

Selected Intellectual Property Issues Arising in Bankruptcy Cases

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SELECTED INTELLECTUAL PROPERTY ISSUES ARISING IN BANKRUPTCY CASES

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I. *Introduction*

Section 365 of Title 11 of the United States Code (the “Bankruptcy Code”) allows a trustee or debtor in possession to assume and assign or reject an executory contract, in order to maximize the profitability and value of the debtor’s estate. The debtor must cure outstanding defaults or provide adequate assurance that it will do so. 11 U.S.C. § 365(a). While “executory contract” is not defined in the Bankruptcy Code, the general standard used in its determination is whether “the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other.” *In re Golden Books Family Entertainment, Inc.*, 269 B.R. 300, 308 (Bankr. D. Del. 2001) (citing Vern Countryman, “Executory Contracts in Bankruptcy,” 57 *Minn. L. Rev.* 439 (1973)). Generally, the debtor’s decision to assume or reject an executory contract is governed by the business judgment rule. *In re Chi-Feng Huang*, 9 B.C.D. 972 (Bankr. 9th Cir. 1982).

As the recognition and value of intellectual property grew, the protection of such intangible assets in the event of bankruptcy became of paramount concern, particularly in the context of executory contracts. Accordingly, businesses dependent upon intellectual property lobbied Congress to gain exceptions to section 365 of the Bankruptcy Code. Fearing that the existing law fostered a chilling effect on the licensing of intellectual property (see S. REP. 100-505 (1988)), Congress enacted the Intellectual Property Bankruptcy Act of 1988, Pub. L. 100-506 (incorporated into the Bankruptcy Code as section 365(n)).

II. *Debtor as Licensor -- Section 365(n) of the Bankruptcy Code*

Section 365(n) of the Bankruptcy Code constitutes an exception to the general rule that trustees may freely assume or reject contracts, and applies *only* when the licensor of a right to intellectual property is the debtor. In cases where the debtor is the licensee, the question of assumption and assignment of intellectual property licenses is more complicated and subject to the often-contradictory provisions of sections 365(c) and (f) of the Bankruptcy Code, as discussed below. In most cases, assumption and assignment of non-exclusive licenses by the debtor/licensee are subject to the consent of the non-debtor licensor. *In re CFLC, Inc.*, 89 F.3d 673, 679 (9th Cir. 1996).

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When a debtor/licensor rejects an intellectual property license, section 365(n) affords the licensee two options. One option is for the licensee to treat the license as terminated and bring a claim for breach of contract. Should the licensee treat the rejection as a breach of contract, its claims against the debtor would be treated as those of an unsecured creditor. See *In re Prize Frize, Inc.*, 150 B.R. 456, 459 (Bankr. 9th Cir. 1993) (licensee retains rights under license but waives setoff). Alternatively, the licensee may elect to retain its rights under the license (as they existed at the time of the bankruptcy filing), subject to its obligations, including making all royalty payments due thereunder. Under this latter option, however, the debtor/licensor has no additional obligations to the licensee other than refraining from interfering with the licensee's use of the license. 11 U.S.C. § 365(n)(1)(B).

III. *Legislative History of and Intent Behind Section 365(n)*

Prior to 1988, the Bankruptcy Code did not explicitly deal with intellectual property contracts. The Fourth Circuit decision, *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), led to significant changes in section 365 of the Bankruptcy Code. In *Lubrizol*, a debtor/patent owner moved to reject its licensing agreement with Lubrizol on the grounds that it was an executory contract. The court upheld the rejection, ruling that it was a valid exercise of the debtor's business judgment. In an effort to protect licensees of intellectual property who could otherwise be harmed by the *Lubrizol* decision, Congress amended section 365 of the Bankruptcy Code to include special provisions for intellectual property contracts.²

In recognition of the underlying policies behind intellectual property laws and the Bankruptcy Code, Congress drafted the Intellectual Property Bankruptcy Act of 1988, Pub. L. 100-506, (incorporated into the Bankruptcy Code at section 365(n)). See Aleta A. Mills, "The Impact of Bankruptcy on Patent and Copyright Licenses," 17 *Bankr. Dev. J.* 575, 575-77 (2001). The House Report to the Intellectual Property Bankruptcy Act noted at the time that *Lubrizol* "has 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." H.Rep. 100-506 (1988), cited by 8 *Norton Bankr. L. & Prac.* 2d 11 U.S.C. § 365. As such, Congress formulated this addition to the Bankruptcy Code in order 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...." S. Rep. 100-505 at 4-5 (1988). See also *Prize Frize*, 32 F.3d at 428 ("[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. The bankrupt cannot terminate and strip the licensee of rights the licensee had bargained for.").

