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363 Sales: What You Get - And What You Are Stuck With

Presented By

§ 363 SALES:

WHAT YOU GET – AND WHAT YOU ARE STUCK WITH

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SUCCESSOR LIABILITY & THE BANKRUPTCY CODE

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In bankruptcy sales outside a plan of reorganization, purchasers rely on Bankruptcy Code Section 363(f), which permits bankruptcy estate property to be sold, subject to certain requirements, "free and clear of any interest in such property." 11 U.S.C. § 363. The level of protection that purchasers can obtain in bankruptcy "free and clear" sales depends in substantial part on the scope of the phrase "interest in property," which is not defined by the Bankruptcy Code. What the phrase means, and whether it encompasses "*in personam*" claims against the debtor-seller that are later asserted against the purchaser, as well as "*in rem*" interests in the assets being sold by the debtor-seller to the purchaser, has been the subject of significant debate, both as a matter of policy and as a matter of practice.

I. Policy: Creditors versus Plaintiffs

As a matter of policy, consideration of whether successor liability claims should be extinguished in a Section 363 sale involves competing goals:

- **Maximizing Value for Creditors**: On the one hand, a broad "free and clear" power has been viewed by courts as:
  - maximizing the value of estate assets, and the return to all creditors, by encouraging purchasers to purchase assets at higher prices (without deduction for potential legacy claims); and
  - maintaining Bankruptcy Code priorities by preventing certain unsecured claimants from proceeding against a successor entity (the purchaser) while leaving secured creditors and other unsecured creditors with recourse only to the estate's remaining, limited assets.
- **Compensating Plaintiffs' Injuries**: On the other hand, parties injured by the seller pre-sale, with no real ability to collect from a debtor-seller, would have a source of compensation if they are able to recover from a purchaser.[1]

While Section 363(f) clearly provides *in rem* relief, cleansing transferred assets of attendant liens, many courts have furthered the policy of maximizing creditor value and concluded that Section 363(f) also offers certain *in personam* relief, releasing the asset purchaser from certain claims. In other words, even though successor liability claims have sometimes been characterized as *in personam*, rather than *in rem*, many courts have placed those claims into the category of "interests in property" that can be extinguished in sales under Section 363, so long as the claims are connected to or arise from the transferred assets.

[1] This paper does not attempt to address in any detail the underlying law of successor liability outside of bankruptcy. That law, which is usually state law but which can also include federal law in some circumstances, is varied and may lead to disparate results when applied to similar fact patterns in different jurisdictions. Very broadly speaking, however, successor liability can be thought of as a doctrine of exception to the general rule that a buyer of an asset should not, as a matter of law outside of contract, be liable for claims against the seller. The exceptions on which successor liability is based usually fall into categories such as: (1) the buyer agrees to assume debts or liabilities, either expressly or by implication, (2) the transaction amounts to a *de facto* merger of the seller into the buyer, (3) the operation of the assets by the buyer is a "mere continuation" of the predecessor seller's operation or the buyer adopts the same potentially injurious "product line" as operated by the seller, and (4) the transaction is fraudulent.

- *In re Trans World Airlines*, 322 F.3d 283 (3d Cir. 2003): In this seminal decision expanding the scope of "interests" under Section 363(f), the Third Circuit held that certain discrimination claims of TWA's employees, as well as claims related to a travel voucher program awarded to TWA's flight attendants in settlement of a sex discrimination class action, could be extinguished as against the buyer in Section 363 sale of TWA's airline assets to American Airlines because those claims would not have arisen but for TWA's investment in airline assets and commercial aviation.

More recent cases have confirmed the vitality of the Third Circuit's perspective in the *TWA* decision. For example:

- *In re USA United Fleet*, 496 B.R. 79 (Bankr. E.D.N.Y. 2013): In this case, the court rejected the state Department of Labor's attempt to transfer a debtor-seller's "experience rating" to the purchaser of assets of the debtor-seller in a Section 363 sale. The court held that the rating is an "interest" because "it is Debtors' prior ownership and use of that property that gives the DOL a contingent right under New York law to assign the Debtors' experience rating to the purchaser of the property." In adopting this broad interpretation of "interest," the court rejected DOL's argument that an experience rating is merely a "computational device" for assessing the likelihood of future unemployment among employees of the purchased business.

- *Dinielli v. Tropicana Hotel and Casino*, 2014 WL 87671 (N.J. Super. Ct. App. Div. Jan. 10, 2014): Here, a plaintiff was injured in a slip-and-fall accident at a casino after the entry of a Section 363 sale order, but before the sale closed. The court rejected a successor liability claim against the purchaser of the casino, but not solely on the basis of Section 363. The court held, on the basis of the TWA decision, that had the debtor-seller not invested in the casino, the claim would not have arisen, and, thus, the bankruptcy court's order approving the sale of the casino from the debtor-seller to the purchaser was "free and clear" of the claim. But the court also evaluated whether, despite the free and clear determination, state successor liability might allow the claim against the purchaser to survive. The court found it did not. However, the court's analysis suggests that in some cases, a successor liability claim against a purchaser under state law might proceed notwithstanding Section 363.

- *In re Christ Hospital (Christ Hospital I)*, 502 B.R. 158 (D.N.J. 2013): In this case, the court found that economic tort claims by a competitor of the buyer in a Section 363, asserted against the buyer in connection with the buyer's purchase of the assets, are "interests" to which Section 363's "free and clear" protections may apply.

- *In re NE Opco, Inc.*, 2014 WL 3884217 (Bankr. D. Del. 2014) & *In re Christ Hospital (Christ Hospital II)*, 2014 WL 2135942 (Bankr. D.N.J. 2013): In these cases with similar facts, claims of former seller employees against buyers, for buyers' failures to rehire the employees after the sales, were barred on the basis that such claims were "interests" subject to "free and clear" treatment.

Indeed, other courts seem more swayed by the policy of compensating injured plaintiffs, and have adopted theories of successor liability that make a Section 363 sale order, and the protection it may provide, essentially irrelevant as protection from successor liability claims.

- *In re Grumman Olson Indus. Inc.,* 467 B.R. 694 (S.D.N.Y. 2012): In this relatively recent decision, Morgan Olson bought Grumman Olson's truck manufacturing business in a Section 363 sale. Five years after the sale, a person was injured by a truck manufactured by Grumman Olson prior to the sale. The injured person sued the purchaser, Morgan Olson, under a successor liability theory. The court upheld the suit, and did not allow Morgan Olson to use the Section 363 sale order as a shield, on the basis that the successor liability claim was a new claim against the purchaser directly, not a claim against the debtor-seller that flowed through to the purchaser. The court also observed that due process requires notice to a potential plaintiff before extinguishing the plaintiff's claims, and that it may be difficult or impossible to effect proper notice to some potential plaintiffs, such as a plaintiff who is injured after the bankruptcy case closes.

- *Teed v. Thomas & Betts Power Solutions, L.L.C.*, 711 F.3d 763 (7th Cir. 2013): In this decision, the court found a Section 363 purchaser liable for Fair Labor Standards Act violations, related to the debtor-seller's nonpayment of overtime, on the basis of successor liability as a matter of the federal FLSA statute. Applying a federal common-law standard for successor liability in a case arising under a federal statute, the court found that the federal standard is more permissive towards successor liability than most state-law standards. The court's standard was whether "good reasons" existed to withhold successor liability, and it found that they did not. The court implied that lack of notice of the claims to the purchaser, or a lower price offered by the purchaser if successor liability claims were not to be released, may have been "good reasons."

- *In re NE Opco (see above at *5)*: The court barred former seller employee claims against the buyer related to the pre-closing period (as described above), even though the buyer's pre-closing conduct was included in the allegations of those claims. But, the court did not bar former seller employee claims against the buyer related to the post-closing period, citing *Grumman*, even though the employee's work for the seller was part of the factual predicate for the employee's post-closing claims against the buyer.

The *Grumman* court's finding that due process requires notice before divesting a potential plaintiff of a claim may not seem remarkable. Nevertheless, a surprising number of courts have enforced "free and clear" sale orders against plaintiffs who lacked notice of the sale order.

- *Molla v. Adamar of New Jersey, Inc.*, — F. Supp. 2d —, 2014 WL 2114848 (D.N.J. May 21, 2014): As in *Dinielli*, the plaintiff alleged a tort that happened at the Tropicana Casino after bankruptcy but before the Section 363 sale closed. The court knew of *Dinielli* and could have simply applied the holding that no cause of action existed under New Jersey's substantive successor-liability law. Instead, the court added that the sale order relieved the purchaser of liability and that the sale order could be enforced against the plaintiff. In doing so, the court stated that notice was required before claims are discharged against a debtor, but not before a court eliminates claims that might otherwise exist against a non-debtor purchaser. This is a surprising statement. Due process protects

against deprivations of any "property," and it is not clear why less notice should be required to divest a claimant of a claim against the debtor, but not to divest the same claimant of a (probably more valuable) claim against a non-debtor.

- *In re Old Carco LLC*, 492 B.R. 392 (Bankr. S.D.N.Y. 2013): The court relied on a sale order to eliminate most successor-liability claims that owners of defective Jeeps had brought against "New Chrysler." In doing so, the court held that the sale order satisfied due process because the design flaws were publicly known at the time of the bankruptcy. This opinion appears to conflate two distinct notice concepts: (1) notice of the existence of the plaintiffs' cause of action, and (2) notice that an order of the bankruptcy court would divest the plaintiffs of their cause of action.

A related issue that has garnered attention in recent decisions is the extent to which a potential plaintiff *with* adequate notice of a "free and clear" sale order could be prevented from challenging the order later. . Sale orders often purport to absolve purchasers from successor liability. Such an order is enforceable against a party who ignores notice of the order, even though such broad "*in personam*" protection probably goes beyond what Section 363 allows.

- *Travelers Indem. Co. v. Bailey*, 557 U.S. 137 (2009): The U.S. Supreme Court, in context of bankruptcy reorganization of Johns-Manville Corporation, a manufacturer of and seller of asbestos products, rejected challenge of certain claimants to enforceability of bankruptcy court's 1986 orders enjoining claims against Manville's non-debtor insurers. Emphasizing "need for finality," the Supreme Court found that once the orders became final and non-appealable, they were enforceable against the parties and those in privity with them "whether or not [the orders were] proper exercises of bankruptcy court jurisdiction and power."

- *Christ Hospital I (see above, at 175)*: An alternate basis for the court's "free and clear" decision was that the claimant received notice of the sale and did not object. The court stated that such notice and failure to object can be binding upon the claimant, and preclude collateral attack on the sale order, even if the sale order itself was incorrectly entered.

However, even if an overbroad "free and clear" order is enforceable against a party with notice, a court—including a state court—may interpret the "free and clear" order narrowly, allowing a plaintiff to pursue a case.

- *Skyline Woods Homeowners Ass'n, Inc. v. Broekemeier*, 758 N.W.2d 376, 392–93 (Neb. 2008): After a bankruptcy court ordered a country club to be sold "free and clear" of interests, the owners of houses beside the country club sued in state court to enforce a covenant requiring the country club's owner to operate a golf course. The Nebraska court interpreted the word "interests" in the bankruptcy court's sale order to exclude restrictive covenants, and required the purchaser's to maintain a golf course. Federal courts gave full faith and credit to the Nebraska court, holding that a state court has concurrent jurisdiction to *interpret* sale orders once property leaves the bankruptcy estate. *Mid-City Bank v. Skyline Woods Homeowners Ass'n* (*In re Skyline Woods Country Club*), 636 F.3d 467, 471 (8th Cir. 2011). Although the Nebraska court was powerless to ignore, modify,

or void the sale order, the Nebraska Supreme Court was free to apply a narrowing interpretation "on the merits," *id.* at 471–72, from which an appeal could lie only to the U.S. Supreme Court.

Some non-bankruptcy law also suggests that, if potential plaintiffs do not have a chance to appeal a final sale order barring their claims, those plaintiffs may be able to argue that they were never bound by that order. This may be relevant in the Section 363 context, because section 363(m) prevents direct appeals from reversing a sale that has not been stayed pending appeal.

- *Kircher v. Putnam Funds Trust*, 547 U.S. 633 (2006): In an earlier non-bankruptcy case, the U.S. Supreme Court noted that the parties could effectively re-litigate the issue of preclusion in state court on remand because they were barred from appealing a prior district court preclusion decision. The district court's decision to remand cases, which involved certain securities claims, because those claims were not precluded under the Securities Litigation Standards Act of 1998 was effectively a decision regarding the court's own jurisdiction, and 28 U.S.C. §1447 accordingly barred review of that decision.

II. Practice: Sale Order Language versus Diligence & Notice

Bankruptcy sale orders typically contain robust language purporting to extinguish successor liability claims, even though decisions (and informal guidance from bankruptcy judges) have called into question the ability to sell free and clear of all such claims. This sale order language tends to be drafted by purchaser counsel, and may vary in terms of its length and complexity. For example:

- "No sale, transfer, or other disposition of the Assets pursuant to the Agency Agreement or entry into the Agency Agreement will subject the Agent to ***any liability for claims***, obligations or Encumbrances ***asserted against the Debtors or the Debtors' interests in such Assets by reason of such transfer*** under any laws, including, without limitation, any bulk-transfer laws ***or any theory of successor or transferee liability***, antitrust, ***environmental, product line, de facto merger or substantial continuity or similar theories***. The Agent is not a successor to the Debtors or their respective estates." Order Approving Sale, *In re Ritz Camera & Image, L.L.C.*, No. 12-11868 (KG) (Bankr. D. Del. Sept. 10, 2012) (Dkt. No. 440) (emphasis added).

- "Except as expressly set forth in the Purchase Agreement, the Purchaser and its Affiliates, successors and assigns shall have no liability for any Claim. ***By virtue of the Sale Transaction, the Purchaser is not and shall not be deemed to: (a) be a legal successor, or otherwise a successor to any of the Debtors (by reason of any theory of law or equity); (b) have, de facto or otherwise, merged with or into any or all of the Debtors; or (c) be a mere continuation or substantial continuation of any or all Debtors or the enterprise or operations of any or all Debtors.*** Further, except for Assumed Liabilities and Transferred Exceptions (and other than the Claims created by the Purchaser and attaching upon consummation of the Debt Financing), the Purchaser shall not assume, be deemed to assume or in any way be responsible for and shall have no liability for any Claim, whether known or unknown as of the Closing Date, now existing or hereafter arising, whether fixed or contingent, ***whether as a successor or transferee, vicariously,***

or otherwise, of any kind, nature or character whatsoever, including Claims arising under or in or related to, without limitation: . . . ***[(ix)] any common law doctrine of de facto merger or successor or transferee liability, successor-in-interest liability theory or any other theory of or related to successor liability*** . . . ." Order Authorizing the Sale of Certain Assets Related to the Debtors' Hostess and Dolly Madison Brands, *In re Hostess Brands, Inc.*, No. 12-22052 (RDD) (Bankr. S.D.N.Y. Mar. 20, 2013) (Dkt. No. 2455) (emphasis added).

