marketplace, and to prevent consumer confusion as to the source of goods and services and unfair competition that is based on such confusion. To further this policy goal, a trademark owner has the duty to police the use of its trademark by licensees and to control the quality of the

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[179] *Gardner*, 279 F.3d at 777–78.

[180] *See id.* at 779–80.

[181] *See id.* at 781. *See also Cadsoft Corp*., 2007 WL 1462394, at *2 ("The policy implications supporting the express consent requirement are strong.") (citing *Gardner*, 279 F.3d at 781); Miller v. Glenn Miller Prods., 318 F. Supp. 2d 923, 937 (C.D. Cal. 2004) (applying policy rationales cited by Ninth Circuit in *Harris* and *Gardner* with equal force to sub-licensing of trademarks).

[182] *See Gardner*, 279 F.3d at 781 n.5 ("Both parties agree that state law controls issues of contractual interpretation, including agreements that pertain to copyrighted material, *unless state law interferes with federal copyright law* or policy.") (emphasis added).

[183] *See* 15 U.S.C. §§ 1051 *et seq.* (2006) ("Lanham Act").

[184] *Id.* at § 1127.

[185] *See* Premier Dental Products Co. v. Darby Dental Supply Co., 794 F.2d 850, 853 (3d Cir. 1986) (explaining that trademarks symbolize public's confidence in products).

[186] *See* 15 U.S.C. § 1060(a)(1) ("A registered mark or a mark for which an application to register has been filed shall be assignable with the good will of the business in which the mark is used, or with that part of the good will of the business connected with the use of and symbolized by the mark."). *See also* Ph. Schneider Brewing Co. v. Century Distilling Co., 107 F.2d 699, 703 (10th Cir. 1939) (stating trademark cannot be assigned in gross, or separate and apart from goodwill with which it is associated).

goods and services sold under its trademark.

While it is not clearly established that a trademark licensor could refuse to accept performance by a party other than the licensee, the ongoing duties imposed on the trademark owner have led most courts addressing this issue to hold that a trademark license, whether exclusive or non-exclusive, is not assignable without the consent of the licensor.[187] For instance, in *N.C.P. Mktg. Group, Inc. v. Blanks (In re N.C.P. Mktg. Grp.),* the court explained that "because the owner of the trademark has an interest in the party to whom the trademark [license] is assigned so that it can maintain the goodwill, quality, and value of its products and thereby its trademark, trademark rights are personal to the assignee and not freely assignable to a third party."[188] A provision in a trademark license agreement stating that the trademark owner's consent to transfer "shall not be unreasonably withheld" does not absolve the licensee from seeking consent from the licensor for an assignment and does not preemptively ensure the licensor's consent.[189] The Seventh Circuit recently held that a licensee may not assign a trademark license in a bankruptcy case over the licensor's objection unless there is an express provision in the license which authorizes such assignment.[190] However, the court also held that a service agreement relating to the production of trademarked goods, but not expressly stated to be a trademark license, was fully assignable in bankruptcy.[191]

IV. REJECTION & SECTION 365(N) OF THE BANKRUPTCY CODE

Thus far, this article has focused primarily on IP issues applicable to a debtor-*licensee*. Issues related to rejection arise when the debtor is the *licensor*. In such cases, the debtor-licensor's right to reject licenses of its IP is curbed by section 365(n), which (in very general terms) provides the non-debtor-licensee with the

[187] *See In re* N.C.P. Mktg. Grp., 337 B.R. 230, 236–37 (D. Nev. 2005) *aff'd*, 279 F. App'x 561 (9th Cir. 2008) (holding non-exclusive trademark license not assignable without licensor's consent); *In re* Travelot Co., 286 B.R. 447, 455 (Bankr. S.D. Ga. 2002) (stating trademark owner must intend to grant license in trademark in order for trademark license to exist); 4 J. Thomas McCarthy, McCarthy on Trademarks and Unfair Competition, § 25.33 (Rel. 49, 3/2009) ("Without specific authorization from the trademark owner, the licensee's right to use the licensed mark is personal and cannot be assigned to another."). *But see In re* Global Home Prods., LLC, No. 06-10340-KG, 2006 WL 2381918, at *1 (D. Del. Aug. 17, 2006) (agreeing with finding that exclusive trademark license was not personal services contract and was freely assignable); *In re* Rooster, Inc., 100 B.R. 228, 232–34 (Bankr. E.D. Pa. 1989) (stating licensing agreement was not contract for personal services and was therefore assignable).

[188] *In re N.C.P. Mktg. Grp.*, 337 B.R. at 236.

[189] *In re* Wellington Vision, Inc., 364 B.R. 129, 136 (S.D. Fla. 2007) (stating clause against unreasonable consent withholding is not same as expressly allowing assignment without consent).

[190] *See In re* XMH Corp., 647 F.3d 690, 695 (7th Cir. 2011); c*f. In re Rooster, Inc.*, 100 B.R. at 234 (concluding that exclusive sublicensing agreement to use "Bill Blass" trade name and trademark on neckties manufactured by debtor was not "personal services contract" and therefore could be assumed and assigned under section 365).

[191] *See In re XMH Corp.*, 647 F.3d at 697–98 ("If [licensor] wanted to prevent [licensee] from assigning the service contract to another firm without [licensor]'s permission, all it had to do was get [licensee] to agree to designate the contract as a trademark sublicense, thus triggering the default rule that we have discussed and endorsed.").

option to continue paying royalties due under the license and thereby retain the right to use the debtor's IP. Ordinarily, when a debtor rejects an executory contract (provided that the rejection is approved by the court), the rejection is treated as a breach by the debtor that terminates the non-debtor's obligations under the contract. However, when a debtor-licensor seeks to reject a license of patents, copyrights or trade secrets, the licensee has the right to keep the license in place. Importantly, section 365(n) does not apply to trademarks and most foreign IP.

A. Business Judgment and Court Approval

The purpose of allowing a debtor to reject executory contracts is to enable the debtor to assume only those contracts which are beneficial to reorganizing its business and to release the debtor from continuing obligations under contracts that do not provide any benefit to the debtor's post-bankruptcy estate. A debtor may choose to retain contracts it deems profitable or valuable, while rejecting those which are unnecessary, costly or damaging. The ability to reject executory contracts is one of the most powerful rights afforded to a debtor in bankruptcy and generally aids greatly in the debtor's successful reorganization.

Courts apply the business judgment test to evaluate whether to approve a debtor's decision to reject an executory contract.[192] Under this test, rejection is a management decision (made by the trustee or debtor-in-possession) within the reasonable business judgment of the debtor and will not be lightly second-guessed by the court.[193] A court will generally defer to the debtor's decision and deny the rejection only if it determines that rejecting the contract would be detrimental to the estate.[194]

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[192] *See In re* Chi-Feng Huang, 23 B.R. 798, 800 (B.A.P. 9th Cir. 1982).

[193] *See id.* at 800.

