The Intersection of Intellectual Property and Bankruptcy Law

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As the worldwide economy expanded over the past decade, intellectual property assets have increased dramatically in value and become an ever-increasing share of a company's balance sheet. Now, as the economy contracts and many companies are facing bankruptcy, a key question concerns the status of the intellectual property that may have been assigned, transferred, sold, or licensed if one of the parties to the transaction declares bankruptcy. The answer may be critically important to any company that may lose rights to manufacture a licensed product because the licensor declared bankruptcy, as well as to any licensor who may be faced with a totally new competitive landscape because the debtor-licensee sold its rights to the licensor's primary competitor.

Intellectual Property Licenses as Executory Contracts

The filing for bankruptcy under Chapters 7 and 11 creates a separate legal entity, the bankruptcy estate, comprising the debtor's assets at the moment of filing, as well as the proceeds of such property and additional property interests the estate may acquire later.[1] In a Chapter 7 proceeding, the court appoints a trustee to collect the debtor's nonexempt property, sell it, and equitably distribute the proceeds to the creditors. In Chapter 11, the debtor in possession (DIB) serves as the bankruptcy trustee, with a fiduciary duty to maximize value for the estate's creditors. The DIB retains possession of the company's assets to continue operating the business while developing a plan of reorganization.

Section 365 of the bankruptcy code gives the bankruptcy trustee or DIB the authority to assume, assign, or reject a debtor's executory contracts based on whether the action is

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in the best interests of the debtor, notwithstanding any contrary provisions appearing in such agreements and subject to certain other limitations as described below.[2] The bankruptcy court will only reject a decision by the trustee if it is "manifestly unreasonable."[3] Upon the court's approval of the debtor's assumption of an executory contract, the prepetition contract is reinstated and becomes fully binding.

The so-called Countryman definition generally accepted by courts defines a contract as executory where the obligations "of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[4] As applied to the intellectual property context, an ongoing obligation to account for and pay royalties for the life of the agreement meets the Countryman test for an executory contract.

Other considerations in determining whether a contract is executory include material ongoing licensee obligations such as sharing of technology with the licensor, reporting on problems with the technology, and marking all products sold under the license with proper statutory patent notice. From the licensor's prospective, courts have held providing a nonexclusive licensee notice of any patent infringement suit or any other use or licensing of the process, refraining from licensing the technology to anyone else at a lower royalty rate, approving grants of sublicensees under reasonable standards, indemnifying licensees for losses, and defending claims of infringement are considerations in determining whether the agreement is executory. Several courts recognize the licensor's duty to forbear from suing the licensee for infringement as, in and of itself, a material ongoing performance obligation that makes the agreement executory.[5]

The bankruptcy code recognizes, however, that because intellectual property law involves goals that may be very different and even contrary to the goals of bankruptcy laws, it includes limitations on the assumption, assignment, and rejection of executory intellectual property agreements and affords additional protections to nondebtor parties to intellectual property licenses and contracts.

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Limitations on the Right to Assume and Assign Intellectual Property Licenses

The bankruptcy code expressly prohibits the assignment of a license, without the consent of the nondebtor party, if applicable law excuses such nondebtor party from accepting performance from or rendering performance to an entity or person other than the debtor. In general, the federal policy designed to protect the limited monopoly of intellectual property owners and restrict unauthorized use constitutes applicable law.

Whether patent licenses are assignable depends on whether they are nonexclusive or exclusive. Federal law has long held that nonexclusive patent license agreements are personal to the licensor and are not assignable unless expressly made so in the agreement.[6] Accordingly, courts have unanimously applied section 365(c) to prohibit the assignability of nonexclusive patent licenses absent consent of the nondebtor licensor.[7]

Similarly, because a nonexclusive copyright license is personal to the licensee and nondebtor licensor cannot be forced to accept performance from or render performance to a party, other than the debtor, section 365(c) also prohibits the assumption and assignment of a nonexclusive copyright license absent consent of the nondebtor licensor.

In contrast, because patent law specifically regards exclusive licenses as conferring property and not merely personal rights, section 365(c) generally has been held not to preclude assumption and assignment of an exclusive patent license by the debtor-licensee.

