INTELLECTUAL PROPERTY ISSUES IN BANKRUPTCY

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I. Section 365 of the Bankruptcy Code Provides the Debtor with the Ability to Assume or Reject an Executory Contract

a. "Executory contract" is not defined in the Bankruptcy Code. Most bankruptcy courts have adopted the definition provided by Professor Countryman as a contract where obligations continue on both sides.[1]

b. Assuming a contract is to reinstate its existence, the debtor will be bound to its terms from the date of assumption forward. The debtor must cure any defaults and provide adequate assurance of future performance. 11 U.S.C. § 365(b)(1)(A). Any future breach after assumption will result in a post-petition default and an administrative claim against the debtor's estate.

c. Rejecting a contract is an act by the debtor to repudiate its terms as burdensome. Upon an order authorizing the debtor to reject the contract, the debtor no longer has to perform. The rejection is a breach and the non-debtor party is allowed a pre-petition claim for the damages for the breach. 11 U.S.C. § 365(g) and 11 U.S.C. § 502(g)(1) set the date of breach as prior to the petition date.

d. Courts generally apply the "business judgment" rule to the debtor's decision to either assume or reject the executory contract.[2]

II. Is an Intellectual Property Contract Executory?

a. <u>Tests to Determine Whether Contract is Executory</u>

i. Tests:

1. *Countryman Test*: The majority of courts have adopted the "Countryman Test," developed by Professor Vern Countryman in the 1970's. According to the "Countryman Test," an executory contract is "a contract under which the obligations of both the bankrupt and the other party are so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other."

2. *Functional Test*: A minority of courts have adopted the "Functional Test." The "Functional Test" asks where the failure to perform would constitute a material breach of the contract." *See In re Access Beyond Techs., Inc.*, 237 B.R. 32 (Bankr. D. Del. 1999)

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[1] Vern Countryman, *Executory Contracts in Bankruptcy, Part 1,* 57 Minn. L. Rev. 439, 460 (1973) (an executory contract is one "under which the obligation 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."); *See also, NLRB v. Bildisco and Bildisco,* 465 U.S. 513, 104 S. Ct. 118, 1194 *n*. 6, 79 L.Ed. 2d 482 (1984).

(citing *Enter. Energy Corp. v. United States (In re Columbia Gas Sys.*), 50 F.3d 233, 240 (3d Cir. 1995)).

ii. Outcomes:

1. Many courts have stated that most intellectual property ("IP") licenses are executory. *See, e.g., RCC Tech. Corp. v. Sunterra Corp.*, 287 B.R. 864, 865 (D. Md. 2003) (stating that "there is a long line of authority holding that intellectual property licensing agreements such as the SLA are executory contracts"); *In re Buildnet, Inc.*, 2002 WL 31103235, at *3 (Bankr. M.D.N.C. 2002) ("[a]s a general rule, most patent, trademark, technology and other intellectual property licenses are executory contracts").

2. Majority of courts apply the Countryman Test. In many instances where courts find IP contracts to be executory, whether unperformed obligation is sufficient to create material breach could be debated. See cases cited below.

b. <u>Leading Cases on "Executoriness" of IP Contracts</u>

i. Cases that Have Found IP Contract Executory:

1. *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 677 (9th Cir. 1996). The court held that a non-exclusive license was executory because the licensor had a continuing obligation to abstain from suing the licensee and the licensee owed a duty to mark all products with the proper statutory patent notice.

2. *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1046 (4th Cir. 1985). The court found a non-exclusive license agreement to be executory where the licensee had the continuing obligation to account for and pay royalties and the licensor was required to provide specific notices and reduce royalty rates in certain instances.

3. *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 510-11 (Bankr. D. Del. 2003). Court held that franchisee's obligations to keep facility open, pay royalties and maintain standards were unperformed obligations that would, if not fulfilled, constitute a material breach. Obligations on franchisors included not using trademark in other territories and breach of such obligations was also a material breach. Based on these findings, the court concluded that the agreement was executory.

ii. Cases that Have Found IP Contract Not Executory:

1. *In re Interstate Bakeries Corp.*, 751 F.3d 955 (8th Cir. 2014). The Eighth Circuit found that a trademark license that was part of an asset purchase agreement was not executory. The court reasoned that the trademark license and the asset purchase agreement must be analyzed as one agreement, and found that the debtor substantially performed its obligations such that a failure to perform would not constitute a material breach under the agreement.

2. *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010). Court found that IP agreement was not executory contract because it did not contain at least one ongoing material obligation for the licensee.

3. *Microsoft Corp. v. DAK Indus., Inc. (In re DAK Indus., Inc.*), 66 F.3d 1091, 1095-96 (9th Cir. 1995). The Ninth Circuit found that an agreement granting a software distribution company the nonexclusive right to distribute Microsoft software in exchange for five installment payments and a per unit royalty fee was "best characterized as a lump sum sale of software to [the distributor], rather than a grant of permission to use an intellectual property." The court found certain facts persuasive in holding that the agreement was not executory, including: (1) the terms governing the timing of payments were more analogous to a sale than a license; (2) the distributor was granted the non-exclusive use of, and was free to sell the software to a third-party; (3) the distributor’s right to re-sell the software was granted at the time the agreement was executed; and (4) Microsoft had no continuing obligation under the agreement.