[194] *See, e.g.*, *In re* Midwest Polychem, Ltd., 61 B.R. 559, 562 (Bankr. N.D. Ill. 1986) (denying rejection where decision to reject made no business or equitable sense); *In re* Myklebust, 26 B.R. 582, 585 (Bankr. W.D. Wis. 1983) (denying rejection of contract where benefits of rejection were speculative). Some courts will also deny a rejection if the debtor has an improper purpose. *See, e.g.*, Shell Oil Co. v. Waldron (*In re* Waldron), 785 F.2d 936, 940–41 (11th Cir. 1986) (where debtor filed chapter 13 case solely to reject option agreement, court dismissed petition as bad faith attempt to "use and abuse Chapter 13 for a greedy and unworthy purpose"). Some courts have also refused to authorize rejection where rejection was expected to have a disproportionate impact on the non-debtor party in comparison to any asserted benefit to the bankruptcy estate. *See, e.g.*, Infosystems Tech, Inc. v. Logical Software, Inc., Civ. A. No. 87–0042, 1987 WL 13805, at *2 (D. Mass. June 25, 1987) (holding that court may disallow rejection of contract if it finds non-debtor counterparty "would be damaged disproportionately to any benefit to be derived by general creditors" from rejection); *In re* Matusalem, 158 B.R. 514, 522 (Bankr. S.D. Fla. 1993) (denying rejection where rejection would provide no economic advantage to debtor and would eviscerate debtor's franchisee); *In re* Petur U.S.A. Instrument Co., Inc., 35 B.R. 561, 563 (Bankr. W.D. Wash. 1983) (denying request to reject license agreement which, if granted, would destroy non-debtor's business). *But see* Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1046–48 (4th Cir. 1985) (declining to consider "obvious adverse consequences" for non-debtor counterparty resulting from debtor's decision to reject contract); *In re* Federated Dep't Stores, Inc., 131 B.R. 808, 811–12 (S.D. Ohio 1991) (criticizing test articulated in Chi-Feng Huang as improperly considering effect of rejection on non-debtor party).

B. Section 365(n): Protecting the Non-Debtor Licensee

Section 365(n) represents an exception to the general rule that a debtor may freely reject an executory contract under its rejection powers, and operates to shield the non-debtor licensee or sublicensee from the consequences of the debtor's rejection.[195] However, section 365(n) applies only when the debtor-licensor rejects the license. Section 365(n) is not implicated when it is the licensee (or sublicensee) that files for bankruptcy and rejects an IP license.

Under section 365(n), a licensee whose IP license[196] is rejected by a debtor-licensor has two options: (1) treat the debtor's rejection as termination of the license and assert a claim for rejection damages, or (2) retain its rights to use the IP as they existed as of the filing of the bankruptcy petition.[197] Importantly, section 365(n) only applies to "intellectual property" as defined in the Bankruptcy Code, which excludes trademarks and certain foreign IP.[198]

If the licensee chooses to retain its rights to the IP under the license agreement, then it may continue to use the licensed IP according to the terms of the license.[199] In exchange for these rights, the licensee is required to continue to make all royalty payments due under the license agreement[200] and must waive its right of setoff and any administrative claims against the bankruptcy estate arising from performance of the license agreement.[201]

The licensee does not retain all of its rights under the license, but instead has a specific set of rights provided by the Bankruptcy Code. These rights include: (a) continued use of the IP as it existed at the time of the filing of the bankruptcy case for the duration of the license agreement plus any period for which the license may be extended by the licensee under applicable non-bankruptcy law;[202] and (b) entitlement to enforce exclusivity provisions against the debtor and any successor entity contained in the license.[203] Section 365(n) does not otherwise impose continuing obligations on the debtor or its successors. Thus, for example, a

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[195] *See generally* 11 U.S.C. § 365(n) (2006).

[196] *See In re* Spansion, Inc., 2012 U.S. App. LEXIS 26131, *7 (3d. Cir. Dec. 21, 2012) (finding covenant not to sue in settlement agreement constituted IP license that was protected by section 365(n)). *See also* De Forest Radio Tel. & Tel. Co. v. United States, 273 U.S. 236, 242 (1927) (defining license as "a mere waiver of the right to sue by the patentee").

[197] *See* Eastover Bank for Sav. v. Sowashee Venture (*In re* Austin Dev. Co.), 19 F.3d 1077, 1082–83 (5th Cir. 1994) (discussing option of contract rejection); *In re* Prize Frize, Inc., 150 B.R. 456, 459 (B.A.P. 9th Cir. 1993) (discussing licensee options); *In re* Sandman Assocs., L.L.C., 251 B.R. 473, 481 n.15 (W.D. Va. 2000) (describing effects of section 365); *In re* Bergt, 241 B.R. 17, 24, 26 (Bankr. D. Alaska 1999) (describing section 365 in context of intellectual property); *In re* Locke, 180 B.R. 245, 259 (Bankr. C.D. Cal. 1995) (describing option of contract rejection).

[198] *See* 11 U.S.C. § 101(35A).

[199] *See id.* at § 365(n)(1)(B).

[200] *See id.* at § 365(n)(2)(B).

[201] *See id.* at § 365(n)(2)(C).

[202] *See id.* at § 365(n)(1)(B).

[203] *See id.*

software licensee would not retain the right to receive any modifications, updates, maintenance services or the like.

An important requirement of section 365(n) is that the licensee must make an affirmative election to (a) accept the rejection and treat the license as terminated, or (b) retain rights under the IP license. The licensee may be deemed to have waived its option to retain its rights under the IP license unless this affirmative election is made. In *In re EI International,* the bankruptcy court found that when the non-debtor licensee failed to make an election to retain its rights under a rejected IP license promptly, the licensee was presumed to consider the rejection as a termination of the license agreement and, consequently, was left with only the right to assert a claim for rejection damages.[204]

Thus, it is important for a non-debtor licensee to assert its election to retain its rights under the IP license promptly following rejection. To maximize its rights in the IP, a licensee should require detailed provisions in the license agreement that delineate the licensee's rights and provide renewal and extension options. To protect the licensee's interests in the IP, the license agreement could further provide that a mere failure by the licensee to assert the retention of its rights under section 365(n) is not a termination of the licensing agreement without an affirmative act by the licensee, although the extent to which such a provision would influence a court considering the issue is unclear.

C. Effect of Rejection as Breach and Rejection Damages

If a debtor is permitted to reject an executory contract, the rejection is deemed a breach of the contract.[205] Upon rejection, the non-debtor party is entitled to seek and recover breach of contract damages (rejection damages) from the estate.[206] Except for compensation owed to the licensor for use of the IP during the bankruptcy, which will constitute administrative claims, rejection damages are treated as pre-petition unsecured claims under section 502(g), which have a relatively low priority in bankruptcy and generally will not be paid in full.[207] Moreover, if the rejection damages claim is unliquidated, the licensee may have to further litigate to establish the amount of its claim. If the licensee chooses to treat the contract as

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[204] *See In re* EI Int'l, 123 B.R. 64, 67 (Bankr. D. Idaho 1991).

[205] *See In re* Drexel Burnham Lambert Grp., 138 B.R. 687, 708 (Bankr. S.D.N.Y. 1992) ("Rejection's effect is to give rise to a remedy in the non-debtor party for breach of the rejected contract."); 3 COLLIER ON BANKRUPTCY, ¶ 365, at 365–79 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) ("[T]he effect of rejection . . . is limited to a breach or abandonment by the trustee or debtor in possession rather than a complete termination."); Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. COLO. L. REV. 845 (1988).

[206] *See In re Drexel Burnham Lambert Grp.*, 138 B.R. at 708 ("right to money damages assertable as a general unsecured claim"); *In re* Picnic 'N Chicken, Inc., 58 B.R. 523, 529 (Bankr. S.D. Cal. 1986) (holding section 502 not to limit damage claim for breach of financing lease).

[207] *See* 11 U.S.C. § 502(g); *In re Picnic 'N Chicken, Inc.*, 58 B.R. at 529 (identifying general unsecured claim for damages resulting from termination of lease as one component of lessor's damages).

terminated,[208] then it is no longer entitled to use the IP provided under the license. Because the administrative claim portion may not be the amount provided in the contract (rather the court determines the value of administrative claims), and the rejection damages claim generally will have a relatively low payment priority under the Bankruptcy Code, a licensee may wish to secure the licensor's performance of its license by perfecting a security interest in the underlying IP.

