AMERICAN BANKRUPTCY INSTITUTE

2019 Rocky Mountain Bankruptcy Conference

A License to Kill: Executory IP Contracts, Licenses and Intellectual Property Transactions in Bankruptcy

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CONCURRENT SESSION

2019

SECURITY INTERESTS IN INTELLECTUAL PROPERTY AND LICENSES OF INTELLECTUAL PROPERTY IN BANKRUPTCY

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I. INTRODUCTION

A. Fundamental Bankruptcy Principles.

The filing of a bankruptcy petition by or against a debtor creates a new legal entity: the bankruptcy "estate." The estate comprises, among other things, all legal or equitable property interests of the debtor.[2] The nature and extent of a debtor's property interests are generally determined by non-bankruptcy law, usually state real and personal property law.[3] One exception to the primacy of *state* law in determining property rights in bankruptcy is in the area of intellectual property law, where *federal* patent, copyright and trademark laws create unique species of property rights. Trade secrets remain governed primarily by state law. The sole legal representative of the estate -- i.e., the "owner" of these property rights in a bankruptcy case -- is the bankruptcy trustee (in a Chapter 7 or Chapter 11 bankruptcy proceeding)[4] or the debtor-in-possession (in a Chapter 11 bankruptcy proceeding).[5]

As a collective proceeding designed to maximize recoveries by creditors generally, several mechanisms exist to, first, increase the value of bankruptcy estate property that is available for distribution to general unsecured creditors, and, second, invalidate, or "avoid," lien claims of secured creditors that effectively remove the collateral from possible distribution to unsecured creditors. One method in which the value of the estate may be enhanced is through the T/DIP's right to assume, assign, or reject any of the debtor's executory contracts.[6] Selected issues involving administration of executory contracts in bankruptcy will be discussed below, with particular emphasis on one type of executory contract: namely, licenses of intellectual property. Second, a secured creditor's lien may be avoided by use of the T/DIP's "strong-arm" powers, under Section 544(a).[7] Under that Section, the T/DIP is given the rights of a judicial lien or execution creditor under state law (*i.e.*, a creditor who will take priority over an unperfected security interest[8]) and may avoid any security interest in the debtor's property

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[2] 11 U.S.C. § 541(a)(1).
[3] Butner v. United States, 440 U.S. 48, 56 (1979).
[4] 11 U.S.C. §§ 323(a), 1104, 1006.
[5] 11 U.S.C. § 1107(a). Subject to limited potential (though potentially significant) exceptions, explained in Part III-D-2, *infra,* a debtor-in- possession has all the rights and powers of a trustee; hence, in this paper the representative of the bankruptcy estate -- whether trustee or debtor-in-possession -- is referred to as the "T/DIP".
[6] 11 U.S.C. § 365.
[7] All references in the text to a statutory "Section" or "§," unless otherwise specified, are to provisions of the United States Bankruptcy Code, Title 11 U.S.C.
[8] Revised Uniform Commercial Code ("UCC") §§ 9-102(52), 9-317(a). Reference herein to Sections of Article 9 of the UCC refer to Article 9 as revised by the American Law Institute and the National Conference of Commissioners

that is unperfected or otherwise subordinate to such a lien or execution creditor at the time of the debtor's bankruptcy. Whether a security interest in intellectual property is perfected, and therefore able to survive the Trustee's "strong-arm" powers, is the focus of the discussion on security interests in intellectual property that will be the first matter addressed, below.

B. Attributes of Intellectual Property.

Intellectual property has certain attributes that differ significantly from other types of property, and each type of intellectual property varies significantly from the other types of intellectual property. There is little correlation between the statutes establishing rights in different types of intellectual property. This is also true with respect to the law governing perfection of security interests in the various types of intellectual property, and how licenses of the different types of intellectual property are treated in bankruptcy.

C. Types of Intellectual Property.

This presentation addresses the four major types of intellectual property: namely, trade secrets, trademarks and service marks (collectively, "marks"), copyrights, and patents. It does not address plant varieties, mask works, or other less prominent types of intellectual property.

D. United States Application.

This paper addresses security interests, licensing issues, and bankruptcy concerns with respect to the laws of the United States. Foreign counsel should always be consulted when dealing with foreign intellectual property or when exploiting intellectual property in, or transporting intellectual property to, foreign jurisdictions.

II. SECURITY INTERESTS IN INTELLECTUAL PROPERTY

A. Creation -- Attachment.

1. **State Law**. Creation (i.e., attachment) of security interests is governed by Article 9 of the UCC.

