Intellectual Property Agreements: The Assumption/Rejection Risk

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This practice note provides an overview of the treatment of intellectual property agreements in bankruptcy. Once a debtor files for bankruptcy, an intellectual property license generally is considered to be an executory contract which may be assumed or rejected. However, as set forth below, the Bankruptcy Code and case law provide special protections for parties to intellectual property agreements in some circumstances. This practice note also discusses the effect of a bankruptcy case filed by a defendant in a patent infringement case on the prosecution of the case by the plaintiff complaining of an infringement.

This practice note addresses the following with respect to intellectual property agreements in bankruptcy:

- Intellectual Property Definitions
- Identifying the Bankruptcy Risks for Licensors and Licensees of Intellectual Property
- Executory Contracts Generally
- Licenses under U.S. Bankruptcy Law
- Assumption of Licenses
- Assignment of Licenses
- Rejection of Licenses
- Managing a Licensee's Assumption Risk
- Patent Infringement – The Bankruptcy Effect

For more information on the treatment of intellectual property in bankruptcy, see Special Considerations for Assumption, Assignment, and Rejection of Certain Executory Contracts and Sale of Intellectual Property. For a sample bankruptcy clause for use in intellectual property license agreements, see IP License Clause.

Intellectual Property Definitions

Intellectual Property

What is a right in intellectual property? Most simply, it is a legally protected interest in a concept. The legal protection afforded to such property interest is comprised of restrictions placed on the exploitation of such concept by others—in other words, a limitation on use.

Generally, intellectual property rights are transferable, either (1) by assignment, or (2) by the grant of a license. The universe of interests known as "intellectual property" covers patents, copyrights, trademarks, trade secrets, and domain names. The Bankruptcy Code defines the term intellectual property as (1) trade secret; (2) invention, process, design, or plant under Title 35 (patent); (3) patent application; (4) plant variety; (5) work of authorship protected under Title 17 (copyright); or (6) (semi-conductor chip) mask work protected under Chapter 9 of Title 17, to the extent protected by applicable non-bankruptcy law. One exclusion from the definition of intellectual property is notable: the Bankruptcy Code's definition of intellectual property does not include trademarks. This omission, and its legal import, is discussed in this practice note under section Assignment of Licenses and Supreme Court Resolves Circuit Split on Effect of Rejection of a Trademark Licensing Agreement in Bankruptcy.

Patents

A patent is a legal monopoly granted by the government on the exploitation of an invention for a limited period of time in exchange for public disclosure and eventual unrestricted public use of the invention. During the term of the patent, the owner may prevent others from making, using, or selling the invention. The subject matter of a patent may be (1) a new and non-obvious process, machine, manufactured item, or composition of matter (utility patent); (2) a new and non-obvious ornamental design for a manufactured article (design patent); or (3) a new and distinct variety of plant that has been invented or discovered and can be asexually reproduced (plant patent).

Patent rights are granted by a national government in response to an application by the individual inventor(s) or, in some countries but not the United States, by the company employing the inventor(s). A corollary to this rule of patent creation is that patents are territorial.

A patent application must be filed before the invention is publicly disclosed or (in the United States but not all other countries) within a limited time after public disclosure. Foreign applications based on an application in the inventor's home country must be filed within one year of the home country filing date in order to claim the benefit of the home country filing date.

Patent rights do not exist until an application has been approved and granted. The use of the phrase patent pending means only that an application has been filed (somewhere, wherever that may be). Unless and until the patent application is granted, the invention may be copied without liability, but if the copying continues after the patent issues, the copier would be liable for patent infringement. In the United States, the term of utility patents applied for since June 8, 1995, is 20 years from the date of application. (Previously, the term was 17 years from the date of issue). The term of design patents is 14 years from the date of issue.

Copyrights

A copyright is the right to control the copying of an original creative work or derivation of such work. The subject matter of a copyright may include the original and creative expressions of an idea in tangible form—for example, writings, photographs, recordings, films, musical notations, source code, artworks, sculpture, etc. However, a copyright does not protect an idea itself. Others are free to paraphrase an idea that is copyrighted or create their own expressions of such idea.

A copyright comes into effect automatically upon the creation of a copyrightable work. The Berne Copyright Convention, to which the United States is a party, provides protection for copyright in nearly every country. No registration, publication, or formal notice is required to create a copyright. Nevertheless, copyright owners are well served by routinely including a copyright notice (e.g., © 2014 by [Owner]) on copyrighted material in order to avail themselves of important procedural rights against possible infringers. However, in the United States, copyright owners must register their copyrights as a prerequisite to filing suit for infringement.

