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Protecting Your Intellectual Property in Bankruptcy Cases

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PROTECTING YOUR INTELLECTUAL PROPERTY

IN BANKRUPTCY CASES

Presented to:
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I. INTRODUCTION

The bursting of the dotcom bubble within the last few years and the landslide of bankruptcy filings by telecommunications companies within the last six months[1] has highlighted the role of intellectual property assets in bankruptcy cases, especially those commenced under Chapter 11. Sometimes, these assets are the only valuable assets that can either be sold by order of the bankruptcy court or used as the basis for a reorganization plan. Consequently, it is becoming more and more important for bankruptcy counsel to be familiar with how intellectual property law interacts with the provisions of the Federal Bankruptcy Code. It is the purpose of this outline to highlight the issues arising from this interaction.

II. WHAT IS INTELLECTUAL PROPERTY?

A. Bankruptcy Code Definitions

The term, "intellectual property", is defined in 11 U.S.C. § 101(35A) to "mean" (and not to "include")[2] the following categories of property "to the extent protected by applicable nonbankruptcy law:

(i) trade secrets;
(ii) inventions, processes, designs or plants protected under federal patent law;
(iii) patent applications;
(iv) plant varieties;

[1] "The dotcom crash, it turns out, was merely the warm-up. The telecoms crash is many times bigger. Michael Powell [Chairman of the FCC] surprised no one when he declared this week that the industry is facing 'utter crisis.' The situation is being likened to the Dark Ages. The old empires have fallen and a prolonged period of uncertainty looms." The Economist, "Special Report: The Telecoms Crisis", p. 59, July 20-26, 2002.

[2] The use of the word, "means", in this statute indicates that this is an exclusive list of intellectual property. The rules of statutory construction of the Federal Bankruptcy Code are contained in 11 U.S.C. § 102, which states that the terms, "include" and "including" are not limiting. 11 U.S.C. § 102(3).
(v) works of authorship protected under federal copyright law; and
(vi) mask works protected under Chapter 9 of Title 17 of the United States Code.³

Congress added this statutory definition to the Federal Bankruptcy Code in 1988 in conjunction with the provisions of 11 U.S.C. § 365(n), which are discussed in Part III(b)(2) below. This Code definition does not include trademarks or trade names.⁴ Senate Report No. 100-505 (September 14, 1988), explains the meaning and operation of 11 U.S.C. § 101(35A):

The first new defined term is "intellectual property." The definition is a listing of types of intellectual property. The definition sets forth in some instances both the actual type of property as to which the intellectual property proprietor obtains (e.g., invention, process, design, confidential research or development information, work of authorship) and the alternative legal mechanism for protecting that underlying property (e.g., trade secret, patents and copyrights). The amendment broadly defines "intellectual property" to include virtually all types of such rights (other than trademarks and similar rights) whether protected by federal or State law, statutory or common law. The bill in no way defines or alters any substantive intellectual property law, it merely refers to those rights which are already protected by applicable nonbankruptcy law. Proposed Section 101(52) makes clear that the operation of the bill is to cover both the intangible legal right associated with intellectual property and the tangible object or objects, such as books, blueprints and electronic media, in which such intellectual property may be fixed or recorded.

The definition of "intellectual property" is unusual for a federal statute because of its inclusion of trade secret, normally a concept reserved for development by the states. Because bankruptcy processes can alter rights created by state law, this inclusion is appropriate. Also included as a separate category is confidential research or development information. This was done because some states narrowly define trade secrets, but accord protection to the developer of confidential technical information falling outside those definitions. The definition

³ The semiconductor Chip Protection Act of 1984, P.L. 98-620. "Mask works" are defined in this statute as a series of related images, however fixed and encoded, (a) having or representing the predetermined, three-dimensional pattern of metallic, insulating, or semiconductor material present or removed from the layers of a semiconductor chip product; and (b) in which series the relation of the images to one another is that each image has the pattern of the surface of one form of the semiconductor chip product. Production under the Federal Copyright Act extends only to the layout or topography of the chip does not protect any idea or concept associated with the mask work.

⁴ Trademarks and trade names were excepted from the scope of 11 U.S.C. § 101(35A) because of concerns about the licensee's ability (or desire) to maintain quality control in the circumstance where a trademark license agreement is rejected by the debtor/licensor. See, e.g., Licensing by Paolo, Inc. v. Sinatra (in re Gucci, Inc.), 126 F.3d 380, 394 (2d Cir. 1997); S. Rep No. 100-505 at p. 5 (1988).
is broad and is to be interpreted liberally to carry out the intent of Congress to remove the cloud cast by that recent interpretation of the Bankruptcy Code upon the intellectual property licensing system.


B. Traditional Definitions of Intellectual Property

1. **Trademarks.** A trademark is defined as a word, name, symbol, slogan, or device used to identify and distinguish the owner's goods or, in the case of a service mark, the owner's services. A trademark indicates the origin of those goods and services and connotes a particular standard of quality associated with them. The basic right of a trademark owner is the exclusive right to use the mark on or with the owner's goods and services and to prohibit others from using the mark or similar marks that are likely to confuse consumers as to the source of the goods and services. See generally Leigh v. Warner Bros., Inc., 212 F.3d 1210 (11th Cir. 2000); CPC Int'l., Inc. v. Skippy, Inc., 214 F.3d 456 (4th Cir. 2000).

The law recognizes and enforces common law trademarks. Trademark owners will acquire such a mark merely by using the mark in their businesses. Trademarks that are used in interstate or international commerce may be registered with the United States Patent and Trademark Office (PTO) under the Lanham Act, 15 U.S.C. 1051, et seq. Federal trademark law also protects what is known as "trade dress." This concept encompasses the total image of a product and may include features such as size, shape, color or combinations, texture or graphics, viz., the way in which the product is presented for sale to the public. As the name implies, trade "dress" is the way in which the product is dressed for sale to the public. See, e.g., Roulo v. Russ Berrie & Co., Inc., 886 F.2d 931 (7th Cir. 1989) and the cases cited and discussed therein.

