INTELLECTUAL PROPERTY RIGHTS IN BANKRUPTCY

Upon the filing of a bankruptcy case, all assets of the debtor, including its intellectual property ("IP") rights, become part of the bankruptcy estate. To the extent that the debtor wholly owns those rights and has not licensed them, the property will generally be treated as any other property. However, if the rights are the subject of a license, the issues become far more complicated.

The Bankruptcy Code* provides the following definition:

11 U.S.C. § 101 – Definitions

(35A) The term "intellectual property" means—

(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 (copyrights); or

(F) mask work protected under chapter 9 of title 17;

to the extent protected by applicable nonbankruptcy law.

This definition was added to the Bankruptcy Code in 1988 for the reasons set forth in the Legislative History to 11 U.S.C. § 365(n) which section will be discussed below. Interestingly, it does not include trademarks which are otherwise, generally considered to fall under IP law. The primary goal of laws protecting patents and copyrights is to encourage innovation by creating a monopoly in favor of the owner of those rights. On the other hand, trademark law is designed to "prevent customer confusion and protect the value [of] identifying symbols [rather than] to encourage innovation by providing a period of exclusive rights." 1 J. McCarthy, *McCarthy on Trademarks and Unfair Competition* § 6:3 (2009). Thus, trademarks, service marks, trade names, and rights of publicity are all excluded from the section 365(n) election provision. Furthermore, foreign patents and copyrights are not included within the scope of section 365(n), as they are not covered by title 35 or 17 of the United States Code.

*Unless specified otherwise, all references to sections or to the "Bankruptcy Code" are to title 11 of the United States Code (11 U.S.C. §101 et seq. (2016)) as amended.

The licenses under which IP rights arise usually will be found to be executory contracts and therefore subject to assumption or rejection. The U.S. Supreme Court has defined an executory contract as one "on which performance remains due to some extent on both sides." *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984). Bankruptcy courts usually use the "Countryman" definition of an executory contract as one "under which the obligation[s] 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 performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 Minn. L. Rev. 439, 460 (1973).

Unless the license is an exclusive assignment or one side has fulfilled all of its obligations, IP licenses will be viewed as executory contracts. An executory contract in bankruptcy may be a) assumed with continuing performance requirement b) assumed and assigned or c) rejected. A debtor's rights to exercise any of those three options as to IP contracts is much more limited than with most other executory contracts due to Bankruptcy Code § 365(c)(1) which says:

> 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-
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> (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
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> (B) such party does not consent to such assumption or assignment….

DEBTOR AS LICENSEE

Most IP licenses are considered "personal" contracts for which the right to free assignability does not apply. A split among the federal circuit courts of appeal currently exists as to the test which should be applied under § 365(c)(1) to determine whether a debtor which is a licensee may assume an IP license over the objection of a non-consenting licensor. Courts have used three approaches: 1) the "Hypothetical Test" 2) the "Actual Test" and 3) the "Footstar Approach" in an attempt to resolve this problem.

The "Hypothetical Test"

The Third, Fourth, Ninth, and Eleventh Federal Circuit Courts of Appeal have all ruled that § 365(c)(1) applies not only to the trustee but to also to the debtor, reading that section literally and thus bar assumption or assignment if the licensor does not consent. Under this "Hypothetical Test," it does not matter whether the debtor intends to assume the license for itself or intends to assume and assign it to a third party. The issue for the court is whether under the contract the licensee may assign the license regardless of its intent to do so, hence the "Hypothetical Test." The Ninth Circuit case of *Perlman v. Catapult Entertainment, Inc.,* 165 F.3d 747, 750 (9th Cir. 1999), cert. denied, 528 U.S. 924 (1999) is one of the leading cases following this test. There, at page 750-51, the court found that pursuant to federal patent law, a non-exclusive patent license is "personal and assignable only with the consent of the licensor," and that § 365(c)(1) consequently restricted the assumption if the licensor refuses to consent to that assumption.

The "Actual Test"

Under the "Actual Test," courts have said that if a debtor-in-possession ("DIP") has no intent to assign the executory contract to a third party, it may be assumed so long as the debtor meets the requirements of assumption under § 365(b), i.e. curing defaults and providing adequate assurance of future performance. The First Circuit expressly adopted this test in *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997). There, the plan of a DIP was to assume a non-exclusive patent license and then transfer its stock to a competitor of the licensor. Naturally, the licensor objected. The court denied the objection finding that under these facts the licensor was not being required to accept performance by "an entity other than the debtor or debtor in possession."