The owner of a copyright generally is the individual who created the work. In the United States, a copyrightable work created by an employee in the scope of employment automatically belongs to the employer (and not the individual employee) under the work-for-hire doctrine. Work-for-hire does not apply to independent contractors, who often are required by contract to assign or license the intellectual property subject to the copyright to the hiring party.

For works created after January 1, 1978, the term of a copyright is the life of the author, plus 70 years. If under the work-for-hire doctrine the author is a corporation or similar legal entity, the term is the shorter of 95 years from the date of publication or 125 years from the date of creation.

Trademarks

A trademark is a right to keep others from appropriating a distinctive commercial identity. The subject matter of a trademark may include a distinctive symbol (e.g., a word, name, symbol, logo, slogan, sound, smell, trade dress, product shape, etc.) used to associate goods or services with a particular source. Trademark rights do not create an absolute monopoly on a particular word or logo, but instead grant only the right to keep others from using the same or a very similar mark on or in association with the same or closely related goods or services, or from otherwise misleading customers into thinking that there is a commercial relationship with the trademark owner. For the forgoing reasons, trademarks are sometimes called industrial property.

Common law rights in trademarks arise in the United States and other English law countries when a mark is used to identify and distinguish goods and products produced or sold by one vendor from those produced or sold by another. It is the use of the mark that creates recognition and the right to keep others from appropriating the mark. Thus, in the United States, an applicant for a trademark must use the mark before a federal registration will be issued. Countries outside the English law system typically base trademark rights on filing for registration. By treaty, non-U.S. applicants generally may obtain a U.S. trademark registration without proving that the mark is in commercial use in the United States. The term of a U.S. registration is 10 years; it can be renewed indefinitely, so long as the mark remains in use.

The owner of a trademark is presumed to control the quality of the goods or services sold under the mark—that is why the mark has value. The owner of the mark can either manufacture and sell the goods by itself and/or can grant a license to another party to manufacture and/or sell the goods subject to the mark.

Trade Secrets

As defined in the Uniform Trade Secrets Act, trade secrecy consists of information, including a formula, pattern, compilation, program, device, method, technique, or process, that (1) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

If a formula, idea, or invention is not patented, it can be protected only by the owner's efforts to keep it secret. If the secret is revealed, the owner may have a cause of action against the party who disclosed the secret without authorization. Once disclosed, a trade secret is gone, since it must be information that is secret.

Domain Names

A domain name is an Internet web address or URL—for example, www.uscourts.gov. Domain names are purchased from a provider or a domain name registrar. As a general matter, a domain name can be treated like a trademark, copyright registration, or a patent. Domain names, in many cases, incorporate a trademark or trade name of the domain name registrant. In such cases, trademark protections may attach to the web address.

Identifying the Bankruptcy Risks for Licensors and Licensees of Intellectual Property

Licensors and licensees of intellectual property face several challenges when the other party to a license files for bankruptcy relief. A licensee faces the risk that its licensor may elect to reject the license under Section 365 of the Bankruptcy Code, thereby depriving the licensee of the ability to use the intellectual property essential to its business. On the other hand, a licensor faces the risk that a licensee may file for bankruptcy and reject the license in question, thus relieving such licensee of its obligations under the license, including the licensee's obligation to pay licensing fees to the licensor. A licensor may also have to deal with an attempt by a trustee or debtor in possession to assume and assign a nonassignable license agreement in the context of Bankruptcy Code Section 363 asset sale.

Purchasers of intellectual property from a debtor in possession or bankruptcy trustee also take on bankruptcy risk. Although it may seem simplistic, the first thing that a prospective purchaser of a bankruptcy estate's interest in intellectual property needs to know is what the seller is able to convey. Intellectual property including trademarks, trade names, patents, copyrights, and domain names may be treated differently under bankruptcy law than they would be treated outside of the bankruptcy context. Once a prospective purchaser understands the legal interest in the asset in play, the prospective purchaser should then take steps to ascertain whether such property is owned by the debtor entity or is licensed to the debtor entity. If it is determined that the debtor entity is a licensee of the intellectual property in question, the next level of inquiry for the prospective purchaser becomes whether the license is an exclusive license or nonexclusive license.

More often than not, a particular copyright or patent covers a bundle of rights. Some licenses may be exclusive, others may be limited to allow the intellectual property in question to be exploited only for a specific purpose or in a certain geographic region. Therefore, during the next phase of the due diligence process, a prospective purchaser should conduct an in-depth review of the terms of a proposed license to determine whether the debtor/licensee has been granted all of the rights that are needed to make use of the intellectual property covered by the relevant intellectual property. For example, a debtor/licensee may have acquired an exclusive license to exploit a patent to make, use, or sell a particular device. But if the patent in question covers multiple devices, the license may cover only some of these devices. The licensor may have retained rights so that the debtor/licensee does not have a license to use all possible rights available by virtue of the patent in question. Another example of a limited grant would be a license to exploit the image of a cartoon character to make tee shirts, but only tee shirts. Similarly, a license may be geographically limited. For example, a license that permits the use of a cartoon character's image to clothing to be sold only in North America.