D. Policy Motivations and the Emergence of Section 365(n)

The decision of a debtor-licensor to reject an IP license can have significant consequences for a non-debtor licensee who has already invested in the IP. Prior to 1988, the Bankruptcy Code did not explicitly address IP.[209] The impetus for section 365(n) emerged in the aftermath of a Fourth Circuit decision, *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc*.[210] In *Lubrizol*, the court held that if an IP license agreement is rejected by a debtor-licensor, the licensee could not use the licensed property or seek specific performance of the contract.[211] The court upheld the rejection as a valid exercise of the debtor's business judgment.[212] The licensee's only remedy then was to file a claim for damages, while the debtor was free to license its technology to others.

The loss of the ability to utilize an IP license can be catastrophic if the licensee has already invested substantial assets in the IP or if its business relies on the continued validity of the license. In an effort to remedy the consequences of *Lubrizol* and protect IP licensees that could otherwise be harmed by this holding, Congress added section 365(n) to the Bankruptcy Code.

In explaining the addition of section 365(n), Congress noted that the *Lubrizol* holding "had a chilling effect on licenses of intellectual property and that businesses are becoming reluctant to rely on licensed technology knowing that the license could be taken away if the licensor files bankruptcy. Licensees sometimes use the licensed technology as the basis for an entire business."[213] Section 365(n) was enacted to "correct[] the perception of some courts that section 365 was ever intended to be a mechanism for stripping innocent licensee[s] of rights central to the operation of their ongoing business,"[214] notwithstanding the fact that other contract parties are routinely stripped of their bargained-for rights under section 365. The legislative purpose of this section is "to make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a

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[208] *See* 11 U.S.C. § 365(n)(1)(A).

[209] *See* H.R. REP. NO. 100-1012, at 6 (1988) (adding "new subsection to section 365 of the Bankruptcy Code to provide special treatment for executory intellectual property licenses").

[210] *See* Lubrizol Enters. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1044 (4th Cir. 1985).

[211] *See id.* at 1048.

[212] *See id.* at 1047–48.

[213] H.R. REP. NO. 100-1012, at 6 (1988).

[214] S. REP. NO. 100-505, at 4 (1988).

result of the rejection of the license pursuant to section 365 in the event of the licensor's bankruptcy."[215] Since its enactment, the Ninth Circuit has recognized that "[s]ection 365(n) has struck a fair balance between the interests of the bankrupt and the interests of a licensee of the bankrupt's intellectual property" by precluding the debtor from "terminat[ing] and strip[ping] the licensee of rights the licensee had bargained for."[216] However, section 365(n)'s limited application means that other contract rights are routinely stripped from non-debtor counterparties to other types of executory contracts.

E. Debtor-Licensor's Release From Affirmative Obligations

While the debtor-licensor cannot interfere with the licensee's rights if it elects to retain the license under section 365(n),[217] upon rejection, regardless of the licensee's choice, the debtor-licensor is released of all affirmative obligations under the license agreement save for the covenant not to sue the licensee for infringement and violations of the license's exclusivity provisions. For instance, the licensor need not continue to provide maintenance, technology updates, upgrades, consultation, help, or other services. In addition, the licensee cannot require the debtor-licensor to defend the licensee against infringement actions.[218] Section 365(n) only requires the "performance of covenants requiring no action by the trustee [that] impose no burden on the estate and result in equity to the nonbreaching party and certainty to the economy as a whole."[219]

In drafting section 365(n), Congress distinguished between the debtor-licensor's "passive obligations" and "affirmative performance."[220] Passive obligations include refraining from interfering with the licensee's exercise of its rights under the license and allowing the licensee to access existing IP.[221] Congress eliminated the debtor-licensor's affirmative performance owed to the non-debtor licensee because it reasoned that the trustee would not be in a position to perform these duties for lack of specialized skill and knowledge.[222] In its report, the Senate explained:

> [Section 365 (n)(2)] represents a careful compromise between the needs of the debtor and the licensee. The licensee requires retention of its rights, even exclusive rights. No longer can the debtor expect to sell these rights through rejection. The debtor's ability to reorganize may depend upon preservation of the royalty payments called for under the contract, free of offset or

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[215] *Id.* at 1.
[216] Encino Bus. Mgmt., Inc., v. Prize Frize, Inc. (*In re* Prize Frize, Inc.), 32 F.3d 426, 428 (9th Cir. 1994).
[217] *See* 11 U.S.C. § 365(n)(B)(3) (2006).
[218] *See* S. REP. NO. 100-505, at 9 (1988).
[219] *Id.* at 8.
[220] *Id.*
[221] *See id.*
[222] *See id.* at 8–9.

> administrative claims which could similarly defeat the right to royalty payments. The bill accomplishes this, but leaves unaffected the licensee's rights under section 365(g), so that a general claim for damages, if any, from rejection can be asserted by the licensee.[223]

Although IP license agreements sometimes purport to cover IP that has yet to be created, section 365(n) does not protect an IP licensee's interest in future IP. Section 365(n) specifically states that it protects a licensee's rights to IP "as such rights immediately existed before the case commenced."[224] Thus, a licensee's right to new or updated IP does not vest until such IP is created or updated. For instance, in *Szombathy v. Controlled Shredders, Inc.*, the court held that the debtor-licensor was not obligated to provide the licensee with improvements to the debtor's patented tire shredders because they were created after the date the debtor-licensor's bankruptcy petition was filed and thus were not part of the bankruptcy estate.[225] The licensee's decision to retain its copyright or patent license rights does not obligate the debtor-licensor to update the IP, or even to provide the licensee with a finished version of the IP in the event that the IP license agreement was consummated prior to the licensor's completion of the IP. This limitation may create serious problems for the licensee where the licensed IP is in the process of being created, such as a partially completed record, book, movie, or software application. It may even render an IP licensee's ability to retain the IP license in spite of the debtor-licensor's rejection—a hollow victory if the licensee is ultimately unable to obtain the final version of the IP it intended to obtain through its paid license.

To address these concerns, a licensee should negotiate provisions in the license agreement that address bankruptcy contingencies. The agreement should provide that, in the event the licensor files for bankruptcy, the licensor will provide the licensee with any IP and any embodiments of that IP held by the licensor. This will provide added protection to the licensee as section 365(n)(3)(A) requires that the debtor provide to the licensee, upon written request and if the licensee elects to retain its rights after the license is rejected, any IP or embodiments "to the extent provided in" the license or any supplemental agreement.

A licensee could further seek to protect itself by requiring the licensor to place the IP and any supporting information and technology into a technology escrow that would release the IP to the licensee upon the licensor's failure to perform or bankruptcy filing. For instance, software escrows are sometimes utilized to ensure that a licensee can continue to service and maintain licensed software if the licensor ceases operations or fails to update the software.[226] In a typical arrangement, the

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[223] *Id.* at 10.

[224] 11 U.S.C. § 365(n)(1)(B) (2006).

[225] *See* Szombathy v. Controlled Shredders, Inc., No. 97 C 481, 1997 WL 189314, at *3 (N.D. Ill. Apr. 14, 1997).