Finally, Michigan law of unfair competition provides protection for trademarks and trade dress similar to the Lanham Act. See, e.g., Wynn Oil Co. v. American Way Service Corp., 943

2. **Patents.** A patent is an exclusionary right granted by the federal government to the owner of the patent to exclude others from making, using, selling, offering to sell, and importing any products covered by a claim of an issued patent. 35 U.S.C. 101 et seq. Patents may be issued for inventions such as processes, machines, and articles of manufacture.

3. **Copyrights.** A copyright is a right granted by the federal government to the creator or owner of an original work of authorship that is fixed in a tangible medium of expression from which it can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or a device. See, e.g., Wickham v. Knoxville Int'l Energy Exposition, Inc., 739 F.2d 1094 (6th Cir. 1984); Ahn v. Midway Mfg. Co., 965 F. Supp. 1134 (N.D. Ill. 1997); Works of authorship include literary works, computer programs, musical works, and motion pictures. 17 U.S.C. 102(a). A copyright owner's exclusive rights include the right to reproduce the copyrighted work, to prepare derivative works based on the copyrighted work, to distribute copies of the copyrighted work, to perform the work in public, and to display that work in public. 17 U.S.C. 106. See also Stewart v. Abend, 495 U.S. 207 (1990).

4. **Trade Secrets.** In order to be protected from disclosure under Michigan "trade secret" law, the information must be subject to secrecy and must have some minimal novelty. The holder of a trade secret has the exclusive right to use the secret. See, generally, Arco Industries Corp. v. Chemcast, 633 F.2d 435 (6th Cir. 1980), McAlpine v. AAMCO Automatic Transmissions, Inc., 461 F. Supp. 1232 (E.D. Mich. 1978).
III. WHOSE INTELLECTUAL PROPERTY IS IT?

The entities that normally will assert rights to and interests in intellectual property in bankruptcy cases will be the following (i) owners of the property, who may sometimes be a licensor or licensee of that property; (ii) secured creditors asserting security interests or liens in the intellectual property or its licenses; and (iii) non-debtor licensees of the intellectual property.

A. The Debtor as Owner of Intellectual Property

1. Identification of Intellectual Property Assets.

The interests of a Chapter 11 debtor in intellectual property become "property of the estate" under the extremely broad definition of that term contained in 11 U.S.C. § 541(a). Thus, the debtor's title to a patent, trademark or copyright will pass to its bankruptcy estate once a voluntary or involuntary bankruptcy petition is filed by or against the debtor. The debtor and, more particularly, its management must act as fiduciaries for their creditors in bankruptcy cases. See, e.g., United Equipment Sales Corp., 47 B.R. 818 (Bankr. W.D. Mich. 1985). These fiduciary duties include a duty not to divert, dissipate or unduly risk assets that are necessary to pay the claims of creditors. See, e.g., Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.), 225 B.R. 646 (Bankr. N.D. Ill. 1998).

Included among the documents that must be filed at or near the date on which a Chapter 11 case is commenced are the debtor's bankruptcy schedules, which identify, inter alia, the debtor's personal property and all executory contracts to which the debtor is a party (including intellectual property licenses). These schedules must be verified, under penalty of perjury, by an appropriate officer or other agent of the debtor as true and correct to the best of his or her knowledge, information and belief. Debtor's counsel normally assists debtor's management in the preparation of these schedules. The information contained in these schedules must be as
complete and accurate as possible, not only to avoid criminal penalties\(^5\) but also to assist the creditors and the bankruptcy court in the administration of the Chapter 11 case. Bankruptcy counsel must work closely with debtor's management in identifying all intellectual property for insertion in these schedules. A form due diligence questionnaire for intellectual property assets prepared by the Columbus, Ohio-based law firm of Porter Wright Morris & Arthur, LLP is attached to these materials as Appendix A. See also, Weston Anson, *Identifying Valuable Intellectual Property in Bankruptcy: Parts I and II*, 21 Am. Bankr. Inst. L. J. (May and June 2002 issues).

2. **Valuation of Intellectual Property Assets.**

Not only must the debtor's bankruptcy schedules describe the debtor's intellectual property, those schedules must also assign values to those assets. These values can be important at various stages in the Chapter 11 case, including the following:

(a) If a secured creditor holds a perfected security interest or lien in intellectual property of the debtor, this value will determine, in whole or in part, the amount of that creditor's secured claim under 11 U.S.C. § 506(a).

(b) If the debtor proposes to sell these assets either by separate motion under 11 U.S.C. § 363 or pursuant to a confirmed Chapter 11 plan, the value of these assets will often determine, in whole or in part, any stalking-horse bid for those assets.

(c) If a creditor with a perfected security interest in intellectual property seeks "adequate protection" under 11 U.S.C. § 361, then the value of these assets will influence the

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\(^5\) 18 U.S.C. §§ 152 and 3571 permit federal courts to fine a person up to $500,000 and/or to imprison him or her for up to five years for making false statements or concealing property in a bankruptcy case.
nature and extent of the adequate protection negotiated by the parties and/or awarded by the
bankruptcy court.

(d) If the debtor seeks to assume or reject any intellectual property licenses under 11
U.S.C. § 365, these values will influence the bankruptcy court in determining whether the debtor
has exercised reasonable business judgment in deciding whether to assume or reject the licenses.