- "The transfer of the Purchased Assets . . . will vest the Purchaser with all right, title, and interest of the Debtor to the Purchased Assets free and clear of all Liens, Claims, encumbrances and interests of any and every kind, at law or equity, ***including those arising under statutory or case law premised on the doctrines of successor, transferee, assignee, derivative, vicarious, de facto merger or continuity liability, or any other legal or equitable principle that would impose liability on the Purchaser, based on, in respect of, as result of, or arising from, in any way, an act, omission, or liability of the Debtor, the Debtor's operation of its business, the Debtor's ownership, control, or use of the Purchased Assets, the sale, or the Purchaser's acquisition of the Purchased Assets, whether asserted or unasserted, known or unknown, fixed or contingent, liquidated or unliquidated ("Successor Liability")*** . . . . ***Following the sale, the Purchaser will not be a successor or mere continuation of the Debtor. By way of example, the Purchaser is not acquiring the Debtor's Auto Sales Business which is being wound down under the Plan and the Purchaser will therefore not be engaged in the sale of new automobiles. The Purchaser is not profiting from or exploiting the goodwill of the Debtor's Auto Sales Business, which the Purchaser is not continuing***." Findings of Fact and Conclusions of Law in Support of Order Confirming Debtor's Fourth Amended Plan of Liquidation, *In re Am. Suzuki Motor Corp.*, No. 12-22808 (SC) (Bankr. C.D. Cal. Mar. 6, 2013) (Dkt. No. 1168) (emphasis added).

While some of this language is quite broad, a prospective purchase may not take perfect comfort from it, in light of decisions such as *Grumman Olson* and *Tropicana*, which seem to open doors to end-run whatever language might exist in a sale order. So, while decisions like *Teed* discussing purchaser reliance on Section 363 "free and clear" protection in consideration of a higher purchase price—advocate for continued robust sale order language, purchasers may want to look to other tools to help mitigate further the risk of successor liability.

- **Diligence.** Successor liability claims can only exist, if at all, where there is an underlying breach or injury, or a potential for the same, created by the debtor-seller or some activity in which it engaged. A purchaser can use diligence to find where the opportunities for such claims are. Indeed, outside of bankruptcy Section 363 sales, diligence is a primary method for investigating, and then mitigating, successor liability risk. Because Section 363 "free and clear" language may not perfectly protect a purchaser, diligence remains crucial in the Section 363 context.

- **Notice.** Bankruptcy's ability to eliminate claims has, at its backbone, the due process concern that potential claimants be notified of the bankruptcy. Once diligence has confirmed potential successor liability claims, notice to potential claimants is required to protect a purchaser. Of course, the person stricken by a Grumman Olson truck after a

Section 363 sale could not have been notified pre-sale. But the plaintiff in *Tropicana* could have been identified in pre-closing bring-down diligence, for example. Not only does notice satisfy due process and create an opportunity for an estoppel argument generally, it may able be the basis for an argument that the claimant impliedly consented to the sale free and clear of its claim, and that the claim does not flow to the purchaser under Section 363(f)(2).

CHRYSLER, GM AND SUCCESSOR LIABILITY

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- **CHRYSLER**

  - **Background**

On April 30, 2009, Chrysler, LLC and certain of its direct and indirect subsidiaries ("Old Chrysler") filed Chapter 11 petitions in the United States Bankruptcy Court for the Southern District of New York. At the time it filed bankruptcy, Old Chrysler estimated the value of the products liability claims against it to be approximately $615 million. May 29, 2009 Hearing Tr. at 174-175. Old Chrysler had made annual cash payments on products liability claims of between $200 and $250 million. *Id*. at 175.

Chrysler sought fast-track bankruptcy court approval under Section 363 of the Bankruptcy Code of a Master Transaction Agreement dated as of April 30, 2009, by and between Chrysler, Fiat S.p.A. ("Fiat") and New Carco Acquisition, LLC ("New Chrysler"), a Delaware limited liability company formed by Fiat (the "Chrysler APA") and funded by the United States and Canadian governments. The Chrysler APA contemplated the sale of substantially all of Old Chrysler's assets to New Chrysler, which would be owned by Fiat, a UAW employee benefit entity, and the United States and Canadian governments. Under the Chrysler APA, New Chrysler would assume certain liabilities, including liabilities for product warranties, product returns and rebates on vehicles sold post-closing. However, New Chrysler specifically would not assume any liability for product liability claims arising from vehicles purchased by consumers prior to the closing date of the proposed sale and the sale would be free and clear of any successor liability claims against New Chrysler.

Not only would New Chrysler not be on the hook for the product liability claims, but the tort claimants would also have little or no prospect for recovery from Old Chrysler's bankruptcy estate. As Old Chrysler's CEO, Robert Nardelli, admitted on cross-examination during the sale hearing, once the remaining assets of Old Chrysler's estates were liquidated, he believed that no value would be available from former Chrysler entities for distribution to tort claimants. May 28, 2009 Hearing Tr. at 402-403.

To make matters worse for tort claimants, Old Chrysler was self-insured against personal injury claims based on products liability, up to $25 million per occurrence. May 29, 2009 Hearing Tr. at 174. As a result, as a practical matter, there were no insurance proceeds available to satisfy almost all of the tort claims.

The tort claimants, many of whom had suffered catastrophic injuries or even death as a result of alleged defects in Chrysler products, faced with this daunting situation, objected to the proposed sale.

Section 363(f)

The tort claimants argued that the assets could not be sold free of clear of product liability personal injury claims under 11 U.S.C. § 363(f). Section 363(f) of the Bankruptcy Code authorizes the debtor-in-possession, under certain specific circumstances, to sell property "free

and clear of any interest in such property." The tort claimants argued that the term "any interest in such property" in Section 363(f) does not include *in personam* personal injury claims:

> Section 363(f) does not authorize sales free and clear of *any interest*, but rather of *any interest in such property*. These three additional words define the real breadth of *any interests*. The sorts of interests impacted by a sale "free and clear" are *in rem* interests which have attached to the property. Section 363(f) is not intended to extinguish *in personam* liabilities. Were we to allow "any interests" to sweep up *in personam* claims as well, we would render the words "in such property" a nullity. No one can seriously argue that that *in personam* claims have, of themselves, an *interest in such property*.

Fairchild Aircraft, Inc. v. Campbell (In re Fairchild Aircraft Corp.), 184 B.R. 910, 917-18 (Bankr. W.D. Texas 1995), *vacated on other grounds*, 220 B.R. 909 (Bankr. W.D.Tex. 1998).

The tort claimants contended, as the court in *Fairchild Aircraft* explained, that unsecured creditors do not have an interest in any specific property of the debtor:

> The closest analogy outside bankruptcy to the position of unsecured creditors in bankruptcy is that of the judgment creditor who has yet to abstract or execute its judgment. Such a creditor has an enforceable judgment that will support remedies such as levies, garnishment, or attachment, but until such steps are actually taken, the judgment creditor has no actual interest in any particular property of its debtor. If the judgment creditor never takes the additional steps necessary to convert its claims from one against the debtor personally, in personam, to one against the debtor's property, in rem, the creditor cannot be said to have any interest in the debtor's property. Bankruptcy gives an unsecured creditor, via the proof of claim process, the functional equivalent of a judgment against the debtor's estate - - but does not give the creditor an interest in any particular property of the debtor.

Id. at 919, n.6; *See also In re Wolverine Radio Co.*, 930 F.2d 1132, 1147, n.23 (6th Cir. 1991); *Kattula v. Republic Bank (In re LWD, Inc.)*, 2009 U.S.Dist. LEXIS 17852 (W.D. Ky. 2009)

The tort claimants asserted, as a result, that Section 363(f) "in no way protects the buyer from current or future product liability; it only protects the purchased assets from lien claims against those assets." *In re Schwinn Bicycle Co.*, 210 B.R. 747, 761 (Bankr. N.D. Ill. 1997), *aff'd* 217 B.R. 790 (N.D. Ill. 1997).

In *United States v. Knox-Schillinger (In re Trans World Airlines, Inc.)*, 322 F.3d 283 (3d. Cir. 2003) ("*TWA*"), the Third Circuit determined that assets of a bankrupt airline could

be transferred free and clear of employment discrimination claims under Section 363(f). The tort claimants urged the bankruptcy court to decline to follow *TWA,* because its holding expanded the term "interest" as used in Section 363(f) far beyond its plain meaning.

The tort claimants also pointed to the distinction between Section 363(f) and Section 1141(c), which governs plans of reorganization. While Section 363(f) permits the sale of property free and clear of "any interest," Section 1141(c) allows property to be dealt with by a plan of reorganization to vest "free and clear of all claims and interests." Thus, Section 363(f) allows only "interests" to be extinguished, while Section 1141(c) allows both "claims and interests" to be extinguished. The tort claimants contended that it made sense that Congress drafted Section 1141(c) to be more expansive than Section 363(f) because Section 1141(c) deals with plans of reorganization, which provide tort claimants and other unsecured creditors with procedural and substantive safeguards not available under Section 363 sales. The tort claimants asserted that the reasoning of the Third Circuit in *TWA* was flawed because it ignored the clear difference between § 363(f) and § 1141(c).

In approving the sale, the bankruptcy court summarily rejected the tort claimants' Section 363(f) argument, relying principally upon the Third Circuit's decision in *TWA*. *In re Chrysler, LLC*, 405 B.R. 84, 111 (Bankr. S.D.N.Y. 2009).

The bankruptcy court entered an order approving the sale on June 1, 2009. Expedited appeals to the Second Circuit ensued. On July 5, 2009, the Second Circuit held oral argument for approximately two hours and after taking a short recess, ruled from the bench, affirming the bankruptcy court's order for substantially the reasons set forth in the bankruptcy court's opinion.

On August 5, 2009, long after the sale closed, the Second Circuit issued its written opinion affirming the bankruptcy court. After noting that it had never addressed the scope of the language of "any interest in such property" within Section 363(f), the Second Circuit concluded that tort claims could be extinguished under Section 363(f). The Second Circuit stated that "[w]e do not place such weight on the absence of the word 'claims' in Section 363(f)." *Indiana State Police Pension Trust v. Chrylser, LLC (In re Chrysler LLC),* 576 F.3d 108, 125 (2d Cir. 2009). The Second Circuit reasoned that "[g]iven the expanded role of § 363 in bankruptcy proceedings, it makes sense to harmonize the application of §1141(c) and § 363(f) to the extent permitted by the statutory language." *Id.* The Second Circuit thus agreed with the Third Circuit's determination in *TWA* that the term "interest" encompassed claims that "arise from the property being sold" and concluded that "[i]t is the transfer of Old Chrysler's tangible and intellectual property to New Chrysler that could lead to successor liability (where applicable under state law)." *Id*. at 126.

After the Second Circuit ruled from the bench on June 5, 2009, it kept the stay of the sale order in place until June 8, 2009, to allow the appellants to seek relief in the United States Supreme Court. On June 8, 2009, Justice Ruth Bader Ginsburg issued a temporary stay. However, one day later, on June 9, 2009, the Supreme Court vacated Justice Ginsburg's order

and denied the appellants' stay, allowing the sale to proceed. *Ind. State Police Pension Trust v. Chrysler LLC*, 556 U.S. 960 (2009). The Chrysler sale closed the next morning.

On December 14, 2009, the United States Supreme Court issued an opinion granting the petition for writ of certiorari filed by certain parties. The opinion states "Judgment vacated, and case remanded to the United States Court of Appeals for the Second Circuit with instructions to dismiss the appeal as moot." *Indiana State Pension Trust v. Chrysler, LLC*, 130 S.Ct. 1015 (2009).

Lack of Good Faith of Purchaser

The tort claimants also objected to the sale on the grounds that the asset purchaser was not acting in good faith as required under Section 363. *See Cumberland Farms Dairy, Inc. v. National Farmers Organization, Inc. (In re Abbotts Dairies of Penn., Inc.)*, 788 F.2d 143, 149-50 (3d Cir. 1986); *In re Summit Global Logistics, Inc.*, 2008 Bankr. LEXIS 896 at *34 (Bankr. D. N.J. 2008) (finding of good faith is a "crucial element" of a sale motion); *In re Exaeris, Inc.*, 380 B.R. 741 (Bankr. D. Del. 2008) (denying motion to approve sale where purchaser was an insider of the debtor, provided the debtor with post-petition financing, sought a release and insisted upon an expedited sale process). The tort claimants asserted that the United States government, which was both funding the transaction and was also an owner of the purchaser, was misusing its enormous leverage to seek to avoid responsibility for tort claims, because extinguishing successor liability claims was not necessary for the viability of the proposed transaction with Fiat. The tort claimants relied, in part, on testimony that Fiat had agreed to assume tort liabilities in an alliance transaction negotiated with Old Chrysler before Old Chrysler contemplated filing bankruptcy. May 27, 2009 Hearing Tr. at 252:1-4. The bankruptcy court and the Second Circuit both rejected this challenge to the sale, the bankruptcy court finding that:

> The U.S. Treasury, as lender, merely conditioned its lending to the Debtors and to New Chrysler on the consummation of the Sale Transaction. In the same way that potential-partner OEM's could elect not to accede to such terms and refuse to purchase the assets, the Debtors were free to reject the funding offer. The Debtors, however, indicated that had they done so, they would have had to liquidate. Thus, the Debtors exercised their own business judgment under the circumstances, as then presented, and determined to consummate the Fiat Transaction rather than liquidate. The fact that the Debtors initially preferred the Stand-Alone Viability Plan is irrelevant to the determination it made in its business judgment, once it realized that there was no funding for the Stand-Alone Viability Plan. *In re Chrysler, LLC*, 405 B.R. at 108.

