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Intellectual Property and Bankruptcy

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The current economic climate has made us all aware that bankruptcy can strike any company, whether a client or a company with whom your client is doing business. A debtor's financial problems can quickly become your client's intellectual property and financial problems. This paper will highlight intellectual property issues raised by the specter of bankruptcy which IP lawyers need to be aware of when drafting license agreements or when your client's licensee or licensor goes into bankruptcy. This paper does not substitute for consulting bankruptcy counsel.

I. BACKGROUND AND GENERAL PRINCIPLES

The purpose of the bankruptcy laws is to give the debtor a fresh start, and thus generally favors the debtor over the companies with which it is doing business. One way in which the bankruptcy law does this is by putting in an automatic stay, which effectively enjoins initiating or continuing any legal action by a creditor against the debtor or debtor's property.[2] This stay would include any action to terminate a license for breach. The purpose of the stay is to allow time for the trustee to organize all of the debtor's assets and for creditors to be brought in to assert their rights in the estate.

Another way the law protects the bankrupt estate is by allowing the trustee/debtor in possession, whether winding up the business[3] or as part of its reorganization,[4] to reject or assume existing executory contracts (subject to court approval). If assumed, the debtor may also be able to assign its rights under the executory contract to a third party, even if the contract has a "no assignment" clause.[5]

A. Executory Contracts

Technically, a contract is "executory" when performance by both parties has not yet been completed and the failure to perform by either party would result in a breach which would relieve the other party of its obligation to perform. However, different courts have adopted different tests for what constitutes an executory contract, vulnerable to assumption or

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rejection. For example, courts have found a licensee's responsibility to account for and pay royalties for use of a patent during the term of the license enough to make the contract executory.[6]

For the purposes of the bankruptcy law, most non-exclusive intellectual property licenses are found to be executory and many exclusive licenses are as well. However, other exclusive licenses have been found to be a "sale" or "assignment" for bankruptcy purposes and thus not an executory contract.

An example in the copyright context would be where the owner licenses a work, such as a novel, to a licensee-publisher for royalties, and the licensee publishes and distributes the work. The licensor-owner's responsibilities generally cease upon delivery of the work to the publisher and are generally deemed a full transfer of rights, making this type of contract non-executory.[7] However, where the licensor owner has yet to create the work, such as a record label contract, the artist and record label typically have future obligations in the recording of albums which would make these agreements executory.

Trademark licenses, whether or not exclusive, are almost always found to be executory because the licensor always has an obligation (and right) to control the quality of the goods or services sold under the licensed mark. The trademark licensee also has future obligations, since it is the party which must adhere to reporting standards, marketing obligations, payment schedules, etc.

B. The Effect of a Contract Being Found Executory

If a license agreement is found to be executory, the trustee generally has three options: assumption, rejection or assignment. Under a Chapter 7 proceeding, a trustee has 60 days from the order of relief to assume or reject the executory contract. Under a Chapter 11 proceeding, the trustee has until confirmation of the bankruptcy plan to assume or reject. The time waiting for confirmation of the plan can be a significant, leaving the nondebtor in limbo. In some situations, however, a nondebtor may be successful in moving the bankruptcy court to set an earlier time for cause. If the license is important, it is wise to consult bankruptcy counsel as soon as you are aware that the client's licensor or licensee is have financial difficulties, to protect your client's position, possibly by attempting to force an earlier decision.

1. Assumption of the Agreement

If the debtor decides, through its trustee, to accept the contract, it is then up to the bankruptcy judge to approve the decision and allow the debtor to effectively reaffirm the pre-petition contract. Bankruptcy courts apply a "business judgment" standard in evaluating whether to approve the debtor's decision to assume the contract or reject it.[8] If the debtor decides to assume the contract, it must first satisfy (or give assurance that it will satisfy) any previous defaults on the contract. Any subsequent breach will result in the creditor's claim being elevated to post-petition status, usually requiring full payment on the part of the estate.

2. Rejection of the Contract

The debtor's option to reject the executory contract illustrates the importance the Bankruptcy Code has placed on giving the debtor a fresh start. By allowing the debtor to reject the executory contract in totality, the creditor's claim becomes a mere pre-petition claim for breach of contract, likely being listed as a general unsecured claim (lowest priority) by the bankruptcy court. Furthermore, the bankruptcy code expressly prohibits the remedy of specific performance for a rejected executory contract.