[226] Escrow agreements are generally enforceable so long as certain formalities are followed, including that: (a) the escrow agent is a neutral third party who ideally specializes in administering technology escrow accounts; (b) the source code escrow agreement is a written contract that clearly identifies the property to be

licensor places the source code and related documentation in escrow for the term of the license, and may also have obligations to provide updates. The source code is released to the licensee when the escrow agent receives notice of an event requiring such release and the licensee is permitted to use the source code to maintain its licensed software. Access rights should permit the licensee to gain access to escrowed source code deposited by a debtor after it files for bankruptcy pursuant to section 365(n)(3). Whether a bankruptcy court will enforce an escrow structure under the anti-forfeiture provisions of section 541(c) of the Bankruptcy Code, or will find that transfers of the escrowed property to the licensee are not subject to avoidance under sections 544(a), 547 and 548 of the Bankruptcy Code, is not clearly established and will depend on the structure of the escrow.[227]

The license agreement should also allow the licensee to provide IP information to third parties without violating nondisclosure or exclusivity provisions in the event that the licensor rejects the license and the licensee has to hire third party vendors for support, maintenance, or development tasks previously performed by the licensor.

F. Royalty Payments to the Licensor

A licensee who elects to continue to use IP pursuant to section 365(n) subsequent to the debtor-licensor's rejection of the IP license is required to continue to pay royalties to the licensor for the use of the IP.[228] Section 365(n)(2)(B) provides that an IP licensee "shall make all *royalty* payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract."[229]

A license agreement may differentiate between various types of fees, but a court may not always follow the designation of fees described in the license agreement. Most notably, in *In re Prize Frize II*, the court held that the term "royalty payments" should be construed broadly to include any payment due to the licensor for the licensee's use of the IP, regardless of the characterization or description of the specific fee in the license agreement.[230] The court rejected the licensee's argument that it should be required to make only payments based on the percentage of the licensee's revenues that were designated as "royalty payments" under the license

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placed in escrow, establishes the conditions under which the source code is to be released, and clearly defines the permissible uses for the source code upon release; and (c) the source code is delivered to the escrow agent and documented such that the bankruptcy court will be able to distinguish the escrowed property from the debtor's other assets. *See, e.g.*, *In re* O.P.M. Leasing Servs. Inc., 46 B.R. 661, 667 (Bankr. S.D.N.Y. 1985); *In re* Chesapeake Assoc. L.P., 141 B.R. 737, 745 (Bankr. D. Kan. 1992) (holding escrow to be ineffective because escrow agent was agent of party and not neutral third party).

[227] For a detailed discussion of software escrows in bankruptcy, *see* THOMAS M. WARD, INTELLECTUAL PROPERTY IN COMMERCE §§ 4:57–63, 108–09 (2011–2012 ed.).

[228] *See* 11 U.S.C. § 365(n)(2)(B).

[229] *Id.* (emphasis added).

[230] *See* Encino Bus. Mgmt., Inc., v. Prize Frize, Inc. (*In re* Prize Frize, Inc.), 32 F.3d 426, 428 (9th Cir. 1994).

agreement.[231] Instead, the court, in upholding the decision of the Bankruptcy Appellate Panel, also required the licensee to continue to pay the fixed license fee required by the license agreement.[232] The Bankruptcy Appellate Panel explained its decision as follows:

> It is important that courts, in construing the term "royalty" used in this subsection, and in deciding what payments are royalty payments, look to the substance of the transaction and not the label. The underlying nature of the payments must be considered. For example, payments based upon the use of intellectual property or on a percentage of sales of end products that incorporate or are derived from the intellectual property should be treated as royalty payments.[233]

However, the court noted that if the license agreement had specified that the license fee was payable in exchange for performance obligations by the licensor, such as warranties, indemnification, maintenance, or upgrades, which the licensor was no longer obligated to continue performing, then the licensee should have been relieved of its obligation to continue paying the license fee.[234] To buttress its reasoning, the court referenced the legislative history of section 365(n), which recognizes that the licensee is not bound by requirements "so directly related to obligations or duties that the licensor has been freed from by rejection as to make it inequitable to bind the licensee to them."[235]

As a practical matter, an IP license frequently includes several different types of fees, which the licensee owes to the licensor in addition to royalties. Because section 365(n) obligates a licensee who chooses to retain a license to make "royalty payments," the license agreement should clearly delineate the types of fees owed to the licensor, identifying the fees that compensate the licensor for services and other obligations as opposed to fees that are unequivocally royalties. These designations may be important to a licensee who, pursuant to a lump sum structure, may otherwise be required to pay for services, such as upgrades and maintenance, on an ongoing basis (which the post-petition licensor is no longer required to provide), while the payment "for the use of the IP" was made up-front.

A licensee choosing to retain its license is deemed to waive "any right of setoff it may have with respect to such contract under [the Bankruptcy Code] or applicable non-bankruptcy law."[236] This provision prevents the licensee from seeking to reduce its payment obligations to the licensor for damages incurred as a result of the

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[231] *Id.* at 428–29.
[232] *See id.*
[233] *In re* Prize Frize, Inc., 150 B.R. 456, 459–460 (B.A.P. 9th Cir. 1992) (citing H.R. REP. NO. 1012 at 9, 100th Cong., 2d Sess. (1988)).
[234] *See id.* at 460.
[235] *Id.* at 460 n.9 (citing H.R. REP. NO. 1012 at 7, 100th Cong., 2d Sess. (1988)).
[236] 11 U.S.C. § 365(n)(2)(C) (2006).

licensor's bankruptcy filing and allows the debtor-licensor to maximize revenue from the use of its IP.[237]

G. The Limitations of Section 365(n)

Section 365(n) applies solely to "intellectual property" as defined by section 101(35A), which provides:

> The term "intellectual property" means—
> (A) trade secret;
> (B) invention, process, design, or plant protected under title 35;
> (C) patent application;
> (D) plant variety;
> (E) work of authorship protected under title 17; or
> (F) mask work protected under chapter 9 of title 17;
> to the extent protected by applicable non-bankruptcy law.[238]

To ensure that an IP license is protected by section 365(n), the license should define the IP at issue in terms that would satisfy the Bankruptcy Code's definition of IP under section 101(35A). Notably absent from this list are foreign IP and trademarks.

1. Section 365(n) May Not Protect Licensees of Foreign IP

Because of section 101(35A)'s specific references to "invention, process, design, or plant protected under title 35," and "work of authorship protected under title 17,"[239] licensees of foreign patents and copyrights may be excluded from the protections of section 365(n). To the extent such foreign IP is not protected by section 365(n), the considerations with respect to rejection of trademark licenses may be applicable.

With respect to patents, the Bankruptcy Code definition of intellectual property covers any "patent application," as well as any "invention, process, design, or plant protected under title 35," in each case, as protected by non-bankruptcy law.[240]

It is unclear whether this definition refers to property actually protected under title 35 (which would mean a patent issued in the United States) or an "invention, process, design, or plant" of the type that is protectable under title 35. A narrow reading would lead to the anomalous result that foreign patent applications would

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[237] *See* S. REP. NO. 100-505, at 10 (1988).
[238] 11 U.S.C. § 101(35A).
[239] *Id.* at § 101(35A)(B), (E).
[240] *See* Patterson v. Shumate, 504 U.S. 753, 758 (1992) (stating there is "no limitation on 'applicable nonbankruptcy law' relating to the source of the law"). *See also*, *In re* Probulk Inc., 407 B.R. 56, 61 (S.D.N.Y. 2009) (extending applicable non-bankruptcy law to contracts governed by U.K. law).

be within the Bankruptcy Code's definition of intellectual property, but foreign patents would not be. This issue has not been directly addressed by the courts; however, while there is no express intent in the legislative history to exclude foreign patents (whereas trademarks were expressly excluded), most courts touching on the issue appear to have assumed that foreign patents would not be protected by section 365(n),[241] even though the legislative intent underlying section 365(n)—to achieve stability in intellectual property licensing for American businesses—may suggest that licenses of foreign patents should be included.[242]

With respect to copyrights, the definition of intellectual property is similarly limited to any "work of authorship protected under title 17."[243] However, the Copyright Act provides somewhat broader protection, covering (a) in the case of unpublished works, while unpublished, works otherwise covered by sections 102 and 103 of the Copyright Act, "without regard to the nationality or domicile of the author," and (b) in the case of published works, works authored by a national or domiciliary of, or first published in, the United States or a nation that is a treaty party.[244] Accordingly, the universe of foreign copyrights protected under title 17 may be larger than patent rights protected under title 35.