Future Claims

Finally, the tort claimants objected to the provision of the sale order extinguishing products liability claims arising for vehicles purchased before the sale even if the accident did not occur until after the sale ("Future Claims"). The tort claimants asserted, *inter alia*, that the preclusion of Future Claims violated the due process rights of future claimants by precluding their claims without meaningful notice. The predicament of the holders of Future Claims was described by counsel for the Ad Hoc Committee of Consumer Victims of Chrysler, LLC during closing argument at the sale hearing:

> At some dealerships in this country somebody is buying a minivan, a Chrysler minivan; and under the proposed form of order and under the master transaction agreement, if that purchaser is injured two years from now in an accident as a result of a defect in that vehicle, that individual will have no recourse against New Chrysler. I'm sure the person right now signing that contract to purchase that New Chrysler has no idea of that.

May 29, 2009 Hearing Tr. at 312.

The bankruptcy court found that there were no due process issues associated with the extinguishment of the Future Claims because notice of the sale was published in newspapers with a wide circulation. *In re Chrysler, LLC*, 405 B.R. at 111. The Second Circuit, however, cast doubt on that portion of the bankruptcy court's ruling, stating that "we decline to delineate the scope of the bankruptcy court's authority to extinguish future claims, until such time as we are presented with an actual claim for an injury that is caused by Old Chrysler, that occurs after the Sale, and is cognizable under estate successor liability law." *Ind. State Police Pension Trust v. Chrysler LLC*, 576 at 127.

GENERAL MOTORS

General Motors Corp. and certain of its affiliates ("Old GM") filed chapter 11 bankruptcy petitions in the United States Bankruptcy Court for the Southern District of New York on June 1, 2009, the same day on which the bankruptcy court entered the order approving the Chrysler sale. GM simultaneously filed a motion seeking approval of a Master Sale and Purchase Agreement ("GM APA"), pursuant to which substantially all of Old GM's assets were to be sold to General Motors, LLC, a newly-formed entity created by the United States Treasury ("New GM"). The GM APA provided that the sale would be free and clear of product liability claims, including Future Claims.

There were two significant differences between the Chrysler transaction and the GM sale as it applied to tort claimants. First, 10 percent (10%) of the equity in New GM was set aside for the Old GM estate and its creditors, including tort claimants, guaranteeing that there would be at least some recovery for them. *See In re General Motors Corp.*, 407 B.R. 463, 483 (Bankr. S.D.N.Y. 2009).

Second, after tort claimants and others filed objections to the proposed sale, the GM APA was amended so that New GM would assume Future Claims. *See* Notice of Filing of the Amended Master Sale and Purchase Agreement and Certain Exhibits and Sections of the Disclosure Statement Thereto, 6/27/09 [Docket No. 2649].

In addition to objecting to Future Claims, the tort claimants pressed objections similar to those in Chrysler, all of which were rejected. After noting that "[t]he issues as to the successor liability provisions in the approval order are the most debatable of the issues now before the Court," the bankruptcy court concluded:

> "The Court fully understands the circumstances of tort victims, and the fact that if they prevail in litigation and cannot look to New GM as an additional source of recovery, they may recall only modest amounts on any allowed claims – if, as is possible, they do not have other defendants who can also pay. But the law in this Circuit and District is clear; the court will permit GM's assets to pass to the purchaser free and clear of successor liability claims, and, in that in connection, will issue the requested findings and associated injunction."

In re General Motors Corp., 407 B.R. at 500-01; 505-06.

After the GM sale closed, on August 28, 2009, New Chrysler then announced that it too would be assuming liability for Future Claims and the Chrysler APA was modified accordingly. *See* Stipulation and Agreed Order Approving Amendment No. 4 to the Master Transaction Agreement, 11/19/09 [Docket No. 5988].

THE AFTERMATH

Future Claims

In *Grumman Olson Industries, Inc. v. Frederico (In re Grumman Olson Industries, Inc.)*, 467 B.R. 694 (Bankr. S.D.N.Y. 2012), the district court held that a "free and clear" sale order did not extinguish a claim against an asset purchaser relating to a truck chassis manufactured by the debtor before the sale where the accident giving rise to the driver's injury took place after the sale was completed and the bankruptcy case was closed. The district court reasoned that to do otherwise would deny the plaintiffs' "due process and violate the Bankruptcy Code's requirements of notice and opportunity to be heard for those affected by a bankruptcy court's rulings." *Id.* at 711. The district court explained:

> The Court is certainly cognizant of the inherent uncertainty that allowing successor liability claims (notwithstanding the "free and clear" provision of a bankruptcy court's orders) imposes upon purchasers of debtor assets in a bankruptcy. However, to whatever extent maximizing the value of the estate is an important policy of

> the Bankruptcy Code, it is no more fundamental than giving claimants proper notice and opportunity to be heard before their rights are affected, to say nothing of constitutional requirements of due process.

Id. at 710. The court did not reach any conclusion as to whether the appointment of a future claims representative in the case would have addressed the due process concerns of the plaintiffs. *Id*. at 711.

Enforcement of Chrysler and GM Orders

The Bankruptcy Court has had numerous occasions on which it has been asked to enforce the Sale Order and Injunction against plaintiffs seeking to sue New GM for Old GM's retained liabilities. In the vast majority of instances, the Court has strictly construed the GM Sale Order and Injunction as prohibiting the attempted claims against New GM. *See, e.g. In re Motors Liquidation Co.*, No. 09-50026 (REG), 2011 WL 6119664 (Bankr. S.D.N.Y. 2011) (ordering various plaintiffs to dismiss with prejudice civil actions in which they had brought claims against New GM that are barred by the Sale Order and Injunction); *Castillo v. Gen. Motors Co. (In re Motors Liquidation Co.)*, Adv. Proc. No. 09-00509 (Bankr. S.D.N.Y.), Hearing Tr. 9:3-9:14, May 6, 2010 ("when you are looking for a declaratory judgment on an agreement that I approved [i.e., the GM APA] that was affected by an order that I entered [i.e., the Sale Order and Injunction], and with the issues permeated by bankruptcy law as they are, and which also raise issues as to one or more injunctions that I entered, how in the world would you have brought this lawsuit in Delaware Chancery Court. I'm not talking about getting in personam jurisdiction or whether you can get venue over a Delaware corporation in Delaware. I'm talking about what talks and walks and quacks like an intentional runaround of something that's properly on the watch of the U.S. Bankruptcy Court for the Southern District of New York."); *Castillo*, 2012 WL 1339496 (entering judgment in favor of New GM) (affirmed by 500 B.R. 333, 335 (S.D.N.Y. 2013)); see also *Trusky v. Gen. Motors LLC (In re Motors Liquidation Co.),* Adv. Proc. No. 09–09803, 2013 WL 620281, at *2 (Bankr. S.D.N.Y. Feb. 19, 2013) (finding that claims for design defects of 2007-2008 Chevrolet Impalas may not be asserted against New GM and that "New GM is not liable for Old GM's conduct or alleged breaches of warranty").

In the Chrysler bankruptcy case, the Bankruptcy Court has also strictly construed the sale order as prohibiting the attempted claims against New Chrysler for Old Chrysler's retained liabilities. *Tulacro v. Chrysler Group LLC, et al.*, Adv. Proc. No. 11-09401 (Bankr. S.D.N.Y. Oct. 28, 2011) [Dkt. No. 18] (determining that New Chrysler was not responsible for claims under California's Lemon Law and holding that unless a claim against New Chrysler relating to an Old Chrysler vehicle manufactured and sold prior to the Closing Date is encompassed by Paragraph 19 of the Sale Order or Section 2.08(h) of the Chrysler APA, it is precluded by the Sale Order); *Tatum v. Chrysler Group LLC*, Adv. Proc. No. 11-09411 (Bankr. S.D.N.Y. Feb. 15, 2012) [Dkt. No. 73] (concluding that plaintiff's New Jersey Consumer Fraud Act claim was barred by the Sale Order); *Wolff v. Chrysler Group LLC*, Adv. Proc. No. 10-05007, slip op. at 11-12 n.4 (Bankr. S.D.N.Y. July 30, 2010) (rejecting argument that New

Chrysler should be liable to plaintiff because New Chrysler had paid other claims similar to the one asserted by plaintiff and noting that the Court only would only enforce those promises that [New Chrysler] made in connection with the Sale Order as part of the value it offered in exchange for Old Chrysler's assets).

In *Burton v. Chrysler Group, LLC (In re Old Carco, LLC)*, 492 B.R. 392 (2013), however, the bankruptcy court allowed some vehicle defect claims against New Chrysler to proceed. In *Burton*, the plaintiffs owned vehicles that were manufactured and sold by Old Chrysler. They alleged that their vehicles suffered from a design flaw known as a "fuel spitback" problem and they commenced a class action against New Chrysler seeking relief under various theories. Among the claims asserted by the vehicle owners was that New Chrysler violated a duty to warn pre-closing purchasers arising from National Highway Traffic and Safety Administration Technical Service Bulletins ("TSB") issued to dealers in 2011 and 2012. The TSBs advised dealers of the fuel spit back problem experienced by consumers, extended lifetime warranties to certain vehicle owners and identified the steps necessary to correct the fuel spit back defect. The lawsuit in *Burton* was transferred to the bankruptcy court for determination as to whether the plaintiffs' claims were barred by the Chrysler sale order. Although the bankruptcy court dismissed several of the claims, the bankruptcy court denied New Chrysler's motion to dismiss claims based upon the plaintiffs' argument that New Chrysler breached a duty to warn arising from the TSBs. The bankruptcy court held that "the Sale Order does not affect any claims . . . based on a duty that New Chrysler assumed *after* the closing under the TSBs or otherwise." *Id.* at 407.

THE GM IGNITION SWITCH RECALL AND PROCEEDINGS TO ENFORCE THE GM SALE ORDER AND INJUNCTION

The Motion To Enforce The Sale Order

General Motors LLC's ("New GM") recent massive ignition switch recall has resulted in the filing of numerous actions against New GM. In response to these filings, on April 21, 2014, New GM filed a Motion Pursuant to 11 U.S.C. §§ 105 and 363 to Enforce the Court's July 5, 2009 Sale Order and Injunction (the "Motion"), seeking a determination that the Sale Order and Injunction precludes plaintiffs (the "Plaintiffs") from pursuing certain ignition switch claims against New GM. On the same day, Plaintiffs filed a class action adversary complaint (the "Complaint") seeking a declaration that the Sale Order is void and unenforceable to the extent it purports to preclude Plaintiffs from seeking legal recourse against New GM for defective ignition switch claims. On April 22, 2014, Plaintiffs filed an objection to the Motion (the "Objection").

New GM's Motion does not involve litigation relating to accidents or incidents causing personal injury, loss of life or property damage, and does not involve whether New GM should repair the ignition switch defect. Rather, New GM's Motion only involves litigation in which Plaintiffs seek economic losses against New GM relating to an Old GM vehicle or part, including, for example, for the claimed diminution in the vehicle's value, and for loss of use, alternative transportation, child care or lost wages for time spent in seeking repairs. New GM

argues that under the June 26, 2009 GM APA approved by the Court, New GM assumed only three expressly defined categories of liabilities for vehicles and parts sold by Old GM: (a) post-sale accidents involving Old GM vehicles causing personal injury, loss of life or property damage; (b) repairs provided for under the "Glove Box Warranty" which was a specific written warranty of limited duration that only covered repairs and replacement of parts; and (c) Lemon Law claims essentially tied to the failure to honor the Glove Box Warranty. Thus, New GM's position is that all other liabilities relating to vehicles and parts sold by Old GM, including economic loss claims resulting from ignition switch defects, were liabilities that were retained by Old GM.

In an attempt to fit ignition switch defect economic loss claims into the third category of assumed liabilities under the GM APA, some Plaintiffs have asserted warranty and state lemon law claims. New GM argues that the Glove Box Warranty is not applicable to the ignition switch claims because: (a) the warranty is only for a limited duration and virtually all of the vehicles that are the subject of ignition switch actions were sold more than three years ago and thus the warranty has expired, (b) the Glove Box Warranty provides only for repairs and replacement parts, which are of an entirely different character than the economic losses asserted by Plaintiffs and which are expressly barred by the Glove Box Warranty, and (c) any purported warranty claims are moot because New GM will make the necessary ignition switch repairs as part of its recall, which is all the Glove Box Warranty would have required New GM to do. New GM further argues that none of the complaints filed have actually pled facts giving rise to lemon law liability as defined in the GM APA, and further asserts that the statutes of limitations on lemon law claims as defined in the GM APA have expired. Accordingly, New GM is seeking an order requiring Plaintiffs to comply with the Sale Order and Injunction and directing Plaintiffs to cease and desist from further prosecuting against New GM economic loss claims resulting from ignition switch defects.

In their Objection, Plaintiffs argue that by selectively directing its Motion solely against Plaintiffs asserting claims for economic loss, while excluding litigation relating to accidents or incidents causing personal injury, loss of life or property damage, New GM is violating the fundamental principal of the Bankruptcy Code that similarly situated creditors be treated equally. Plaintiffs further argue that Old GM deprived Plaintiffs and ignition switch claimants of constitutional due process by not providing them with actual notice of critical bankruptcy events. Plaintiffs contend that as Old GM knew of the defective ignition switches since 2001 and obtained evidence of the dangerous consequences of the defective ignition switches many years in advance of its chapter 11 filing, it was reasonably ascertainable to Old GM that persons exposed to the ignition switch defect have been harmed and would naturally have claims under the Bankruptcy Code. Having not received adequate notice, Plaintiffs assert that Plaintiffs and other ignition switch claimants cannot be bound by orders issued by the Bankruptcy Court, including the Sale Order. Finally, Plaintiffs argue that Old GM and New GM committed a fraud on the court through their deliberate and intentional nondisclosure of the ignition defects. Accordingly, the Plaintiffs seek release from the relevant releases and injunctions and an opportunity to assert their claims of successor liability or the functional equivalent against New GM in a court of competent jurisdiction.