3. Assignment

If a debtor assumes an executory agreement, it may have the further option of assigning the contract to a third party. Except as provided for in 11 U.S.C. §365(c), 11 U.S.C. §365(f)(1) provides that a debtor may assign the contract if it would be in the financial interest of the debtor in its plans of reorganization, <u>even if the contract, as drafted expressly forbids assignment</u>. Not only do these provisions allow the debtor to effectively absolve itself by rejecting an executory contract, but it also permits the debtor to assign the executory contract to a third party, in express contravention of the agreement.

11 U.S.C. §365(c)(1) prohibits assignments in certain situations, however, primarily when non-bankruptcy laws allow the nondebtor to refuse performance of the contract by anyone other than the debtor. Under contract law, any contract that is of a "personal" nature would fall within the scope of "applicable non-bankruptcy law" under §365(c)(1). As a unambiguous example, a personal service contract whereby a Hollywood actor would appear and perform cannot be assigned without the actor's consent.

II. DIFFERING RESULTS DEPENDING ON WHETHER THE BANKRUPT IS THE LICENSOR OR LICENSEE AND THE PARTICULAR IP INVOLVED

The results of these basic principles will differ depending on whether it is the licensor or the licensee which is the debtor. Whether the IP involved is a patent, copyright or trademark also effects the treatment of the license agreement.

A. <u>When It Is the Licensor Who Is Bankrupt</u>

The wide latitude given to the debtor to reject a license can have catastrophic consequences for the nondebtor party to an IP contract. When the nondebtor is a licensee, the effect of a rejected executory contract can potentially (and ironically) lead to its going bankrupt as well. "Ipso facto" provisions in a contract providing for specific terms in case one party files for bankruptcy are unenforceable. If a debtor is a licensor who rejects the executory contract, then the licensee will no longer be able to use the licensed property. This can severely hamper licensee operations, especially if it has made substantial investments in reliance on the continued use of the licensed IP. In a famous 1985 case dealing with this scenario, the court, in holding for the debtor-licensor, conceded that rejection of these types of contracts "imposes serious burdens on contracting parties [and] could have a general chilling effect upon the

willingness of [potential IP licensees] to contract at all with businesses in possible financial difficulty."[9]

1. 365 (n) to the Rescue

Based on the results of the *Lubrizol* case and the outcry by many in industry, Congress enacted §365(n) of the Bankruptcy Code in 1988 to ameliorate the effects of debtor-licensor rejection of executory contracts. The Code now permits a nondebtor-licensee, if it so chooses, to retain its rights under certain types of rejected executory contracts by the debtor-licensor for the life of the initial contract plus any potential renewal, as long as the contract deals with "intellectual property."[10] Under this scenario, the licensee would continue to make royalty payments as per the contract, but the licensor would not be responsible for any additional affirmative obligations under the agreement.[11]

365(n) generally provides a rational compromise between the interests of the debtor-licensor and its licensee. It allows a potential licensee to cast a wide net for licensors, without being overly concerned with the licensor's financial condition, and prevents the devastation which might be caused if the licensee could no longer use the licensed IP. At the same time, the licensor still reaps the intended benefits of bankruptcy by not having to perform significant obligations under the contract while still receiving the revenue stream from royalty payments. However, as drafted, the provision leaves room for interpretation. First, Congress limited the definition of "intellectual property" by specifically excluding trademarks from its scope.[12] It left the definition of "affirmative obligations" relating to the licensor, as well as the breadth of "royalty payments" by the licensee, to interpretation by the courts.

2. Excluding Trademarks from the Scope of §365(n)

Trademarks were excluded from the scope of §365(n) because Congress understood that trademark licenses are essentially different from patent and copyright licenses. What makes them different is the licensor's obligation to exercise quality control over its licensee's goods or services sold under the mark. It is, therefore, almost impossible for a debtor-licensor to be free from having to fulfill "affirmative obligations" under the continued license. This is why, whether or not the license is exclusive, trademark licenses are almost universally executory contracts. In addition, failure to exercise quality control could compromise the trademark and lessen its economic value. This exclusion from §365(n) can lead to serious consequences for the trademark licensee, who may have invested heavily in exploiting the license, including payment of significant advances against royalties. If such license is rejected, the licensee is left to sue on a general, unsecured, pre-petition breach of contract claim.