2. **General Intangible.** Under the UCC, a "general intangible" is "any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software."[9] Trade secrets, marks, copyrights, patents, and licenses of intellectual property are general intangibles under the UCC.

3. **Power to Choose Applicable Law.** When a transaction bears a reasonable relation to a state and also to another state or nation the parties may agree that the law of either such state or nation shall govern their rights and duties.[10]

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on Uniform State Laws which became effective in most states on July 1, 2001.

[9] UCC § 9-102(42).

[10] UCC § 1-301(a).

4. **Enforceability.** A security interest attaches when it becomes enforceable against the debtor. A security agreement is enforceable if: (a) value has been given; (b) the debtor has rights in the collateral; and (c) there is an authenticated security agreement that contains a description of the collateral.[11]

5. **Description of Collateral.** The description in a security agreement of the property encumbered by a security interest must "reasonably identif[y] what is described."[12] A description reasonably identifies the collateral if it identifies the collateral by category or type of collateral, as defined by the UCC.[13] Thus, a description of collateral in a security agreement should be acceptable if it refers to, for example, "all of the debtor's patents, copyrights, trademarks, service marks and trade secrets," or even to "all general intangibles." However, a "supergeneric" description of collateral, such as "all the debtor's assets" or "all the debtor's personal property" does not reasonably identify the collateral and would be invalid.[14]

6. **Security Agreement.** A security agreement should be structured to provide the secured party, upon foreclosure, with all the benefits of ownership of the particular type of intellectual property. Generally, the granting clause in a security agreement should conform to what would be required to assign or otherwise transfer the type of intellectual property, all rights therein, and any associated rights.

a. Trade Secrets. The unique aspects of trade secrets that must be taken into consideration when creating security interests therein are that trade secrets can mature into other types of intellectual property and that reasonable efforts must be made to preserve confidentiality to maintain "trade secret" status. A security agreement covering trade secrets must not only describe the type of information or data that constitutes the trade secrets, but must also do so in a manner that does not destroy the status of the information and data as trade secrets. Therefore, the security agreement must include sufficient nondisclosure and confidentiality provisions to protect the trade secrets as, in fact, "secrets." Both the debtor and the secured party have a vested interest in maintaining the trade secret status of the information and data.

b. Copyrights. The principal unique aspect of copyrights that must be taken into consideration when creating security interests therein is that copyrights can be unregistered or they can be registered federally with the United States Copyright Office ("Copyright Office"). A security agreement covering copyrights should include not only the copyrights and any registrations thereof and applications therefor, but, in addition, should include all renewals and extensions, and all income, royalties, damages, and payments, including damages and payments for past, present, and future infringement, and the right to sue for past, present, and future infringement. The security agreement should also contain adequate covenants covering perfection of the security interest including filings in the Copyright Office for registered copyrights, filings under the UCC for unregistered copyrights, as well as covenants

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[11] UCC § 9-203(b).
[12] UCC § 9-108(a).
[13] UCC § 9-108(b).
[14] UCC § 9-108(c). Note, however, that such a supergeneric description of collateral, if accurate under the circumstances of a particular transaction, would typically be acceptable for a financing statement. UCC § 9-504.

requiring the debtor to give the secured party notice prior to registering any copyrights with the Copyright Office.

c. Patents. The unique aspects of patents that must be taken into consideration when creating security interests therein are that ideas, concepts, and trade secrets can "mature" into patents, and that additional patents (e.g., continuations, divisionals, and continuations-in-part) may arise out of existing patents. A security agreement covering patents should not only include the patents, and any patent applications and the inventions and improvements described and claimed therein, but, in addition, should include all reissues, divisionals, continuations, renewals, substitutions, extensions, and continuations-in-part of the patents and patent applications, and all income, royalties, damages, and payments due or payable thereunder, including the right to all damages and payments for past, present, and future infringements, and the right to sue for past, present, and future infringements. The security agreement must also have adequate provisions requiring the debtor to assist in perfecting the security interest in the UCC records and, for certainty (see Sections II-B-2 and II-B-5 below), with the United States Patent and Trademark Office ("PTO"). The debtor should be required to give the secured party notice prior to filing any patent application with the PTO.