The Current Procedural Posture

The Bankruptcy Court has consolidated briefing of the issues raised in the Motion, Complaint and Objection, and has directed the parties to address several Threshold Issues. Under the current operative scheduling order entered on July 11, 2014, briefing on these Threshold Issues begins on August 22, 2014 and ends on September 30, 2014. A hearing to address the Threshold Issues will be scheduled by the Court on or after October 10, 2014. The Threshold Issues are as follows:

1. Whether Plaintiffs' procedural due process rights were violated in connection with the Sale Motion and the Sale Order and Injunction, or alternatively, whether Plaintiffs' procedural due process rights would be violated if the Sale Order and Injunction are enforced against them;

2. If procedural due process was violated, whether a remedy can or should be fashioned as a result of such violation and, if so, against whom;

3. Whether any or all of the claims asserted in the Ignition Switch Actions are claims against the Old GM bankruptcy estate (and/or the GUC Trust);

4. If any or all of the claims asserted in the Ignition Switch Actions are or could be claims against the Old GM bankruptcy estate (and/or the GUC Trust), should such claims or the actions asserting such claims nevertheless be disallowed/dismissed on grounds of equitable mootness; and

5. The legal standard applicable to the issue of whether a fraud on the Court was committed in connection with the Sale Motion and Sale Order and Injunction based on the alleged issues regarding the ignition switch defect.

PRIMER ON INTELLECTUAL PROPERTY LAW

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I. Patents.

U.S. Patent Law has as its foundation Article 1, Section 8 of the U.S. Constitution which gives Congress the power to "promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries." U.S. Const. art. 1, § 8. Thus, in exchange for disclosing his invention so others can understand it and make further scientific progress based upon it, the Patent Act gives an inventor the right to prevent others from using his invention for the term of the patent. 35 U.S.C. § 271. A patent is an exclusionary right, then, granted by the Federal Government to an inventor to exclude others from making, using, selling, offering for sale or importing into the United States products that are covered by an issued United States patent. *Id.* To be patented an invention must fall within one of the subject areas specifically identified in the Patent Act. Those subject areas include processes, machines, articles of manufacture and compositions of matter. 35 U.S.C. § 101. It must also be new and non-obvious. 35 U.S.C. § 102–03. Scientific principles and laws of nature are not patentable. 35 U.S.C. § 101; *Buckingham Prods. Co. v. McAleer Mfg. Co.*, 108 F.2d 192, 195 (6th Cir. 1939); *In re Arnold*, 185 F.2d 686, 691 (C.C.P.A. 1950). A patent has a term of twenty years measured from the date the application is filed. 35 U.S.C. § 154.

Patent law is exclusively federal and preempts the states. 28 U.S.C. § 1338. Accordingly, actions for infringement of patents must be brought in the federal courts. *Id.* Patent rights are geographically constrained. A U.S. patent affords no protection outside the United States and a foreign patent has no effect within the United States. 35 U.S.C. § 271; *Microsoft Corp. v. AT & T Corp.*, 550 U.S. 437, 441 (2007).

Patents are freely assignable and may be freely licensed by the patent owner. 35 U.S.C. §§ 152, 261. A patent owner may parse the bundle of patent rights and license only selected parts of the bundle. 35 U.S.C. §§ 152, 261; *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 135 (1969). In the absence of a contrary agreement, each joint owner of a patent has all of the rights afforded a patentee with no duty to other joint owners. 35 U.S.C. § 261. The rights to a patent are owned by the individual inventor (not the inventor's employer) but the inventor may be obligated by her employment agreement to assign the rights in the invention to her employer. 35 U.S.C. §§ 115, 116.

Historically, patent rights belonged to the first to invent. As a result of enactment of the America Invents Act in 2011, the United States has now joined the majority of other countries in affording patent protection to the first inventor to apply for a patent. Leahy-Smith America Invents Act, Priv. L. No. 112-29, 125 Stat. 284 (2011). It is important to note that, while a patent gives its owner the right to prevent others from making, using, offering for sale, selling or importing the patented invention, it does not guarantee the patent owner itself the right to make or sell the patented invention. 35 U.S.C. § 154; *Herman v. Youngstown Car Mfg. Co.*, 191 F. 579, 584–85, 112 CCA 185 (6th Cir. 1911) ("A patent is not the grant of a right to make or use or sell.

It does not, directly or indirectly, imply any such right. It grants only the right to exclude others.").

II. Copyrights.

Like patents, U.S. copyrights find their basis in Article 1, Section 8 of the U.S. Constitution. U.S. Const. art. 1, § 8. Copyrights protect original works of authorship that are fixed in a tangible medium of expression. 17 U.S.C. § 102. Works of authorship include literary works, software, musical works, dramatic works, pictorial, graphic and sculptural works, motion pictures and other audio visual works, multi media works and sound recordings. *Id.* Copyright protects the expression of the idea not the idea itself. *Id.* Copyright also does not protect procedures, processes, systems, methods of operation, concepts, principles or discoveries. *Id.* Copyright exists upon creation of the work without any need to register it. 17 U.S.C. § 408. A copyright may be registered at any time but must be registered before it can be enforced in an infringement action. 17 U.S.C. § 411. Early registration provides procedural advantages. 17 U.S.C. §§ 410(c), 412.

A copyright is owned by the creator of the work unless the work falls within the Copyright Act's "work for hire" doctrine in which case the "author" of the work is considered the creator's employer or, for a select group of works, the person who commissioned the work. 17 U.S.C. §§ 101, 201, 409. Copyright owners have the exclusive right to reproduce the copyrighted work, to prepare derivative works based on that work, to distribute copies of the work (including by sale, rental, lease, lending, or other transfer) and to perform and display the work publicly. 17 U.S.C. §§ 106, 201. These rights are separable and individually transferable. While a copyrighted work may be embodied in a tangible object (such as a book, film or CD), the copyright is legally distinct from the object. 17 U.S.C. §§ 201–02. Thus, the sale of an object does not transfer the copyright interest in the object absent an express assignment. *Id.* For example, while a person may "purchase" Windows 8 at their local retailer, they are purchasing only the CD on which the program is burned and merely licensing the rights in the program.

The term of copyright has been extended over the years. In general, for works created after January 1, 1978, copyright subsists from the creation of the work and endures for a term of the life of the author plus 70 years. 17 U.S.C. § 302. If the work is "made-for-hire," the term of copyright is 95 years from the year of the work's first publication or 120 years from the year of its creation, whichever expires first. *Id.*

Like patent law, copyright is exclusively federal and state law is preempted. 17 U.S.C. § 301. Unlike patent law, works created in the United States and protected by copyright here are generally protected throughout most of the world as a result of international treaties. 17 U.S.C. § 104. Also in contrast to patent law, each author of a copyrighted work has all rights under copyright but with a duty to account to her coauthors or owners. 17 U.S.C. § 201; *Pye v. Mitchell*, 574 F.2d 476, 480 (9th Cir. 1978) (if work is product of joint authorship, each coauthor automatically becomes holder of undivided interest in the whole); *Kaplan v. Vincent*, 937 F.Supp. 307 (S.D.N.Y. 1996) (holding that each author of joint work maintains right to use or

license work, subject only to accounting to other co-owner). A copyright is freely assignable and may be freely licensed. 17 U.S.C. § 201.

III. Trademarks.

Trademarks are not based in the U.S. Constitution nor is trademark protection afforded as a means for encouraging the creation of trademarks. Rather, U.S. trademark law has its origins in the law of unfair competition. Trademarks are protected primarily to avoid consumer confusion and to facilitate consumer purchase decisions. 15 U.S.C. § 1127; *Two Pesos, Inc. v. Taco Cabana, Inc.*, 505 U.S. 763, 767–68 (1992). A trademark is a word, name, symbol, slogan or "device" used to identify and distinguish the trademark owner's goods or services. 15 U.S.C. § 1127. Consumers rely on trademarks to identify not only the source of the goods but also a consistent, expected level of quality of those goods. *See* William M. Landes & Richard A. Posner, *The Economics of Trademark Law*, 78 Trademark Rep. 267 (1988).

Prior to the industrial revolution in the United States, trademarks could not be licensed because licensing of a mark would perpetrate a fraud on the consumer who would be misled regarding the source of the product bearing the licensed trademark. *See* 3 McCarthy on Trademarks and Unfair Competition § 18:39 (4th ed.); Irene Calboli, *The Sunset of "Quality Control" in Modern Trademark Licensing*, 57 Am. U. L. Rev. 341, 351 (2007); Benjamin G. Paster, *Trademarks—Their Early History*, 59 Trademark Rep. 551, 552 (1969); Note, *Quality Control and the Antitrust Laws in Trademark Licensing*, 72 Yale L.J. 1171, 1175 (1963). The profoundly changed nature of commerce that was introduced with the industrial revolution necessitated a change in the law. *See* Calboli at 351. Beginning in the early 20th Century, courts, and later Congress, gave effect to trademark licenses. *Id.* Even so, a trademark may be licensed only so long as the owner of the mark ensures that goods bearing the mark are of a consistent quality. A licensor's failure to police the quality of goods bearing its mark will destroy the mark and result in a loss of all rights in the mark. 15 U.S.C. § 1127; *see*, *e.g.*, *Oberlin v. Marlin Am. Corp*., 596 F.2d 1322, 1327 (7th Cir. 1979) (outlining requirement of supervision of trademark licensees by licensor to avoid abandonment of trademark); *Haymaker Sports, Inc. v. Turian*, 581 F.2d 257, 261–62 (C.C.P.A. 1978) (licensing of trademark without quality control results in abandonment).

Trademark rights are created upon use of the mark in commerce without the need for registration. 15 U.S.C. §§ 1051, 1127. It is a misnomer, then, to speak of "applying for a mark." *Id.* These common law trademark rights are recognized and enhanced through federal registration of the trademark in the U.S. Patent and Trademark Office. A federal registration provides to its owner certain procedural rights including serving as prima facie evidence of the validity and ownership of the mark and of the owner's exclusive right to use the mark with the goods or services for which it is registered. 15 U.S.C. § 1115. With certain exceptions, the first user of a mark has rights superior to later users. 15 U.S.C. § 1052. Except in very limited circumstances, a trademark may be owned only by a single owner. 15 U.S.C. §§ 1051, 1114; *Carl Zeiss Stiftung v. VEB Carl Zeiss Jena*, 433 F.2d 686, 704–05 (2d Cir. 1970).

The owner of a trademark (whether or not registered) has the exclusive right to use the mark on or with the goods or services for which it has been used and to prevent others from using the same or a similar mark that is likely to confuse consumers as to the source or affiliation of the goods. 15 U.S.C. §§ 1057(b), 1114, 1125. Trademark rights are geographical and, in the case of common law rights, exist only in the areas of use. 15 U.S.C. § 1114; *Hanover Star Milling Co. v. Metcalf*, 240 U.S. 403, 415–416 (1916) (The "Tea Rose" Case: "Into whatever markets the use of a trademark has extended, or its meaning has become known, there will the manufacturer or trader whose trade is pirated by an infringing use be entitled to protection and redress."); *see also Tana v. Dantanna's*, 611 F.3d 767, 780 (11th Cir. 2010) (citing *Hanover Star Milling Co.*, 240 U.S. at 415–416) ("[I]t is well-established that the scope of protection accorded his mark is coextensive only with the territory throughout which it is known and from which it has drawn its trade."). Federal registration may expand those rights nationally. 15 U.S.C. § 1057. If an owner permanently ceases use of a mark, its rights in the mark are lost. 15 U.S.C. § 1127.

Because a trademark is a symbol of its owner's goodwill, trademark rights exist only in association with that goodwill. 15 U.S.C. § 1060. Assignment of a trademark divorced from the owner's goodwill, that is, an assignment in gross, will destroy all rights in the mark. *Id.* Accordingly, "mortgaging" of trademark rights destroys the underlying rights. *Yellowbook Inc. v. Brandeberry*, 708 F.3d 837, 844 (6th Cir. 2013) ("[A]ssignment of a trademark without its associated goodwill is treated as an invalid 'assignment in gross' that gives the assignee no rights."); *In re Roman Cleanser Co.*, 43 B.R. 940, 944 (Bankr. E.D. Mich. 1984), *aff'd*, 802 F.2d 207 (6th Cir. 1986) ("[A] valid assignment of a mark must be accompanied by an assignment of the goodwill of the business."); *Lil' Red Barn, Inc. v. Red Barn System, Inc.*, 322 F. Supp. 98, 107 (N.D. Ind. 1970), *aff'd*, 174 U.S.P.Q. 193 (7th Cir. 1972) ("[T]he rule is well established that a mere agreement for the future assignment of a trademark is not an assignment of either the mark itself or the good will attached to it.").

IV. Licensing of Intellectual Property Rights.

A license of intellectual property rights is, in essence, a covenant not to sue. *See De Forest Radio Tel. & Tel. Co. v. United States*, 273 U.S. 236, 242 (1927) ("[A] license … [is] a mere waiver of the right to sue by the patentee"); *Graham v. James*, 144 F.3d 229, 236 (2d Cir. 1998) ("A copyright owner who grants a nonexclusive license to use his copyrighted material waives his right to sue the licensee for copyright infringement."). In other words, because the right attendant a patent, trademark or copyright is the right to exclude, a license relaxes the exclusivity provided by law, giving the licensee the right to engage in activities that would otherwise be unlawful. 35 U.S.C. §§ 152, 261; 15 U.S.C. § 1060; 17 U.S.C. §§ 106, 201.

It is axiomatic that a licensor cannot license what it does not own. 35 U.S.C. §§ 152, 261; 15 U.S.C. § 1060; 17 U.S.C. §§ 106, 201; *Preload Enters. Inc. v. Pac. Bridge Co.*, 86 F. Supp. 976, 980 (D. Del. 1949). Accordingly, a license is subject to all of the limitations of the licensor's rights. If the licensor has previously licensed others, the rights that he has already divested cannot be licensed again. *See Sanofi, S.A. v. Med-Tech Veterinarian Prods., Inc.,* 565 F. Supp. 931, 939 (D.N.J. 1983) ("[T]he purchaser of a patent takes subject to outstanding

licenses."). If the license is a sublicense, the sublicensor is limited by the rights to which she has been licensed. *See Imperial Appliance Corp. v. Hamilton Mfg. Co.*, 239 F. Supp. 175, 177 (E.D. Wis. 1965) (licensee could transfer only such rights as it held under its license from patent holder and the terms of its license were thus binding on sublicensee). Just as "a stream cannot rise above its source," a licensor cannot license rights that she does not have.