Executory Contracts Generally

As a general rule, a contract is executory if performance is still due from both parties to the contract, and the failure of either party to perform would constitute a material breach. Courts differ in their interpretation of this definition of "executory contract." The term itself is not defined in the Bankruptcy Code. Section 365(a) of the Bankruptcy Code gives the bankruptcy trustee or debtor in possession the power to assume (keep) and the power to reject (disavow) those contracts and leases entered into prior to a bankruptcy filing. The bankruptcy trustee or the debtor in possession has the authority to decide whether an executory contract or unexpired lease is advantageous or not, and to assume or reject the agreement. Debtors and trustees may modify obligations under executory contracts and unexpired leases through the use of two tools:

- The right to assume a contract or lease by curing defaults, notwithstanding a contrary provision in the affected lease, or contract providing for termination due to insolvency – and–
- The right to assign such contract or lease, notwithstanding contractual restrictions on assignment

The benefits of assumption and of assumption and assignment are balanced by the requirements of Section 365 of the Bankruptcy Code for assumption and for assignment and assumption. Under Section 365, a debtor may assume or assume and assign an executory contract or unexpired lease only if it cures any existing defaults and pays damages arising from a breach of the contract or lease. The debtor must also provide adequate assurance of future performance of its obligations under the contract or lease.

Prior to assumption or rejection and after the filing of a bankruptcy case, all executory contracts and unexpired leases remain in existence and enforceable by the debtor or trustee but are not enforceable against the debtor or trustee. Moreover, the Bankruptcy Code provides debtors in possession and trustees with the means to compel third parties to continue doing business with them when a bankruptcy filing might otherwise cause a non-debtor party to be reluctant to do so.

For more information about executory contracts and unexpired leases, see Assumption, Assignment, and Rejection of Executory Contracts.

Licenses under U.S. Bankruptcy Law

A license of intellectual property, in effect on the date of a bankruptcy filing, generally is considered to be an executory contract for the purposes of Section 365 of the Bankruptcy Code. This is because such licenses impose ongoing obligations on both the licensor and licensee, until the license expires or is terminated. The ongoing obligations for a licensee may include accounting for sales or earnings, paying royalties, marking all products sold under the license with a statutory patent notice, sharing technology with the licensor, and reporting problems with the technology to the licensor. For the licensor, the ongoing obligations may include providing a nonexclusive licensee with notice of patent infringement suits, refraining from licensing the intellectual property subject to the license to third parties at lower royalty rates, approving sublicenses, indemnifying the licensee for losses, defending claims for infringement, and forbearing from suing the licensee for infringement.

Patent licenses generally are executory by their very nature, as they generally follow the pattern described above. With respect to patent licenses, the licensor commonly has an ongoing duty to defend infringement claims and to notify the licensee of any infringement proceeding. In re Access Beyond Technologies, Inc., 237 B.R. 32 (Bankr. D. Del. 1999) (patent license is executory because there is "material duty" not to sue each other for infringement covered under the license); Everex Systems, Inc. v. Cadtrax Corp. (In re CFLC, Inc.), 89 F.3d 673 (9th Cir. 1996) (patent license constitutes an executory contract). On the other hand, the licensee of a patent license is likely to have business obligations under the patent license like an ongoing fee payment requirement and an ongoing "most favored nation" clause, under which the licensor agrees to adjust fees downward if it gives a better rate to another licensee.

Copyright licenses often are executory due to their very nature, as the licensor generally will have ongoing obligations under the licensing agreement and the licensee will have obligations, including to pay and account for royalties. In re Qintex Entertainment, Inc., 950 F.2d 1492 (9th Cir. 1991).

Similarly, trademark licenses often are executory, as the licensor generally will have ongoing quality control obligations and the licensee will have payment obligations and continuing nonmonetary obligations under the license. In re Blackstone Potato Chip Co., Inc., 109 B.R. 557, 560 (Bankr. D.R.I. 1990); In re Chipwich, Inc., 54 B.R. 427 (Bankr. S.D.N.Y. 1985).

Assumption of Licenses

As licenses generally are executory contracts subject to Section 365 of the Bankruptcy Code, a trustee or debtor in possession may assume or reject an intellectual property license, if applicable non-bankruptcy law would permit assignment. Under Section 365(c)(1) of the Bankruptcy Code, however, the trustee or debtor in possession may not assume or assign any executory contract if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties."