d. Marks. The unique aspects of marks that must be taken into consideration when creating security interests therein are that marks can be unregistered or registered federally with the PTO or with a state, that transfers of marks must include the good will associated with the marks, and that intent to use applications can only be transferred with the entire business to which the underlying mark pertains. A security agreement covering marks should include not only the marks and any registrations thereof and applications therefor, but should also include all renewals, and all income, royalties, damages, and payments due or payable thereunder, including the right to all damages and payments for past, present and future infringements, and the right to sue for past, present and future infringements. The grant should include the goodwill associated with the mark through a clause including "all associated goodwill." Because an intent to use trademark application cannot be assigned without assigning the entire goodwill of the business, or that portion of the goodwill associated with the business to which the mark pertains,[15] either intent to use applications should be excluded from the terms of the security agreement, or the security agreement must include a security interest in the entire business (or at least that part of the business associated with the relevant mark). The security agreement must also have adequate provisions requiring the debtor to assist in perfecting the security interest in the UCC records and, for certainty (see Sections II-B-2 and II-B-6 below), with the PTO. The debtor should be required to give the secured party notice prior to filing any trademark application with the PTO.

e. Licenses. The unique aspects of licenses that must be taken into consideration when creating security interests therein are that licenses are contracts which are general intangibles under the UCC, that the type of intellectual property subject to the license can affect perfection and how the license is dealt with in the security agreement, and that licenses may be either exclusive or non-exclusive. It bears repeating that licenses are simply contract rights and are treated as general intangibles under the UCC's classification of collateral types.[16]

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[15] 15 U.S.C. § 1060.

[16] This paper focuses on security interests in the debtor-licensee's rights under a license of intellectual property. If a

Accordingly, a security agreement covering licenses has provisions similar to security agreements covering other types of contracts. Depending, however, on the type of intellectual property involved and whether the license is exclusive or non-exclusive, the security agreement may have to provide for perfection under not only the UCC, but also with the Copyright Office or the PTO.

Often, general security agreements (which are typical in financing transactions) that cover all of a debtor's personal property run afoul of the principles enumerated above that are specific to intellectual property. The foregoing general concepts emphasize the need to consult with lawyers familiar with intellectual property and security interests therein if intellectual property collateral is involved.

B. **Perfection.**

1. **Mixture of Federal and State Law.** Perfection of a security interest in intellectual property involves a mixture of state and federal law. Article 9 of the UCC does not apply to particular property to the extent that a statute, regulation, or treaty of the United States preempts Article 9.[17] Filing a financing statement is not necessary or effective to perfect a security interest in property subject to a United States statute, regulation or treaty, which has requirements for a security interest to take priority over the rights of a judicial lien creditor that preempt the UCC's filing requirements.[18] Each type of intellectual property must be considered separately to determine whether the state law for perfection under the UCC is preempted by applicable federal law.

2. **Certainty.** Financial institutions require certainty with respect to their security interests that secure a debtor's obligations. Specifically, institutional lenders require assurance that their security interests are perfected and are prior to the rights of subsequent transferees or lienholders, unsecured creditors, and a potential T/DIP. They need to know that, if foreclosure is necessary, they will be able to realize upon the collateral. Because much of the law relating to the perfection of security interests is case law, none of which is from the U.S. Supreme Court, and regarding which conflicts sometimes exist among the lower courts, secured parties are often forced to file in two places -- one under the UCC and one under the applicable federal recording statute.

3. **Trade Secrets.**

a. Recording Statute. Except for the Economic Espionage Act of 1996, trade secrets are governed by state law, primarily the Uniform Trade Secrets Act. There is no state or federal system of recording ownership of trade secrets or transfers thereof.

b. Where to File. Trade secrets are general intangibles under Article 9 of the UCC. There is no federal law that preempts the UCC with respect to the perfection of

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lender is financing a licensor, the licensor's property rights could be classified as an "account" under UCC § 9-102(a)(2) as well as a general intangible, so both terms should be included in the collateral description in a security agreement signed by a debtor-licensor.

[17] UCC § 9-109(c)(1).

[18] UCC § 9-311(a).

security interests in trade secrets; accordingly, such security interests are perfected solely under Article 9 of the UCC.