The licensor of intellectual property rights may carve up its "bundle of rights" in any permutations and combinations that it chooses for licensing. *Zenith Radio Corp.*, 395 U.S. at 135. For example, in a license under a patent, the licensor may license any or all of its rights to make, use, sell, offer for sale and import the patented invention. *Id.*; 35 U.S.C § 154(a). It can license those rights in limited geographic territories, in specific industries or channels of commerce or for specified periods of time up to and including the full patent term. 35 U.S.C § 261. Similarly, the owner of a copyright may license some or all of its bundle of rights including the right to reproduce, distribute, publicly perform, and publicly display the copyrighted work, to prepare derivative works based on it and, for sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission. 17 U.S.C. § 106. The owner of a trademark, whether registered or not, can license others to use its trademark or trademarks "confusingly similar" to it. 15 U.S.C. § 1060. Like the patent licensor, a licensor of copyright or trademark rights may parse its bundle of rights in any manner that it chooses. *S.O.S., Inc. v. Payday, Inc.*, 886 F.2d 1081, 1088 (9th Cir. 1989) ("[L]icenses are assumed to prohibit any use not authorized.").

V. Assignability of Intellectual Property Licenses.

Under basic contract law, a contract silent on assignability is generally assignable. Restatement (Second) of Contracts § 317(2) (1981); *see also* U.C.C. §2-210(2) (2012). A license of intellectual property rights silent regarding assignability is, likewise, assignable by the licensor without the consent of the licensee. *See ICEE Distribs., Inc. v. J&J Snack Foods Corp.*, 325 F.3d 586, 593 (5th Cir. 2003); *Am. Dirigold Corp. v. Dirigold Metals Corp.*, 125 F.2d 446, 452 (6th Cir. 1942). The rationale for this rule is that the licensed intellectual property, not the licensor's identity, is the primary benefit of the license to the licensee. So long as the licensee may continue to use the licensed rights, the licensee usually does not care who owns them. But the licensee's right to assign is less clear and depends on the form of the license. *See generally In re Patient Educ. Media, Inc.,* 210 B.R. 237 (Bankr.S.D.N.Y.1997); *Perlman v. Catapult Entm't, Inc.,* 165 F.3d 747 (9th Cir.1999); *see also* Aleta A. Mills, Note: The Impact of Bankruptcy on Patent and Copyright Licenses, 17 Bankr.Dev.J. 575, 585–86 (2001) (collecting and summarizing cases).

A. Nonexclusive licenses

Regardless of the type of intellectual property involved, nonexclusive licenses have almost universally been held to be nonassignable by a licensee without the licensor's consent. *Everex Sys., Inc. v. Cadtrak Corp.*, 89 F.3d 673, 679 (9th Cir. 1996). This presumption of non-assignability arises from the federal policy derived from the Constitution favoring a copyright or patent owner's right to control the identity of its licensees. *Id.* The identity of the

licensee generally *does* matter to the rights owner who may be willing to license a non-competitor (but not a competitor), or who carefully selects a licensee well-suited to exploit a particular market. *Id.* The free assignability of non-exclusive patent and copyright licenses by the licensee would erode the value of the underlying intellectual property right and defeat the Constitutional purpose of "promot[ing] the progress of science and useful arts." *Id.*; U.S. Const. art. 1, § 8. The presumption against assignability can also be explained by the nature of a nonexclusive license which is in substance a mere covenant not to sue the licensee for infringement. Courts typically consider covenants not to sue as inherently personal to the recipient. *Patient Educ. Media, Inc.*, 210 B.R. at 240–43.

Although protection of trademarks has different legal underpinnings than patents and copyrights, courts still generally prohibit the licensee's assignment of a trademark license without the consent of the trademark owner. *See In re XMH Corp.*, 647 F.3d 690, 695 (7th Cir. 2011); 4 McCarthy on Trademarks and Unfair Competition §25:33 (4th ed.) (while the case law in this area is limited, a trademark is personal to the licensee and cannot be assigned unless the license expressly provides otherwise). This prohibition is seen as essential to preventing customer confusion and to protecting the public's expectations regarding source and quality of goods or services provided under the licensed mark. *Gorenstein Entm't, Inc. v. Quality Care-USA, Inc.*, 874 F.2d 431, 435 (7th Cir. 1989). Trademark licenses are viewed as similar to personal services agreements and are therefore not assignable without consent. *XMH Corp.*, 647 F.3d at 695; *Miller v. Glenn Miller Prods., Inc.*, 454 F.3d 975, 988 (9th Cir. 2006).

B. Exclusive licenses

While the assignability of nonexclusive intellectual property licenses has received considerable judicial attention, fewer cases have addressed the assignability of an exclusive license. And the courts that have addressed that issue have not always resolved it in the same way. If the license is a true exclusive license that transfers "all substantial rights" including the right to sue without consent of the licensor, the right to grant sublicenses and all other aspects of ownership of the intellectual property, most courts have held that the common law right of free alienability of personal property favors assignability. But if the licensor retains any substantial rights, even if it calls the license "exclusive," the trend has been to treat an "exclusive" license the same as a non-exclusive and to require the consent of the licensor for assignment. *Contrast Vaupel Textilmaschinen v. Meccanica Euro Italia*, 944 F. 2d 870, 874 (Fed. Cir. 1991) (an exclusive license that transfers "all substantial rights" — but not necessarily *all* rights — constitutes a virtual sale of the patent, making the licensee the patent owner) *with AsymmetRx v. Biocare Med.*, 582 F.3d 1314, 1320 (Fed Cir. 2009) (licensor retained substantial rights; licensee lacked standing to sue for infringement).

VI. Security Interests in Intellectual Property.

Like security interests in all forms of personal property, security interests in intellectual property are governed by Article 9 of the Uniform Commercial Code. A security interest in intellectual property attaches when the three prerequisites of Section 9-203(b) have been satisfied: a valid agreement; the giving of value; and the debtor's possession of rights in the collateral. U.C.C. § 9-203(b).

Although Article 9 provides several methods for perfecting a security interest, perfection of a security interest in intellectual property requires filing with the appropriate registry or other record keeping authority. *See* U.C.C. §§ 9-306, 9-312, 9-313. Article 9 promotes the filing of a financing statement as the primary method of perfecting a security interest. *See* U.C.C. § 9-310. But Section 9-311(a) provides that the filing of a financing statement is neither necessary nor effective to perfect a security interest in property that is subject to "a statute, regulation, or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor" preempts Section 9-310(a). U.C.C. § 9-311(a). Thus, the filing requirements of Article 9 explicitly defer to any federal intellectual property law requirements. Compliance with the federal statute is deemed to be "equivalent" to filing proper U.C.C. financing statements and is the exclusive means for perfecting a security interest in the subject intellectual property. U.C.C. § 9-311(b). In addition to Article 9 calling for the U.C.C. to defer to a federal system, if Congress exercises its authority to occupy the field, then federal law preempts the U.C.C. Preemption may be found where Congress explicitly or implicitly preempts state law or where compliance with both state and federal law would obstruct the "full purposes and objectives of Congress." *Aerocon Eng'g v. Silicone Valley Bank*, 303 F.3d 1120, 1128 (9th Cir. 2002).

Intellectual property rights are governed (at least in part) by federal copyright, patent and trademark law. And the federal system for the registration of such rights provides for the recordation of assignments of those rights. But no express provision is made for the recording of security interests in federally registered or especially unregistered intellectual property rights. Article 9 fails to address this ambiguity regarding how or whether the federal law or the U.C.C. governs with respect to the filings required for perfection of security interests in such property. Official Comment 1 to former Section 9-104 referred to the federal copyright and patent laws and stated, "the filing provisions under the [federal copyright and patent laws] are recognized as the equivalent to filing under this Article," citing former Section 9-302(3) and (4). However, the extent of equivalency, and the consequent effectiveness of the filing provisions of the three federal statutes for copyrights, patents, and trademarks was not clear prior to the 2001 revisions. Nothing in revised Article 9 changes the general preemption rule. Given the uncertainty of the interplay between federal and state law in this area, some commentators suggest, "the careful lawyer will file everywhere it is possible to do so with respect to a patent, trademark or copyright." 4 James J. White & Robert S. Summers, *Uniform Commercial Code*, § 30-12 at p. 87 (4th ed. 1995). This more prudent approach has evolved in recent years and a general practice is developing with respect to the documents filed in the federal registries.

VII. Recording Transfers of Intellectual Property Rights.

Patents, copyrights and federally registered trademarks as well as applications for patents, copyrights and federal registration of trademarks may be assigned and the assignment recorded with the corresponding federal registry. *See 35 U.S.C. §261, 17 U.S.C. §205 and 15 U.S.C. §1060.*[2] If the assignment is not recorded, a subsequent bona fide purchaser for value without notice of the assignment will cut off the rights of the earlier assignee. The grace period for recording of assignments of patents and federal trademark rights is three months, 35 U.S.C. §261 and 15 U.S.C. §1060(a)(4), and for copyrights one month, 17 U.S.C. §205(d).

Before taking an interest in federal intellectual property rights it is important to search the assignment records in both the U.S. Patent and Trademark Office and the U.S. Copyright Office. Recordal of an assignment of patent or trademark rights submitted to the Patent and Trademark Office in hard copy currently takes several months, but an electronically submitted assignment will be recorded and acknowledged within 24 - 48 hours. At the Copyright Office, administrative delays and backlogs commonly delay recordation of assignments and other interests in copyrights by as much as nine to twelve months. Further complicating searches of Copyright Office records, the office maintains only limited information in publicly accessible online databases. A comprehensive examination of Copyright Office assignments and other transfers therefore requires onsite searching at the Copyright Office. These administrative delays may frustrate efforts to verify ownership of federal intellectual property rights and suggests further, post closing checks to verify ownership.

To protect the rights of the buyer, the assignment should be recorded immediately. It is prudent for the buyer to record not only the document assigning rights to the buyer but also any other assignments that may be necessary to complete the chain of title to the buyer. Licenses and other transfers or documents affecting title may also be recorded for the notice benefit that recordation provides.

[2] Assignments of applications for federal registration of a trademark based on the applicant's intent to use the mark may generally not be assigned, however, until actual use of the mark has commenced and the corresponding amendment to allege use or statement of use has been filed. *See 15 U.S.C. §1060(a)(1).*

ASSET SALES AND EXECUTORY CONTRACTS: THE CLASH OF SECTIONS 363(F) AND 365

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Asset sales in business bankruptcy cases often include contract rights, some of which may be essential to the operation of the business assets being acquired. As part of an asset purchase, buyers often seek to obtain the benefit of certain contracts and leases by having them assumed by the debtor and assigned to the buyer, and to avoid the burden of other contracts by having them rejected by the debtor.

Intellectual property licenses are both contracts and a form of transfer of ownership. This dual character complicates the analysis of the degree to which the debtor's interest in IP can be transferred "free and clear" of the interests of third parties. Whether the debtor can effectively transfer its IP licenses as part of a §363 sale primarily depends upon whether the debtor is the licensee or the licensor/owner of the IP.

If the debtor is the IP licensee, generally it cannot assign its interest in the IP license to the asset purchaser without the consent of the nondebtor licensor. One exception: if the debtor is the exclusive licensee under a license that effectively transferred all of the licensor's rights in the IP, the license may be deemed to constitute a sale of the IP to the debtor, in which case the debtor, as the owner of the IP, would have the right to sell the IP by assignment of the exclusive license.

If the debtor is the IP owner/licensor, it can assign its IP licenses to the §363 purchaser. However, nondebtor licensees of the debtor's IP have the right under both applicable nonbankruptcy law and pursuant to §365(n) of the Bankruptcy Code to retain their licenses, even if the debtor finds those licenses to be burdensome and rejects them. Thus, a §363 asset purchaser should be alert to the fact that it may not be able to buy the debtor's IP free and clear of the "interests" of the nondebtor parties to the IP licenses.

I. BASIC PRINCIPLES APPLICABLE TO TREATMENT OF EXECUTORY CONTRACTS IN §363 SALES

A. IP Licenses are "Interests" Within the Meaning of § 363(f) of the Bankruptcy Code

Section 363(f) of the Bankruptcy Code authorizes bankruptcy courts to approve the sale of estate property "free and clear of any interest in such property of an entity other than the estate . . . ," provided one of the five conditions under § 363(f) is satisfied. 11 U.S.C. § 363(f). The Bankruptcy Code does not define "any interest," but courts have interpreted the term broadly. *See Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537, 543-48 (7th Cir. 2003) (lessee who leased real property from debtor sought determination of its possessory rights in the leased property when the debtor's assets were sold "free and clear" of other interests; held bankruptcy sale terminated the lessee's possessory interest in the property). A license in intellectual property is generally considered an "interest." *See FutureSource LLC v. Reuters Ltd.*, 312 F.3d 281, 285 (7th Cir. 2002) (finding that the sale extinguished all "interests" and the assets were acquired free and clear by the purchaser, including in the intellectual property).

Section 365 of the Bankruptcy Code gives a debtor-in-possession/trustee the ability to assume, assume and assign, or reject an executory contract, notwithstanding any contractual

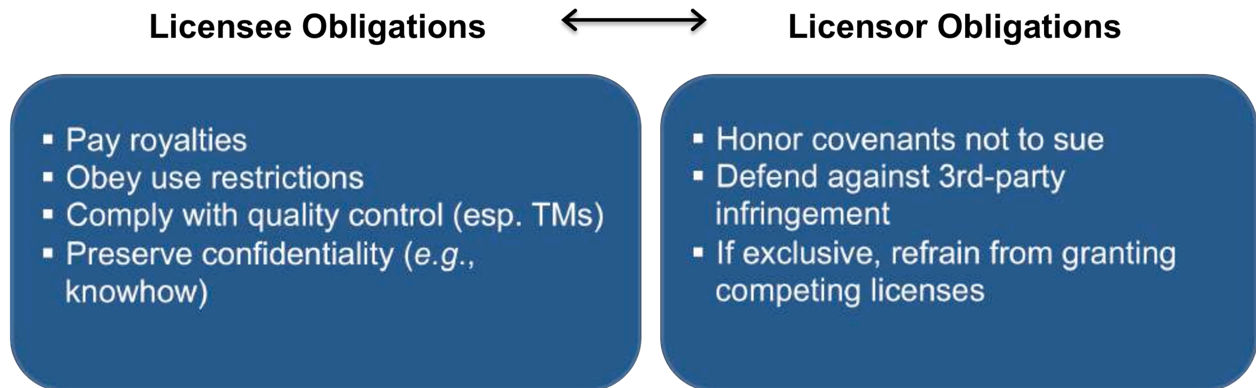
prohibitions on assignment. *See* 11 U.S.C. §365(a) ("the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor"); 11 U.S.C. §365(f)(1) (subject to certain exceptions, the trustee may assign contracts and leases "notwithstanding a provision in an executory contract or unexpired lease of the debtor . . . that prohibits, restricts or conditions the assignment" thereof). Those exceptions are the focus here, because the debtors/trustees' powers to transfer their rights to an asset purchaser are limited with respect to IP licenses.