4. *Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp.*, 143 B.R. 360, 374 (Bankr. D. Md. 1992). Court reviewed IP agreement which stated that the "[holder of the patents] hereby sells, assigns, transfers and sets over to [the grantee] its entire right, title and interest in, to, and under the aforesaid Invention(s) and any and all Letters Patent . . . ." The court found that the agreement was a complete transfer of rights and, therefore, the agreement did not constitute an executory contract.

III. Assignability of Intellectual Property

a. <u>IP Assignments Outside of Bankruptcy</u>

i. General:

1. The assignment of a patent is a transfer of the ownership interests in the patent. 35 U.S.C. § 261 specifically authorizes and regulates the assignment of a patent.

2. Federal common law governs the assignability of a licensee's interest in a patent or copyright. The federal common law on the assignability of a licensee's interest in a patent or copyright is referred to as the "*Non-Assignability Doctrine*."

b. <u>Factors Considered in Applying the *Non-Assignability Doctrine*</u>

i. Exclusive v. Non-Exclusive:

1. Generally, an exclusive license is freely assignable because the licensee is entitled to all of the rights and protections of the IP owner.

2. A non-exclusive license, on the other hand, will generally be restricted from assignment due to the licensee's lack of ownership rights.

3. Courts examine whether the license refers to itself as exclusive or non-exclusive, as well as the economic rights granted therein.

ii. Type of Intellectual Property:

1. *Patents*

a. The Supreme Court developed the federal common law of patents in the 19th century. The Supreme Court found patent licenses to be a personal contract and by their nature unassignable because the identity of the licensee is a material term of the license agreement. Courts have applied the Non-Assignability Doctrine to both exclusive and non-exclusive patent licenses. *See, e.g., Everex Sys., Inc.,* 89 F.3d at 678–79 (non-exclusive patent license unassignable); *In re Aerobox Composite Structures, LLC,* 373 B.R. 135, 141 (Bankr. D.N.M. 2007) (exclusive patent license unassignable).

2. *Copyrights*

a. Courts have found that non-exclusive copyrights licenses are not assignable. *See, e.g., In re Patient Educ. Media, Inc.*, 210 B.R. 237, 240 (Bankr. S.D.N.Y. 1997). However, courts seem less consistent on whether exclusive copyright licenses are assignable. *See, e.g., In re Golden Books Family Entm't, Inc.*, 269 B.R. 300, 309-11 (Bankr. D. Del. 2001) (discussing reasons why exclusive copyright licensees are assignable, but finding that the relevant licensees in this case were non-exclusive); *Gardner v. Nike, Inc.*, 279 F.3d 774 (9th Cir. 2002) (finding that an exclusive copyright license cannot be assigned).

3. *Trademarks*

a. The majority of courts have found trademark licenses to be unassignable under federal law. *See, e.g., In re N.C.P. Mktg. Grp., Inc.*, 337 B.R. 230, 236 (D. Nev. 2005); *see also McCarthy on Trademarks and Unfair Competition* § 25.33 (4th ed. 2005) ("While the case law is sparse, it appears to be the rule that unless the license states otherwise, a license mark is personal and cannot be assigned.").

c. <u>Section 365 and the Non-Assignability Doctrine</u>

i. Under section 365(f), the trustee may assign any contract that has been assumed. This authorization that the trustee may assume and assign executory contracts is subject to, among other things, the exceptions provided in section 365(c).

ii. Section 365 (c) provides: The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment. . ."

iii. Bankruptcy Courts have applied the federal common law when considering the "applicable law" of intellectual property licenses under section 365(c)(1)(A). Under a plain meaning reading of section 365, this means that the debtor cannot assume an executory intellectual property contract without counterparty consent even though the debtor was the pre-petition party to that contract. Courts have grappled with this issue and have come to different conclusions.

iv. The Circuits are split as to how to interpret Section 365 when deciding whether a debtor-licensee of intellectual property may assume its obligations under the contract. The Circuit Courts have used two tests in this situation: (1) the "hypothetical test"; and (2) the "actual test."

    1. Whether the "hypothetical test" or the "actual test" is applied, much of the courts' discussion in considering the issues is centered on whether the debtor in possession is a materially distinct entity from the pre-bankruptcy entity such that an assumption of an executory contract by the debtor in possession would be a *de facto* assignment to a third-party.

    2. Under the "hypothetical test," the language in § 365(c) is read literally, thus preventing the licensee from assuming the contract. The Circuits that have adopted the "hypothetical test" bar the assumption of the license contract if, hypothetically, the license contract could not be assigned under § 365(c)(1).

        a. As examined below, the Third, Fourth, Ninth, and Eleventh Circuit have adopted the "hypothetical test."

    3. Unlike the "hypothetical test," the "actual test" asks whether the debtor actually intends to assign the license to a third party.

        a. As examined below, the First and Fifth Circuits have adopted the "actual test."

v. Perhaps to address what appears to be an outcome at odds with the goals of bankruptcy, alternative approaches to the hypothetical and actual analyses have also been applied, although the number of reported decisions on these approaches is very modest.

    1. *Footstar*: The *Footstar* analysis finds that that the explicit limitations on assumption and assignment under § 365(c)(1) only apply to a trustee, and not to a debtor, thus negating any need to address the hypothetical and actual analysis. This approach is analyzed further below.