(e) The value of intellectual property assets will be important in determining whether
a bankruptcy court may confirm a proposed Chapter 11 plan. For example, if an impaired
creditor votes to reject a plan, the plan may be confirmed only if that creditor receives in plan
distributions an amount not less than what the creditor would have received in a Chapter 7
liquidation of the debtor. This is the "best interest of creditors" test of 11 U.S.C. § 1129(a)(7).
In addition, if a class of secured or unsecured, impaired creditors votes to reject the plan, the plan
must provide for a proper "cram down" of those claims under 11 U.S.C. § 1129(b)(2) in order for
that plan to be confirmed. The bankruptcy court will consider the value of a debtor's intellectual
property in determining whether the plan proponent has satisfied this confirmation standard.

Because these values may determine whether a Chapter 11 debtor lives or dies, a debtor
and its bankruptcy counsel should seriously consider retaining an expert appraiser to value the
debtor's intellectual property prior to commencing a Chapter 11 case. Counsel should carefully
examine the proposed appraiser's qualifications and abilities as a potential expert witness in the
Chapter 11 case before retaining that professional.

B. The Debtor as Licensor of Intellectual Property

1. The Lubrizol Enterprises Decision.

A Chapter 11 debtor may be the owner of intellectual property that has issued either
exclusive or nonexclusive licenses of that property to third parties. These licenses are normally
classified as "executory contracts" subject to assumption or rejection by a Chapter 11 debtor or a bankruptcy trustee. See, e.g., Everex Systems, Inc. v. Cadtrak Corp. (In re CLFC, Inc.), 89 F.3d 673 (9th Cir. 1996) (patent license); In re Superior Toy & Mfg. Co., 78 F.3d 1169 (7th Cir. 1996) (trademark license); In re Patient Educ. Media, Inc., 210 B.R. 237 (Bankr. S.D.N.Y. 1997) (copyright license). But see Microsoft Corp. v. DAK Indus., Inc. (In re DAK Indus., Inc.), 66 F.3d 1091 (9th Cir. 1995) (license reclassified as a sale). In 1988, Congress enacted and then President Ronald Reagan signed into law Section 365(n) of the Federal Bankruptcy Code, which restricted the power of a trustee or debtor in possession to modify a non-debtor licensee's rights. This amendment to the Bankruptcy Code was in response to the decision of the Fourth Circuit Court of Appeals in Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.), 756 F.2d 1043 (4th Cir. 1985), which permitted the debtor/licensor of intellectual property to reject a nonexclusive license to use its metal-coating process technology as an "executory contract" under 11 U.S.C. § 365. As a consequence of this rejection, the non-debtor licensee was left only with an unsecured claim for damages in Lubrizol's Chapter 11 case and could no longer avail itself of the license. This result challenged a basic norm of intellectual property licensing law - - that license rights could not be terminated unless the licensee breached the license agreement.


a) The Legislative History.

The legislative history of 11 U.S.C. § 365(n) unmistakably reflects Congress' intent to alleviate the harsh results of Lubrizol Enterprises, which "relieved the debtor not simply of its ongoing affirmation performance obligations under the executory license agreement, but also of its passive obligation to permit the licensee to use the intellectual property as provided in the
license." S. Rep. No. 100-505, p. 2 (1988). Consequently, Congress drafted Section 365(n) to permit a non-debtor licensee to continue use of the license notwithstanding its rejection by the debtor/licensor:

The bill provides for treatment of intellectual property licenses under Section 365 in a manner that parallels generally the treatment of real estate leases in the existing provisions of Section 365(h)(1). While intellectual property plays a unique role in technological and economic development, the problems associated with the rejection of executory contracts are common with other special forms of property, such as real property leases. In both real estate leases and intellectual property licenses, the underlying property is unique. When the lessee or the licensee is threatened with loss of use of the property, it is not possible to obtain precise cover from another source.

In adopting the Code, Congress recognized this problem with respect to real property leases and enacted Section 365(h). That section clarified that, although a bankrupt lessor could avoid performance of future obligations under the unexpired lease, it could not cause through rejection of the lease an innocent lessee to forfeit the remainder of its leasehold. Neither the bar nor Congress then foresaw the need to protect similarly the reasonable expectations of intellectual property licensees. The bill corrects the perception of some courts that Section 365 was ever intended to be a mechanism for stripping innocent licensee of rights central to the operations of their ongoing business and stripping the American licensing system of its dependability and flexibility. Thus, the bill does not accord special treatment for intellectual property or the interests of its licensors or licensees beyond that which Congress has recognized in the past is required for these other unique property rights. The bill recognizes that there may be circumstances in which the future affirmative performance obligations under a license cannot be performed in a manner that benefits the estate, but limits the consequences of the breach or rejection of the contract.


b) The Statutory Language.

Section 365(n) of the Bankruptcy Code provides as follows:

(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect

(A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms,
applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or

(B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for –

(i) the duration of such contract; and

(ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.

(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract –

(A) the trustee shall allow the licensee to exercise such rights;

(B) the 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; and

(C) the licensee shall be deemed to waive –

(i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and

(ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall –

(A) to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity.
(4) Unless and until the trustee rejects such contract, on the written request of the licensee the trustee shall –

(A) to the extent provided in such contract or any agreement supplementary to such contract

(i) perform such contract; or

(ii) provide to such licensee such intellectual property (including any embodiment of such intellectual property to the extent provided by applicable nonbankruptcy law) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including any embodiment), including any right to obtain such intellectual property (or such embodiment) from another entity.

The statute offers the licensee a choice if the debtor/licensor rejects the license. It can elect to retain the rights in the license and pay what is due (although future development of the product may be questionable), or it can return the product and file a claim. In the interim, though, the licensee may not interfere with the licensee's rights under the license, avoiding the tacit extortion employed by the debtor in Lubrizol Enterprises. See generally Encino Bus. Management Inc. v. Prize Frize, Inc. (In re Prize Frize, Inc.), 32 F.3d 426 (9th Cir. 1994), which expresses the opinion that section 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." Id. at 428.