B. Section 365 Only Applies to IP Licenses that Remain *Executory* as of the Petition Date

Section 365 only applies if the contract qualifies as "executory" as of the petition date. This term is not defined in the Bankruptcy Code. Under the most commonly accepted test, "executory" means that the "obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." *Gloria Mfg. Corp. v. Int'l Ladies' Garment Workers' Union*, 734 F.2d 1020, 2033 (4th Cir. 1984) (quoting Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn.L.Rev. 439, 460 (1973). *See, e.g., Lubrizol Enter., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1045 (4th Cir. 1985) ("[t]his court has recently adopted Professor Countryman's more specific test for determining whether a contract is 'executory' in the required sense"); *see also In re Norquist*, 43 B.R. 224, 228 (Bankr. E.D. Wash. 1984) (stating that "the Supreme Court in citing the legislative history appears to have agreed with the expression of Congress that a precise definition of an executory contract is inadvisable" but applying the Countryman definition).

Conversely, a contract is generally not considered executory if one party to the contract has completed all material performance. *See, e.g., In re Spectrum Info. Tech., Inc.*, 190 B.R. 741, 750 (Bankr. E.D.N.Y. 1996) (holding that separation agreements were not executory because they lacked "the requisite material future obligations on both sides"); *see also In re Monument Record Corp.*, 61 B.R. 866, 868 (Bankr. M.D. Tenn. 1986) (holding that recording contract was not executory because it did not "contain the continuing mutual obligations necessary to constitute an 'executory' contract").

IP licenses are generally presumed to be executory because each party has continuing obligations that remain unperformed:



See, e.g., In re Golden Books Family Entm't, Inc., 269 B.R. 300, 308-309 (Bankr. D. Del. 2001) (nonexclusive copyright license agreement to produce and market products relating to children's cartoon characters qualified as executory contracts "because each party to the license had the material duty of 'refraining from suing the other for infringement of any of the [intellectual property] covered by the license'") (citation omitted); *see also In re CFLC, Inc.*, 89 F.3d 673, 677 (9th Cir. 1996) (nonexclusive patent licenses are executory contracts because the licensor "must continue to refrain from suing [the licensee] from infringement" and because the licensee "must mark all products made under the license with proper statutory patent notice"); *In re New York City Shoes, Inc.*, 84 B.R. 947, 960 (Bankr. E.D. Pa. 1988) (exclusive trademark licensing agreement was executory when the agreement provided for annual royalties).

However, if the *only* remaining obligation is the licensee's payment of royalties or installment payments, the IP license is probably not executory because it would be deemed to be the sale of all rights and interest in the IP, with no continuing obligations on the licensor's side. For example, exclusive copyright licenses are often treated as a completed transfer of that bundle of IP rights. *See In re Golden Books Family Entm't, Inc.*, 269 B.R. 311, 314 (Bankr. D. Del. 2001) (comparing nonexclusive copyright licenses, which are personal and not assignable without consent, and exclusive copyright licenses, which may be freely transferred); *cf. Thompkins v. Lil' Joe Records, Inc.*, 476 F.3d 1294 (11th Cir. 2007), *cert. denied,* 552 U.S. 1022 (2007) (copyright owner that had assigned all rights in its copyright to the debtor held only a monetary claim for payment of royalties; debtor could sell copyright "free and clear"); *see also* discussion in 5 Melville B. Nimmer & David Nimmer, Nimmer on Copyright, §19A.07[E] at 19A-84 - 19A-94 (Matthew Bender, Rev. Ed. 2013).

Occasionally, an IP license that would ordinarily be deemed executory may be so embedded in a broader transaction – usually the prepetition transfer of an entire business – that the license no longer qualifies as executory. That would mean that the license would no longer be subject to rejection. Most recently, in *In re Interstate Bakeries Corp.,* the Eighth Circuit *en banc* determined that the exclusive trademark license at issue was not an executory contract subject to assumption or rejection because it was part of a larger, integrated asset purchase agreement, the obligations under the asset purchase agreement and license agreement were substantially performed, and "failure to perform any of its remaining obligations would not be a

material breach of the integrated agreement." 751 F.3d 955, 963 (8th Cir. 2014) (reversing the contrary ruling by its own panel). *See also In re Exide Tech.,* 607 F.3d 957, 964 (3d Cir. 2010) (trademark license agreement granted to purchaser of debtor's business was not executory and could not be rejected; no material further performance was owed by purchaser that could result in the termination of the license); *Exide Tech. v. Enersys Del., Inc. (In re Exide Tech.)*, No. 02-11125, 2013 WL 85193 (Bankr. D. Del. Jan. 8, 2013) (agreement governing use of certain trademarks was found not to be an executory contract; because debtor/licensor could not reject the trademark license agreement, it could not deprive non-debtor/licensee of its right to use the trademark and, by means of the bankruptcy process, somehow obtain revesting of use of the trademark free and clear of the purchaser's interest).

On the other hand, if a transaction includes multiple related agreements and the court does *not* find that the agreements are a fully integrated arrangement, the court may allow the debtor to reject one agreement and assume the other. *See, e.g., In re Physiotherapy Holdings, Inc.*, 506 B.R. 619, 626 (Bankr. D.Del. 2014) (allowing the debtor to assume license agreement and reject the master agreement based on court's finding that "[t]he Agreements do not constitute an integrated arrangement which the Court should consider singular"). This determination that the license agreement and master agreement were separate agreements was significant in *Physiotherapy Holdings* as the master agreement had a much broader indemnification clause than the license agreement and thus the debtor could assume the license while rejecting the master agreement with its broad indemnification requirements.

These cases underscore the challenges of just how difficult it is to draw the line between executory and nonexecutory contracts in some circumstances. The answer may well depend upon whether the IP license is entirely free-standing versus being embedded in a broader, substantially complete transaction. If the overall transaction is substantially consummated, then the debtor/licensor in a subsequent bankruptcy case would likely not be able to treat the IP license as separate, and could not reject it in an effort to achieve a "free and clear" transfer to an asset purchaser pursuant to a §363 sale.

C. Assignment of Executory Contracts and Leases to Asset Purchasers

In the context of §363 sales, the issue is not whether a debtor can assume an executory contract or lease for its own benefit as a reorganized entity, but rather whether it can assume and then assign the contract or lease to the asset purchaser, and what if any restrictions apply to such an assignment.

1. Assumption Prerequisites. The requirements for *assumption* must, of course, still be satisfied. First, contracts can only be assumed as a unitary whole; no cherry-picking is allowed. *See, e.g., In re Arts Dairy, LLC*, 417 B.R. 495, 500 (Bankr. N.D. Ohio 2009) ("In effect, the assumption of an executory contract means that during the pending bankruptcy, the contract will continue to operate according to its terms. Assumption must be done *cum onere* — that is, the contract must be assumed with all of its benefits and burdens."). Second, any defaults must be cured, as required by §365(b)(1). Finally, between the debtor during the case and the buyer after the sale, full performance must be provided under the contract. *See, e.g.*, *In re PRK Enter., Inc.*, 235 B.R. 597 (Bankr. E.D. Tex. 1999).

2. Assignment Prerequisites. Contractual clauses that forbid or restrict assignment of the debtor's rights are generally unenforceable in bankruptcy. 11 U.S.C. §365(f)(1). As a matter of bankruptcy policy, debtors are encouraged to maximize the value of all of their assets – including contract rights – for the benefit of their creditors generally. However, IP licenses fall within an important exception: non-contractual restrictions on assignment are still binding with respect to contracts as to which a non-debtor third party cannot be forced to accept performance from someone other than the original debtor as a matter of "applicable [nonbankruptcy] law." 11 U.S.C. §365(c)(1)(A). The nondebtor party can, of course, consent to assignment. "The term 'applicable law' means any law applicable to a contract, other than bankruptcy law." *In re XMH Corp.,* 647 F.3d 690, 695 (7th Cir. 2011). The application of this exception to IP licenses is discussed in detail below.

D. Rejection of Executory Contracts

1. Buyers' Right to Exclude Burdensome Contracts. Typically, asset purchasers negotiate for the right to pick and choose which contracts they want to have assumed and assigned to them, and which ones they do not want. If the buyers exclude a contract associated with the assets being acquired, then the debtor will usually reject the contract as it is of no further use to the estate. Debtors are generally authorized to reject any burdensome contracts. *See, e.g., In re Central Jersey Airport Servs.*, *LLC*, 282 B.R. 176, 183 (Bankr. D. N.J. 2002) (debtor authorized to reject agreement to sell real property because property appraised for approximately $2 million more than the sale price). IP licenses are subject to rejection, whether the debtor is the licensee or licensor.

2. Effect of Rejection. Rejection is treated as a breach by the debtor as of the petition date. *See* 11 U.S.C. §§ 365(g) and 502(g) ("the rejection of an executory contract . . . of the debtor constitutes a breach of such contract"). Although rejection does not "terminate" a contract, it does generally end the debtor's performance obligations. *See* 3 Collier on Bankruptcy ¶ 365.03[3] (15th ed. rev.), *citing* Treister, *et al*., Fundamentals of Bankruptcy Law, § 5.04(f), at 249 (5th ed. 2004) ("[r]ejection relieves the estate of the debtor's remaining obligations under the contract"); *see also In re Taylor-Wharton Int'l LLC*, No. 09-14089, 2010 WL 4862723, at *3 (Bankr. D. Del. 2010) ("[t]hus the effect of rejection is to relieve a debtor from future performance under the contract"). However, for IP licenses, real estate leases, and certain other types of contracts, the nondebtor party retains some rights after rejection even though the debtor can no longer be required to render active performance. These exceptions for IP licenses are discussed in more detail below.

II. SPECIAL ISSUES FOR INTELLECTUAL PROPERTY LICENSES IN BANKRUPTCY SALES

The contract and IP rights that an asset purchaser may acquire in a §363 sale depend upon whether the debtor owns the IP or licenses it from a nondebtor party.

A. Debtor as Licensee of IP: Most IP Licenses are Non-Assignable Without the Licensor's Consent

Patent, copyright and trademark law have been held to qualify as "applicable law" for purposes of §365(c)(1)'s exception to the general principle favoring unilateral assignability of executory contracts by debtors. A nondebtor licensor is thus excused from being forced to accept performance or to render performance to any entity other than the debtor licensee. The case law differs somewhat among the various circuits and districts, and by type of IP license, as summarized below. In particular, the circuits are split as to whether exclusive copyright licenses may be assigned by debtors without the licensor's consent.

1. **Nonexclusive Patents Uniformly Held to be Non-Assignable:**

Unarco Indus., Inc. v. Kelley Co., Inc., 465 F.2d 1303, 1306 (7th Cir. 1972), *cert. denied*, 410 U.S. 929 (reversing district court and holding that nonexclusive patent license agreement was personal and not assignable without consent).

In re CFLC, Inc., 174 B.R. 119, 123-24 (N.D. Cal. 1994), *aff'd sub nom*., *Everex Sys., Inc. v. Cadtrak Corp*. (*In re CFLC, Inc*.), 89 F.3d 673, 680 (9th Cir. 1996) (holding federal law precluded debtor's assignment of nonexclusive patent license over objection of patent holder).

In re Access Beyond Techs., Inc., 237 B.R. 32, 46 (Bankr. D. Del. 1999) (holding debtors' rights as licensee were non-assignable, absent objector's consent).

Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.),165 F.3d 747, 750-51 (9th Cir. 1999), *cert. dismissed*, 120 S.Ct. 369 (holding that the debtor could not assume nonexclusive patent licenses because "federal patent law makes nonexclusive patent licenses personal and nondelegable").

2. **Exclusive Patent Licenses Uniformly Held to be Non-Assignable:**

In re Hernandez, 285 B.R. 435, 440 (Bankr. D. Ariz. 2002) (finding that federal patent law requires consent to assignment by the licensor whether the license is exclusive or nonexclusive).

In re Aerobox Composite Structures, LLC, 373 B.R. 135, 141 (Bankr. D.N.M. 2007) (noting that "[f]ederal patent law generally prohibits assignment of both exclusive and nonexclusive license agreements absent consent of the licensor").

Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.), 165 F.3d 747, 750 n.3 (9th Cir. 1999), *cert. dismissed*, 120 S.Ct. 369 (nonexclusive licenses are non-assignable; "we express no opinion regarding the assignability of *exclusive* patent licensees under federal law") (emphasis in original).

3. **Nonexclusive Copyright Licenses Uniformly Held to be Non-Assignable:**

Patient Educ. Media, Inc., 210 B.R. 237, 240-42 (Bankr. S.D.N.Y. 1997) (holding copyright license for photographs used in videotapes was nonexclusive and could not be assigned without copyright owner's consent).

In re Buildnet, Inc., Nos. 01-82293, 01-82294, 01-82295, 01-82296, 01-82297, 01-82298, 01-82299, 2002 Bankr. LEXIS 1851, at *17-18 (Bankr. M.D.N.C. Sept. 20, 2002) (holding applicable copyright law barred debtor-in-possession from assigning nonexclusive copyright license for sophisticated software, absent consent).

4. **Split on Assignability of Exclusive Copyright Licenses:**

In re Golden Books Family Entm't, Inc., 269 B.R. 311, 314 (Bankr. D. Del. 2001) (comparing nonexclusive copyright licenses, which are personal and not assignable without consent, and exclusive copyright licenses, which may be freely transferred).

Traicoff v. Digital Media, Inc., 439 F. Supp. 2d 872, 877-80 (S.D. Ind. 2006) (analyzing split of authority and concluding that consent is not required for transfer of exclusive copyright license).

In re GT Brands Holding LLC, No. 05-15167 (PCB), 2005 Bankr. LEXIS 2807, at *2-3 (Bankr. S.D.N.Y. Sept. 2, 2005) (finding copyright licenses at issue were exclusive and therefore assignable).

In re Valley Media, Inc., 279 B.R. 105, 135 (Bankr. D. Del. 2002) ("[e]xclusive [copyright] licenses grant the licensee a property right in the copyright that is freely transferable and the licensor is precluded from transferring those rights again to someone else" because the licensor no longer has any rights to transfer).