² As noted in greater detail below, Congress also amended the Bankruptcy Code to incorporate a definition of intellectual property that includes trade secrets, inventions, processes or designs protected under patent law, patent applications, works of authorship protected under the copyright laws, and mask works. See 11 U.S.C. §101(35A). Not included were trademarks, although at least one court has held that section 365(n) may extend to cover trademarks when they are entwined with other intellectual property. *In re Matusalem*, 158 B.R. 514 (Bankr. S.D.Fla. 1993).

While meant to balance the interests of licensor and licensee, section 365(n) still offers some unique advantages to the debtor/licensor. Although the debtor/licensor may be liable for damages if it rejects a license, its obligations under the rejected agreement will be terminated. Furthermore, other obligations, such as providing upgrades of the technology, fixing any problems or glitches that arise, or providing additional training are not enforceable.

IV. *Types of Intangible Assets*

Pursuant to 11 U.S.C. §101(35A), “intellectual property” includes trade secrets, inventions, processes or designs protected under patent law, patent applications, works of authorship protected under the copyright laws, and mask works. This definition does not include trademarks, service marks and trade name licenses. Despite these exclusions from the definition of intellectual property, at least one court has held that section 365(n) may extend to cover trademarks when they are entwined with other intellectual property. *Matusalem*, 158 B.R. at 522. Additionally, courts have found franchise agreements (*In re Silk Plants, Etc. Franchise Sys. Inc.*, 100 B.R. 360 (Bankr. M.D. Tenn. 1989) and distributor agreements (*In re Monarch Tool & Mfg. Co.*, 114 B.R. 134 (Bankr. S.D. Ohio 1990) to be executory contracts.

A. *Copyrighted Material*

Copyrights are original works of authorship and can include text, software, artwork, literary works, dramatic works, choreographic works, movies or other audiovisual works, architectural works, and sound recordings. 17 U.S.C. § 102(a) (2000). While copyrights are included under the definition of intellectual property governed by section 365(n), exclusive copyright licenses may nonetheless be excluded. Under section 101 of the Copyright Act, an exclusive copyright license constitutes a transfer of ownership and may be considered an assignment rather than an executory contract.³ See *Mills*, supra, at 575-77 (“[B]ecause an exclusive copyright license constitutes a transfer of ownership, in the event the licensee becomes a debtor under the Bankruptcy Code, the transferred copyright interest may be considered a part of the debtor’s estate and not an executory contract.”).

B. *Patents*

The Patent Act states that “[w]hoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title.” See 35 U.S.C. § 101, et. seq. A patent holder may license the right to make, use or sell the patented article. 35 U.S.C.A. § 261. A critical distinction between an assignment of a patent and a patent license is that “an assignment of a patent is a transfer of an ownership interest in the patent, while a license is an agreement allowing the licensee to use the patent but not transferring any ownership interest in the patent.” *CFLC*, 89 F.3d at 676 n.2. A patent license may be either exclusive or non-exclusive, with

³ 17 U.S.C. § 101 states “a transfer of copyright ownership [includes] 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.” Under section 201(d)(2) of the Copyright Act, the holder of an exclusive license has the same rights as the owner of the copyright.

an exclusive license generally granting the transferee full ownership and control of an undivided share of the patent. See *Amgen, Inc. v. Chugai Pharm. Co.*, 808 F. Supp. 894, 899-900 (D. Mass. 1992) (“an exclusive license can be created by a grant of exclusivity based solely on geographic, time, or field-of-use limitations.”). Alternatively, a non-exclusive license may operate to distribute the patented technology to various third parties or end users, and the holder of such a license retains a limited right to use the technology and enforce against infringement of the patent, but not the right to distribute or sell the technology to others.