C. The Debtor as Licensee of Intellectual Property


Section 365(n) of the Federal Bankruptcy Code only addresses the situation where the debtor is a licensor of intellectual property. There are no corresponding provisions to address the situation where the Chapter 11 debtor is a licensee. In many Chapter 11 cases, an intellectual
property license is the most valuable asset and the debtor/licensee's only hope of effecting a successful reorganization or liquidation plan is through the assumption (and, perhaps, the assignment to a third party) of that license. The license may constitute the most valuable asset of the debtor. A recent series of judicial decisions, however, has severely limited the power of a debtor/licensee to assume/assign an intellectual property license under 11 U.S.C. § 365.

2. Catapult and its Progeny.

The power of a Chapter 11 debtor to assume and assign an executory contract under 11 U.S.C. § 365 is broad but is not limitless. One of the statutory restrictions on this power is set forth in 11 U.S.C. § 365(c)(1) which reads, in relevant part, as follows:

The trustee [or debtor in possession] may not assume or assign any executory contract . . . of the debtor, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties, if -

(1)(A) applicable law excuses a party, other than the debtor, to such contract . . . prohibits or restricts assignment of rights or delegation of duties; and
(B) such party does not consent to such assumption or assignment . . . .

A recent line of cases has applied this statutory prohibition against assumption and assignment to intellectual property that has been licensed to debtors, thereby causing much consternation among debtors and their counsel.

In general executory contracts that may not be assumed or assigned under 11 U.S.C. § 365(c)(1) are contracts where, under applicable nonbankruptcy law, the nondebtor party is excused from accepting performance of or rendering performance to someone other than the contracting party. See, e.g., Reiser v. Dayton Country Club Co. (In re Magness), 972 F.2d 689 (6th Cir. 1992) (debtor's country club membership held nonassumable and nonassignable). Under
federal law, nonexclusive patent and copyright licenses that do not expressly permit their assignment by the licensee to a third party may not be so assigned over the licensor's objection.6

The Ninth Circuit Court of Appeals recently applied this statutory provision to prohibit the mere assumption of patent licenses by a Chapter 11 debtor/licensee. In Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.), 165 F.3d 747 (9th Cir. 1999), cert. filed, 67 U.S.W.L. 3749 (May 28, 1999)(No. 98-1915), cert. dismissed pursuant to Rule 46.1, 67 U.S.W.L. 3749 (Oct. 12, 1999), the Ninth Circuit held that a Chapter 11 debtor could not assume patent licenses as part of a plan of reorganization over the objection of a licensor. Because federal patent law makes nonexclusive patent licenses personal and nondelegable, it constituted "applicable law excus[ing] a party other than the debtor . . . from accepting performance," absent consent of the nondebtor party, and therefore, such licenses could not be assumed. 11 U.S.C. § 365(e)(1). This decision aligns the Ninth Circuit with the Third, Fourth and Eleventh Circuits. See, e.g., In re West Electronics, Inc., 852 F.2d 79 (3d Cir. 1988); Breeden v. Catron (In re Catron), 158 B.R. 629 (E.D. Va. 1993), aff'd without op., 853 F.2d 1038 (4th Cir. 1994); City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.), 27 F.3d 5341 (11th Cir. 1994). Contra., Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1996), cert. denied, 521 U.S. 1120, 117 S.Ct. 2511, 138 L.Ed.2d 1014 (1997). The Catapult decision is particularly troubling because it allows an individual creditor to prevent confirmation of a plan to the detriment of the entire creditor body and the debtor under circumstances where that creditor's

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rights are not being negatively impacted and it is receiving the benefit of its bargain with the debtor.

In Catapult, one Perlman licensed several patents to the debtor, a gaming network. The debtor entered into a merger agreement that proposed to leave the debtor as the surviving entity. This agreement also contemplated the filing of a bankruptcy petition, followed by a reorganization via a reverse triangular merger. As part of the plan, the debtor filed a motion seeking to assume one hundred and forty (140) executory contracts and leases, including the Perlman licenses. It was clear that assumption of these licenses was critical to the success of the debtor's plan. The court approved the assumption over Perlman's objections, and subsequently confirmed the plan that had been accepted by the requisite majority of creditors and equity holders required under the Code. On appeal, the United States District Court for the Northern District of California affirmed the decision of the Bankruptcy Court. Perlman appealed and the Ninth Circuit Court of Appeals reversed.

The Ninth Circuit began its analysis with Section 365(c)(1) and by explaining the "hypothetical" and "actual" tests, the two primary approaches utilized by the courts in interpreting the rights and obligations of the parties under Section 365(c)(1). The "hypothetical test" is derived from a plain statutory language approach and provides:

...The plain language of § 365(c)(1) "link[s] nonassignability under 'applicable law together with a prohibition on assumption . . . . 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. The literal language of § 365(c)(1) is thus said to establish a "hypothetical test," a debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession has no intention of assigning the contract in question to any such third party . . . .
ld. at 750 (citations omitted). The "actual test" is premised on reasoning that Congress did not intend to bar debtors in possession from assuming their contracts when no assignment is contemplated.

... the statute bars assumption by the debtor in possession only where the reorganization in question results in the nondebtor actually having to accept performance from a third party. Under this reading of § 365(c), the debtor in possession would be permitted to assume any executory contract, so long as no assignment was contemplated.

ld.

The debtor urged the court to adopt the "actual test" because (i) a literal reading of Section 365(c)(1) creates inconsistencies within Section 365(c) as adoption of the "hypothetical" test would render Section 365(c)(2), prohibiting assignment of contracts to make loans, or extend other debt financing or financial accommodations to or for the benefit of the debtor, unnecessary and superfluous, (ii) a literal reading is inconsistent with the legislative history, and (iii) a literal reading flies in the face of sound bankruptcy policy. The court, however, rejected each of these arguments in favor of a plain reading of the statute.