Gardner v. Nike, Inc., 279 F.3d 774, 781 (9th Cir. 2002) (requiring copyright licensees to get explicit consent from the licensor, even where the license is exclusive, "strikes the balance between the competing interests" of both the "need for free alienability and divisibility" and "the necessity to preserve the rights and control of the owners and creators").

5. **Trademark Licenses Uniformly Held to be Non-Assignable:**

In re N.C.P. Mktg. Group, Inc., 337 B.R. 230, 235-37 (D. Nev. 2005) *aff'd*, 279 F. App'x 561 (9th Cir. 2008), *cert. denied*, 129 S.Ct. 1577 (stating "under applicable trademark law, trademarks are personal and non-assignable without the consent of the licensor").

Tap Publ'n, Inc. v. Chinese Yellow Pages (New York) Inc., 925 F. Supp. 212, 218 (S.D.N.Y. 1996) (quoting the general rule "that unless the [trademark] license states otherwise, the licensee's right to use the licensed mark is personal and cannot be assigned to another") (citation omitted).

In re Travelot Co., 286 B.R. 447, 455-58 (Bankr. S.D. Ga. 2002) (nonexclusive trademark license was non-assignable absent consent).

In re XMH Corp., 647 F.3d 690, 695 (7th Cir. 2011) ("the universal rule is that trademark licenses are not assignable in the absence of a clause expressly authorizing assignment").

In re Global Home Prod., LLC, No. 06-10340, 2006 WL 2381918, at *1 (D. Del. Aug. 17, 2006) (finding that "the Bankruptcy Court correctly concluded that the Sublicense Agreement was not a personal services contract and was freely assignable as an exclusive license that places no restriction on assignments").

In re Rooster, Inc., 100 B.R. 228, 231-34 (Bankr. E.D. Pa. 1989) (concluding exclusive trademark agreement was not for personal services and assignable without consent).

B. Debtor as Licensee: Uncertain Enforceability of Contractual Consent to Assignment

Section 365(c)(1) and (f)(1) preclude assignment of IP licenses by debtor licensees absent consent, based upon protections afforded to IP owners by the U.S. patent and copyright statutes and other applicable law. Some license agreements, however, expressly grant contractual consent to assignment under specified terms and conditions. The courts have split as to whether such contractual waivers of the statutory protections are enforceable in bankruptcy even where the debtor proposes to assume and not assign the IP license. Generally, however, such contractual waivers are viewed as operative only outside of bankruptcy on the premise that IP owners have relied upon existing law barring assignment in a bankruptcy case. Relatively few reported decisions have addressed this question.

RCI Tech. Corp. v. Sunterra Corp., 361 F.3d 257, 271 (4th Cir. 2004) (holding that software license was not assumable over licensor's objection, even though pre-petition the licensor had consented in the agreement to assignment by the licensee to successors in interest).

Matter of Midway Airlines, Inc., 6 F.3d 492, 496-97 (7th Cir. 1993) (trustee could assign debtor airline's gate lease at airport over lessor's objections because agreement clearly stated that lease could be assigned in the event of bankruptcy).

In re Quantegy, Inc., 326 B.R. 467, 471 (Bankr. M.D. Ala. 2007) (commenting that "consent is irrelevant if applicable law does not excuse [the counterparty] from performance" and declining to follow *Sunterra* because "section 365 allows assumption over the objection of the other party to the contract if applicable law does not excuse that party's performance").

C. Debtor as Licensee: The Controversy and Circuit Split Regarding the Hypothetical Test vs. Actual Test

This paper focuses on §363 sales of assets and the assignment of related contracts to the asset purchasers. In this situation, the debtors are presumptively not assuming and *keeping* their contracts and leases. Therefore, we need not delve into the sharp circuit split on the question of whether a debtor may assume and retain a contract that it cannot assign. We simply note that the Third, Fourth, Ninth and Eleventh Circuits have adopted the "hypothetical" test, which bars assumption of a contract that cannot be assigned by the debtor under applicable nonbankruptcy law.[3] On the other hand, the First and Fifth Circuits and many bankruptcy courts considering the question have adopted the "actual" test, which takes the position that a non-assignable contract may be assumed by the debtor if the debtor is not attempting to assign the contract.[4]

D. Debtor as Licensor: Rights of Nondebtor IP Licensees

Debtors often file bankruptcy so that they can reject burdensome contracts or leases. Retail chain store operators frequently shed large numbers of real estate leases by rejection in bankruptcy. Similarly, debtors may use bankruptcy to reject IP licenses as to which they are licensees if they no longer need access to the IP.

Occasionally, the burdensome contract is an IP license that a debtor has granted in its own IP. For example, a debtor may have granted an exclusive license in a certain territory or product line at a relatively low royalty rate, but now believes that it could achieve a much higher rate if it could consider competing offers for that exclusive license. In a famous 1985 case, the Fourth Circuit held that the debtor could do just that. *See Lubrizol Enter., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986). Upsetting conventional wisdom, *Lubrizol* held that the debtor could reject an IP license, thereby eliminating all of the licensee's rights and freeing the debtor to re-license the IP or otherwise exercise the IP rights it had previously granted under the license.

The IP community was horrified at the *Lubrizol* result because it directly conflicted with the well-established principle that any sale of IP was subject to pre-existing licenses. *See, e.g., Sanofi, S.A. v. Med-Tech Veterinarian Prods., Inc.*, 565 F. Supp. 931, 939 (D.N.J. 1983) ("[T]he purchaser of a patent takes subject to outstanding licenses"). In response to the *Lubrizol* uproar,

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[3] *See, e.g., RCI Tech. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 267 (4th Cir. 2004) ("[b]y its plain language, § 365(c)(1) addresses *both* assumption and assignment") (emphasis in original); *Cinicola v. Scharffenberger*, 248 F.3d 110, 127 n.19 (3d Cir. 2001); *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747, 750-51 (9th Cir. 1999), *cert. dismissed*, 528 U.S. 924; *In re James Cable Partners, L.P.*, 27 F.3d 534, 537 n.6 (11th Cir. 1994).

[4] *See, e.g., Institut Pasteur, et al. v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997) *abrogated on other grounds by Hardemon v. City of Boston*, No. 97-2010, 1998 WL 148382 (1st Cir., Apr. 6, 1998); *Bonneville Power Admin v. Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006); *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).

Congress legislatively overruled the holding by quickly enacting § 365(n) of the Bankruptcy Code.

Section 365(n) provides, in relevant part, that upon rejection, the nondebtor IP licensee can either treat the license as terminated or retain its rights to use the IP under the terms of the license. If the licensee elects to retain its rights, it must, of course, continue to pay any royalties that come due, but it cannot obtain any specific performance from the debtor. Rejection does relieve the debtor of any affirmative performance obligations. From the viewpoint of the debtor seeking to maximize the sale value of its IP and of the potential §363 buyer with its own ideas for the use of the IP, the retention of rights by the licensee may significantly diminish the value of the IP. This is consistent with the general principle that subsequent purchasers of IP can only acquire such rights as the owner still holds at that time. *See Sanofi, supra*. In other words, the filing of a bankruptcy case cannot confer upon the debtor greater property rights in its IP than existed as of the petition date.

1. <u>Limitations on the Scope of §365(n): Trademarks Excluded</u>

Section 365(n) only applies to "intellectual property" as defined in a corresponding provision added to the Bankruptcy Code at the same time as the *Lubrizol* amendments. Section 101(35A) of the Code defines IP to include: trade secrets, U.S. patents, U.S. copyrights, patent applications, and plant varieties. Notably, trademarks and foreign patents are omitted from this definition.

2. <u>*Sunbeam:* Trademark Licensees Are Entitled to Protection, Despite Literal Exclusion From § 365(n)</u>

Despite this legislative gap, nondebtor trademark licensees were held to be protected in *Sunbeam Prod., Inc. v. Chicago Am. Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012), *cert. denied*, 133 S.Ct. 790 (2012). The Seventh Circuit relied on applicable trademark law, not on §365(n), in ruling that a nondebtor trademark licensee was entitled to retain its right to use the trademarks after rejection. The court noted that "[s]ome bankruptcy judges have inferred from the omission that Congress codified *Lubrizol* with respect to trademarks, but an omission is just an omission. The limited definition in § 101(35A) means that § 365(n) does not affect trademarks one way or the other." *Id.* at 375. The debtor's rejection of the license agreement did not deprive the licensee of its right to use the trademark license because rejection was a *breach,* not a termination of the license. *Id.* at 378 (criticizing *Lubrizol* and holding that the trustee's rejection of the [trademark licensing] contract . . . did not abrogate [the licensee's] contractual rights").

III. TRANSFERABILITY OF INTELLECTUAL PROPERTY RIGHTS "FREE AND CLEAR" OF INTERESTS

A. Protection of Debtor's Licensees Under § 365(n) Upon Sale

Assuming a licensee of intellectual property elects to retain its rights under § 365(n), a debtor cannot use rejection as a mechanism for transferring IP free and clear of obligations to a pre-existing licensee. Separate from and in addition to §365(n), under IP law, it is well-

established that owners can transfer rights in their IP in various packages via exclusive and nonexclusive licenses, as discussed below. The principle underlying §365(n) is consistent with applicable IP law in treating license rights as a form of property interest.

B. Protection of Prior Licensees of Debtor's IP Under IP Law

In bankruptcy, as a general rule, the bankruptcy estate can only convey the bundle of property rights that the debtor owns, and nothing more. The filing of a bankruptcy petition does not create or confer on a debtor/trustee any property rights beyond what the debtor owned as of the petition date. *See, e.g., Jason Realty, L.P. v. First Fidelity Bank (In re Jason Realty, L.P.),* 59 F.3d 423, 429 (3d Cir. 1995) (title to rents used as cash collateral had transferred to lender prepetition pursuant to applicable state law and thus were not property of the estate); *First Fidelity Bank v. McAteer* (*In re McAteer*), 985 F.2d 114 (3d Cir. 1993) (life insurance proceeds payable upon debtor's death were not property of the estate, but instead belonged to beneficiary).

Therefore, in bankruptcy, the sale of intellectual property rights remains subject to any pre-existing grants and existing licenses. The court in *In re Novon Int'l, Inc.,* Nos. 98-CV-0677E(F), 96-BK-15463B, 2000 WL 432848, at *5, 10-11 (W.D.N.Y. Mar. 31, 2000), held that a bankruptcy trustee's assignment of patents "free and clear" must still comply with applicable nonbankruptcy law. In *Novon*, this meant that the patents assigned to another party were still subject to preexisting licenses, because "the assignee of a patent . . . takes subject to the legal consequences of the patentee's previous acts, and subject to the licenses previously granted by assignor." *Id.* at *5 (internal quotations omitted); *see also In re Access Beyond Techs., Inc*., 237 B.R. 32, 38 (Bankr. D. Del. 1999) (prior existing license, granted pre-bankruptcy, limited rights in purchased patents); *see also In re Spansion,* 507 Fed. Appx. 125 (3d Cir. 2012) (prepetition covenant not to sue is enforceable against purchaser of patents in a bankruptcy sale).

The relevant cases for each type of IP are summarized below:

1. **Patents:** Pre-existing patent licenses are binding upon successors in interest.*WiAV Solutions LLC v. Motorola, Inc.* 631 F.3d 1257, 1265 (Fed. Cir. 2010) (purchasers of IP take subject to preexisting patent rights).

Jac USA, Inc. v. Precision Coated Prods., Inc., No. 00 C 3780, 2003 WL 1627043, at *12 (N.D. Ill. Mar. 25, 2003) ("[T]he purchaser of a patent takes subject to outstanding licenses") (*quoting Sanofi, S.A. v. Med-Tech Veterinarian Prods., Inc.*, 565 F. Supp. 931, 939 (D.N.J. 1983)).

Syndia Corp. v. Lemelson Med., *Educ.*, *& Research Found., Ltd. Partnership*, 165 F. Supp. 2d 728, 753 (N.D. Ill. 2001) (where two licenses conflict, the first prevails, even though the taker of the second has an exclusive license and the right to enforce the patent, and had no notice of the existence of the first license).

New York Phonograph Co. v. Edison, 136 F. 600, 606 (C.C.S.D.N.Y. 1905), *aff'd* 144 F. 404 (C.C.A. 2d Cir. 1906) (holding that in patent sales, "the doctrine is well established

that a license follows the assets of the licensor into the possession of him who buys [the patents] with his eyes open to the pre-existing contractual relations and existing equities").

Pratt v. Wilcox Mfg. Co., 64 F. 589, 590 (C.C.N.D. Ill. 1893) (successor corporation by merger took patents of predecessor corporation subject to existing licenses).

2. **Copyrights:** Licensees takes subject to any pre-existing licenses and grants of rights.*In re Waterson, Berlin & Snyder Co. v. Irving Trust Co*., 48 F.2d 704, 710 (2d Cir. 1931) ("while the copyrights may be sold by the trustee, they should be sold subject to the right of the composers to have them worked in their behalf and to be paid royalties according to the terms of the contracts").

3. **Trademarks:** Subsequent licensees and successors take subject to pre-existing licenses.*ICEE Distrib., Inc. v. J&J Snack Foods Corp*., 325 F.3d 586, 593 (5th Cir. 2003) ("an assignee, by following in the footsteps of the assignor, acquires not only all the rights and priorities of the assignor, but also any burdens and limitations on use that were incumbent on the assignor") (*quoting McCarthy On Trademarks And Unfair Competition* § 18:15 (4th ed. 2002)).

Johanna Farms, Inc. v. Citrus Bowl, Inc., 468 F. Supp. 866, 874-75 (E.D.N.Y. 1978) (noting that a trademark can be sold in bankruptcy, after which "the legitimate purchaser becomes transfixed to the position of his predecessor, enjoying the latter's rights in the mark dating from its initial use and suffering the burdens on and limitations of its use that were incumbent on his predecessor").

C. Implied Waiver: Licensees Must Assert Rights to Avoid Elimination of Licenses in § 363 Sales

Despite the extensive body of IP case law upholding rights of prior licensees against subsequent purchasers, bankruptcy courts are likely to authorize § 363 sales "free and clear" of all interests, either implicitly or explicitly including IP rights, if the licensee fails to object. One of the conditions under § 363(f) that allows for "free and clear" sales is the consent of the interest holder, "and lack of objection (provided of course there is notice) counts as consent." *See FutureSource LLC v. Reuters Ltd*., 312 F.3d 281, 285 (7th Cir. 2002), *cert. denied*, 538 U.S. 962 (2003) ("It is true that the Bankruptcy Code limits the conditions under which an interest can be extinguished by a bankruptcy sale, but one of those conditions is the consent of the interest holder, and lack of objection (provided of course there is notice) counts as consent.").