C. Trademarks

A trademark can take many forms, including a word, a sentence, a design, a color, a sound, or even a smell. Trademarks are governed by the Lanham Act, Title 15 of the United States Code. As noted above, the definition of intellectual property governed by section 365(n) excludes trademarks, trade names and services marks. Although these exclusions exposes licensees to the risk that debtors/licensors will reject trademark licenses, Congress purposefully omitted them from section 365(n). See S. Rep. 100-505 (1988). According to the Senate Report, while rejection of executory trademark licenses was of concern in light of the interpretation of section 365 by the *Lubrizol* court:

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.

S. Rep. 100-505 (1988). However, as noted above one court has held that a trademark license may be covered by section 365(n) when it is inextricably bound with other covered licenses. See *Matusalem*, 158 B.R. at 522.

V. Debtor as Licensee -- Assumption and Sale of Intangible Asset Licenses

A. Intellectual Property Contracts as Executory Contracts

Intellectual property contracts are frequently characterized by courts as executory contracts. See *Golden Books*, 269 B.R. at 308-309 (intellectual property licenses are executory contracts because each party has a duty to refrain from suing the other party for infringement of the license). As noted above, the ongoing performance of duties under the agreement is what distinguishes an executory contract from a sale of intellectual property that is the subject of the license. While an exclusive license may more likely be regarded as a sale due to the transfer of a greater portion of ownership, see *Flanders v. United States*, 172 F. Supp. 935 (N.D. Cal. 1959) (exclusive license considered a sale when the agreement transfers all substantial ownership rights to licensee), where there are remaining obligations between the parties, a license is generally considered an executory contract. See *Lubrizol*, 756 F.2d at 1046; *In re Access Beyond Tech., Inc.*, 237 B.R. 32, 44 (Bankr. D. Del. 1999). Where all obligations under a contract are completed, the contract may be deemed non-executory, and the debtor may not be able to reject the contract. See 2 *Norton Bankr. L. &*

Prac. 2d § 39:57 (section 365(n) is not intended to apply to licenses of intellectual property which are not executory in nature).

Section 365(a) of the Bankruptcy Code provides that “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.” 11 U.S.C. § 365(a). Therefore a debtor/lessee may choose to retain contracts for licenses it deems profitable or valuable to the estate, while rejecting those which are unnecessary or damaging. However this power to assume or reject is subject to certain limitations. For instance, section 365(c) of the Bankruptcy Code limits the trustee’s ability to assume or assign if applicable nonbankruptcy law excuses the non-debtor from performance to someone other than the debtor, unless the non-debtor party consents. See 11 U.S.C. § 365(c). As such, the characterization of an intellectual property contract as executory is critical in the event of a debtor/lessee’s bankruptcy.

B. *Exclusive Licenses v. Non-Exclusive Licenses and Consent*

Once the intellectual property license contract is deemed executory, it is then important to determine whether applicable non-bankruptcy law prohibits the free assignment of the license at issue. Under federal copyright law, the assignability of a license depends on whether the license is exclusive or non-exclusive.

i. Exclusive Intellectual Property Licenses

An exclusive license confers property rights and may be freely transferred by the licensee, however the licensor may not transfer the same rights to anyone else. *Golden Books*, 269 B.R. at 308. Because an exclusive license transfers a significant share of ownership in the intellectual property, it is more likely to be considered a non-executory contract. See *Access Beyond*, 237 B.R. at 44 (“if the rights conferred upon the alienee are not exclusive rights investing in him alone or him jointly with the alienor, the monopoly is not transferred and the conveyance is a license”) (quoting *Preload Enter., Inc. v. Pacific Bridge Co.*, 86 F. Supp. 976 (D. Del. 1949)).

ii. Non-Exclusive Intellectual Property Licenses

A non-exclusive license grants only a personal interest (as opposed to a property interest) in the intellectual property which, under federal law, cannot be assigned unless the intellectual property owner consents. See 17 U.S.C.A. § 201(d).