The term "applicable law" in Section 365(c)(1) refers to state, federal, or other law (such as municipal law) other than the Bankruptcy Code. The purpose of this provision, as articulated by one court, is to prevent a debtor from assigning (over objection by a party in interest) contracts of the sort ordinarily made nonassignable by the applicable law. RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.), 361 F.3d 257, 266 (4th Cir. 2004). A non-debtor licensor may always consent by contract to a prospective assignment notwithstanding any applicable anti-assignment statute. In re Supernatural Foods, LLC, 268 B.R. 759, 805 (Bankr. M.D. La. 2001).

Courts generally look to the license in question to determine whether the non-debtor licensor has consented prospectively to an assignment. "[N]othing in federal patent law prevents the assignment of a license where there are express words to show an intent to extend the right to an assignee." In re Hernandez, 285 B.R. 435, 440–41 (Bankr. D. Ariz. 2002) (citing Oliver v. Rumford Chemical Works, 109 U.S. 75, 81–82 (1883)). As the court in *Hernandez* explained, "[i]n consenting to assignment in such situations, the non-debtor parties to the contracts gave up any interest in the identity of the assignees, thereby effectively removing the contracts from the protections otherwise afforded to them under 'applicable law' and [section] 365(c)(1), to control the identity of assignees." Hernandez, 285 B.R. at 441.

When it comes to assumption (as opposed to assumption and assignment to a third party), there is a split in authority regarding the construction and application of Section 365(c)(1) of the Bankruptcy Code, which states that "[t]he trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts such assignment or rights or delegation of duties" if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession" and "such party does not consent to the such assumption or assignment." In re Aerobox Composite Structures, LLC, 373 B.R. 135, 140 (Bankr. D.N.M. 2007) (referencing the circuit split). The U.S. Supreme Court has noted that the circuits are split on the issue, but the Court has stated that it is "waiting" for a "suitable" case before addressing the issue. N.C.P. Marketing Group, Inc. v. BG Star Prod. Inc., 129 S. Ct. 1577 (2009) (denying *certiorari*).

Courts have followed three different approaches: the hypothetical test, the actual test, and the literal reading test.

Rule	**Circuits**	**Description**
The Majority Rule: "Hypothetical Test"	Third, Fourth, Ninth, and Eleventh Circuits	Under the majority rule, known as the hypothetical test, if applicable non-bankruptcy law precludes assignment of an executory contract to a third party, a debtor in possession or trustee may not assume or assign the contract notwithstanding that the debtor in possession or trustee may have no intention whatsoever of assigning the contract at issue to a third party. A majority of the circuit courts construing Section 365(c)(1) of the Bankruptcy Code have followed the hypothetical test. See In re Sunterra Corp., 361 F.3d 257 (4th Cir. 2004); City of Jamestown v. James Cable Partners (In re James Cable Partners), 27 F.3d 534, 537 (11th Cir. 1994); In re West Electronics, Inc., 852 F.2d 79 (3d Cir. 1988).

The Minority Rule: "Actual Test"	First and Fifth Circuits	Under the minority rule, known as the actual test, courts focus on whether the non-debtor would actually be forced to accept performance from someone other than the debtor with whom it has contracted. Additionally, several courts have permitted assumption where a debtor in possession proposed selling itself to a competitor of the non-debtor licensor entity. Under this construct, the debtor in possession or trustee may assume a license agreement that is an executory contract if there is no intent to assign the debtor's interest in the license. See Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 41 U.S.P.Q.2d 1503 (1st Cir. 1997) (holding that the debtor's proposed sale of stock to the non-debtor licensor's competitor did not constitute a de facto assignment but instead qualified as an assumption of the licenses by the reorganized debtors under new ownership); In re Mirant Corp., 440 F.3d 238, 248–49 (5th Cir. 2006) (rejecting the Third Circuit's hypothetical approach to Bankruptcy Code Section 365(c)(1)); see also In re Cardinal Indus., 116 B.R. 964, 982 (Bankr. S.D. Ohio 1990).
The "Literal Reading" Approach	Certain cases in the Bankruptcy Court for the Southern District of New York.	Under the literal reading approach, the statute's use of the word "trustee" does not include the debtor or the debtor in possession, and as such, the right of the non-debtor party to object to assignment applies only to the trustee's right to assume or assign, not the debtor in possession's right. In re Footstar, 323 B.R. 566, 570–72 (Bankr. S.D.N.Y. 2005); In re Adelphia Commc'ns Corp., 359 B.R. 65, 72 (Bankr. S.D.N.Y. 2007); see also In re Aerobox Composite Structures, LLC, 373 B.R. 135, 138, 140–42 (Bankr. D.N.M. 2007).