    2. *The "Ride Through" Approach*: A small number of courts have found that a debtor need not assume or reject a contract but can simply allow the contract to "ride through" the bankruptcy process. This approach is analyzed further below.

d. Leading Cases Applying the "Hypothetical" Test

i. **3rd Circuit:** *In re West Electronics Inc.*, 852 F.2d 79, 82-84 (3rd Cir.1988). The court found that the "debtor in possession" was a materially distinct entity from the "debtor" and held that assumption of the executory contract would be impermissible if the non-debtor objected.

1. The court explained that the hypothetical test asks whether under applicable law, the non-debtor could refuse performance from “an entity *other* than the debtor or the debtor in possession."

2. In this case, the debtor-in-possession would be barred from assignment to a third party under applicable law (federal law related to military contracts) and, therefore, the court held that the debtor-in-possession was barred from assuming performance under the contract.

ii. **4th Circuit:** *RCI Technology Corp. v. Sunterra Corp. (In re Sunterra Corp.),* 361 F.3d 257 (4th Cir. 2004). The court applied the "hypothetical test" and concluded that the debtor in possession could not assume nonexclusive software licenses over the objection of the non-debtor party. The court found that the application of the "actual test" would force the court to read the disjunctive "or" in the "assume *or* assign" language in section 365(c) as a conjunctive "and." The court rejected the "actual test" on this basis, finding that interpreting the term "or" in this matter would violate the plain meaning rule.

iii. **9th Circuit:** *Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.),* 165 F.3d 747, 750-55 (9th Cir.1999). The court applied the "hypothetical test" in holding that a Chapter 11 debtor in possession may not assume a nonexclusive patent license over objections by the non-debtor party.

1. The court stated that "[Section 365(c)] by its terms bars a debtor in possession from *assuming* an executory contract without the non-debtor’s consent where applicable law precludes *assignment* of the contract to a third party." The court found the "hypothetical test" to be derived from the literal language of Section 365, in that a debtor in possession may not assume the executory contract over the objections of the non-debtor "even where the debtor in possession has no intention of assigning the contract in question to any such third party."

2. In response to the debtor in possession’s contention that the "hypothetical test" caused an "internal inconsistency" between section 365(c) and section 365(f), the court concluded that section 365(f)(1) should be interpreted as a broad rule precluding any

"applicable law" that prohibits or restricts assignment. The court interpreted section 365(c)(1) as posing an exception to the rule in section 365(f), where the "applicable law" will apply if the law "'excuses a party . . . from accepting performance from or rendering performance to an entity' difference from the one with which the party originally contracted."

iv. **11th Circuit:** *City of Jamestown v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 534, 537 (11th Cir. 1994). Although the Eleventh Circuit had not explicitly adopted either test in an intellectual property license case, the Eleventh Circuit applied the "hypothetical test" in the context of the assumption of a cable franchise agreement.

e. <u>Leading Cases Applying the "Actual" Test</u>

i. **1st Circuit:** *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997). The court held that the debtor-licensee's Chapter 11 plan, which called for the assumption of a patent license and the sale of the debtor in possession's stock to a third-party, was permissible under § 365(c) over the objections of the non-debtor party.

1. The court stated that its test calls for a "case-by-case inquiry into whether the non-debtor party . . . '*actually* was being forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.'" When a debtor-in-possession seeks to assume an executory contract, the court "cannot presume as a matter of law that the debtor-in-possession is a legal entity *materially* distinct from the prepetition debtor with whom the non-debtor party . . . contracted with."

2. The court rejected the non-debtor's contention that the sale of stock to a competitor under the Chapter 11 plan amounted to a *de facto* assignment. The court found that because "a corporation . . . is a 'legal entity distinct from its shareholders,'" the sale of stock under Chapter 11 plan would not change its finding that the debtor in possession is not a materially distinct party from the pre-petition entity.

f. <u>Cases Applying Alternative Approaches</u>

i. The *Footstar* Approach:

1. *In re Footstar, Inc.*, 323 B.R. 566 (Bankr. S.D.N.Y. 2005). The court in *Footstar* on the term "trustee" in section 365(c)(1), holding that the debtor in possession can assume the executory contract over the objections of the non-debtor party. The court reasoned that a trustee is a separate and distinct entity from the

debtor and that the limitations on assumption and assignment under § 365(c)(1) can only apply to a trustee.

2. *Footstar* was cited with approval in the *In re Adelphia Commc'n Corp.*, 359 B.R. 65, 72 (Bankr. S.D.N.Y. 2007) decision.

ii. The "Ride Through" Approach:

1. Courts have recognized that in certain instances, the application of the hypothetical test will leave a debtor with fewer rights than they would have outside of bankruptcy. This is inconsistent with reorganization principals.

2. The ride through doctrine provides that executory contracts that are neither affirmatively assumed nor rejected by the debtor under section 365 will be unaffected by a bankruptcy filing. *See In re Hernandez*, 287 B.R. 795 (Bankr. D.Ariz 2002).

   a. "Ride though" doctrine is purely a creature of case law that was created almost 80 years ago. *See, e.g., In re JZ, LLC*, 357 B.R. 816, 821 (Bankr.D.Idaho 2006).

   b. Section 365(d)(2) provides that the debtor may assume or reject an executory contracts but, given the permissive language, the section does not require such assumption or rejection. *In re Hernandez*, 287 B.R. at 803-04 (also citing Bankruptcy Code section 1123(b)(2), which is similarly permissive).