2. Section 365(n) and Chapter 15 Cases

When cases under chapter 15 of the Bankruptcy Code are brought in the United States, but foreign laws are applied, a question arises as to the effect of section 365(n). Chapter 15 cases are designed to facilitate cross-border restructurings and insolvency proceedings. In these proceedings, the laws governing the foreign main proceeding will be applied in the U.S. chapter 15 case, which allows the "foreign representative," who acts on behalf of the international debtor, to request that the bankruptcy court apply certain provisions of the Bankruptcy Code to the chapter 15 case, including section 365.[245] If applicable foreign laws do not include a provision equivalent to section 365(n), and the foreign representative does not request that section 365 apply, a non-debtor licensee's ability to retain its license may be curtailed.

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[241] *See In re* Qimonda AG, 462 B.R. 165, 186 (Bankr. E.D. Va. 2011) (stating section 365(n) need not be applied to non-U.S. patents).

[242] *See* S. REP. NO. 100-505, at 5, 7 (1988) ("The bill in no way defines or alters any substantive intellectual property law, it merely refers to those rights that are already protected by applicable nonbankruptcy law"). *See also*, Ward, *supra* note 227, at § 4:102 (finding it unlikely that Congress meant to exclude foreign patents).

[243] 11 U.S.C. §§ 101(35A), 1521(a).

[244] 17 U.S.C. §§ 104(a), (b)(2) (per 17 U.S.C. § 101, "treaty party" is defined as "a country or intergovernmental organization other than the United States that is a party to an international agreement." An "international agreement" is defined as: "(1) the Universal Copyright Convention; (2) the Geneva Phonograms Convention; (3) the Berne Convention; (4) the WTO Agreement; (5) the WIPO Copyright Treaty; (6) the WIPO Performances and Phonograms Treaty; and (7) any other copyright treaty to which the United States is a party.").

[245] *See* 11 U.S.C. § 101(24).

This issue was recently addressed in *In re Qimonda AG*.[246] Qimonda commenced insolvency proceedings in Germany as well as a chapter 15 case in the U.S.[247] The German proceeding was recognized as the "foreign main proceeding" for purposes of chapter 15.[248] Initially, the foreign representative requested that section 365 of the Bankruptcy Code apply in Qimonda's chapter 15 proceeding.[249] However, when Qimonda's licensees tried to invoke section 365(n), the foreign representative asked for a supplemental order opting out of section 365, requesting that the court instead apply section 103 of the German Insolvency Code (which does not have a corollary to section 365(n)).[250] The court initially allowed the foreign representative to opt out of section 365(n), reasoning that application of section 365 of the Bankruptcy Code would significantly undermine section 103 of the German Insolvency Code dealing with the treatment of executory contracts in German insolvency proceedings, and held that applying section 365 to IP in the U.S. would defeat the purposes of chapter 15 of the Bankruptcy Code.[251]

On appeal, the district court identified two issues to be resolved on remand: (i) whether limiting the applicability of section 365(n) appropriately balanced the interests of the debtor and the licensees as required by section 1522(a), and (ii) whether granting comity to German insolvency law would be "manifestly contrary to the public policy of the United States" within the meaning of section 1506.[252] On remand, the bankruptcy court revised its ruling to permit the application of section 365(n) to licensees of the foreign debtor's U.S. patents.[253] The court based its revised ruling on a concern that "failure to apply § 365(n) under the circumstances in *this* case and *this* industry would 'severely impinge' an important statutory protection accorded licensees of U.S. patents and thereby undermine a fundamental U.S. public policy promoting technological innovations. For that reason . . . deferring to German law . . . would be manifestly contrary to U.S. public policy."[254] The court also determined that a balancing of debtor and creditor interests weighed in favor of the application of section 365(n) since the U.S. patents could still be licensed to parties that do not already have a license and because the licensees had already made very substantial investments in research and manufacturing facilities in the U.S. in reliance on the licenses.[255]

Thus, while section 365(n) generally provides protections for licensees of U.S. IP in U.S. bankruptcy proceedings, unless other courts follow *Qimonda*, licensees remain at risk when licensing IP from international companies. In addition, it is not clear whether the reasoning of *Qimonda* would apply had the foreign representative

[246] *See In re* Qimonda AG, No. 09-14766-RGM, 2009 WL 4060083 (Bankr. E.D. Va., Nov. 19, 2009).
[247] *Id.* at *1.
[248] *See* 11 U.S.C. § 101(23).
[249] *See In re Qimonda*, 2009 WL 4060083, at *1.
[250] *See id.* at *1–2.
[251] *See id.* at *1–2.
[252] *In re* Qimonda AG Bankruptcy Litigation, 433 B.R. 547, 558, 571 (E.D. Va. 2010).
[253] *See In re* Qimonda AG, 462 B.R. 165, 182 (Bankr. E.D. Va. 2011).
[254] *Id.* at 185 (emphasis added).
[255] *See id.* at 182–83.

not initially request that section 365 apply to the chapter 15 case.[256]

3. Trademark Licensees Are Not Explicitly Protected by Section 365(n)

Trademark licensees are *not* explicitly protected from the consequences of a debtor-licensor's rejection of a trademark license by section 365(n) because trademarks are not included in section 101(35A)'s definition of IP (however, trademark licenses are covered by the Bankruptcy Code's provisions concerning assumption and assignment of IP).[257] The exclusion of trademarks from the Bankruptcy Code's definition of IP appears to be intentional. According to the legislative history of section 365, Congress explained that it specifically did not address trademarks when it enacted section 365(n) because:

> such contracts raise issues beyond the scope of [the] legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.[258]

Several courts have held that trademark licensees are not protected under section 365(n).[259] This result leaves trademark licensees with pre-petition claims for damages caused by the rejection (as with any other non-IP executory contract), while allowing the debtor-licensor to sell its trademark free and clear of the licensee's interests in the trademark under the license agreement.

However, despite its exclusion from the Bankruptcy Code's definition of IP, a

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[256] Section 1506 provides that nothing in chapter 15 prevents the court from refusing to take an action governed by chapter 15 if the action is "manifestly contrary to the public policy of the United States." 11 U.S.C. § 1506 (2006). In addition, section 1522(a) allows the court to grant, modify or terminate relief under sections 1519 and 1521. Under these provisions, the court had the authority not to apply section 365(n) when interested parties were not adequately protected. However, under sections 1519 and 1521, most Bankruptcy Code provisions, including section 365, may only be applied at the foreign representative's request. Accordingly, had the foreign representative not opted in to section 365 in the first instance, it is not clear whether the court would have had the authority to apply section 365(n) to the chapter 15 proceeding on its own.

[257] *See In re* Dynamic Tooling Sys., Inc., 349 B.R. 847, 856 (Bankr. D. Kan. 2006) (noting that "trademarks are not 'intellectual property'"). *See also In re* Centura Software Corp., 281 B.R. 660, 673–74 (Bankr. N.D. Cal. 2002) (noting that trademarks are not protected by section 365(n)).

[258] S. REP. NO. 100-505, at 5 (1988).