In recent years, courts have attempted to alleviate these burdens on trademark licensees by incorporating the effects of §365(n) in trademark cases if possible. When a trademark license is "bundled" with other IP licenses that fall within the scope of §365(n), some courts have grouped the IP all together, thus indirectly extending the benefits of §365(n) to the trademark licensee, since other IP rights were involved.[13] No court has granted the benefits of §365(n) to a trademark licensee on the statute's specific grounds exclusively, likely because the exclusion of trademarks in the statute is so clear.

There are ways trademark licensees attempt to protect themselves at the time of entering into the license, including demanding that the licensed marks be owned by a bankruptcy-remote entity or receiving a security interest in the trademarks. However, these types of alternatives require a licensee with the greater bargaining power. Licensees have also become less willing to pay large advances against royalties.[14]

3. Licensor's "Affirmative Obligations"

Licensor's "Affirmative Obligations" after Rejection of Executory Contract §365(n) exempts a debtor-licensor from any affirmative obligations post-rejection of an executory contract. If the nondebtor-licensee reaffirms its rights under §365(n), the debtor-licensor is only required to perform passive duties, such as providing the licensee with the requisite IP and not interfering with the rights of the licensee. As to whether the licensor has any obligations to provide the licensee with any improvement it may make to the licensed technology, one court held that since §365(n) does not explicitly state that future improvements are included within the responsibilities of the debtor-licensor when it rejects an executory contract, it was unable to extend the licensee's rights beyond the technology obtained at the time of the bankruptcy petition.[15] This holding further burdens the licensee and could create a disincentive for potential licensees to take any long-term risks when contracting with a company which is in less than perfect financial condition. Possible contract terms which may help could include the setting up a third-party technology escrow agreement, so that the licensee (itself or by a third party on its behalf) could then maintain and make upgrades and improvements to the technology if the licensor fails to do so. [16]

4. Royalty Payments under 365(n)

For purposes of §365(n), royalty payments are broadly defined to include any payment for the use of the IP. This typically means that any flat licensee fee, including those which include improvements or updates or guaranteed minimum royalties, must still be paid by the licensee as part of "royalty payments" under §365(n), if the licensee decides to retain its rights. Contracts should, therefore, be drafted so that royalties for the licensed IP is clearly broken out from payments for future services, which under 365(n), the debtor-licensor will not be required to render.

B. <u>When the Licensee Is Bankrupt</u>

When it is the licensee which is bankrupt, licensors are in a very precarious position, as §365(n) plays no role. §365(n) was created to benefit the nondebtor-<u>licensee</u> when the <u>licensor</u> filed for bankruptcy. It included no provisions for the opposite type of situation. Unless the agreement falls within the parameters of §365(c), prohibiting assignment under applicable, non-bankruptcy law such as when a contract is <u>personal</u> in nature, the debtor-licensee could, according to the Bankruptcy Code, sell or assign its rights under the agreement to an unreliable company or potential competitor of the licensor. That competitor could alter the business strategy or cease use of the licensed IP, thereby diminishing licensor revenue and possibly the goodwill of the product. Generally, contract law strongly favors the assignability of contracts.

The key protection for the non-debtor-licensor, therefore, is whether the contract is found to be personal. In determining whether a license agreement is personal, courts generally look to whether the license is exclusive or non-exclusive license. However, the license's exclusivity or non-exclusivity itself may not be dispositive. Therefore, when drafting the agreement on behalf of a licensor, it is important to include language which highlights the personal nature of the licensee's obligations. Especially for exclusive patent and copyright license, licensor's counsel may want to provide for pre-petition termination for well defined events which may signal the licensee's financial difficulties, such as a missed royalty payment, or have those events trigger a provision making the license non-exclusive.[17]

1. Non-Exclusive Licenses v. Exclusive Licenses

Non-exclusive licenses are seen to be more personal in nature, thus less likely to be assignable by the debtor-licensee and more likely to fall within the scope of §365(c). Exclusive licenses, on the other hand, are more problematic for the nondebtor licensor. Since exclusive licenses are seen as conveying more "property" than "personal" rights, courts have been more mixed in their analysis. However, the law treats the licenses for different types of IP differently.