3. At least two intellectual property cases have found that allowing the license to "ride through" bankruptcy is an available option for debtors. *See In re Hernandez*, 287 B.R. at 807 (patent license); *In re JZ, LLC*, 357 B.R. at 823 (licensing agreement). However, at least one court has questioned this approach. *See In re Access Beyond Techs., Inc.*, 237 B.R. at 47-48 ("courts have held that, with respect to an executory contract, until it is assumed under section 365, the debtor has nothing" and the contract will be deemed rejected).

4. Even if valid, a "ride through" does not cure all ills. The doctrine permits a debtor to assume the benefits of the contract, not the benefits of assumption. *See In re Hernandez*, 287 B.R. at 800-01. Thus, as a contract that "rides through" is not entitled to any of the benefits of section 365, the triggering of an ipso facto provision cannot be fixed by a "ride through." *But see Mette Kurth and Joel Ohlgren, Ride-through Revisited (Again)*, 26 ABI Journal at *2 (2005) (among other options to address curing *ipso facto* default in a ride through scenario, writers suggest debtor consider including

finding in confirmation order that class is unimpaired and *ipso facto* provision is unenforceable).

IV. Section 365 and Intellectual Property Licenses

a. <u>Treatment prior to 1988 Intellectual Property Bankruptcy Protection Act (§365(n)).</u>

i. *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, (In re Richmond Metal Finishers, Inc.)* 756 F.2d 1043, 1045 (4th Cir. 1985). A nonexclusive licensing agreement between Richmond Metal Finishers ("RMF") and Lubrizol was found to be executory by the Fourth Circuit Court of Appeals. The appellate court affirmed the bankruptcy court which had allowed the rejection of the licensing agreement. The appellate court agreed with the bankruptcy court in finding that RMF owed Lubrizol the duty to notify it of any patent infringement suits and to defend in such suit, to notify Lubrizol of any other use or licensing of the process, to reduce royalty payments if a lower royalty rate agreement was reached with another licensee, and to indemnify Lubrizol for losses arising out of any misrepresentation or breach of warranty by RMF. Lubrizol owed RMF reciprocal duties of accounting for and paying royalties for use of the process and of canceling certain existing indebtedness. The Fourth Circuit noted that the bankruptcy judge had evidence that the metal coating process subject to the licensing agreement was the debtor's principal asset and that the sale or licensing of the technology was the primary potential source of funds to support a plan. Under § 365(g), Lubrizol would be entitled to treat rejection as a breach and seek money damages through its unsecured claim.

ii. The *Lubrizol* opinion sent shockwaves through the business and bankruptcy communities and as a consequence, Congress enacted the Intellectual Property Bankruptcy Protection Act of 1988 ("IPLBA") which was codified into § 365(n) of the Bankruptcy Code.

b. Enactment of 11 U.S.C. § 365 (n).[3]

i. Section 365(n) ensures that a licensee of intellectual property receives the benefit of its bargain despite the debtor's authority to reject the license. The critical provisions of the IPLBA make "clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license . . . ."[4]

ii. Section 365(n) is limited to licenses of intellectual property.

1. Section 11 U.S.C. § 101(35A) defines intellectual property as the following to the extent protected by applicable nonbankruptcy law:

a. Trade secret;

b. Invention, process, design or plant protected under title 35;

c. Patent application;

d. Plant variety;

e. Work of authorship protected under title 17; or

f. Mask work protected under chapter 9 of title 17.

c. Rights of Licensees Under Section 11 U.S.C. § 365(n).

i. If the debtor/trustee elects to reject a licensing agreement,

1. The licensee may choose to treat the license as terminated if the debtor-licensor's rejection amounts to such a breach as would entitle the licensee to treat the contract as terminated under the

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[3] Section 365(n) provides, in part:

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

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

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

(i) the duration of such contract; and

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

[4] S. Rep. No. 100-505,, at 5 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 2307.

terms of the contract, applicable non-bankruptcy law or an agreement between the licensee and a third party; ***or***

2. The licensee can elect to retain certain of its rights under the license. The licensee would be required to make all royalty payments due under the licensing agreement for the duration of the license agreement.

d. <u>Trademarks, trade names and service marks are not included in § 365(n)</u>.

Senate Committee's 1988 Report stated that these were beyond the scope of the legislation creating § 365(n). Senate Committee indicated that it would wait for bankruptcy courts to develop a way to equitably handle the treatment of executory contracts and/or licenses regarding trademarks, trade names and service marks.[5]

i. Initially courts dealing with the rejection of trademarks followed *Lubrizol* and held that trademarks are not protected by § 365(n) and rejection terminates any right of the licensee to use the property.

1. *Raima UK Ltd. v. Centura Software Corp. (In re Centura Software Corp.)*, 281 B.R. 660, 675 (Bankr. N.D. Cal. 2002) (explaining that upon rejection of trademark license, the licensee was left with unsecured rejection claim under § 365(g) for its damages).

2. *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D.Del. 2003) (stating that rejection of a trademark license terminates any right of the licensee to use the property and *Lubrizol's* harsh holding controls.").

3. *In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009)("Trademarks are not 'intellectual property' under the Bankruptcy Code . . . . rejection of licenses by licensor deprives licensee of right to use trademark . . . .").

ii. Recent decisions considering the rejection of trademark license agreements seem to move beyond the earlier cases and protect the rights of trademark licensees.