[259] *See* Licensing by Paolo, Inc. v. Sinatra (*In re* Gucci), 126 F.3d 380, 394 (2d Cir. 1997) (concluding trademarks are not intellectual property for purposes of section 365(n)); *In re* Old Carco L.L.C., 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009) ("Trademarks are not 'intellectual property' under the Bankruptcy Code."); *In re Centura Software Corp.*, 281 B.R. at 674 ("§ 365(n) plainly excludes trademarks"); *In re* Blackstone Potato Chip Co., 109 B.R. 557, 562 (Bankr. D.R.I. 1990) (approving rejection and ordering return of trademarks and trade names to debtor).

few courts have noted that section 365(n) may extend to cover trademarks when the trademarks are bundled with other protected IP.[260] In *In re Matusalem*, the debtor-licensor sought to reject an agreement with a sub-franchisee which held the exclusive right to use the debtor's secret formula to produce and distribute rum products and use the debtor's trademark label.[261] The court noted that the rejection would "utterly destroy" the franchisee's business and ultimately decided that the debtor-licensor's decision to reject the agreement did not pass the business judgment test.[262]

In *In re Exide Technologies*, the Third Circuit held that the debtor-licensor could not reject a trademark license because the trademark licensee had substantially performed the license in the more than ten years since it was signed and the perpetual, exclusive and royalty free license was no longer executory.[263] In his concurring opinion, Judge Ambro noted that Congress intended to allow the development of "equitable treatment" of trademark licenses and concluded that courts could use their equitable powers to deny a debtor-licensor's efforts to reject a trademark license.[264] In August 2012, in *In re Interstate Bakeries Corporation*, the Eighth Circuit distinguished *Exide* and held that the trademark licensee's continuing obligations under the license, including to maintain the character and quality of the goods sold under the licensed trademarks, and the licensor's continuing obligations under the license, including to forbear from using the trademarks in a specified territory, were material obligations that rendered the prepaid, perpetual exclusive trademark license at issue executory and subject to rejection.[265] The court rejected the licensee's argument that the license was an integral part of a completed acquisition of a line of business, that the acquisition was fully performed and that the license was not an executory contract.[266]

In July 2012, in another trademark license case, the Seventh Circuit, in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,[267] affirmed a bankruptcy court ruling holding that a trademark licensee could continue to use a

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[260] *See In re* Matusalem, 158 B.R. 514, 515 (Bankr. S.D. Fla. 1993) (noting section 365(n) applies to intellectual property of secret formula and trademark). *See also In re Centura Software Corp.*, 281 B.R. at 671–72 (licensees "'must assert their rights early in the case, before the franchisor [licensor] receives court approval of its rejection decision' . . . licensees must at that time persuade the bankruptcy court to weigh the equities and not to reject the agreement because its trademarks are integrally linked to other intellectual property" that is protected by section 365(n)).

[261] *See In re Matusalem*, 158 B.R. at 519.

[262] *See id.* at 522.

[263] *See In re* Exide Techs., 607 F.3d 957, 963–64 (3d Cir. 2010).

[264] *See id.* at 967–68 ("Courts may use §365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not-as occurred in this case-use it to let a licensor take back trademark rights it bargained away. This makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve.").

[265] *See* Lewis Bros. Bakeries Inc. v. Interstate Brands Corp. (*In re* Interstate Bakeries Corp.), 690 F.3d 1069, 1075 (8th Cir. 2012).

[266] *See id.* at 1075–76.

[267] Sunbeam Prods., Inc. v. Chi. Am. Mfg., L.L.C., 686 F.3d 372, 377 (7th Cir. 2012) (citing Thompkins v. Lil' Joe Records, Inc., 476 F.3d 1294, 1306 (11th Cir. 2007)).

trademark after the contract licensing the trademark to the licensee was rejected by the debtor-licensor.[268] The *Sunbeam* court held that rejection "merely frees the estate from the obligation to perform" and "has absolutely no effect upon the contract's continued existence."[269] While the Bankruptcy Court used its equitable powers to protect the licensee's trademark rights,[270] the Court of Appeals noted that "[o]utside of bankruptcy, a licensor's breach does not terminate a licensee's right to use intellectual property," and focused on the fact that rejection of a contract is treated as a *breach* by the rejecting party; rejection does not give rise to termination or rescission.[271] The *Sunbeam* decision creates a circuit split with the Fourth Circuit's *Lubrizol* opinion and the Eighth Circuit's *Interstate Bakeries* decision regarding the treatment of trademark licenses following rejection; under *Lubrizol* and *Interstate Bakeries*, the licensor would be permitted to bring suit against the licensee for unauthorized use of the trademark following rejection of the license, whereas the *Sunbeam* decision expressly states that rejection of the license does not terminate the licensee's rights. The *Sunbeam* decision may also have broader implications for licenses not protected by section 365(n), as well as other executory contracts.

Therefore, although the exclusion of trademarks from the ambit of section 365(n) may jeopardize the rights of a non-debtor licensee upon rejection by a debtor, a trademark licensee may also seek to protect itself by bundling trademark rights with copyright or patent licenses, which are protected under section 365(n). Additionally, courts may be willing to use their equitable powers to avoid harm to the trademark licensee, or under the *Sunbeam* decision, rejection may not inhibit the licensee's continued use of the trademark. However, until the circuit split created by *Sunbeam*, *Lubrizol* and *Interstate Bakeries* is resolved, a trademark licensee should consider protecting its interests in an IP license by (1) explicitly establishing a transition period in the license agreement, and (2) taking a security interest in the IP, both discussed in detail below.

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[268] *See In re* Lakewood Eng'g & Mfg. Co., 459 B.R. 306, 347 (Bankr. N.D. Ill. 2011) ("[I]nstead, this court uses its equitable powers to ensure that [the licensee] is not stripped of its 'fairly procured trademark rights.'").

[269] *Sunbeam Prods.*, 686 F.3d at 377.

[270] *See In re Lakewood Eng'g & Mfg. Co*., 459 B.R. at 347 ("[I]nstead, this court uses its equitable powers to ensure that [the licensee] is not stripped of its 'fairly procured trademark rights.'").

[271] *See Sunbeam Prods.*, 686 F.3d at 376–77 ("What §365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. The debtor's unfulfilled obligations are converted to damages; when a debtor does not assume the contract before rejecting it, these damages are treated as a pre-petition obligation, which may be written down in common with other debts of the same class. But nothing about this process implies that any rights of the other contracting party have been vaporized. Consider how rejection works for leases. A lessee that enters bankruptcy may reject the lease and pay damages for abandoning the premises, but rejection does not abrogate the lease (which would absolve the debtor of the need to pay damages). Similarly a lessor that enters bankruptcy could not, by rejecting the lease, end the tenant's right to possession and thus re-acquire premises that might be rented out for a higher price. The bankrupt lessor might substitute damages for an obligation to make repairs, but not rescind the lease altogether.") (citing NLRB v. Bildisco & Bildisco, 465 U.S. 513, 531 (1984); Midway Motor Lodge of Elk Grove v. Innkeepers' Telemanagement & Equip. Corp., 54 F.3d 406, 407 (7th Cir. 1995)).

a. Transition Period for Phasing Out the Licensee's Use of a Trademark Upon Rejection of the Trademark License

Although several courts have denied protection under section 365(n) to trademark licensees, courts have granted certain licensees of rejected trademark licenses a "transition period" to phase out their use of the trademark in at least two reported cases.