In 2006, the Fifth Circuit adopted the "Actual Test" in Bonneville Power Admin. v. Mirant Corp. (in re Mirant Corp.), 440 F.3d 238, 248-249 (5th Cir.2006). In that case, a non-debtor tried to end its executory contract with a DIP based on an ipso facto clause once the debtor filed its bankruptcy case. The non-debtor argued that the contract could not be assigned based on the applicable law of the Anti-assignment Act, 41 U.S.C. § 15, which prohibits the transfer of contracts to which the United States is a party. However, the Fifth Circuit followed courts applying the "Actual Test" to deny the objection.

Use of the "Actual Test" allows a debtor to retain a valuable license for its estate. Judge Phillips writing for the bankruptcy court for the Middle District of Louisiana found in *Texaco Inc. v. Louisiana Land & Exploration Co.*, 136 B.R. 658, 671 (Bankr. M.D. La. 1992) that applying state law to prevent assumption of leases would be counterproductive to the goals of bankruptcy. Judge Schiff, sitting in that same court, similarly found such assumption permissible in *In re Cajun Elec. Power Co-op., Inc.,* 230 B.R. 693, 705 (Bankr. M.D. 1999). He rejected the holding of *In re West Electronics, Inc.,* 852 F.2d 79 (3rd Cir.1988), where the Third Circuit held that section 365(c)(1) required the court to hold a hypothetical test to determine if the debtor in possession may assume and assign an executory contract. He stated:

> While the *West* decision has some support, the majority of cases considering this issue have rejected its "hypothetical test" and have held that section 365(c) does not prohibit assumption by the debtor in possession. See, e.g., *Texaco, Inc. v. Louisiana Land & Exploration Co.*, 136 B.R. 658 (M.D.La.1992), and *In re Lil' Things, Inc.*, 220 B.R. 583 (Bankr.N.D.Tex.1998).
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> In *Texaco,* the Court criticized the reasoning of *West,* stating that it was directly contrary to the view expressed by the Supreme Court in *NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984), that the debtor in possession is the same entity as the prepetition debtor. The court in *Texaco*

> concluded that Congress did not intend section 365(c) —to bar an assumption of a contract by a debtor in possession simply because there is a statute that conditions transfers to third persons upon approval of the non-debtor party.
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> 136 B.R. at 670.
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> The court in *Lil' Things* recognized that most courts have rejected *West*'s "separate entity" theory "and have criticized *West Electronic's* conclusion that a debtor in possession is somehow different from the pre-bankruptcy contracting party and can be prevented from assuming its contracts by § 365(c)." 220 B.R. at 586.

The bankruptcy court for the Middle District of Louisiana faced yet another transfer issue with regard to a license agreement in *Murray v. Franke-Misal Techs. Grp.,* (*In re Supernatural Foods, L.L.C.*), 268 B.R. 759 (M.D. La. 2001). The court determined that an exclusive license agreement for certain patented technology had not expired prior to the filing of the bankruptcy case and was therefore assumable. The court further found that the licensor's written consent was not required for transfers incident to sales of a substantial portion of the licensee's assets.

The "Footstar Approach"

The bankruptcy court for the Southern District of New York established the "Footstar Approach" in 2005 by holding that § 365(c)(1) limited only the trustee, and not a DIP, from assuming an IP license if applicable law would allow the licensor to oppose the assignment of the license. In re Footstar, Inc., 323 B.R. 566 (Bankr. S.D.N.Y. 2005). The court found that the debtor's "mere assumption (without assignment) would *not* compel the counterparty to accept performance from or render it to 'an entity other than' the debtor." *Id.* at 573 (emphasis in the original).

U.S. Supreme Court Declines Chance to Settle Split

In 2009, the U.S. Supreme Court passed on an opportunity to address this split between the circuits as to which test should be applied regarding the assumption of in IP license under § 365(c)(1). It denied a petition for a writ of certiorari in *N.C. P. Marketing Group, Inc. v. Blanks (In re N.C.P. Marketing Group, Inc.),* 129 S.Ct. 1577 (2009). Although Justices Kennedy and Beyer issued a statement that the split between the circuits should be resolved, they said that this was not the "most suitable case" for resolving the split. On the one hand, they noted that the "Hypothetical Test" was flawed for undermining the Bankruptcy Code's general policy for maximizing value in the debtor's estate and promoting reorganization. On the other, they acknowledged that the "Actual Test" tended to subvert the plain language of § 365(c)(1). Until such time as the split is resolved, this uncertainty should be noted and guide practitioners in choice of venue as well as in attempting to draft language to the benefit of their clients.