Assignment of Licenses

Under Section 365(f) of the Bankruptcy Code, a debtor in possession or trustee generally, but not always, is permitted to assign a license agreement. Section 365(c) of the Bankruptcy Code prohibits the debtor from assigning rights under an executory contract if applicable law excuses a party to that agreement from accepting performance from or rendering performance to an entity other than the debtor, and such party does not consent to the assignment or delegation. However, in contrast to the disagreement seen among courts with respect to assumption, courts have been fairly uniform in holding that a nonexclusive patent or copyright license is presumptively not assignable.

Patents

Courts look to federal patent law to determine assignability and have consistently held that the patent license, as a form of personal property, is "not assignable unless expressly made so" in the licensing agreement. The bankruptcy courts have found this rule to apply under Section 365(c) in order to block the assignment of nonexclusive patent licenses without the consent of the patent owner. See Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997); see also In re Rupari Holding Corp., 2017 Bankr. LEXIS 2341, at *12 (Bankr. D. Del. Aug. 18, 2017) (advance consent to assignment provision in a license agreement did not vitiate application of the Section 365(c)(1) barrier to assignment, as a clause against unreasonable withholding of consent was not the equivalent of a clause expressly allowing assignment without consent and therefore stay relief was granted so licensor could pursue termination of license agreement). The licensee's rights are personal to the licensee and not freely assignable, unless the right to assign is expressly granted in the agreement. On the other hand, assignment of exclusive licenses is generally permitted. Courts view exclusive licenses as conferring a property interest rather than mere personal rights.

Copyrights

Courts generally hold that a nonexclusive copyright license "is personal to the transferee . . . and the licensee cannot assign it to a third party without the consent of the copyright owner." See Seawind v. Creed Taylor, Inc. (In re Creed Taylor, Inc.), 10 B.R. 265, 267–68 (Bankr. S.D.N.Y. 1981) (upholding an anti-assignment clause in an exclusive license to manufacture and distribute sound recordings in part because of the "personal nature of certain licensing arrangements"). Courts are split on whether exclusive licenses are assignable when the agreement is silent. An exclusive license is a transfer of copyright ownership to the licensee. Gardner v. Nike, 279 F.3d 774, 780–81 (9th Cir. 2002) (holding that consent of the licensor is required for assignment). Compare In re Golden Books, 269 B.R. 300, 309 (Bankr. D. Del. 2001) (opining in *dicta* that, except as otherwise provided in the license, the holder of an exclusive license is entitled to all of the rights and protections of the copyright owner and has the right to assign such rights).

Trademarks

Section 365(c)(1) of the Bankruptcy Code provides an exception to the general ability of a debtor in possession or trustee to assume and assign executory contracts under Section 365 of the Bankruptcy Code, by providing that such a contract may not be assigned if "applicable law" excuses the non-debtor contracting party from accepting performance from an entity other than the debtor. The Seventh Circuit in In re XMH Corp., 647 F.3d 690 (7th Cir. 2011), relied on this "applicable law" exception in stating that a trademark license may not be assigned to a third party without the licensor's consent. Specifically, the *HMX* court explained that Section 365(c)(1) of the Bankruptcy Code prohibits the assignment of an executory contract if "applicable law" authorizes the other party to the contract to refuse to accept performance from an assignee, whether or not the contract prohibits or restricts assignment. The Seventh Circuit noted that the term "applicable law" means any law applicable to a contract (other than bankruptcy law) and that includes trademark law. The Seventh Circuit went on to explain that as a trademark owner is concerned about the quality of the trademarked product, it makes sense to follow a universal rule that a trademark license is not assignable without the owner's express permission.

Many courts make a distinction between exclusive or nonexclusive license or right of use. The courts that view this distinction to be relevant have held that a debtor in possession or trustee may not assume or assume and assign a nonexclusive license but may freely assume or assume and assign an exclusive license. These courts make their determination by applying applicable non-bankruptcy and determining that a nonexclusive license is a grant of a license of a personal property interest, while an exclusive license gives the debtor much more—complete ownership rights and, therefore, such ownership rights may be assumed and assigned. Conversely, some courts, however, hold that licensees cannot freely transfer rights even under an exclusive license. In re N.C.P. Marketing Groups, 337 B.R. 230, 236 (D. Nev. 2005) (finding that, under the Lanham Act, all trademark licenses are personal and nonassignable), *aff'd sub nom.*, N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc., 279 Fed. Appx. 561 (9th Cir. 2008), cert. denied, 129 S. Ct. 1577 (2009).