4. **<u>Copyrights</u>.**

a. <u>Recording Statute</u>. The federal statute governing the recordation of interests in copyrights provides as follows:

> (a) Conditions for Recordation. – Any *transfer of copyright ownership or other document pertaining to a copyright* may be recorded in the Copyright Office if the document filed for recordation bears the actual signature of the person who executed it, or if it is accompanied by a sworn or official certification that it is a true copy of the original, signed document.
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> * * *
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> (c) Recordation as Constructive Notice. -- Recordation of a document in the Copyright Office gives all persons constructive notice of the facts stated in the recorded document, but only if:
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> (1) the document, or material attached to it, specifically identifies the work to which it pertains so that, after the document is indexed by the Register of Copyrights, it would be revealed by a reasonable search under the title or registration number of the work; and
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> (2) *registration has been made for the work.*
>
> (d) Priority between conflicting transfers. -- As between two conflicting transfers, the one executed first prevails if it is recorded, in the manner required to give constructive notice under subsection (c), within *one month* after its execution in the United States or within *two months* after its execution outside the United States, or at any time before recordation in such manner of the later transfer. Otherwise the later transfer prevails if recorded first in such manner, and if taken in good faith, for valuable consideration or on the basis of a binding promise to pay royalties, and without notice of the earlier transfer.

> (e) Priority between conflicting transfer of ownership and nonexclusive license. -- A *nonexclusive license, whether recorded or not*, prevails over a conflicting transfer of copyright ownership if the license is evidenced by a written instrument signed by the owner of the rights licensed or such owner's duly authorized agent, and if
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> (1) the license was taken before execution of the transfer; or
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> (2) the license was taken in good faith before recordation of the transfer and without notice of it.[19]

A "transfer of copyright ownership" is defined as "an assignment, mortgage, exclusive license, or any other conveyance, alienation, or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license."[20]

b. Where to File. Because recordation of documents with the Copyright Office gives constructive notice if the applicable copyright has been registered, courts have held that federal law preempts UCC perfection provisions with respect to registered copyrights, and that the predecessor to UCC § 9-311(a) excluded security interests in copyrights from UCC perfection procedures.[21] The same result should be reached under Section 9-311(a) of Revised Article 9. Consequently, security interests in *registered* copyrights should be perfected by filing with the Copyright Office, not by filing financing statements under the UCC (though prudence would support duplicate filings in compliance with *both* copyright law and the UCC).

Under the Copyright Act, recordation with the Copyright Office gives constructive notice only if the original work has been registered. Thus, with respect to unregistered copyrights, the dominant authority is that federal law does not preempt the UCC, so security interests in unregistered copyrights are perfected under the UCC.[22] The Ninth Circuit

[19] 17 U.S.C. § 205 (emphasis added).
[20] 17 U.S.C. § 101.
[21] *In re* Peregrine Entm 't., 116 B.R. 194 (Bankr C.D. Cal. 1990) (filing UCC-1 financing statements is ineffective to perfect security interest in registered copyrights). *Accord* Aerocon Eng'g Inc. v. Silicon Valley Bank (*In re* World Aux. Power Co.), 303 F.3d 1120 (9th Cir. 2002) (adopting the holding in *Peregrine* with respect to registered copyrights). In Gasser Chair Co. v. Infanti Chair Mfg. Corp., 2006 WL 297451 (E.D.N.Y. Feb. 8, 2006), the Court cited *Peregrine* to support its assertion that, prior to the 2001 revisions to Article 9 of the UCC, courts held that Section 261 of the Patent Act, 35 U.S.C. § 261, displaced the UCC in providing a mechanism for perfecting security interests in patents. Of course, *Peregrine* has nothing to do with the Patent Act, which, as is explained in subsection 5, below, does not displace the UCC with respect to perfecting security interests in patents. Thus, *Gasser Chair's* oblique reference to *Peregrine* should be regarded as *dictum* (and erroneous, at that), and *Peregrine* should continue to be regarded as the leading authority on the perfection of security interests in registered copyrights.
[22] Aerocon Eng'g Inc. v. Silicon Valley Bank (*In re* World Aux. Power Co.), 303 F.3d 1120 (9th Cir. 2002) (where

Court of Appeals has explained that there is no way for a secured creditor to perfect a security interest in unregistered copyrights by recording in the Copyright Office, because the underlying copyright is, by definition, unregistered.[23] The court continued that to hold otherwise than by giving the UCC primacy would make registration a requirement to copyright perfection, which would strip unregistered copyrights of their value as collateral because lenders will not lend against collateral against which they cannot perfect their security interests.[24] Moreover, the court stated that deference to the federal law of copyrights is not supported by the text of the Copyright Act or the associated Congressional intent, both of which support a system where many copyrights will remain unregistered.[25] There are earlier cases, now overruled, that found to the contrary.[26]

Accordingly, with respect to *unregistered* copyrights, it is advisable to file under the UCC. It may be prudent to require that valuable unregistered copyrights be registered to take advantage of the relative certainty provided by the federal copyright recording statute. In the alternative, the debtor should be required in the applicable security agreement to notify the secured party within a reasonable time before a copyright application is made in the Copyright Office, to enable the secured party to concurrently file in the Copyright Office and perfect the security interest. When searching for security interests in copyrights, both the Copyright Office records and the UCC records should be searched.