DEBTOR AS LICENSOR

A debtor which is a licensor may either assume or reject a license agreement that qualifies as an executory contract. In order to assume the license agreement, under § 365(b)(1), the debtor must cure its defaults, compensate the licensee for its actual losses, and provide the licensee with adequate assurances of future performance by the debtor or, if the license agreement is assigned, by a prospective assignee. Although the option of assumption and assignment may be restricted for debtor licensees, as discussed above, a debtor licensor may generally assume and assign an intellectual property license even if the terms of the agreement prohibit it from doing so under § 365(f)(2). However, when a debtor/licensor decides to reject an IP license, it can have significant consequences for the non-debtor/licensee.

Until 1988, the Bankruptcy Code did not specifically address IP or the effect of rejection of an intellectual property license. In the *Lubrizol* case, the debtor had licensed technology for a metal process to Lubrizol on a non-exclusive basis a little over a year before filing its petition for bankruptcy. *In re Richmond Metal Finishers, Inc.*, 34 B.R. 521,526 (Bankr. E.D. Va. 1983). The bankruptcy court approved the rejection of the technology license as an executory contract. Lubrizol appealed to the district court, which reversed on the grounds that the contract was not executory and that rejection could not reasonably be expected to benefit the bankrupt debtor substantially, based partly on the assumption that rejection of the contract would not deprive Lubrizol of all its rights to the technology. *In re Richmond Metal Finishers, Inc.*, 38 B.R. 341, 345 (E.D. Va. 1984).

On appeal from the district court, the Fourth Circuit Court of Appeals held that the debtor's continuing obligation under a "most favored licensee" clause, as well as the obligations to notify, defend and indemnify the licensee against litigation, made the license agreement an executory contract so that rejection did in fact terminate Lubrizol's rights to use the technology. *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.,* 756 F.2d 1043 (4th Cir. 1985). The court relied on the well-established proposition that the non-debtor party to an executory contract is not entitled to specific performance from the debtor following rejection. However, this treats the grant of license as if it were a stream of goods to be delivered rather than a promise of forbearance from suing for infringement during the license term.

The Fourth Circuit acknowledged the draconian nature of its ruling, noting that allowing rejection in such circumstances could have "a general chilling effect upon the willingness of such parties to contract at all with businesses in possible financial difficulty." *Lubrizol* at 1048. Regardless, it held that bankruptcy law did not allow courts to alter the result based upon equitable considerations and added that Congress could change those the consequences if it desired to do so, as it had with respect to collective bargaining contracts.

Congress actually did respond to the *Lubrizol* decision by enacting the Intellectual Property Protection Act of 1988, which created statutory protections for intellectual property licensees whose licenses were rejected by a debtor as licensor. These protections, now found in §365(n), apply both before and after rejection by the debtor.

Prior to rejection, on receiving a written request from the licensee, the debtor/licensor must perform under the license agreement and provide the licensee with access to the licensed intellectual property in accordance with the terms of the agreement and may not interfere with the contractual rights of the licensee to such intellectual property.

Upon rejection by the debtor/licensor, the licensee has two options: a) treat the license agreement as terminated, in which case any claim for damages would be treated as a general unsecured claim against the bankruptcy estate, or 2) it may elect to retain its existing rights in the licensed intellectual property. In the latter case, the licensee must continue to make royalty payments and waive any right of set-off it may have under the agreement and any administrative claim allowable under Section 503(b) of the Bankruptcy Code.

TRADEMARKS

As noted above, trademarks do not come within the Bankruptcy Code's definition of "intellectual property." Courts generally hold that trademarks are "personal" and therefore not subject to assignment under trademark law without the consent of the trademark licensor. I*n re N.C. P. Mktg. Group Inc.*, 337 B.R. 230 (D. Nev. 2005) aff'd 279 Fed. Appx. 561 (9th Cir. 2008); In re XMH Corp., 647 F.3d 690, (7th Cir. 2011). However, courts have suggested that equitable considerations are relevant in such determinations. The bankruptcy court for the Southern District of Florida found protection appropriate for a trademark licensee where the license fell within a bundle of other licenses that did come within the Bankruptcy Code's definition of "intellectual property." *In re Matusalem*, 158 B.R. 514, (Bankr. S.D.Fla. 1993).