Section 365(n) applies to a licensee of intellectual property, as defined in Section 101(35A) of the Bankruptcy Code. The definition does not include trademarks (as discussed below). Prior to the Supreme Court decision in Mission Prod. Holdings v. Tempnology, 2019 U.S. LEXIS 3544, at *18 (May 20, 2019), there was a circuit split concerning the question of whether rejection of a trademark license agreement terminates the licensee's rights to use the trademark. Compare Lubrizol Enters., Inc., v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985) (licensee of rejected license could not retain control of its right to use the intellectual property by specific performance), with Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC, 686 F.3d 372 (7th Cir. 2012) (licensee of rejected trademark license cannot be deprived continued use of the trademark) and In re Tempnology LLC, 559 B.R. 809 (1st Cir. 2016) (same). The Supreme Court resolved this circuit split and held that where a debtor licensor rejects a license agreement, the licensee can continue to use the trademark (to the extent authorized by the license) (i.e., the debtor can reject the trademark license and stop performing but the rejection does not terminate the licensee's rights). Tempnology, 2019 U.S. LEXIS 3544, at *18. For more information on the Supreme Court's decision, see Supreme Court Resolves Circuit Split on Effect of Rejection of a Trademark Licensing Agreement in Bankruptcy.

Bundling Trademark Licenses with Other Intellectual Property, including Copyrights or Patents

A court may also allow a debtor to retain its rights under a trademark license that is coupled with a license to other intellectual property. The Eighth Circuit, in reversing decisions of the district and bankruptcy courts, held in a 9-3 *en banc* ruling that a trademark license agreement which was part of a larger integrated purchase agreement, was not an executory contract subject to rejection pursuant to Section 365(a) of the Bankruptcy Code. Lewis Brothers Bakeries Incorporated and Chicago Baking Company v. Interstate Brands Corporation (In re Interstate Bakeries Corporation), No. 11-1850, 2014 U.S. App. LEXIS 10537 (8th Cir. June 6, 2014) (Interstate Bakeries IV). See also In re Exide Tech., 607 F.3d 957 (3d Cir. 2010) (finding trademark license agreement, which was part of a larger integrated contract, was not an executory contract and thus, could not be rejected by the debtor). The *Interstate Bakeries IV* decision is quite instructive.

In addressing the issue of whether a license agreement is an executory contract, unlike the focus that both the bankruptcy court and the district court placed on the license agreement standing alone, the Eighth Circuit in *Interstate Bakeries IV* found that "the proper analysis must consider an integrated agreement that includes both the Asset Purchase Agreement and the License Agreement." Id. The Eighth Circuit concluded that finding otherwise "would run counter to the plain language of both the Asset Purchase Agreement and the License Agreement, which describe the two as one piece, and would ignore the valuable consideration paid for the license." Id. Because the Eighth Circuit found that the agreement it was reviewing was not an executory contract, the court did not have to address the question of whether rejection of a trademark license agreement terminates the licensee's rights to use the trademark.

Another example of a court allowing a transaction to proceed due to bundling of the trademark in question with other contract rights is the HMX decision discussed above. In HMX, although the circuit court concluded that the trademark at issue was not assignable in light of licensor's refusal to consent to the assignment, the court determined that the contract at issue was actually not a trademark sublicense at all, but merely a "service agreement" with a trademark license component. The court also found that the trademark sublicense had expired prior to assignment of the contract, but if the license had not expired, the outcome in HMX should have been the same, based on how the court logic and analysis of the bundling issue.

Rejection of Licenses

Section 365(n) of the Bankruptcy Code gives a licensee of intellectual property (as defined in Section 101(35A) of the Bankruptcy Code and does not include trademarks) two options:

- Treat the rejection as a termination of the contract if the rejection constitutes a breach entitling the licensee to treat the contract as terminated. –or–
- Retain the rights that the licensee held immediately before the bankruptcy commenced.

If the licensee chooses the first option, the breach gives the licensee an unsecured claim against the bankruptcy estate. If the licensee chooses the second option, the licensee retains the rights that existed just before the bankruptcy was filed for the duration of the contract, plus any extension to which the licensee may be entitled under applicable non-bankruptcy law. A licensee, selecting option two, must continue to pay royalties due under the contract and waive the right to setoff and the right to assert an administrative expense claim for obligations under the license. See sample Software License (Tandem Use with Software Escrow) (Identifying and Managing Bankruptcy Risk) clause.