The court first concluded that the various subsections of Section 365 could be "credibly reconciled" because "each subsection recognizes an "applicable law" of markedly different scope." Id. at 752, citing Reiser v. Dayton Country Club Co. (In re Magness), 972 F.2d 689, 695 (6th Cir. 1992). Section 365(f)(1), which permits the assignment of executory contracts, delineates a broad rule rather than a carefully crafted exception. If applicable law does not contain a general ban on assignment, but specifically excuses a party from accepting performance from an entity different from the one with whom the party originally contracted, then the applicable law prevails and the proposed assignment can be vetoed by the non-debtor party.
The Ninth Circuit rejected the suggestion that adoption of the "hypothetical" test created inconsistencies within the statute by articulating distinctions between the two subparts of Section 365(c). Subsection 365(c)(2) has been rendered superfluous by national uniformity of applicable state laws, not by the court's interpretation of subsection (c)(1). Moreover, the court reasoned that the debtor could avoid the prohibition of subsection (c)(1) by obtaining the consent of the nondebtor party, whereas consent of the nondebtor party could never alter or waive the prohibition in subsection (c)(2).

Because the court believed that a plain reading of the statute was clear and unambiguous, the legislative history of 11 U.S.C. § 365(c)(1) need not have been consulted. Nevertheless, the Court reviewed the legislative history and found that no contemporaneous legislative history regarding the current formulation of Section 365(c)(1) existed. The legislative history from a 1980 House proposal proffered by the debtor was rejected by the court as not constituting authoritative support for the language subsequently adopted as part of the 1984 amendment to Section 365(c)(1) - - too much time had elapsed between the earlier proposal and the 1984 amendments, without evidence of any clear connection between the two legislative proposals.

The court also rejected policy arguments advanced by the debtor because "[p]olicy arguments cannot displace the plain language of the statute; that the plain language of § 365(c)(1) may be bad policy does not justify a judicial rewrite." Id. at 754. Ultimately, if the language creates a "bad result," it is incumbent on Congress, not the courts, to rewrite the statute.

Since the Ninth Circuit decided Catapult, it has been cited with approval or followed by a number of other courts. See In re TechDyn Systems Corp., 235 B.R. 857 (Bankr. E.D. Va. 1999) (involving a government contract for telecommunications services); In re Schlick, 235 B.R. 318 (Bankr. S.D.N.Y. 1999) (rights in a partnership); and In re Access Beyond Technologies.
Inc., 237 B.R. 32 (Bankr. D. Del. 1999) (license that could not be assigned under applicable could not be assumed).

IV. PROTECTING THE SECURED PARTY'S INTEREST IN INTELLECTUAL PROPERTY

A. The Role of Secured Creditors' Counsel

Creditors claiming security interests in intellectual property owned by a Chapter 11 debtor should retain bankruptcy counsel to represent their interests in the bankruptcy case. One of counsel's first actions taken after retention should be to review all of the creditor's files relating to the debtor and the secured loans extended to it and interview the creditor's personnel responsible for the administration and collection of those loans. In order to determine whether a creditor's liens and interests are perfected under applicable nonbankruptcy law, counsel should order Uniform Commercial Code searches in the appropriate jurisdictions and, in situations where the creditor asserts a security interest in a copyright, order lien searches from the United States Copyright Office in Washington, D.C. In the event that the creditor's liens and security interests have not been perfected as of the Chapter 11 filing date, the debtor (or a properly authorized creditors committee) may request the bankruptcy court to avoid those liens and interests under the "strong-arm powers" granted to a trustee or debtor in possession by 11 U.S.C. § 544(a).

B. Determining Perfection of Security Interests and Liens in Intellectual Property

1. In General.

This section contains a brief overview of how security interests in trademarks, patents, and copyrights may be perfected under Revised Article 9 and applicable federal law. If a federal
statute or regulation creates an alternative method of perfection, that statute or regulation will
preempt Revised Article 9. M.C.L.A. § 440.9109(3)(a), M.S.A. § 19.9109(3)(a); Official
Comment 8 to Revised § 9-109. As discussed in more detail below, the existing case law holds
that only the Federal Copyright Act, 17 U.S.C. 101 et seq., preempts Revised Article 9.
Consequently, perfection of security interests in trademarks and patents may be accomplished by
filing a financing statement in accordance with the applicable provisions of Revised Article 9.

2. Trademarks.

The reported case law holds that a security interest in a common law or federally
registered trademark may be perfected by filing a financing statement in the proper state filing
office. See, e.g., In re Roman Cleanser Co., 43 B.R. 940 (Bankr. E.D. Mich. 1984), aff’d, 802
F.2d 207 (6th Cir. 1986); In re Chattanooga Choo Choo Co., 98 B.R. 792 (Bankr. E.D. Tenn.
classified as a "general intangible" under M.C.L.A. 440.9102(1)(pp); M.S.A. 19.9102(1)(pp), the
secured party must file a financing statement with the filing office in the debtor's "location."
However, when a federally registered trademark serves as collateral, the secured party should, in
an abundance of caution, record its security agreement with the PTO.

3. Patents.

Reported case law holds that a security interest in a patent may be perfected by the filing
of a financing statement in the proper state filing office. See, e.g., Moldo v. Matsco, Inc. (In re
Cybernetic Servs.), 239 B.R. 917 (BAP 9th Cir. 1999), aff’d, 252 F.3d 1039 (9th Cir. 2001); In re
Transportation Design & Tech., Inc., 48 B.R. 635 (Bankr. S.D. Cal. 1985). Like trademarks,
patents are "general intangibles" and a financing statement should be filed with the proper filing office in the state where the debtor is located. Again, it is advisable, but not required, to record the security agreement with the PTO.