1. *In re Exide Technologies*, 607 F.3d 957 (3rd Cir. 2010).

a. Third Circuit held that the trademark license between Exide and EnerSys was not an executory contract and Exide therefore could not reject it. There was nothing left for EnerSys to do.

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[5] S. Rep. No. 100-505, at 5 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3202, 3204.

b. In an interesting concurring opinion, Judge Ambro states that "[c]ourts may use § 365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not—as occurred in this case—use it to let a licensor take back trademark rights it bargained away. This makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve." *Id.* at 967-68.

2. *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012).

   a. In a matter of first impression, the Seventh Circuit Court of Appeals upheld the bankruptcy court holding that the debtor/licensor's rejection and breach of the license agreement allowing the licensee to use the trademark did not preclude the licensee from continuing to manufacture fans under the trademark. The Court specifically stated it was not persuaded by *Lubrizol*. The debtor no longer was required to perform but the licensee retained its rights to use the trademark.

3. *Lewis Brother Bakeries Inc. and Chicago Baking Company v. Interstate Brands Corporation (In re Interstate Bakeries Corporation)*, 751 F.3d 55 (8th Cir. 2014).

   a. The Eighth Circuit Court of Appeals, in an *en banc* decision reversed the bankruptcy and district courts that held the license agreement between Interstate Brands and Lewis Brothers Bakeries, Inc. ("LBB") was executory under § 365(a). In finding that the trademark license agreement was not executory and could not be rejected, the Court relied upon principles of contract integration and found that the contract (which included the trademark license agreement) was substantially performed.

   b. The trademark license agreement was an integral part of the asset purchase agreement ("APA") entered into at the time Interstate Brands sold its assets to LBB. After examining the Countryman definition of executory, the Court looked at the doctrine of "substantial performance" to determine whether the license agreement and the APA were an integrated agreement. The Court found that they were and found that the entire integrated contract had been substantially performed. e.g. sale of the bread business was complete and the trademark license was only a portion of the assets sold and paid for.

c. Three of the circuit court judges dissented on the issue of whether the contract was actually executory and found that both parties to the trademark license agreement contained on-going obligations that were important to the integrated APA and license agreement and there would be material breaches if not performed.

d. Note that parties should consider integration clauses which link all of the agreements in a transaction. This makes it more likely that a license agreement will be considered part of the total transaction and less likely that it is executory because of the substantial performance by one party.[6]

4. *In re Crumbs Bake Shop, Inc.,* 522 B.R. 766 (Bankr. D.N.J. 2014).

a. Pre-petition, Crumbs entered into licensing agreements that allowed parties to use the Crumbs trademark and trade secrets and to sell products using the Crumbs brand (the "Trademark Licenses"). BSL provided brand licensing services to Crumbs. After ceasing operations and filing a chapter 11 petition, Crumbs entered into a credit bid asset purchase agreement with LFAC for a sale of substantially all of Crumbs' assets. After conducting an auction to elicit higher and better bids, LFAC became the purchaser. The day after the court approved the sale, Crumbs filed a motion to reject certain executory contracts including the Trademark Licenses. BSL objected to the rejection motion claiming that the trademark licensees could use § 365(n) to retain their rights under the License Agreements. BSL also claimed that it was entitled to receive the royalties if the licensees elected to use § 365(n) to retain their rights under the Trademark Licenses.

b. Ruling: The bankruptcy court held that trademark licensees whose licenses have been rejected are protected by § 365(n). The court held that Congress did not intend to exclude trademarks from the definition of "intellectual property" but that it "intended the bankruptcy courts to exercise their equitable powers to decide, on a case by case basis, whether trademark licensee may retain the rights listed under § 365(n)." 522 B.R. at 772.

[6] An excellent discussion of the *Interstate* and *Crumbs* cases is found in the *Business Case Law Updates*, American Bankruptcy Institute, Annual Spring Meeting 2015 in the material prepared by Lisa S. Gretchko, "Let Them Eat (And Bake) Cake! *Interstate Bakeries* and *Crumbs* Serve Up Victories for Trademark Licensees in 2014."

c. The court found that it was inequitable to strip away the rights of the licensees who had previously been granted the trademark license through the rejection process. It also stated that it was unlikely that Congress intended to force trademark licensees to sacrifice their rights so that the secured lender could get paid. Upon rejection of the Trademark Licenses, the licensees were entitled to the protection offered by § 365(n).

d. The court also addressed the failure of the trademark licensees to object to the § 365 sale as they had not been provided with adequate notice that their rights would be stripped away by the sale. The Asset Purchase Agreement did not clearly indicate what was being sold. The descriptions of the "Purchased Assets" and "Excluded Assets" were murky and the reference to third-party licenses consisted of ten words buried in the long document.

e. The court also reasoned that the Crumbs sale was a credit bid and the lender was the stalking horse and could have adjusted its price due to the trademark licenses.

f. *Crumbs* suggests that if a licensee consents to a § 365(f)(2) sale, the sale could be "free and clear" of the licensee's rights under § 365(n). Adequate notice would be required. The decision suggests that licensees of intellectual property should object to a sale if they have notice that the sale will strip away their rights. In *Crumbs,* there was no objection but the court found that the notice was murkyat best.

e. <u>Remedy Upon Rejection under § 365(a)</u>.

i. § 365(g) provides that rejection "constitutes a breach of . . . [the] contract."

ii. The "other party's rights remain in place . . . [and] after rejecting a contract, a debtor is not subject to an order of specific performance." *Sunbeam,* 686 F.3d at 377.

iii. The debtor's unfulfilled obligations are converted to damages and the damages are treated as a pre-petition obligation. The contract is not rescinded or terminated but merely breached.

iv. Judge Easterbrook in *Sunbeam,* and Judge Ambro in the *Exide* dissent underscore that rejection does not abrogate the contract. The non-debtor party's right to continued performance by the debtor is converted to damages.[7] The *Sunbeam* Court held that the non-debtor party still has all of its rights under contract to continue to use the intellectual property after such rejection. 686 F.3d at 378.