a. Patents

Generally, the patent owner's prior consent prior to the assignment of a non-exclusive patent license. This effects whether the debtor-licensee of a patent can assign it license (or even assume the license). Without this requisite consent in place, any potential licensee could become a competitor and the owner would be unable to control the identity of its licensees.[18]

Because exclusive licenses are viewed as more akin to a "property transfer" rather than being personal nature, debtor-licensees would seem to be able to freely transfer the license. In these cases, the debtor-licensee appears to be outside the scope of §365(c).[19]

b. Copyrights

As in patent law, non-exclusive copyright licenses generally cannot be assigned by the debtor-licensee without licensor approval; the license is personal in nature, and falls within the scope of §365(c).

The Copyright Act defines an exclusive license in §101 as a "transfer of copyright ownership."[20] This language makes it difficult for courts to prohibit a debtor-licensee from assigning an exclusive copyright license. Most courts have followed this reasoning and allowed the debtor-licensee to assign an exclusive license without the licensor's consent. The Ninth Circuit, however, has refused to automatically allow the debtor-licensee to assign the license without licensor consent. It does so by shifting its focus from the language in §101 of the Copyright Act to §201, holding that an exclusive licensee only receive the "protection and remedies" of the Act, and not the ability to assign.[21]

c. Trademarks

Trademark licensors have a greater interest in its licensee's day-to-day operations and the quality of the products produced or services offered under the licensed mark, than does a

patent or copyright licensee because of its obligation to exercise quality control and how the value of the asset – the goodwill attached to its mark – is directly effected by what its licensee does. The prospect of a debtor-licensee assigning the license without its consent is of significant concern. Some courts have realized the nondebtor-licensor's precarious position and have held that trademark licenses are within the realm of §365(c)(1) – being personal in nature and thus, non-assignable without licensor consent.

The licensee's obligations to adhere to the licensor's quality standards is continuing and "personal" in nature. The courts have reasoned that since the licensor has the right to oversee the quality of the goods offered under the mark, the licensor should then be able to control who specifically is able to use that mark going forward, concluding that it is personal in nature and falls within the scope of §365(c)(1).[22] Using this rationale, courts have barred the assignment by the debtor-licensees without the prior consent of the licensor. Other courts, though, have used a more restrictive definition of "personal services contract."[23] These courts have held that a license is of personal nature only if it involves the special judgment, task, skill, or ability of the licensee.[24] Under this standard, numerous trademark licenses would not be found to be "personal" and would fall outside the scope of §365(c)(1), and be assignable by the debtor-licensee, despite any non-assignability clauses in the license agreement. Therefore, when drafting a trademark license agreement, it behooves a licensor to add language which sets out the "personal" nature of the licensee's obligations.

C. Can the Licensee Assume the Contract – the Hypothetical Test v. Actual Test

In addition to preventing the assignment of a license by the debtor-licensee, §365(c) may even prohibit assumption of an executory contract if applicable non-bankruptcy law excuses the nondebtor-licensor from dealing with a third party entity.

If §365(c) does, in fact, apply and the licensee cannot assign the contract, the next issue is whether the contract can still be assumed by the debtor-licensee. Some courts have read the language of §365(c)(1)[25] very literally, concluding that a debtor cannot assume an executory contract where applicable law simply prohibits its assignment. Called the "hypothetical test," it prohibits any assumption or assignment if applicable non-bankruptcy law would bar assignment to a third party.[26] The overarching intent of § 365(c)(1) is to avoid burdening the nondebtor-licensor by having to deal with a random third party. However, the "hypothetical test" has been criticized as making little sense in the context of the rest of the statute, as under this test, the debtor-licensee would be unable to assume the contract.

An alternate test is the "actual test." Under this test, the statute would bar assumption of the executory contract by the debtor-licensee only if the bankruptcy ultimately and actually results in the licensor having to deal with a third party. Of course, as a result of reorganization, the debtor itself can become akin to a third party. Some courts have held that a debtor-in-possession, if materially different than the original debtor, can be considered a legally different entity. Such material differences could include a significant change in the corporate structure of the debtor-in-possession or its management. In that case, the nondebtor-licensor should be able to withhold consent if the debtor-licensee attempts to assume the contract, but courts have not been uniform on this particular issue.