5. **Patents.**

a. Recording Statute: The federal statute governing the recordation of interests in patents provides as follows:

> An *assignment, grant or conveyance* shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office

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copyright was unregistered, so that Copyright Act provided no means by which security interest could be perfected, federal law did not preempt UCC perfection provisions and the predecessor to Revised UCC § 9-311(a) did not exclude unregistered copyrights from UCC perfection provisions. Similar results should occur under Revised UCC § 9-311(a), which should apply to allow perfection of unregistered copyrights under the UCC.).

[23] The Aerocon court reasoned, at 303 F.3d at 1128:

> The U.C.C. doesn't defer to the Copyright Act . . . because the Copyright Act doesn't provide a "national registration": unregistered copyrights don't have to be registered, and because unregistered copyrights don't have a registered name and number, under the Copyright Act there isn't any place to file anything regarding unregistered copyrights that makes any legal difference. So, as a matter of state law, the U.C.C. doesn't step back in deference to federal law, but governs perfection and priority of security interests in unregistered copyrights itself.

[24] Aerocon Eng'g Inc., 303 F.3d at 1130-32.

[25] *Id.* at 1130-31.

[26] *In re* AEG Acquisition Corp., 127 B.R. 34, 40-41 (Bankr. C.D. Cal. 1991), *aff'd*, 161 B.R. 50, 58 (9th Cir. B.A.P. 1993), *overruled by* Aerocon Eng'g Inc., 303 F.3d at 1120; *In re* Avalon Software Inc., 209 B.R. 517 (Bankr. D. Ariz. 1997), *overruled by* Aerocon Eng'g Inc., 303 F.3d at 1120.

> within three months from its date or prior to the date of such subsequent purchase or mortgage.[27]

Note that this statute only applies to assignments, grants or conveyances. What constitutes an "assignment" for the purposes of this statute is not always clear. Generally, to constitute an assignment, the entire patent or an undivided interest therein must be transferred, or there must be a grant of an exclusive right to practice the invention within a specified territory.

b. Where to File. As reflected above, the federal patent recording statute only applies to an "assignment, grant or conveyance." It has been held that these terms do not include a security interest, only a transfer of title.[28] Therefore, federal law does not preempt the UCC with respect to perfection of security interests in patents, and the predecessor to UCC § 9-311 (a) did not exclude patents from UCC perfection procedures.[29] Accordingly, a security interest in patents should be perfected under the UCC.[30]

Unfortunately, there is no clear or definitive authority with respect to the method of perfection. There is no U.S. Supreme Court decision and the statutory language is not definitive. Accordingly, if the secured party desires certainty, it is advisable to file both under the UCC and with the PTO. The debtor should be required in the security agreement to notify the secured party within a reasonable time before a patent application is filed with the PTO to enable the secured party to file in the PTO as soon as possible. Similarly, when searching for security interests in patents and patent applications, it is advisable to search both the UCC records and the records maintained by the PTO.

6. **Marks.**

a. Recording Statute. The federal statute governing the recordation of interests in marks provides as follows:

> An *assignment* shall be void as against any subsequent purchaser for a valuable consideration without notice, unless the prescribed information reporting the assignment is recorded in the Patent and Trademark Office within 3 months after the date of the assignment or prior to such subsequent purchase. The Patent and Trademark Office shall maintain a record of information on assignments, in such form as may be prescribed by the Director.[31]

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[27] 35 U.S. C. § 261 (emphasis added).

[28] Moldo v. Matsco, Inc. (*In re* Cybernetic Servs.), 252 F. 3d 1039, 1054 (9th Cir. 2001), *cert. denied*, 534 U.S. 1030 (2002) (security interest in patent is perfected by filing UCC-1 financing statement; the Patent Act only permits recordation of an "assignment" and, although undefined, "assignment" appears not to include transfer of security interest, only transfer of title). *Accord* Elec. Constructors, LLP v. Tower Tech, Inc. (*In re* Tower Tech, Inc.), 67 Fed. Appx. 521, 524 (10th Cir. 2003).