V. Protections Available When Other Party to an IP License Files for Bankruptcy

a. <u>Licensee Files for Bankruptcy</u>

If a licensor enters into a license of intellectual property owned by the licensor with a licensee, what can the licensor do to try to protect itself in the case of a licensee's bankruptcy?

i. Security Interest:

The licensor could seek a security interest in the licensee's assets, other than the license of the licensor's intellectual property, to secure the licensee's obligations to the licensor under the license agreement.[8] The benefit of taking such a security interest is that, if the Bankruptcy Court were to find that the license agreement is an executory contract and the licensee were to reject the license agreement, then the licensor would have a secured claim for the damages, as opposed to an unsecured claim. Even if the intellectual property license were determined not to be an executory contract, the licensor would have a security interest in other collateral in the event that the licensee owes any amounts pre-petition to the licensor or subsequently ceases to perform under the license agreement.

ii. Assumption and Assignment by Licensee:

Depending on what type of intellectual property is being licensed, whether it is an exclusive or a non-exclusive license of the intellectual property and whether the bankruptcy of the licensee is filed in a jurisdiction that applies the "actual" or the "hypothetical" test under Section 365(c) of the Bankruptcy Code, the licensor's consent may be required in order for the licensee to assume or to assign the license of the intellectual property. If the licensee wants to assume the intellectual property license, the jurisdiction in which the licensee's bankruptcy is pending is important.

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[7] *Sunbeam,* 686 F.3d at 377; *Exide,* 607 F.3d at 965; *see also Med.Malpractice Ins. Ass'n v. Hirsch (In re Lavigne),* 114 F.3d 379, 387 (2d Cir. 1997); *In re Murphy,* 694 F.2d 172, 174 (8th Cir. 1982); *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 687, 708 (Bankr. S.D.N.Y. 1992); *In re Exec. Tech. Data Sys.*, 79 B.R. 276, 282 (Bankr. E.D. Mich. 1987); *In re Midwest Polychem, Ltd.*, 61 B.R. 559, 563 (Bankr. N.D. Ill. 1986); *Consol. Oil & Gas, Inc. v. Sun Oil Co. of Pa.*, 16 B.R. 490, 493 (D. Colo. 1981).

[8] To perfect a security interest in patents, best practice is to file a UCC-1 and to file with the United States Patent and Trademark Office ("USPTO"). To perfect a security interest in trademarks, if they are federally registered trademarks, best practice is to file with the USPTO. If they are state registered trademarks and/or common law trademarks, best practice is to file a UCC-1. To perfect a security interest in federally registered copyrights, best practice is to file with the Copyright Office and to file a UCC-1. For unregistered copyrights, some Courts have held that a security interest may be perfected by a UCC-1 filing and other Courts have held that a copyright must be registered with the Copyright Office in order to perfect a security interest.

Certain circuits (including the Third, Fourth, Ninth and Eleventh) follow the "hypothetical" test and certain circuits (including the First and Fifth) follow the "actual" test. The "hypothetical" test precludes the licensee from assuming the intellectual property license if the licensee could not assign the license under applicable nonbankruptcy law. Courts that apply the "actual" test allow assumption of an executory contract by a debtor-in-possession unless performance of the assumed contract by the debtor-in-possession will in fact deprive the non-debtor party to the contract of the benefit of the bargain. As discussed above, many licenses of intellectual property cannot be assigned without the licensor's consent under applicable non-bankruptcy law and thus, in jurisdictions that apply the "hypothetical test", such licenses may not be able to be assumed by a debtor-in-possession.

b. <u>Licensee Files for Bankruptcy</u>

If a licensee enters into a license of intellectual property owned by a licensor, what can the licensee do to try to protect itself in the case of a licensor's bankruptcy? Section 365(n) of the Bankruptcy Code provides licensees of intellectual property with various protections, including providing a licensee with the option of treating the intellectual property license as terminated if the license is rejected or alternatively, to retain its rights to continue to use the intellectual property in the event that the licensor rejects the license agreement.

i. Risks:

Despite all of the protections set forth in section 365(n), there are still several risks to an intellectual property licensee if the licensor files for bankruptcy. First, it is unclear if licenses of trademarks are within the scope of section 365(n) at all since they are not expressly included in the definition of intellectual property. 11 U.S.C. § 101 (35A). *But see In Re Crumbs Bake Shop, Inc.*, 522 B.R. 766, 771 (Bankr. D.N.J. 2014). Second, although the language of section 365(n) purports to give a licensee of intellectual property the continuing right to use such intellectual property in exchange for royalty payments, the licensee does not always have complete access to the intellectual property nor is it always clear who should receive the royalty payments or how much should be paid.

ii. Tips to Minimize Risks:

1. *Source Code Escrow*

Licensees should consider whether a source code escrow arrangement or something similar would provide additional protection in the case of a licensor's bankruptcy filing. A source code escrow is generally established among the licensor, the licensee and a third party who specializes in acting as an escrow agent for technology. "The escrow agent provides a repository for the human readable program statements, called the source code. A source code escrow agreement establishes the conditions under which the escrow agent may release the source code to the licensee, such as the filing of bankruptcy by the licensor." Risa Lynn Wolf-Smith and Erin L. Connor, *Bankruptcy Considerations in Technology Transactions*, ABI Journal Vol. XXIII, No. 3, Apr. 2004. It is generally thought that an agreement "supplementary" to a license agreement, such as source code escrow agreement, should be enforceable under section 365(n). However, there is very little case law where courts have enforced source code escrow agreements. *See Behr Venture Partners, Ltd. v. Bedford Computer Corp. (In the Bedford Computer Corp.)*, 62 B.R. 555, 568 n. 11 (Bankr. D.N.H. 1986).

Any source code escrow arrangement would need to be carefully documented and the source code held in the escrow would need to be updated frequently. There is always the risk that the licensor may liquidate or dissolve in a bankruptcy proceeding so it is important to make sure that there is a video, a detailed manual or other documentation and any other relevant information held by the third party escrow agent in case there are no longer any employees at the licensor to assist the licensee.[9] Additionally, the source escrow agreement should clearly specify what triggers the release of the source code. While a release provision conditioned upon a bankruptcy filing by the licensor may not be enforceable as an ipso facto clause, release conditions tied to an event of default (other than a bankruptcy filing) under the license agreement or a rejection of the intellectual property license by the licensor and the licensee's elector under section 365(n) to retain its rights should be enforceable release provisions.[10]

2. *Security Interest*

In addition, the licensee should also try to obtain a security interest in the intellectual property being licensed to the licensee or in other assets of the licensor to secure the licensor's obligations under the license agreement. If the licensor files for bankruptcy, rejects the license agreement and the licensee decides to treat the license

[9] The licensee may want to expressly provide in the license agreement that it can hire employees of the licensor to assist it with the intellectual property.

[10] In addition, the statute is not clear that the licensee is able to exercise its rights under section 365(n)(3) or 365(n)(4) without first obtaining relief from the automatic stay. Those sections of 365(n) do not explicitly provide that the licensee's rights to obtain access to the debtor's intellectual property supersede the automatic stay. See Tyler S. Dischinger, *Section 365(n): A Call for Clarity*, ABI Law Journal, Vol. XXXII, No. 8, Sept. 2013 at 50, 61.

agreement as terminated, the licensee will then have a secured claim and benefit from any sale or relicensing of the intellectual property.

3. *Bankruptcy Remote Entity*

The licensee should also try to negotiate for the intellectual property to be held by the licensor in a bankruptcy remote or special purpose vehicle to make it more difficult for the licensor of the intellectual property to file for bankruptcy.

iii. Rights of Use Other than Under Section 365(n):

Finally, the Seventh Circuit has held that a licensor's breach by rejecting the intellectual property license agreement does not terminate a licensee's right to continue to use the intellectual property. *Sunbeam* 686 F.3d at 376. Therefore, an intellectual property licensee may be able to argue to the Bankruptcy Court that it contractually has the right to use the intellectual property, despite a trustee or debtor-in-possession's rejection of intellectual property license, without making an election under section 365(n) or if such election is not available (i.e. trademarks). However, the Sunbeam court was clear that the debtor is not subject to an order of specific performance. *Id.* at 377. Thus, a licensee will have to decide if it is better off making a section 365(n) election or declining it and asserting the licensee's continuing rights to the intellectual property under the breached intellectual property license agreement.

VI. Chapter 15 and U.S. Patents

There have been a couple of decisions by Bankruptcy Courts involving U.S. patents which might make foreign representatives think a little harder before deciding to commence a Chapter 15 proceeding in the United States. In *In re Elpida*, the United States Bankruptcy Court for the District of Delaware (the "Delaware Bankruptcy Court") held that a decision of a foreign court authorizing the sale of assets located in multiple jurisdictions must be reviewed under section 363 with respect to the sale of patents (or other assets) located in the United States. *In re Elpida Memory, Inc.*, No. 12-10947(CSS), 2012 WL 6090194, at *9 (Bankr. D. Del. Nov. 20, 2012). In Qimonda, the United States Court of Appeals for the Fourth Circuit (the "Fourth Circuit") affirmed the judgment of the Bankruptcy Court for the Eastern District of Virginia (the "Virginia Bankruptcy Court") which held that section 365(n) is applicable to U.S. patents owned by a foreign debtor. *See Jaffé v. Samsung Elecs. Co. (In re Qimonda AG)*, 737 F.3d 14 (4th Cir. 2013).