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Endnotes:

1 The author would like to thank Robert Riether, an associate at Cowan, Liebowitz & Latman for his assistance in the preparation of this paper.

2 11 U.S.C. §362.

3 Chapter 7 of the Bankruptcy Code.

4 Chapter 11 of the Bankruptcy Code.

5 On the other hand, the nondebtor party cannot simply terminate the license, even if the license agreement so provides. 11 U.S.C. § 365(e)(1).

6 The Ninth Circuit takes an even broader view. In *Everex Systems, Inc. v. Cadtrak Corp*, 89 F.3d 673 (9th Cir. 1996), the court found the mere forbearance of a licensor to sue a licensee during the term of the agreement is sufficient to constitute an executory obligation.

7 The logic of this result is strengthened by the Copyright Law. The owner of an exclusive right under copyright is considered an owner of copyright under 17 U.S.C. § 201 (d)(2).

8 The business judgment standard is very broad and deferential to the debtor, so it is rare that a court will deny a debtor's decision one way or the other.

9 *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986).

10 11 U.S.C. §101(35A), 11 U.S.C. §365(n)(1)(B)(ii).

11 11 U.S.C. §365(n)(3)(B).

12 Foreign intellectual property is also excluded.

13 *In re Matusalem*, 158 B.R. 514, at 521-22, (Bankr. S.D.Fla. 1993).

14 While a large guarantee against royalties might be an inducement for the licensor-debtor to assume the license, a large advance may have the opposite effect.

15 *Szombathy v. Controlled Shredders, Inc.*, 1997 U.S. Dist. LEXIS 5168 (N.D.Ill. 1997).

16 Peter S. Menell, Professor of Law, Berkeley Center for Law & Technology, University of California at Berkeley (Boalt Hall) School of Law, in his March 13, 2007 UC Berkeley Public Law Research Paper No. 969521 "Bankruptcy Treatment of Intellectual Property Asset: An Economic Analysis" argues that a debtor-licensor's supposed future technological improvements are done without any thought of the nondebtor-licensee. Thus, how can it be said that providing such technology would be anything but a passive obligation? If the intent of §365(n) is to provide the licensee with the opportunity to continue with the license but at the same time not force the debtor-licensor into burdensome activities, Menell asks how is providing the licensee with further improvements that have, in theory, already been created at the sole behest of the debtor-licensor, be anything more than passive activity? Since the improvements have already been made, it would cost the licensor virtually nothing to simply provide them to the licensee. *Menell* at 41. On the other hand, it gives the debtor-licensor the

ability to negotiate for additional payment for providing updates – part of the fresh start envisioned by the Bankruptcy Code.

17 The triggering mechanism cannot be the bankruptcy itself, as this type of provision would be unenforceable under the Bankruptcy Code.

18 *In re Catapult Entertainment*, 165 F.3d, at 750, In re CFLC, Inc., 89 F.3d 673, 678-679 (9th Cir. 1996).

19 One court has hesitated in allowing full transferability, on public policy grounds, because of the severe consequences that a nondebtor-licensor may face. Even though the exclusive licensee could itself sue for infringement of the patent, it still could not actually assign the license upon bankruptcy. While this outcome the fairer in that case, it should be noted that it does seem to fall far outside the scope of §365(c) and more under the guise of 365(f)(1), which suggests that the debtor licensee should have been freely able to assign the license. *In re Hernandez*, 285 B.R. 435, 2002 Bankr. LEXIS 1701 (Bankr. D. Ariz. 2002).

20 17 U.S.C. § 101.

21 *Gardner v. Nike*, 279 F.3d 774 (9th Cir. 1999).

22 *In re N.C.P. Mktg. Group*, 337 B.R. 230, (Bankr. D. Nev. 2005).

23 *In re Sunrise Restaurants*, 135 B.R. 149, (Bankr. M.D. Fla. 1991).

24 *Id*. at 153.

25 §365(c) states in part that "a trustee may not assume or assign any executory contract…if (1)(A) 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…whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties;.."

26 *In re Catapult Entertainment*, 165 F.3d 747, 750 (9th Cir. 1999).