In enacting § 365(n), Congress explained the omission of trademarks and service marks as follows:

> [T]he bill does not address the rejection of executory trademark, trade name or service mark licenses by debtor-licensors. While such rejection is of concern because of the interpretation of section 365 by the L*ubrizol* court and others ..., such contracts raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts. S. REP. No. 100-505, at 5 (1988), reprinted in 1998 U.S.C.C.A.N. at 3204

Regardless of this statement of Congressional intent, some courts have held that the omission of trademarks from the definition of intellectual property means that Congress intended *Lubrizol's* holding to control when a debtor-licensor rejects a trademark license. For example *In re Old Carco LLC,* 406 B.R. 180,211 (Bankr. S.D.N.Y. 2009) the court held that trademarks are not "intellectual property" under the Bankruptcy Code, so "rejection of licenses by licensor deprives licensee of right to use trademark" (internal citations omitted); *In re HQ Global Holdings, Inc.,* 290 B.R. 507, 513 (Bankr. D. Del. 2003) holding that "[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisees' right to use the trademarks stops on rejection".

SECURITY INTERESTS IN INTELLECTUAL PROPERTY

Security interests in most types of personal property must be perfected under the applicable rules in Article 9 of the Uniform Commercial Code. The method of perfection is usually to file a UCC-1 financing statement in the proper state in which to perfect under UCC choice of law rules. However, Article 9 does not apply if a federal statute such as those governing patents, copyrights and trademarks preempts Article 9.

Patents

There is no preemption of Article 9 as to patents, so a security interest in a patent is properly perfected by filing a UCC-1 financing statement. In 2001, the Ninth Circuit held that the Patent Act does not preempt Article 9. *In re Cybernetics Servs., Inc.*, 252 F.3d 1039 (9th Cir. 2001). A lender, however, should also file a short-form IP security agreement with the United States Patent and Trademark Office ("USPTO") to provide protection against and serve as notice to subsequent bona fide purchasers or mortgagees of the patent who search the USPTO records and take such patent subject to the existing security interest. To be considered timely, the filing of the IP security agreement with the USPTO must be within three months from its date or before the date of a subsequent purchase or mortgage. 35 U.S.C. § 261. If the lender does not timely file a short-form IP security agreement providing notice of its security interest, a subsequent purchaser or mortgagee of the affected patent will not have notice of the security interest, and this may impact the effectiveness of the security interest. The security agreement should have a broad definition of the subject patents and related claims.

Copyrights

The federal Copyright Act, 17 U.S.C. 101, et. seq., governs the attachment and perfection of security rights to copyrights. To perfect a security interest in registered copyrights and pending copyright applications, the short-form IP security agreement must be filed with the United States Copyright Office. The Copyright Act generally awards priority to the first executed transfer over the first recorded transfer. U.S.C. § 205(d). Under the Copyright Act, a "transfer" of copyright ownership is defined to include a "hypothecation of a copyright," and "hypothecation" includes "a pledge of property as security or collateral for a debt." The transfer, however, must be recorded within one month after execution of the transfer agreement (two months if the agreement is executed outside of the U.S.), or before the recordation of a later transfer in order to ensure priority over such later transfers.

A security agreement should have an expansive definition of copyrights that includes copyright rights to any works of authorship or other copyrightable subject matter, copyright registrations, applications for copyright registrations, rights of renewal and unregistered copyrights as well as claims for past and future infringements.

Trademarks

Federally registered trademarks and trademark applications are governed by the Lanham Act, 15 U.S.C. § 1051 et seq. Courts have concluded that a state filing alone is sufficient to perfect a security interest in trademarks because the Lanham Act only governs the recordation of assignments and not security interests. *In re TR-3 Industries*, 41 B.R. 128 (Bankr. C.D. Cal. 1984); T*rimarchi v. Together Dev. Corp.,* 255 B.R. 606 (D. Mass. 2000). Since Article 9 of the UCC is not preempted, it governs the perfection of security interests in all trademarks, whether registered or unregistered.

Just as with patents, a lender should file the UCC-1 financing statement and short-form IP security agreements with the USPTO to ensure notice to subsequent bona fide purchasers and mortgagees who would take the property subject to such lien. To be considered timely, the filing of the short-form IP security agreement with the USPTO must be within three months of its date or before the date of a subsequent purchase.