[29] *In re* Transportation Design & Technology, Inc., 48 B.R. 635 (Bankr. S.D. Cal. 1985).

[30] Elec. Constructors, 67 Fed. Appx. at 524; Gasser Chair, 2006 WL 297451.

[31] 15 U.S.C. § 1060 (emphasis added).

b. Where to File. Unlike the patent recording statute, the federal recording statute governing marks refers only to "assignments," but otherwise is very similar to the patent recording statute. It has been held that the word "assignment" in the statute refers only to transfer of title, not to grants of security interests.[32] Therefore, federal law does not preempt the UCC with respect to perfection of security interests in marks, and the predecessor to UCC § 9-311 (a) did not exclude marks from the UCC perfection procedures.[33] Accordingly, security interests in registered marks and applications therefor should be perfected by filing under the UCC. Unregistered marks should also be perfected by filing under the UCC.

Unfortunately, as with patents, there is no governing U.S. Supreme Court decision and the statutory language is not definitive. Accordingly, if the secured party desires certainty, it is advisable to file both under the UCC and, with respect to federally registered marks or applications therefor, with the PTO. The debtor should be required in the security agreement to notify the secured party within a reasonable time before an application to register a mark is filed with the PTO to enable the secured party to file in the PTO as soon as possible. When searching for security interests in marks, it is advisable to search both the UCC records and, with respect to federally registered marks or applications therefor, the records maintained by the PTO.

7. **Licenses.** A license of intellectual property is a general intangible under Article 9 of the UCC. If it is a true license, a security interest therein would be perfected under the UCC like any other contract right.[34] Often, a so-called license, particularly an exclusive license, can have so many attributes of ownership that in essence it becomes an assignment or sale. Unfortunately, when a license becomes an assignment or sale depends on the type of intellectual property involved and the terms of the license and is not always easy to determine.

a. Trade Secret. A security interest in a license of trade secrets (including a nondisclosure or confidentiality agreement) should be perfected by filing under the UCC.

b. Copyrights. As reflected above, the copyright recording statute specifically applies to a "transfer of copyright ownership," which includes an exclusive license, but does not include a nonexclusive license.[35] Accordingly, a security interest in an exclusive license of a registered copyright should be filed with the copyright office to perfect the security

[32] Trimarchi Personal Dating Servs. v. Together Dev. Corp., 255 B.R. 606, 611-12 (D. Mass. 2000) (and authorities cited therein) (Trademark Act does not preempt state law by requiring recordation of "assignment" with PTO because, as used by the Trademark Act, "assignment" refers only to transfer of title, not to transfer of security interest).

[33] Trimarchi, 255 B.R. at 611-12; *In re* Roman Cleanser Co., 43 B.R. 940, 944 (Bankr. E.D. Mich. 1984), *aff'd*, 802 F.2d 207 (6th Cir. 1986); Joseph v. Valencia, Inc. (*In re* 199Z, Inc.), 137 B.R. 778 (Bankr. C.D. Cal. 1992). *See also* Moldo, 252 F.3d at 1039 (pertaining to security interests in patents, but because of the similarity of the trademark recording statute to the patent recording statute, the analysis should be applicable to security interests in marks).

[34] As stated earlier, although this paper focuses on security interests in a licensee's rights under a license, a licensor's rights could be classified as either an "account" or a "general intangible" under the UCC. Including the term, "account," in the description of collateral in a security agreement signed by a debtor-licensor doesn't change the requirement that the creditor must perfect its security interest in a license by filing a financing statement under the UCC.

[35] 17 U.S.C. § 101. *See* discussion *supra* Part II-B-4-a.

interest, but a security interest in a nonexclusive license should be perfected under the UCC.[36] As reflected above, the copyright recording statute requires the original work to be registered and it has been held that federal law does not preempt state law with respect to unregistered copyrights.[37] Accordingly, security interests in licenses (either exclusive or nonexclusive) of unregistered copyrights should also be perfected by filing under the UCC.

c. Patents and Trademarks. Security interests in marks and patent licenses (provided they are not considered assignments or sales) are generally not filed with the PTO. Unfortunately, when a patent or trademark license becomes an assignment or sale (which means it would be subject to the patent and trademark recording statutes) depends on a number of factors and is not easy to determine. It is advisable that, whenever a patent or trademark license taken as security approaches an exclusive license, the security interest therein be perfected by filing with the PTO in addition to the UCC.