In the case of rejection, the debtor-licensor must provide its licensee with access to the intellectual property that is subject to the license, refrain from interfering with the licensee's exercise of its rights, and, if the license is exclusive, refrain from licensing it to others. A debtor-licensor has no other affirmative duties and is not required to update, maintain, or improve the intellectual property. How can a licensee protect itself and its investment in a debtor-licensor's intellectual property in the event of rejection? One way in which the licensee can protect its investment is by use of a software escrow.

A software escrow is a deposit of source code of data and other relevant materials with a third-party escrow agent. The reason that a software escrow is so important to a licensee is that the licensee may need access to source code information to continue its use, make updates, and develop intellectual property that it has invested in using the licensor's intellectual property, even though the licensor (for any reason, including a business failure or bankruptcy rejection of the license under Section 365 of the Bankruptcy Code) no longer can or will provide support at agreed-upon levels.

Additionally, a licensee will want a license to enumerate with specificity the post-bankruptcy rights that the licensee may retain upon a rejection of the license, under Section 365, by its licensor. Typically, license fees, renewal fees, and maintenance fees implicitly include royalties for the use of the licensed intellectual property, but the actual amount for royalties is not broken out. If the licensor is not providing maintenance, for example, then there should probably be no continuing obligation for the licensee to pay such maintenance fees. Thus, the licensee will want the license to contain payment and other terms that will apply after a rejection in a bankruptcy case. These bankruptcy specific terms should be designed to reflect the responsibilities of the parties in the event that the licensee elects to retain the licensed software and related source code after a rejection. See Source Code Escrow Clause (Identifying and Managing Bankruptcy Risk).

Section 365(n) of the Bankruptcy Code may be used to avoid the imposition of liquidated damages or other damages and the application of foreign law under a governing law provision in the executory contract. In re EI International, 123 B.R. 64 (Bankr. D. Idaho 1991). In *EI International*, the debtor had agreed to supply a customized version of its PMAX software to Ontario Hydro, a Canadian public utility corporation. After *EI International* filed its Chapter 11 case, it rejected its executory contract with Ontario Hydro under

Section 365. Ontario Hydro asserted a claim in excess of $3.6 million, mostly to recover for post-petition development costs expended to make the software work as intended. Under the circumstances, the bankruptcy court concluded that Ontario Hydro's claim should be treated like any other claim resulting from a rejected executory contract under Section 365. Therefore, the court reasoned, the liquidated damages provision in the contract was not enforceable because "if liquidated damage clauses were enforceable, there would be no reason for rejection of the contract by a debtor."

Since Ontario Hydro elected to retain the software rather than treat the rejection as a termination, Ontario Hydro was deemed to have waived any right of setoff and any post-petition contract claims. Based on this analysis, the court ruled that Ontario Hydro was only entitled to a pre-petition damage claim limited to actual "out of pocket costs" incurred by Ontario Hydro prior to the Chapter 11 filing. This was so, according to the court, even though the contract in question included an Ontario law choice of law provision, and Ontario Hydro's claim was allowed but only to the extent of $176,752.00.

As a practical matter, if the reasoning of *EI International* is adopted by other U.S. Bankruptcy Courts, Section 365(n) of the Bankruptcy Code could be used as a strategy for limiting damages and remedial obligations. This strategy, for example, could be useful in connection with a failed software development project in which the licensor is facing significant potential money damages and performance obligations. The ruling in *EI International* appears to stand for the proposition that U.S. bankruptcy law will apply to contracts with foreign parties when a Title 11 case has been filed in the United States. This implies that Section 365(n) may be used as a vehicle for avoiding the application of foreign law under limited circumstances.

Managing a Licensee's Assumption Risk

A licensee's bankruptcy assumption risk may be managed by including a provision such as the following:

> **Assumption.** Notwithstanding any provision to the contrary, in the event Licensee files for [bankruptcy relief] and elects to assume this Agreement in the bankruptcy case, Licensor hereby consents to such assumption by Licensee provided Licensee agrees to comply with all of the terms and conditions of the License Agreement.

This provision starts with the well-worn "notwithstanding any provision to the contrary" clause, as most license agreements provide for termination in the event of a bankruptcy filing, even though such *ipso facto* bankruptcy default clauses are unenforceable pursuant to the current version of Section 365(e) of the Bankruptcy Code. The licensor's consent to an assumption occurs only if the licensee makes the decision to assume the license. The provision does not obligate the licensee to assume the license. In most bankruptcy situations, it is likely that the licensee will reject most software licenses; however, there is a contingent risk respecting assumption for which the licensee should seek protection.

Patent Infringement – The Bankruptcy Effect

In a patent infringement case where a debtor under the Bankruptcy Code is one of multiple defendants, the litigation may be stayed with respect to the debtor, but allowed to proceed with respect to other defendants. If, however, the claims against all of the defendants are "hopelessly intertwined," the entire patent infringement action may be stayed. See, e.g., Int'l Consumer Prods. of N.J., Inc. v. Complete Convenience, LLC, No. 07-325, 2008 U.S. Dist. LEXIS 41532 (D.N.J. May 23, 2008).