In order to perfect a security interest in a federally registered copyright, a secured party must record its security agreement or copyright mortgage in the U.S. Copyright Office. 17 U.S.C. 205(a). This federal system is designed to give all persons constructive notice of the facts contained in the recorded document and, therefore, preempts Revised Article 9. M.C.L.A. 440.9109(1)(c), M.S.A. 19.9109(1)(c). The failure to so record a security agreement or copyright mortgage will render the security interest unperfected. See, e.g., In re Peregrine Entertainment, Ltd., 116 B.R. 194 (C.D. Cal. 1990). See also Note, Transfers of Copyright Under the New Copyright Act, 88 Yale L.J. 125 (1978); S. Weinberger, Note, Perfection of Security Interests in Copyrights: The Peregrine Effect on the Orion Pictures Plan of Reorganization, 11 Cardozo Arts & Ent. L.J. 959 (1993). In an abundance of caution, secured parties should also file financing statements listing the copyright as collateral with the proper filing office in the state where the debtor is located.

There is a split of decisional authority on how to perfect a security interest in an unregistered copyright. In In re AEG Acquisition Corp., 127 B.R. 34 (Bankr. C.D. Cal. 1991), the bankruptcy court held that unregistered copyrights must be registered with the U.S. Copyright Office in order to perfect a security interest in that property. See also In re Avalon Software, 209 B.R. 517 (Bankr. D. Ariz. 1997), which held that a security interest in an unregistered copyright may be perfected only by both registering the copyright and recording the security agreement with the U.S. Copyright Office. Nevertheless, at least one court has
disagreed with AEG Acquisition and Avalon Software by holding that a security interest in an unregistered copyright may be perfected by the filing of a financing statement in the proper filing office dictated by Article 9 of the U.C.C. Aerncon Eng'g, Inc. v Silicon Valley Bank (In re World Auxiliary Power Co., 244 B.R. 149 (Bankr. N.D. Cal. 1999). In light of this disagreement in the case law, a secured party should require the owner to record the copyright with the U.S. Copyright Office, record the security agreement or copyright mortgage there, and then file a financing statement with the proper filing office in the state where the debtor is located.

C. Valuation Issues

As discussed in Part III(A)(2), supra, creditors holding security interests and liens in a Chapter 11 debtor's intellectual property, as well as counsel to these creditors, should be extremely sensitive to the value of these intangible assets. The value assigned to this property by the bankruptcy court will determine the amount of the creditor's secured claims, at least for the purposes of that particular hearing. 11 U.S.C. § 506(a).7

1. Adequate Protection Disputes.

At the outset of a Chapter 11 case, valuation of a secured creditor's collateral will be important for purposes of adequate protection. Under 11 U.S.C. § 363(e), a debtor may not use a secured creditor's collateral without that creditor's consent unless the bankruptcy court finds that the creditor's liens and security interests in the collateral are "adequately protected." The court will normally conclude that adequate protection exists when the secured creditor is or will be

7 The last sentence of 11 U.S.C. § 506(a) provides that the value of a secured creditor's collateral "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." Thus, a valuation for adequate protection purposes will not act as res judicata for confirmation purposes. See, e.g., In re Woolley's Parkway Center, Inc., 147 B.R. 996 (Bankr. M.D. Fla. 1992).
compensated for any deterioration in the value of those interests and liens caused by the debtor's use of collateral during the pendency of the Chapter 11 case. See, e.g., In re Holly's, Inc., 140 B.R. 643 (Bankr. W.D. Mich. 1992). For these purposes, a debtor that desires to use intellectual property over the secured creditor's objection should be prepared to introduce evidence at the hearing\(^8\) that the value of these assets will not depreciate through their use during the Chapter 11 case or, if such depreciation does occur, the creditor will be protected against any loss, either through periodic cash payments made to the creditor or replacement liens on other property granted to the creditor. 11 U.S.C. § 361. The debtor may also argue that the value of the intellectual property assets far exceeds the amount of the creditor's liens and interests in that property and, consequently, this "equity cushion" provides the secured creditor with the necessary adequate protection.

In opposing the debtor's request for use of collateral under 11 U.S.C. § 363(e) or in requesting relief from the automatic stay under 11 U.S.C. § 362(d) to recover and dispose of collateral, the secured creditor should be prepared to introduce expert testimony of a qualified appraiser of intellectual property to establish the amount and rate of depreciation in value of the collateral caused by the debtor's anticipated use. In addition, the secured creditor should be ready to prove at the hearing that the debtor's adequate protection offers are inadequate to compensate for the depreciation in value of the creditor's lien. For example, the creditor may introduce evidence that the proposed cash payments are insufficient to compensate for the decrease in value of the creditor's lien and/or that no equity cushion exists in the particular intellectual property to protect that lien.

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\(^8\) This evidentiary hearing could be held either upon the debtor's motion to provide adequate protection to the secured creditor or upon that creditor's motion for relief from the automatic stay provisions of the Bankruptcy Code.
2. **Objections to Confirmation.**

In a proposed Chapter 11 plan, the debtor may provide that the value of the secured creditor's lien in intellectual property is less than the amount of the debt owed to that creditor. In these circumstances, the creditor would hold two claims: one claim for the value of the lien as its secured claim and the other claim, which would be unsecured, for the projected deficiency. The debtor would then be required to pay the "present value" of that secured claim in the plan by installment payments bearing a market rate of interest in order to overcome a "cram down" objection by that creditor under 11 U.S.C. § 1129(b)(1). See, e.g., *In re Trevarrow Lanes, Inc.*, 183 B.R. 475 (Bankr. E.D. Mich. 1995); *In re Eastland Partners Ltd. Partnership*, 149 B.R. 105 (Bankr. E.D. Mich. 1992); *In re Kain*, 86 B.R. 506 (Bankr. W.D. Mich. 1988). In the event that the secured creditor objects to confirmation of the plan on the basis that the debtor failed to satisfy the cram down standards of 11 U.S.C. § 1129(b)(1), then the secured creditor should be prepared to introduce expert testimony of a qualified appraiser of intellectual property to support the creditor's assertion of value. The debtor, in turn, will normally be prepared to introduce evidence supporting its own asset valuation.
APPENDIX A
INTELLECTUAL PROPERTY EXCERPT FROM DUE DILIGENCE QUESTIONNAIRE

Please provide us with a copy of, or access to, the following documents or items in connection with the proposed ... by _____________ (the “Company”).