C. **Miscellaneous UCC Provisions**.

1. **Section 9-408.** One of the principal concerns in connection with security interests in intellectual property is whether there is a prohibition against assignment or other transfer of the intellectual property that would be violated either by the granting of a security interest or the transfer of intellectual property upon foreclosure thereof. Revised Article 9 of the UCC renders ineffective a restriction on transfer, in a license or arising under other law, to the extent the restriction would interfere with the creation, attachment or perfection of the security interest.[38] Revised Article 9 does not interfere with the enforceability of an otherwise effective restriction in the license or under other law on the secured party's enforcement of its security interest in the license.[39] Accordingly, a security interest in a license that by its terms prohibits a transfer or the granting of a security interest is effective notwithstanding such restriction; but the secured party is not entitled to enforce the security interest if such enforcement would violate the restriction.[40] This provision is important in granting a creditor the rights of a secured creditor in a bankruptcy case, particularly in an asset sale under §363(f) and a cramdown of a Chapter 11 plan under § 1129(b)(2)(A).[41]

2. **Where to File Under the UCC to Perfect.** If a security interest is required to be perfected under the UCC by filing, the law of the state where the debtor is located governs perfection.[42] A "registered organization" (defined in UCC § 9-102 as an organization organized solely under the law of a single state which state must maintain a public record of such organization, such as most corporations, limited partnerships and limited liability companies) is deemed to be located in the state where it is organized.[43] With respect to individuals and

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[36] *See supra* Part II-B-4-a.
[37] Aerocon Eng'g, Inc., 303 F.3d at 1120.
[38] UCC § 9-408(a) and (c).
[39] UCC § 9-408(d).
[40] *Id.*
[41] *Id.* at Official Comments 7 and 8.
[42] UCC § 9-301(1).
[43] UCC § 9-307(e).

organizations other than registered organizations (e.g., trusts, partnerships, associations, foreign (non-U.S.) corporations, nationally chartered organizations, etc.), the rules are not as simple.[44]

D. **Consequences of Non-perfection**.

The consequences of failing to properly perfect a security interest in intellectual property are harsh: the security interest can be completely avoided by the T/DIP, in which case the creditor would lose the benefit of any collateral securing its claim, and the creditor would be relegated to the pool of general unsecured creditors.[45] A creditor's perfection of its security interest in intellectual property will frequently be the difference between repayment of the creditor's claim in full and no (or very little) recovery on that claim.

III. LICENSES OF INTELLECTUAL PROPERTY IN BANKRUPTCY

A. **Executory Contracts**.

There are three principal issues affecting the treatment of intellectual property licenses in bankruptcy, arising from the ability of the T/DIP to (1) assume, (2) assign, or (3) reject such licenses. One of the primary benefits afforded to a T/DIP under the Bankruptcy Code is the ability to assume or assign an executory contract if it represents a favorable economic "deal" for the estate or if the T/DIP can sell the estate's rights thereunder at a profit; alternatively, a debtor can reject an executory contract that represents a bad economic bargain.[46] If the T/DIP wishes to assume an executory contract as a post-bankruptcy obligation, it must provide "adequate assurance" that it will be able to cure past defaults and meet future performance requirements under the contract. A T/DIP may also assign the estate's rights under an executory contract to a third-party, thereby generating additional assignment proceeds for distribution to creditors of the bankruptcy estate and freeing the debtor from further obligation on the contract. Finally, if the T/DIP rejects an executory contract, the contract is deemed breached retroactively as of the date the debtor filed for bankruptcy, and the creditor's claim for damages as a result of such breach becomes a pre-petition unsecured claim.[47]

1. **Definition of an Executory Contract**. Under the prevailing Countryman definition, an executory contract is a contract under which substantial performance remains on both sides, such that a failure by one side to perform would constitute a material breach that would excuse the other's further performance.[48] A contract that has been fully performed on either side is generally not executory, which, as will be discussed later, is a key principle in intellectual property license disputes.