Automatic Stay

A key risk under any set of transaction documents is that a party to the agreement could become a debtor in a case under the Bankruptcy Code, implicating the automatic stay. The stay, when imposed works as an injunction against collection efforts outside of the bankruptcy process. As its name suggests, the automatic bankruptcy stay automatically springs into effect upon the filing of a voluntary or involuntary bankruptcy case, without a need to show the elements ordinarily required to obtain injunctive relief, including irreparable injury. In addition to collection efforts, the stay prohibits a creditor from taking actions that inevitably would have an adverse effect on property of the estate.

The automatic bankruptcy stay applies to a debtor's property wherever it is located, within or outside the territory of the United States. However, as discussed herein, the stay does not apply to actions on claims arising after commencement of a bankruptcy case.

As the automatic stay is designed to shield debtors and their assets from financial pressure, any exceptions to the automatic stay are read narrowly. Although the stay shields a debtor and its property from collection efforts, it does not extinguish or discharge any debt. The debtor has no greater rights than those that it has outside of bankruptcy.

The automatic stay, however, does not impact pre-petition injunctions related to infringement. A patent holder may be able to seek contempt sanctions for a continuing violation of an injunction while in bankruptcy. At minimum, courts are likely to grant relief from the stay to pursue a contempt charge. A patent holder claiming an ongoing infringement also should seek an administrative claim for damages related to the post-petition infringement of its patent. If infringement continues after a debtor receives a discharge, the holder of the patent may sue for damages.

The automatic stay applies to any suit against the debtor that "could have been commenced before the filing of a bankruptcy petition or that asserts a cause of action that arose before the filing of a bankruptcy petition." Hazelquist v. Guchi Moochie Tackle Co., Inc., 437 F.3d 1178, 1180 (Fed. Cir. 2006). The automatic stay does not, however, generally apply to suits based on post-petition torts, including post-petition patent infringement. "Damages for wrongs done during the bankruptcy proceeding are administrative claims, and thus paid in full most of the time." In re Mahurkar Double Lumen Hemodialysis Catheter Patent Litig., 140 B.R. 969, 977 (N.D. Ill. 1992); see also Lancaster Composite, Inc. v. Hardcore Composites Operations, LLC, 2005 U.S. Dist. LEXIS 47378, at *4 (D. Del. Jan. 14, 2005) (noting that a default judgment had been entered against the debtor regarding post-petition acts of infringement and also pointing out that the official committee of unsecured creditors acknowledged that the automatic stay is not applicable to infringement claims arising post-petition).

For example, in Alloc, Inc. v. Unilin Decor N.V., No. 02-1266, 2006 U.S. Dist. LEXIS 65889 (E.D. Wis. Dec. 15, 2005), the court held that the automatic stay provision of the Bankruptcy Code was inapplicable, where the patent at issue was issued post-petition. Other courts, such as the court in Voice Sys. and Servs., Inc. v. VMX, Inc., 26 U.S.P.Q.2d 1106, 1113 (N.D. Okla. 1992) have allowed patent suits based on post-petition conduct to proceed pursuant to 28 U.S.C. § 959(a), which states that:

> Trustees, receivers or managers of any property, including debtors in possession, may be sued, without leave of the court appointing them, with respect to any of their acts or transactions in carrying on business connected with such property. Such actions shall be subject to the general equity power of such court so far as the same may be necessary to the ends of justice . . .

Even if an infringement suit against the debtor is allowed to go forward after a bankruptcy filing, the automatic stay may limit the patent holder's ability to enforce a money judgment. For example, in Larami Ltd. v. Yes! Entm't Corp., 244 B.R. 56, 58 (D.N.J. 2000), the court held that while an infringement suit based on post-petition activities was not stayed under Section 362(a)(3) of the Bankruptcy Code, "the execution or attachment of a judgment obtained as a result of a post-petition claim would be barred."

A bankruptcy court may terminate the automatic stay under appropriate circumstances. Section 362(d) of the Bankruptcy Code spells out what needs to be shown to obtain entry of an order terminating or modifying of the automatic stay.

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For more information about the automatic stay, see Automatic Stay. For more information on relief from the automatic stay under the subsections discussed above, see Relief from the Automatic Stay for Cause, including Adequate Protection, Automatic Stay Relief for Lack of Equity in Property That Is Unnecessary for an Effective Reorganization, and Automatic Stay Relief under Sections 362(d)(3) and (4).

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