However, at least one court has barred the licensee from assigning its interest under an exclusive patent license.[8] The court reasoned that to permit the assignability of exclusive licenses "would create a situation where a patent holder loses control over the identity of its license holders whenever the license agreement provides a licensee with an exclusive right. Such a result, which effectively treats the grant of an exclusive license as the equivalent of an outright assignment of the patent, is inconsistent with federal case law."[9]

Courts are split on the assignability of exclusive copyright licenses where the contract is silent on this issue. The Ninth Circuit has held the copyright act does not allow a copyright licensee to transfer its rights under an exclusive license, without the consent of the

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original licensor.[10] On the other hand, a number of courts have expressly disagreed with the Ninth Circuit and determined that the holder of an exclusive license is entitled to all the rights and protections of the copyright owner to the extent of the license, as well as the right to transfer such rights, and accordingly an exclusive licensee may freely transfer his rights.[11] Therefore, section 365(c) does not prohibit a debtor-licensee from assigning an exclusive copyright license.[12]

Finally, with regard to trademark law, although it is generally not in the interest of the trademark owner to have the license transferred to a third party without consent, section 365(c) will not necessarily excuse a trademark holder, in the absence of a contract provision barring assignment of the trademark, from accepting performance from or rending performance to a party other than the debtor in accordance with the terms of a license. Thus, a number of courts have permitted trademark licenses to be assumed or licensed.[13] However, at least one court agreed that, as with patent and copyright licenses, a trademark licensor has a significant interest in a licensee's identity, which flows from the trademark owner's need to protect its mark's good will, value, and distinctiveness.[14]

Limitations on the Assumption of a Nonassignable Intellectual Property License

A related issue is whether a DIB may assume a license even when no assignment is contemplated. This is obviously an important question because it may be critical for many DIBs to be able to continue to have access to licensed intellectual property. Section 365(c)(1) states that "a trustee may not assume or assign any executory contract [if applicable nonbankruptcy law excuses the nonbankrupt party] from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession." Courts have split on the meaning of this subsection with a majority relying on the literal language finding that it prevents a debtor from even assuming a license if the applicable law prohibited assignment.[15]

In contrast, a minority of courts has rejected the hypothetical test in favor of an alternative actual-test approach that allows assumption of contracts that are nonassignable and nondelegable under applicable law.[16] The test focuses on whether or not the nondebtor

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party would actually be forced to accept performance under the executory contract from someone other than the party with whom it originally contracted.[17]

Rights of Nondebtor Licensee upon Rejection

Prior to the passage of the Intellectual Property Bankruptcy Protection Act of 1988,[18] which amended section 365 of the bankruptcy code, licensees faced the real possibility that where the debtor-licensor rejected an executory contract, the licensee would lose its right to continue to use the licensed intellectual property and would be left with a prepetition claim for contract damages even in cases in which the licensee may have built a business or product line upon use of the licensor's intellectual property.[19]

Section 365(n) addressed this issue by providing a nondebtor intellectual property or technology licensee with two options in the event that a licensor seeks to reject a license falling within the bankruptcy's definition of *intellectual property*. First, the licensee can treat the rejection as a breach, giving rise to a potential claim for money damages under section 365(g). Alternatively, the licensee can elect to retain the rights to the intellectual property covered by the license. Where the licensee elects to retain rights to the intellectual property, the debtor-licensor is required to (1) provide the licensee with access to the subject intellectual property or technology, (2) not interfere with the exercise of licensee's rights under the license, and (3) comply with any exclusivity provision in the license agreements. In return, the licensee must continue to pay royalties due under the licensing agreement and must waive all rights to set off or any claim for administrative expenses.

Section 365(n) permits the licensee to enforce only the passive obligations of the licensor such as adhering to confidentiality agreements and, in the case of an exclusive license, not licensing the technology to others, that are necessary for the licensee to enjoy the continued use and exploitation of licensed intellectual property. In other words, by rejecting the licensing agreement, the debtor is relieved from performing any affirmative duties under the contract. Thus, while the code permits a licensee to retain its rights to intellectual property that existed prepetition, it does not permit postrejection enforcement of the debtor-licensor's ongoing obligations to update or improve such intellectual property.

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This potential problem is exacerbated by the fact that under bankruptcy law, the parties cannot contract around this situation. This can create problems for the licensee who may be left with no means to gain access to critical technological updates and is left with outdated or obsolete technology. Thus, companies that are considering entering into a licensing agreement with financially strapped but technology rich companies should weigh the advantages of access to the technology with the risk that that they may not have continued access to latest technology should the licensor declare bankruptcy. One solution under such circumstances would be for the licensee to acquire the technology outright from the licensor with the means to improve upon it.