Patents

1.1 All patents, pending patent applications, reissue patent applications and reexamination certificates, including filing date, issue date, status, country of issuance or application, and claims coverage

1.2 File wrappers for patent applications and patents with references, including all assignments in the chain of title from inventors to the Company

1.3 Files for any office actions, interferences, continuations, reissues, reexaminations, or other patent office proceedings

1.4 Patent searches and opinion letters concerning non-infringement, patentability, and validity

1.5 Maintenance fee records for any issued patents

1.6 Engineers’ and scientists’ notebooks and invention disclosure schedules kept by the Company

1.7 Files concerning any patent assignments, which should include the right to sue for past infringements, and any patent licenses, which should not exceed the term of the patent

1.8 Files concerning any threatened or pending patent infringement litigation whether brought by the Company against another or by another against the Company

Trademarks

2.1 All trademark and service mark registrations, renewal applications, and applications, including dates of first use, filing dates, issue dates, classes of goods and services, geographical markets where marks are used, status, countries of issuance or application, and assignments

2.2 All trade names and company names, brand names and unregistered trademarks and service marks

2.3 File wrappers for trademark applications and registrations, including all Continued Use Affidavits

PORTER WRIGHT MORRIS & ARTHUR LLP
Attorneys & Counselors at Law
2.4 Files for any office actions, oppositions, cancellations or other trademark office proceedings

2.5 Searches and opinion letters concerning clearance and registrability

2.6 Files relating to any Internet domain names registered by or for the Company

2.7 Documentation concerning recordation of trademark assignments with Trademark Office

2.8 Files concerning any trademark assignments, which should include an assignment of goodwill and, if the mark is the subject of an intent-to-use application, an assignment of the business to which the mark pertains, and any trademark licenses.

2.9 Files concerning any trademark licenses, which should include quality control language

2.10 Files concerning any threatened or pending opposition or cancellation proceedings in the Trademark Office, or any federal or state trademark infringement, dilution, false advertising or unfair competition proceedings involving either the Company’s trademarks or the marks of another

Copyrights

3.1 All registered copyrights, copyright registration renewals, and applications for copyright registration, including titles of works, authors, owners, publication dates, filing dates, issue dates, countries of registration or application

3.2 All material unregistered copyrights, including for software

3.3 Documentation concerning chain of title, including assignments to the Company of works created by contract programmers and chain of title opinion letters

3.4 Copyright clearance opinion letters evaluating possible infringement

3.5 Documentation concerning recordation of copyright registrations with Copyright Office

3.6 Files concerning review of software usage for unlicensed copies of copyrighted software

PORTER WRIGHT MORRIS & ARTHUR LLP
Attorneys & Counselors at Law
3.7 Files concerning copyright assignments, licenses and security interests, including "work for hire" agreements with independent contractors and company employees.

3.8 Files concerning any threatened or pending copyright infringement litigation, including demand letters sent to or from the Company

**Trade Secrets**

4.1 All inventions that are not the subject of issued patents, but may be the subject of patent applications or may have invention, discovery or reduction to practice dates

4.2 All software developed by or for the Company for which confidentiality has been maintained

4.3 All other material business information which has been kept secret and from which the Company derives economic benefit by keeping secret

4.4 Documents reflecting procedures to protect the Company's trade secrets, such as the Company's written confidentiality policies and non-disclosure agreements with employees or third parties, and the Company's implementation of its policies, such as by marking materials as confidential, restricting access to sensitive parts of its manufacturing plants, and the like

4.5 Documents relating to hiring and exit interviews of technology and other sensitive personnel

4.6 Confidential disclosure agreements (non-disclosure agreements)

4.7 Documents reflecting any Company policies addressing protection of the trade secrets of others which may be received by the Company through authorized disclosure, inadvertent receipt or competitive intelligence

4.8 Documents relating to the policies and procedures for receiving unsolicited submissions

4.9 Files concerning any trade secret misappropriation litigation, which may involve departed employees, relations with suppliers and customers, or competitive intelligence

**Internet-Related Intellectual Property**

5.1 All service or registration agreements with domain name service providers, website developers, and website hosting service providers

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PORTER WRIGHT MORRIS & ARTHUR LLP
Attorneys & Counselors at Law
5.2 Files containing agreements with employees or third parties involved in the
creation and/or maintenance of any company sponsored web site, including “work
for hire” agreements with all non-employees

5.3 All files concerning domain name registration for company sponsored web sites

5.4 Any and all documents transferring ownership of domain name registration,
changes in domain name, or other modifications to initial service or registration
agreement with domain name service provider

5.5 All forms authorizing modifications to the Company’s domain name records,
personal contact records, role account contact records, or host/name server
records

5.6 Copies of domain name service providers most current domain name dispute
policy

5.7 Files concerning threatened or pending domain name disputes filed by or against
third parties with the domain name service provider

5.8 Does the Company have Cyber Coverage with reputable insurance companies,
including coverage for third-party liability (claims arising from electronic
business activities) and first-party policies

Licenses

6.1 All intellectual property licenses where Company is licensee, including names of
parties, dates of expiration, rights granted and any pertinent restrictions such as
territory or transferability

6.2 All intellectual property where Company is licensor, including names of parties,
dates of expiration, rights granted and any pertinent restrictions