Thus, the preclusive effect of a "free and clear" order with respect to prior licenses may turn upon whether the licensee received adequate notice of the proposed sale and its terms. *See Precision Indus., Inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003) (trustee's power under § 363(f) of the Bankruptcy Code to sell estate assets free and clear of other interests trumps protections provided to third-party lessees by § 365(h) in absence of objection by lessee); *see also Compak Cos., LLC v. Johnson*, 415 B.R. 334, 342-43 (N.D. Ill. 2009). In *Compak Cos., LLC v. Johnson*, the court applied *Qualitech* and found that "§ 365(n) would not prevent the trustee or debtor-in-possession from extinguishing a license in a sale of intellectual property free

and clear of interests *provided that* one of § 363(f)'s conditions was satisfied." *Id.* (emphasis in original). However, the court declared the sale void for failure to meet these requirements. *Id.*

These cases highlight the complexity of reconciling the conflict between §363(f) and §365(n). Courts following *Precision Industries* would likely allow §363(f) sales "free and clear" of §365(n) interests, at least absent an objection by the licensee. Other courts may hold that a licensee's §365(n) interests cannot be trumped by §363(f). Bottom line: (i) for any licensee who wishes to retain its §365(n) rights, object early and often to any "free and clear" sale under §365(f) and be proactive; and (ii) for any prospective purchaser, as part of the sale transaction undertake due diligence regarding the debtor's licenses as you may - assuming you consummate the asset purchase -- be subject to the licensee's §365(n) rights.

IV. SPECIAL ISSUES FOR FOREIGN PATENTS/PARTIES.

Section 365(n) only applies if there is a US-based bankruptcy filing; by its terms, § 365(n) is inapplicable to an insolvency outside of the United States. However, an open question exists with respect to the applicability of § 365(n) to Chapter 15 bankruptcy proceedings. In *Jaffe v. Samsung Elecs. Co., Ltd. (Qimonda)*, 737 F.3d 14, 25-28 (4th Cir. 2013), the court addressed the application of § 365(n) to a Chapter 15 proceeding. In this case, Qimonda, a German debtor, owned patents licensed to U.S. licensees who asserted § 365(n) rights in the Chapter 15 proceeding. On remand to the bankruptcy court, the court held that § 365(n) applied with respect to Qimonda's U.S. patents; the debtor sought direct appeal to the Fourth Circuit.

The Fourth Circuit focused its opinion on an analysis of § 1522(a) and found that: (1) the requirement under § 1522(a) for sufficient protection of the "interests of the creditors and other interested entities, including the debtor" warranted a balancing of the interests; and (2) balancing of the interests of the patent licensees against the interests of the foreign debtor required the application of § 365(n). *Id.* at 31 ("we affirm the decision of the bankruptcy court, finding reasonable its exercise of discretion in conducting the balancing analysis under §1522(a) and concluding that attaching the protection of § 365(n) was necessary when granting Jaffe the power to administer Qimonda's U.S. patents").

On April 30, 2014, Jaffe filed a petition for writ of certiorari with the United States Supreme Court, which petition is currently pending under Case No. 13-1324. The question presented in the petition is "whether the court of appeals erred in construing § 1522(a)'s sufficient protection requirement to permit denial of comity based on an open-ended balancing of competing bankruptcy regimes, without regard to the demanding public policy standard of § 1506."

The Fourth Circuit opinion is beneficial for licensees, but only time will tell if the Supreme Court will grant the pending petition and alter the holding and/or whether other courts adopt the court's reasoning, and, whether under different facts a court would come out differently in its "balancing analysis."

LEASEHOLD INTERESTS UNDER SECTIONS 363(F) AND 365(H) OF THE BANKRUPTCY CODE

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Leasehold Interests Under Sections 363(f) and 365(h) of the Bankruptcy Code

Section 363(f) authorizes a debtor-in-possession to sell property of the estate free and clear of any interests in such property of an entity other than the estate if one of the following five conditions are met: (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest, (2) the entity consents, (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property, (4) such interest is in bona fide dispute, or (5) the entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Section 365(h) provides lessees with certain protections in the event their lease is rejected by the debtor. Section 365(h)(1)(A)(ii) provides that if an unexpired lease of real property is rejected by a debtor-lessor, "if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) that are in or appurtenant to the real property for the balance of the term of such lease and for any renewal or extension of such rights to the extent that such rights are enforceable under applicable nonbankruptcy law.

Given a lessee's rights under section 365(h), courts have grappled with the issue of whether a debtor can sell property free and clear of a lessee's leasehold interest and its rights appurtenant thereto under section 363(f). Not surprisingly, a split of authority has developed over this question. The majority of courts that have addressed this issue conclude that section 365(h) and 363(f) are not reconcilable and that section 365(h) trumps section 363(f). The courts adopting this majority view often rely on the principle of statutory construction that the specific governs the general and the legislative history of section 365(g) which demonstrates the intent of Congress to protect lessees in this situation. The minority of courts that have addressed the interplay between section 365(h) and 363(f) have held that section 365(h) applies only to the specific scenario of lease rejections, and not to sales under section 363(f). However, courts adopting this minority position often hold that even though section 365(h) does not apply in the context of a 363 sale, a lessee's appurtenant rights under section 365(h) are still protected by section 363(e)'s requirement that "on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest."

One decision in which the minority view was adopted is *Precision Industries, inc. v. Qualitech Steel SBQ, LLC*, 327 F.3d 537 (7th Cir. 2003). In *Qualitech*, the bankruptcy court held that pursuant to section 363(f), the sale order extinguished the possessory rights of a lessee. The district court reversed and adopted the majority view that sections 365(h) and 363(f) are not reconcilable and that the more specific terms of section 365(h) trump section 363(f). The 7th Circuit reversed the district court and held that "the term 'any interest,' as used in section 363(f) is sufficiently broad to include [a lessee's] possessory interest. . . ." *Id*. at 545. The court further explained that "nothing in the express terms of section 365(h) suggests that it applies to any and all events that threaten the lessee's possessory rights. Section 365(h) instead focuses on a specific

type of event--the rejection of an executory contract by the trustee or debtor-in-possession--and spells out the rights of parties affected by that event. It says nothing at all about sales of estate property, which are the province of section 363. The two statutory provisions thus apply to distinct sets of circumstances." *Id.* at 547. The court then concluded that "[b]ecause a leasehold qualifies as an 'interest' in property for purposes of section 363(f), a lessee of property being sold pursuant to subsection (f) would have the right to insist that its interest be protected. 'Adequate protection' does not necessarily guarantee a lessee's continued possession of the property, but it does demand, in the alternative, that the lessee be compensated for the value of its leasehold--typically from the proceeds of the sale." *Id*. at 547-48.

In a recent case from the U.S. District Court for the Southern District of New York, the court adopted a new approach to reconciling the seemingly irreconcilable provisions of section 365(h) and 363(f). *Dishi & Sons v. Bay Condos, LLC*, 510 B.R. 696 (S.D.N.Y. 2014). In *Bay Condos*, the court's reasoning went as follows: "First, at the commencement of the bankruptcy case, the estate acquires two relevant interests: (i) the lessor's reversion, and (ii) the lease. Although the latter is subject to assumption or rejection, the former is not." *Id.* at 706. "Second, the power to assume or reject does not alter the appurtenant rights of the lessee under the lease. Thus, whether the trustee assumes, rejects, or does nothing with respect to the lease, the lessee retains such rights." *Id*. "Third, and accordingly, nothing in § 365(h)--which simply preserves the lessee's appurtenant rights in the event of rejection--precludes the trustee from terminating such rights if so empowered under another provision of the Code." "And since § 363(f) is such a power, the trustee theoretically can sell property free and clear of the lessee's appurtenant rights." *Id*. at 707. Therefore, the court held that while any sale under section 363(f) must take a lessee's appurtenant rights into account, a sale under 363(f) may nevertheless be completed free and clear of such rights, subject to adequate protection under section 363(e) if requested by the lessee. Turning its attention to the issue of adequate protection, the *Bay Condos* court held that in this particular case, the only means for achieving adequate protection was permitting the lessee to continue its possession of the property.

In another recent case, the U.S. Bankruptcy Court for the District of Montana declined to adopt either the majority or minority views. *In re Spanish Peaks Holdings II LLC*, 2014 Bankr. LEXIS 913 (Bankr. D. Mont. March 10, 2014). The court observed that cases "which have found that the § 365(h) rights of a tenant may be extinguished by a § 363 sale, such as *Precision Industries*, generally rel[ied] on two canons of statutory construction[:] (1) that the court should afford a statute its plain meaning[;] and (2) that courts should interpret statutes so as to avoid conflicts between them if such construction is possible and reasonable. In contrast, courts holding that a tenant's rights under § 365(h) may not be extinguished by a § 363 sale . . . rely in part upon the statutory construction principle that the more specific provision should prevail over the general[,] and also rely upon the legislative history of § 365(h) . . . [in which it is remarked that under § 365(h)] . . . a tenant will not be deprived of his estate for the term for which he bargained." *Id*. at *50-51. The court then found that "a case-by-case, fact-intensive, totality of the circumstances, approach, rather than a bright line rule, governs whether § 363(f) or § 365(h) prevails in any given situation." In this particular case, the court held that section 363(f) authorized the sale free and clear of the possessory interests held by debtor-affiliates under their insider leases with the debtor.

YET ANOTHER EXCEPTION TO SECTION 363(f): COVENANTS RUNNING WITH THE LAND

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In addition to leasehold interests, real property being sold in a §363 sale may also be subject to other types of contract-based interests and restrictive covenants that cannot be eliminated with a "free and clear" sale order. The issues closely resemble those with respect to IP licenses: the contractual covenant restrictions are either treated as no longer executory or as limitations on the estate's ownership interest in the real property, rather than as mere contract obligations that can be rejected.

A. Interests in Real Property: Covenants Running with the Land

The recent decision in *Newco Energy v. Energytec Inc.*, 739 F.3d 215 (5th Cir. 2013), illustrates the issue for asset purchasers. In that case, the asset being sold was a natural gas pipeline system and its right of way that the debtor had originally acquired "subject to" a transportation fee based upon the amount of natural gas flowing through the pipeline. The original purchase agreement described this fee as partial consideration for the conveyance of the pipeline. Newco Energy, the recipient of the fee, was also granted a security interest in the pipeline to secure the payment obligation. The transportation fee obligation was described as a "covenant running with the land." Newco objected to the §363 sale of the pipeline on the grounds that it could not be sold free and clear of Newco's right to the transportation fee. This issue was reserved for later decision, and the sale closed. The bankruptcy court eventually overruled the objection, holding that the fee obligation was not a "covenant running with the land" despite its characterization as such in the underlying agreements. The Fifth Circuit reversed. Applying Texas state law, it concluded that the transportation fee qualified as a covenant running with the land because (i) the right to the transportation fee was created at the same time as the pipeline was conveyed to the debtor and (ii) the fee was in essence a payment for the use of the pipeline's real property right of way.

The Fifth Circuit, however, left for determination upon remand whether the conditions of §363(f)(5) could be satisfied. A sale free and clear under that prong of §363(f) could be authorized only if Newco could be compelled to accept a monetary satisfaction in exchange for the extinguishment of a nondebtor's interest in the debtor's property in a qualifying legal or equitable proceeding. Unless that option exists under Texas state law, then the sale will have to remain subject to Newco's right to transportation fees.

B. Majority Rule: Restrictive Covenants Not Executory and Thus Not Subject to Rejection

The majority trend has been to treat restrictive covenants as not executory, and therefore binding on asset purchasers as they cannot be rejected. Although following a different analytic path, these cases reach the same result as *Newco Energy*: the covenants define the package of rights that the debtors acquired in the first place, so the sale of the asset during the bankruptcy case is limited by those limitations. Examples of this approach include the following:

Gouveia v. Tazbir, 37 F.3d 295, 299 (7th Cir. 1994) (restrictive covenants not executory; remain binding)

Water Ski Mania Estates Homeowners Ass'n v. Hayes, 2008 Bankr. LEXIS 4668, at *29-*34 (BAP 9th Cir. Mar. 31, 2008)(restrictive covenants not executory; remain binding)

In re Inwood Heights Hous. Dev. Fund Corp. 2011 Bankr. LEXIS 3251 (Bankr. S.D.N.Y. Aug. 25, 2011) (property could not be sold free and clear of deed restrictions prohibiting sale of property for period of years without city's consent)

In re Three A's Holdings LLC, 364 B.R. 550 (Bankr. Del. 2007)(covenants and restrictions ran with the land per state law and limited nature of eligible tenant for limited lease)

Mancuso v. Meadowbrook Mall Co. Ltd. P'ship, 2007 U.S. Dist. LEXIS 23308, at *29-30 (Bankr. N.D. W. Va. Mar. 28, 2007) (use restrictions ran with land; debtor could not sell free and clear)

In re Pintlar Corp., 187 B.R. 680 (Bankr. D. Idaho 1995) (land cannot be sold free and clear of nondebtor party's right to deposit mining tailings into river, even though such right could not be exercised due to environmental protection laws)

In re 523 E. Fifth St. House Preservation Dev. Fund Corp., 79 B.R. 568, 574-75 (Bankr. S.D.N.Y. 1987) (property could not be sold free and clear of deed restriction requiring use for low-income housing)

C. Minority Rule: Restrictive Covenants as Executory and Rejectable

Some cases have allowed rejection of agreements despite the nondebtor's contention that it held a property interest that was not subject to rejection.

In re Coordinated Fin. Planning Corp., 65 B.R. 713 (BAP 9th 1986), the co-owners of real property entered into an ownership agreement granting mutual rights of first refusal to buy out the other's interest. The court determined that, although the contract qualified as a covenant running with the land that was binding on successors under California state law, it also qualified as an executory contract under federal bankruptcy law which could therefore be rejected under §365(j).

In re Nevel Props. Corp., 2012 Bankr. LEXIS 551, at *25 (Bankr. N.D. Iowa, Feb. 17, 2012), the court found that the easement provisions contained in the "Deep Water Well Lease - Water Line and Access Easement" were incidental to and conterminous with the real property lease, which, as an unexpired lease, could properly be rejected.