In *In re HQ Global Holdings, Inc.*, a franchisor-debtor sought to reject license agreements with its franchisees.[272] The franchisor was a full-service office space lessor and issued licenses to franchisees granting them exclusive rights to use "certain trade names, trademarks, service marks, logos, emblems, insignia, and other indicia of origin."[273] The court held that the debtor-franchisor had the right to reject the license agreements because "trade names, trademarks, and other proprietary marks are expressly excluded from the definition of 'intellectual property.'"[274] However, the court granted the request by the franchisees for a "transition period" during which they could still use the licensor's trademark for the purpose of "phasing out the Franchisees' use of the marks."[275] The court noted that "[t]here is no authority for any transition period," but granted the licensees a thirty-day transition period nonetheless.[276]

In *In re Exide Technologies*, the debtor-licensor had granted an exclusive, royalty-free license to use its trademark in the course of selling substantially all of its industrial battery division to the licensee.[277] During its chapter 11 case, the debtor sought to reject the trademark license agreement.[278] The court held that the debtor exercised appropriate business judgment and allowed the debtor to reject the license agreement in order to re-acquire "the right to use the mark in whatever capacity or market in which use by the licensor was previously excluded and extinguishing the licensee's right to use it."[279] However, the court also approved a two-year "transition period" for the benefit of the licensee, reasoning that "it is appropriate to fashion a transition period to mitigate any potential damage and business disruption that [the licensee] may suffer as a result of losing the [trade] mark."[280] In determining the length of the transition period, the court relied on a provision in the trademark license agreement executed by the parties that stated: "upon termination of this Trademark License, Licensee and its sublicensees shall, within a reasonable period of time not to exceed two (2) years, discontinue all use

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272 *See In re* HQ Global Holdings, Inc., 290 B.R. 507, 508 (Bankr. D. Del. 2003).
273 *Id.* at 509.
274 *Id.* at 513.
275 *Id.* at 514.
276 *Id.* (stating court rejected franchisees' request for ten month long transition period through end of year and granted thirty day period instead based on debtor-franchisor's recommendation).
277 *See In re* Exide Techs. 340 B.R. 222, 227 (Bankr. D. Del. 2006) (explaining nature of agreements between parties).
278 *See id.*
279 *Id.* at 250.
280 *Id.*

of the Licensed Marks and Licensee shall discontinue all use of the Licensed Trade Name."[281] The court deemed the length of this transition period to be reasonable "given the fact that both parties, who are highly sophisticated businesses, agreed upon such time-frame after much negotiation and, presumably, careful consideration in the course of their arm's-length transaction."[282] Although the court's ruling in *Exide* was ultimately overturned when the Third Circuit held that the trademark license was not an executory contract,[283] the lower court's utilization of a transition period may be instructive in other cases where trademark licenses are rejected.

Thus, a trademark licensee should negotiate for the inclusion of a "transition period" in any trademark license that will provide it with a sufficient amount of time to reasonably accomplish the transition away from use of the trademark without undue damage to the licensee's business. As noted in *Exide*, a period of up to two years has been deemed reasonable.[284] Without such a provision in the license agreement, a licensee risks being awarded a very short transition period or no transition period at all.

b. Acquiring a Security Interest to Secure Licensor's Obligations

To protect its interest in the IP, a licensee may wish to obtain and perfect a security interest in the IP to which it holds a license. Given the unprotected status of a trademark license, this protection is of particular value to a trademark licensee since it may have to rely on other means besides section 365(n) to protect its trademark license rights. If a licensee acquires a security interest in the IP and the licensor subsequently files for bankruptcy, the licensee (as a lien holder) has standing to seek relief from the automatic stay and foreclose on the IP. The existence of a security interest will also reduce the licensor's incentive to reject the license in bankruptcy because the rejection will cause the licensee to suffer rejection damages that are secured by the IP. Thus, even if the licensor rejects the license, any revenue the licensor realizes from relicensing or selling the IP will be applied toward the satisfaction of the licensee's secured claim for damages.

A security interest in IP that is perfected pre-petition (and not subject to avoidance) survives even if a debtor-licensor chooses to reject the IP license in the course of its bankruptcy.[285] Because of gaps and issues of preemption between federal IP laws (the Patent Act, the Copyright Act and the Lanham Act) and recording systems and state laws and recording systems (*e.g.*, the Uniform Commercial Code), there are important nuances to creating and perfecting security

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[281] *Id.* at 251 n.42.

[282] *Id.* at 251 n.43.

[283] *See In re* Exide Techs., 607 F.3d 957, 962 (3d Cir. 2010) (holding that purchaser had substantially performed its obligations under the agreement and thus it was not considered an executory contract).

[284] *See In re Exide Techs.*, 340 B.R. at 250–51.

[285] *See* Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp., 143 B.R. 360, 374 (D. Md. 1992) (assignment of patent as security non-executory), *aff'd*, 8 F.3d 817 (4th Cir. 1993).

interests in IP collateral that have led to increased costs and risks for lenders and other parties extending credit or entering into transactions based on IP assets.[286] For example, "courts routinely have held that the Lanham Act does not displace [the Uniform Commercial Code's] filing requirements."[287] Thus, recording security interests in trademarks with only the United States Patent and Trademark Office and not also with the applicable state recording office, has created a "trap for the unwary."[288]

Perfection of security interests in IP is beyond the scope of this article. However, in general: (i) security interests in patents and trademarks are typically perfected by UCC Article 9 filings under applicable state law;[289] (ii) security interests in registered copyrights must be recorded in the United States Copyright Office to be perfected;[290] and (iii) security interests in unregistered IP are perfected by UCC Article 9 filings, although such perfection may be jeopardized if the IP, particularly a copyright, is subsequently registered.[291] While perfection of security interests in IP can be complicated, these complexities should not deter an IP licensee from perfecting a security interest in the IP through appropriate federal and UCC Article 9 filings.

H. The Impact of Section 365(n) on a Section 363 Sale

When a debtor-licensor rejects a copyright or patent license and the licensee elects to retain its rights under the license pursuant to section 365(n), the licensee should not assume that its interest in the IP and its rights under the IP license are secure. In the event that the debtor-licensor engages in a section 363 asset sale, an IP licensee may find itself dispossessed of its rights in the IP.

The case law on the intersection between section 363 and section 365(n) is very sparse. Section 365(h) protects a lessee and tenant in possession from being dispossessed of its lease when a lessor files for bankruptcy and rejects the unexpired lease pursuant to section 365. Similarly, section 365(n) of the Bankruptcy Code protects an IP licensee from being dispossessed of its rights under a license agreement in the event that the IP licensor chooses to reject the license agreement. Given the similarities between section 365(h) and section 365(n), courts have

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[286] *See* 21 NORTON J. BANKR. L. & PRAC. 1 at 87 & 89 (2012).

[287] *Id.* at 86 (collecting cases).

[288] *See In re* Together Dev. Corp., 227 B.R. 439, 441 (Bankr. D. Mass. 1998) (holding security interest in trademark invalid by reason of lack of perfection).

[289] For patents and registered trademarks, filing with the United States Patent and Trademark Office, while not strictly necessary for perfection, puts subsequent bona fide purchasers, licensees and secured parties on notice of the licensee's security interest and is therefore advisable. *See In re* Peregrine Entm't Ltd. v. Capitol Fed. Sav. & Loan Ass'n of Denver, 116 B.R. 194, 203 (C.D. Cal. 1990) (holding recording in U.S. Copyright Office, rather than filing under Article Nine, is proper method for perfecting a security interest in copyright).

[290] *See id.* at 202–03.