a. Elpida

Elpida was a Japanese debtor whose trustees had filed a Chapter 15 proceeding in the Delaware Bankruptcy Court. Elpida owned patents registered in many jurisdictions, including some registered in the United States. The Japanese Court approved the sale of certain of patents, including some of the patents registered in the United States. The Delaware Bankruptcy Court had to determine if section 363 of the Bankruptcy Code applies to the sale of the U.S. patents when the sale of such assets had already been approved by the Japanese Court. The Delaware Bankruptcy Court held that because section 1520(a) of the Bankruptcy Code provides that "sections 363, 549 and 552 apply to a transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States to the same extent that the sections would apply to property of an estate", it must review the sale under section 363 of the Bankruptcy Code. The Delaware Bankruptcy Court did not accept the argument made by the Elpida trustees that the judgment of the Japanese Court should be afforded comity and thus, no separate review under section 363 was appropriate or required. The Delaware Bankruptcy Court held that "[t]here can be no doubt that promoting comity is the general objective of Chapter 15. But that is not the end all be all of the statute. To require this Court to defer in all instances to foreign court decision would gut section 1520. It is important to note that section *1520* is mandatory. Sections *1507, 1519, 1521* and *1522* provide the Court with broad discretion to 'grant any appropriate relief.' While those sections cross reference each other they do not mention, let alone authorize, amendment of section 1520 to make section 363 inapplicable. This is not surprising. To do so would akin to a bankruptcy court holding that *section 1129* does not apply to plan confirmation, which would clearly be impermissible." 2012 WL 6090194 at *8 (emphasis added). The Delaware Bankruptcy Court held that the Elpida trustees must present evidence with respect to the assets located in the United States to demonstrate that the proposed sale of U.S. patents satisfies section 363 of the Bankruptcy Code. *Id.* at *9.

b. Qimonda

In *Qimonda*, the Virginia Bankruptcy Court held that section 365(n) was applicable to the U.S. patents and thus, the licensees were entitled to the protections of section 365(n). Qimonda AG was a German corporation that manufactured semiconductor devices and was the subject of a German insolvency proceeding. Michael Jaffé was the insolvency administrator. The insolvency administrator filed a Chapter 15 proceeding in the Virginia Bankruptcy Court. The insolvency administrator sought to cancel the patent licenses under section 103 of the German Insolvency Code and replace the existing licenses with new licenses of the patents. 737 F.3d at 17.

The Virginia Bankruptcy Court's first decision on section 365(n) issue (the Court held that section 365(n) was not applicable) was appealed to the District Court which remanded it back to the Bankruptcy Court. The District Court's instructions on remand were that the Virginia Bankruptcy Court must consider whether, under section 1522(a), "the interests of the creditors and other interested parties, including the debtor are sufficiently protected", and "whether section 365(n) embodies the fundamental public policy of the United States, such that subordinating § 365(n) to German Insolvency Code § 103 is an action 'manifestly contrary to the public policy of the United States'" under section 1506. *See In re Qimonda AG Bankr. Litig.,* 433 B.R. 547, 557-565 (E.D.Va. 2010).

The Virginia Bankruptcy Court held a four day evidentiary hearing regarding the likely effects of applying 365(n) to licenses under Qimonda's U.S. patents. 737 F. 3d at 18. The Virginia Bankruptcy Court heard testimony as to what value relicensing the U.S. patents would bring to Qimonda, the costs and consequences to Qimonda if the licensees were able to make an election under section 365(n) and continue to use the U.S. patents, and the costs and consequences to the licenses if they were not able to make such election under section 365(n). The Virginia Bankruptcy Court held that, while it was close, the balancing of the debtor and creditor interests required by section 1522(a) weighed in favor of making § 365(n) applicable to the licenses of Qimonda's U.S. patents. *In re Qimonda AG*, 462 B.R. 165, 182 (Bankr. E.D. Va. 2011). As an independent ground for its decision, the Virginia Bankruptcy Court determined that "deferring to German law, to the extent it allows cancellation of the U.S. patent licenses, would manifestly contrary to U.S. public policy." *Id.* at 185. The District Court certified an appeal directly to the Fourth Circuit. *Jaffé v. Samsung Elecs. Co. (In re Qimonda AG),* 470 B.R. 374 (E.D.Va. 2012).

On appeal, the Fourth Circuit held that the Virginia Bankruptcy Court had the authority to apply section 365(n) as discretionary relief under section 1521(a).[11] The Fourth Circuit held that the Bankruptcy Court cannot grant relief under section 1521(a) unless it determines that the interests of the creditors and other interested entities, including the debtor, are sufficiently protected in accordance with section 1522(a). The insolvency administrator argued that the Virginia Bankruptcy Court erred in even considering section 1522(a) because the insolvency administrator had not affirmatively requested rejection authority under section 365 and/or the Court should have applied a test under section 1522(a) which placed all creditors under equal footing. 737 F.3d at 26-27. The Fourth Circuit held that the insolvency administrator had sought relief under section 1521(a)(5) to administer and realize the assets of Qimonda located in the United States, including its U.S. patents, and that any relief under section 1521 requires that the Bankruptcy Court apply section 1522(a). *Id.* at 26. The Fourth Circuit held that the balancing analysis performed by the Virginia Bankruptcy Court was appropriate based on the language of the statute and the Guide to Enactment for the Model Law on Cross-Border insolvency issued by UNCITRAL which indicated that Article 22 of the Model Law (which is the basis for section 1522) is

[11] 11 U.S.C. § 1521(a) provides that "where necessary to effectuate the purpose of this chapter and to protect the assets of the debtor or the interests of the creditors, the Court may, at the request of the foreign representative, grant any appropriate relief."

designed to “protect the interests of the creditors (in particular local creditors), the debtor and affected persons”. *Id.* at 28-29. The Fourth Circuit noted that its affirmance based on its application of section 1522(a) would “indirectly further the public policy that underlies §365(n)” but, did not explicitly affirm based on the public policy exception in section 1506. *Id.* at 32.