Case law is divided on the issue of whether a debtor/licensee may assume a non-exclusive patent license absent the consent of the licensor. Most courts apply the “hypothetical test” that is based on the plain language of section 365(c)(1): “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.” *In re NeuhoF Farms*, 258 B.R. 343, 350 (Bankr. E.D.N.C. 2000). The majority rule is “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 authorized the assignment or the license itself permits assignment.” *In re CFLC, Inc.*, 89 F. 3d at 679 (quoting *Gilson v. Republic of Ireland*, 787 F.2d 655, 658 (D.C. Cir. 1986)). See also *In re Catapult Entertainment, Inc.*, 165 F. 3d 747, 754-755 (9th Cir. 1999), *cert. dismissed*, 528 U.S. 924 (1999) (debtor could not assume and assign non-exclusive patent license under its

Chapter 11 plan over licensor's objection, despite potential benefit of \$14 million to the estate, since the language of section 365(c) incorporates "applicable law" and under federal patent law non-exclusive patent licenses are personal and assignable only with the consent of the licensor); *In re Access Beyond Techs, Inc.*, 237 B.R. at 48-49 (no assumption of license without consent); *In re Golden Books Family Entertainment, Inc.*, 269 B.R. at 311 (debtor may not assume or assign non-exclusive copyright licenses without licensor's consent); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997) (in case of non-exclusive copyright license, ownership stays with licensor; non-exclusive copyright license non-assignable under longstanding federal policy).

Other courts have held that a debtor is not automatically precluded from assuming a license that it otherwise could not have assigned to a third party under applicable non-bankruptcy law. See *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F. 3d 489 at 493 (1st Cir. 1997) (although applicable federal common law barred assignment of patent licenses, assumption by debtor not precluded even though debtor's stock had been sold to licensor's competitor). See also *In re LeRoux*, 167 B.R. 318 (Bankr. D. Mass. 1994); *In re Ninzy*, 175 B.R. 934 (Bankr. S.D. Ohio 1994); *In re Cardinal Indus., Inc.*, 116 B.R. 964 (Bankr. S.D. Ohio 1990).

iii. Consent

Generally, most executory contracts under section 365(f) may be assumed and assigned regardless of any restrictions in the contract. However, under section 365(c)(1) a debtor cannot assign a contract if the non-debtor party would not be required to accept performance from a third party under applicable law. This is true even if there is no language in the contract explicitly restricting assignment. Under these circumstances, consent from the non-debtor party is required. Several courts have suggested that intellectual property licenses are transferable where the agreement provides that the licensor may not withhold consent under certain conditions, as long as those conditions are met. See *In re Supernatural Foods, LLC*, 268 B.R. 759, 805 (Bankr. M.D. La. 2001) (upholding transfer of exclusive license rights under asset purchase agreement where the licensor's express written consent was not required for transfers incident to the sale of a substantial portion of the 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."). See also *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27 (1st Cir. 1984) (analyzing whether it was reasonable for an automobile manufacturer to withhold consent to the assignment of franchise rights where a state statute provided that such consent could not be unreasonably withheld); *In re Midway Airlines, Inc.*, 6 F.3d 492, 497 (7th Cir. 1993) (finding that the debtor was not barred from assigning airport gate lease where, pursuant to lease, assignment was conditioned upon debtor's providing adequate assurance of future performance).

However, if the licensor reasonably withholds its consent to the debtor/licensee's assumption of a non-exclusive license, the debtor/licensee will be compelled to reject the license. This is true even when the express terms of the license agreement prevent forced termination under such circumstances, and despite the automatic stay provisions of the Bankruptcy Code. See *In re West Electronics, Inc.*, 852 F.2d 79 (3rd Cir. 1988) (analogously, because debtor could not assume arms supply contract under federal law, non-debtor party to contract could compel debtor to reject it: "[t]he bankruptcy court was, therefore, confronted with a situation in which the debtor in possession was not entitled to assume the contract without the government's consent and the government was unwilling to

give that consent. In that situation, the debtor in possession did not have a legally cognizable interest in the contract and it was an abuse of discretion for the court to decline to lift the stay to compel rejection of the contract.”).

VI. Conclusion

As the importance of the assumption and assignment of intangible assets in bankruptcy continues to grow, further evaluation and judicial clarification of section 365 may be needed. While section 365(n) is a significant step towards synthesizing the fundamental concerns of two different areas of law, the tension between the Bankruptcy Code’s policy of the free assignability of contracts to maximize the debtor’s estate and federal protections of non-debtors’ interests in intellectual property assets remains unresolved.