[291] *See* Aerocon Eng'g, Inc. v. Silicon Valley Bank (*In re* World Auxiliary Power Co.), 303 F.3d 1120, 1128 (9th Cir. 2002) (explaining security interest in unregistered copyright does not give constructive notice and thus cannot preserve creditor's priority).

looked to cases interpreting section 365(h) for guidance on the effect of a section 363 sale on IP licensees.[292]

In *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, the Seventh Circuit allowed the debtor to sell its assets free and clear of the interests of a tenant in possession holding a lease that the debtor had chosen to reject.[293] The court reasoned that section 363(f) allowed the sale free and clear of the leasehold because a leasehold is an "interest" that could be extinguished through the operation of a section 363 sale.[294] The court explained that "Congress authorized the sale of estate property free and clear of '*any* interest,' not 'any interest *except* a lessee's possessory interest.'"[295] By analogy, the interests of an IP licensee could be at risk if a debtor-licensor chooses to reject the IP license agreement and then sells its assets in a section 363 sale. However, where an actual rejection of a lease is contemplated by the debtor, other cases have held that section 365(h) is the exclusive remedy for a debtor/lessor and the "debtor cannot avail itself of the provision of section 363 to sell property and extinguish a tenant's leasehold interest."[296] This result could have a detrimental effect on the value of the property being sold if, by analogy, a debtor's assets may not be sold free of a licensee's interests pursuant to section 365(n).

In re Dynamic Tooling Systems, Inc. addressed IP licenses in the context of a section 363 sale.[297] In that case, the debtor-licensor sought to conduct a section 363 sale free and clear of all claims and interests.[298] A non-debtor licensee objected to the sale.[299] The court debated whether the analysis with respect to the intersection of section 365(h) and section 363 was transferable to section 365(n) in the IP context.[300] Ultimately, the court found that section 365(n) does not trump section 363, and a debtor can indeed sell its assets free and clear of all interests, such as IP licenses held by non-debtor third parties.[301] However, the court also noted that the court can ameliorate the potentially devastating consequences for licensees and a licensee's "interests can be protected by [an] express order that to the extent [the debtor's] intellectual property is included in the asset transfer, the property is subject

[292] *See In re* Dynamic Tooling Sys., Inc., 349 B.R. 847, 856 (explaining that to extent sale is made free and clear of liens and interests, section 363(h) is implicated).

[293] *See* Precision Indus., Inc. v. Qualitech Steel SBQ (*In re* Qualitech Steel Co.), 327 F.3d 537, 548 (7th Cir. 2003).

[294] *See id.* at 540.

[295] *Id.* at 548 (emphasis in original).

[296] *See In re* Haskell, L.P., 321 B.R. 1, 7 (Bankr. D. Mass. 2005) ("[A] sale free and clear of a leasehold interest pursuant to § 363 would effectively enable a debtor to dispossess a lessee, negating the protections afforded by § 365 and contravening congressional intent."). *See also In re* Churchill Props. III, L.P., 197 B.R. 283, 288 (Bankr. N.D. Ill. 1996); *In re* Taylor, 198 B.R. 142, 166 (Bankr. D.S.C. 1996) (contrasting to outcome if debtor/lessor rejects lease).

[297] *See In re Dynamic Tooling Sys., Inc.*, 349 B.R. at 856 (demonstrating scope of "free and clear" with regard to IP licenses).

[298] *See id.*

[299] *See id.* at 851.

[300] *See id.* at 855.

[301] *See id.* at 856.

to whatever license rights [the licensee] may have."[302] Consequently, the court suggested that a section 363 sale may not always result in a free and clear sale with respect to IP licenses.

Bankruptcy courts in other circuits have concluded that a lessee's interest in a leasehold is not necessarily destroyed when a debtor conducts a section 363 asset sale. In *In re Haskell L.P.*, the court held that a debtor was unable to terminate a 99-year lease through the operation of section 363.[303] Unlike the lessee in *Qualitech*, which notably did not object to the debtor's motion to sell its assets free and clear of its leasehold, Haskell's lessee objected to the debtor's proposed section 363 sale free and clear of its leasehold interest.[304] The court found that the debtor could not compel the lessee to accept monetary compensation in exchange for the rejection of its lease.[305] The court in *In re Samaritan Alliance, LLC* likewise found that a lessor in bankruptcy could not sell its assets free and clear of a sublessee's interest in the property.[306] The debtor's real property was transferred to the buyer subject to the rights of a sublessee under the sublease.[307] Consequently, a licensee should be vigilant and prepared to object to a motion to sell a debtor's IP pursuant to section 363 free and clear of liens and interests.

In addition, royalty payments owed pursuant to section 365(n) are likely to be owed to the debtor and not to the purchaser of the debtor's assets. In *Schlumberger Resource Management Services, Inc. v. CellNet Data Systems, Inc.*, the court confirmed that, where a sale cannot be structured free and clear of an IP license, and the licensee elects to retain certain of its rights pursuant to section 365(n) subsequent to the rejection of its license by the debtor, royalty payments may not necessarily follow the IP assets that have been sold.[308]

CONCLUSION

Where IP rights are involved in a bankruptcy case, all parties must thoroughly analyze the situation in light of both IP laws and bankruptcy laws to determine how best to proceed. This article addresses the many pitfalls that exist for both IP licensors and licensees in bankruptcy scenarios. In short, it is important that interested parties understand such things as: (i) the limitations and implications of section 365(n) of the Bankruptcy Code; (ii) the effect of and ability to reject, assume or assign IP licenses; (iii) the interplay between foreign IP laws and chapter 15; and (iv) the protections provided by IP security interests and escrows.

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302 *Id.*

303 *See In re* Haskell L.P., 321 B.R. 1, 9 (Bankr. D. Mass. 2005).

304 *See id.* at 2.

305 *See id.* at 9.

306 *See In re* Samaritan Alliance, No. 07–50735, 2007 WL 4162918, at *4 (Bankr. E.D. Ky. Nov. 21, 2007).

307 *See id.* at *4.

308 *See In re* Cellnet Data Sys., Inc., 277 B.R. 588, 594–95 (D. Del. 2002), *affirmed* 327 F.3d 242, 250 (3d Cir. 2003) (finding royalty payments made pursuant to section 365(n)(2)(B) remain property of licensor where underlying IP assets have been sold and sale excludes license agreements).

Where an executory contract licensing IP is at issue, the three fundamental questions that arise are:

> A. Can the license be *assumed*? This question is relevant when the debtor is the *licensee* under an executory IP license and wishes to retain its IP rights so that the reorganized company may continue to use the IP after emerging from bankruptcy.
> B. Can the license by *assigned*? This question is pertinent when the debtor is the *licensee* under an executory IP license and wishes to transfer its rights to the IP, either through the sale of specific IP rights or in connection with the sale of all or a portion of the debtor's assets.
> C. Can the license be *rejected* and, if so, what are the consequences of such rejection? This question is relevant when the debtor (a) owns the IP, (b) has licensed rights to the IP to another party under an executory IP license, and (c) wishes to reject the executory contract because it no longer provides a significant enough (or any) benefit to the debtor's estate.

Where the debtor is a licensee, its ability to assume or assign the IP license will usually be restricted unless the contract allows assignment, the licensor consents or, as a matter of IP law, the assignment is permissible. While the rules governing IP issues are complex and uncertainties persist, most issues are manageable. Frequently, no special analysis will be required, as in the case of IP that is owned by the debtor or is licensed under agreements that allow for the assignment of IP rights. In other instances, successfully navigating through the issues raised in this article can be achieved through thoughtful planning and careful analysis.

Understanding the intersection of IP and bankruptcy law with respect to such things as a debtor's ability to assume, assign or reject a given IP license may be key to a debtor's successful restructuring. A thorough comprehension of these issues is also vital for any entity interested in purchasing a debtor's IP rights, as an unwary buyer may otherwise find itself without the benefit of its bargain.