Section 365(n) specifically includes licenses to patents, copyrights, and trade secrets, but does not encompass trademark licenses.[20] Thus, the rejection by a debtor-licensor of a trademark license extinguishes the licensee's right to use the mark and leaves the licensee with only a claim for breach of contract. Indeed, one court confirmed the rejection by the debtor-licensor of a trademark license agreement over the objections of the licensee that rejection would result in damages of $67 million.[21]

Conclusion

The intersection of intellectual property and bankruptcy law presents real challenges to both intellectual property and bankruptcy lawyers. While Congress has enacted amendments to the bankruptcy code, such as section 365(n), that has clarified certain areas and provided increased protection to licensees and licensors in the event of a bankruptcy, several areas remain open to questions.

Accordingly, it is critical that intellectual property lawyers, who are involved in drafting intellectual property licensees, have an understanding of the consequences that a bankruptcy filing would have on the rights and obligations of the respective parties to the licensing agreement. It is equally important for bankruptcy attorneys to have a basis understanding of intellectual property law, or at a minimum, to know when they should be consulting with their intellectual property colleagues about a bankruptcy estate that includes a large amount of intellectual property.

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Notes

1. 11 U.S.C. § 541.
2. 11 U.S.C. §§ 365 (a), (c) & (f).
3. See e.g., *In re Sandman Associates, L.L.C.* 251 B.R. 473 (Bankr. W.D. Va. 2000).
4. Very Countryman, *Executory Contracts in Bankruptcy: Part I,* 57 MINN.L.REV. 439, 446 (1973)
5. *In re Access Beyond Technologies, Inc.* 237 B.R. 32, 43 (Bankr. D. Del. 1999).
6. See e.g., *PPG Indus., Inc. v. Guardian Indus. Corp.* 597, F.2d 1090, 1093 (6th Cir. 1979).
7. See e.g., *In re CFLC, Inc.,* 89 F.3d 673, 679 (9th Cir. 1996); *In re Catapult Entertainment, Inc.,* 165 F.3d 747 (9th Cir. 1999).1
8. *In re Hernandez,* 285 B.R. 435 (Bankr. D. Ariz. 2002).
9. Id. at 439.
10. *Nike v. Gardner,* 279 F.3d 774 (9th Cir. 2002).
11. *In re Golden Books,* 269 B.R. 311, 318 (Bankr. D. Del. 2001).
12. See e.g., *I.A.E. v. Shaver,* 74 F.3d 768, 775 (7th Cir. 1996);l *In re Golden Books*, 269 B.R. 311, 318 (Bankr. D. Del. 2001).
13. *In re Rooster Inc*. 100 B.R. 228 (Bankr.E.D. Pa. 1989) *In re Sunrise Restaurants* 135 B.R. 153, *In re Luce Indus., Inc.* 14 B.R. 529 (Bankr. S.D.N.Y. 1981).
14. *In re N.C.P. Mkt'g Grp.* 337 B.R. 230 (D. Nev.2005 (on appeal to the 9th Circuit).
15. *In re Access Beyond Tech.., Inc.* 237 B.R. 32, 48 (Bankr. D. Del. 1999); *Perlman v. Catapult Entertainment, Inc.* (In re Catapult Entertainment, Inc.) 165 F.3d 747, 749-50 (9th Cir. 1999); *City of Jamestown v. James Cable Partners, L.P.* (In re James Cable Partners L.P.), 27 F/3d 534. 537 (11th Cir. 1994); *In West Electronics, Inc.* 853 F.2d 79, 83 (3d Cir. 1988); *Breeden v. Catron,* (In re Catron), 158 B.R. 629, 633-38 (E.D.Va. 1993), aff'd without op. 25 F.3d 1038 (4th Cir. 1994).
16. The debtor would have to cure any existing monetary defaults and provide adequate assurance of future performance in order to assume (and in order to assume and assign) the contract. So even if, for example, an anti-assignment clause may not be enforceable, the nondebtor party may still have a basis to challenge the assumption in the event the debtor (or the assignee as the case may be) cannot cure and/or cannot demonstrate the ability to perform the obligations going forward.

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17. See e.g., *Institut Pasteur v. Cambridge Biotech Corp.,* 104 F.3d 489, 493 (1st Cir. 1997).
18. 11 U.S.C. 365(n).
19. See e.g., *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986).
20. *In re Centura Software Corp.* 281 B.R. 660, 670 (Bankr. N.D. Cal. 2002)
21. *In re Exide Technologies,* 340 B.R. 222 (Bankr. D. Del. 2006).

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