6.3 Evidence of registered user filings in countries where required

Assignments

7.1 Documents evidencing assignments of intellectual property to or from the
Company, including grants of security interests

7.2 Documents evidencing recordation of assignments of patents and patent
applications, trademark registrations and applications, and copyrights, including
grants of security interests

PORTER WRIGHT MORRIS & ARTHUR LLP
Attorneys & Counselors at Law
7.3 Documents evidencing releases of any security interests in intellectual property, and evidencing recordation of such releases

Other Agreements

8.1 Agreements with those persons and entities who may create, work with or have access to the Company's intellectual property (including employees and independent contractors) evidencing assignment to the Company of rights in intellectual property and confidentiality of trade secrets

8.2 Software development agreements, including Year 2000 warranties which address avoiding software problems that may be caused by the input of information referring to a date after December 31, 1999, and Euro recognition and conversion to other currencies

8.3 Database and processing service agreements

8.4 Technology, know-how, and research and development agreements

8.5 Partnership, joint venture, strategic alliance, teaming and co-branding agreements

8.6 Government grants and related agreements

8.7 Source code escrow agreements

8.8 Non-compete and non-solicitation agreements

Litigation and Enforcement

9.1 Files concerning litigation over intellectual property warranties, including claims that Year 2000 problems in software have not been fixed or attempts to allocate responsibility for fixing Year 2000 problems

9.2 Files for any threatened or pending litigation alleging that Company is infringing or diluting the intellectual property rights of another

9.3 Files concerning any potential future litigation or objections that the Company has identified through clearance practices or through industry review

9.4 Files for any threatened or pending litigation brought by the Company asserting that a third party is or was infringing or diluting the intellectual property rights of Company

9.5 Enforcement files, including cease and desist letters sent or received and agreements of any kind restricting use of any intellectual property by the Company or by any third party
9.6 Files concerning administrative proceedings such as trademark opposition and cancellation proceedings or custom proceedings

9.7 Insurance policies and related files addressing coverage issues concerning intellectual property claims and damages caused by intellectual property, such as system crashes due to unresolved Year 2000 problems

9.8 Files concerning any threatened or pending disputes under domain name dispute policies

Valuation of Intellectual Property

10.1 Any documents concerning valuation of any intellectual property holdings of the Company

10.2 Any documents concerning valuation of competitive intellectual property owned by others

10.3 Any information about the royalty revenues or other income stream generated by the Company’s or competitive intellectual property
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Foreclosures and Bankruptcies

The Chimerical Value of Intellectual Property Licenses in

Since 1997

July 2002
GRAND RAPIDS

BY SCOTT PAYNE

GRAND RAPIDS — Amid the welter of bad business news, there’s been little coverage of some court decisions’ implications concerning the value of intellectual property as collateral.

According to Patrick E. Mears, a lawyer with the Grand Rapids office of Dickinson Wright PLLC, recent rulings may reduce the value of such property in certain financial circumstances to zero ... or worse.

The University of Michigan graduate noted that banks often take liens on intangible assets, intellectual property such as software licenses and patent licenses, to secure loans.

“The licenses are often the licensee’s most valuable assets,” he told the Business Journal. “But he said the converse isn’t necessarily true.

When the licensee begins to suffer financial distress, he asked, ‘Will a bank with a security interest in an intellectual property be able to foreclose upon and sell that property?’

He said it’s an issue that banks began to consider seriously two years ago when many dot-com values started becoming widely inflated.

“The banks started seeing what was going on, and they took appropriate steps,” he said.

And it’s well that they did, he said, because recent developments in foreclosure and bankruptcy law suggest that foreclosures concerning intellectual property licenses sometimes may not be a realistic option for a bank.

The problem, he said, is that some recent court decisions seem to give intellectual property licensors a virtual veto over the disposition of intellectual property in foreclosures. In such cases, he said, a bank holding a security interest suddenly may learn that the assets in question have little or no value.

Mears cited two hypothetical cases to illustrate what he meant.

The first concerns a Tier II maker of precision parts for a Tier I supplier to one of the Big Three automakers.

He said the Tier II firm licenses custom software so that its complex machinery can make parts. In essence, he explained, the machines are inoperable without the software.

“The bank financing the Tier II supplier holds a security interest in the machinery and the software,” he said, and should the Tier II supplier default on its loan, the bank normally would repossess and auction both the machinery and software.

But the courts’ latest view is that the licensor can prohibit the sale of the software license when the software is not “embedded” in the machinery, as in, say, a Palm Pilot. And that leaves the bank trying to auction equipment that, absent its software, is basically scrap, “useful only as a heavy and bulky paperweight,” he said.

In the other hypothetical case, he said, a patent protects the manufacturing design of a revolutionary household appliance.

“The patent owner grants to a manufacturer an exclusive license to produce and sell the appliance for a period of 10 years in return for quarterly royalty payments,” Mears said.

Without the license, he said, the manufacturer can’t market the appliance and the patent licensor, again in this case, prohibits transferring the license to a third party without the licensor’s consent.

He said that if the manufacturer has financial difficulty and seeks Chapter 11 reorganization, it normally would try to keep the license by formally “assuming” it.

But now it appears the patent owner is in a position to torpedo that plan, potentially leaving the manufacturer in a grave position — and giving the licensor tremendous negotiating power in the Chapter 11.

“Under the laws as they now stand, the licensor’s special negotiating position is a stays on sale of the intellectual property,” Mears said.

He said any talk of a Stay on sale of the intellectual property is a stays on sale of the intellectual property, a major legal hammer to the bank and a major legal hammer to the bank.

So what’s a bank to do?

Mears says his advice for banks, no matter how florid the promise the intellectual property seems to offer, is to do due diligence just as they did traditionally — and to secure their interests in traditional assets that retain their value in foreclosures.