2. **Licenses as Executory Contracts**. Generally, with very limited exceptions, a license of intellectual property is an executory contract.[49] The obligation to be performed by the licensor is that of forbearing from suing for infringement; the obligations of the

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[44] UCC § 9-307.
[45] 11 U.S.C. §§ 544(a), 726.
[46] 11 U.S.C. § 365.
[47] 11 U.S.C. § 365(g).
[48] *See generally In re* Baird*,* 567 F.3d 1207, 1211 (10th Cir. 2009); *In re* Aerobox Composite Structures, LLC, 373 B.R. 135, 139 (Bankr. D.N.M. 2007); *In re* Kmart Corp., 290 B.R. 614, 617 (Bankr. N.D. Ill. 2003).
[49] *See generally* Kmart Corp., 290 B.R. at 619 (and authorities cited therein).

licensee are to use the intellectual property in accordance with the terms of the license and, usually, to pay ongoing licensing fees or royalties to the licensor. Certain licenses, particularly exclusive licenses, may grant so many indicia of ownership that they are not truly licenses, but transfers or sales. In addition, a license that is a mere waiver of the right to sue the licensee for infringement, without any future obligations on the licensee's part (i.e., to make royalty payments, mark products with a patent notice, provide quality control, etc.), should not be an executory contract. Thus, a fully paid-up license, without significant duties on the licensee's part, should not be an executory contract[50] and the "license" rights should be property of the debtor-licensee's estate under § 541, subject to continuation, termination and assignment according to the contractual terms and subject to sale under § 363. However, courts have strained to find bilateral contractual obligations sufficient to make nearly any license "executory," and it will be the rare agreement, labeled as a license, that is not found to be an executory contract.[51]

Such a rare situation occurred in the *Interstate Bakeries* case. Interstate Bakeries, as part of an antitrust settlement, granted LBB, a competitor, a transferable exclusive license to use Interstate Bakeries' trademarks in two territories. This transfer was executed as part of a broader Asset Purchase Agreement whereby Interstate Bakeries assigned both the licenses and the operational assets associated with those trademarks in those markets. After Interstate Bakeries filed for bankruptcy, LBB sought a declaratory judgment that the License Agreement was not an executory contract and, therefore, couldn't be rejected.[52]

Although it took until an *en banc* rehearing by the 8th Circuit, LBB finally prevailed and the court found the license to be nonexecutory. First, the court upheld the state-law contract principle that a contract "should be treated as entire when, by a consideration of its terms, nature, and purposes, each and all of the parts appear to be interdependent and common to one another and to the consideration."[53] Thus, the court held, because the License Agreement and Asset Purchase Agreement were executed contemporaneously and served a common purpose – namely, divesting Interstate Bakeries of its entire use of the licensed trademarks and their related operations in those two markets – "[t]o treat the License Agreement as a separate agreement would run counter to the plain language of [the agreements] . . . and would ignore the valuable consideration paid for the license."[54] Because Interstate Bakeries had substantially performed its obligations under the joint agreement by selling its operational assets, the entire contract, including the license, was no longer executory.[55]

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[50] *In re* Gencor Indus., Inc., 298 B.R. 902, 911-12 (Bankr. M.D. Fla. 2003).
[51] *See, e.g.* Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1045 (4th Cir. 1989) (finding agreement to use technology balanced by obligation to forbear from suing for infringement); *In re* Biopolymers, Inc., 136 B.R. 28, 30 (Bankr. D. Conn. 1990) (same); *In re* Access Beyond Technologies, Inc., 237 B.R. 32, 43 (Bankr. D. Del. 1999) (mutual duties to refrain from suing for infringement made license executory). *See generally* Kmart Corp., 290 B.R. at 618. *But see, e.g, In re* Interstate Bakeries Corp., 751 F.3d 955, 963 (8th Cir. 2014) (when license duties are a minor part of a greater agreement, such that the failure to perform them would not be a material breach of the agreement as a whole, a contract is not executory despite being labeled as a "license agreement").
[52] Interstate Bakeries, 751 F.3d at 959.
[53] *Id.* at 962.
[54] *Id*.
[55] *Id*. at 963-64.

Following *Interstate Bakeries*, therefore, parties seeking to maintain the executory nature of a license agreement would be advised to sever completely their licensing agreements from other contemporaneous agreements involving the licensor. Otherwise, the material performance of those other agreements may subsume the license agreement and render the license non-executory.

In contrast, the Fifth Circuit recently employed a more conventional approach toward characterizing the parties' obligations under a patent license in order to find that the license was an executory contract.[56] The licensor, Tech Pharmacy, claimed that its patent license to the debtor had been rejected by operation of law (specifically, Bankruptcy Code § 365(d)(1)), and therefore couldn't have been assigned to RPD, which purchased the bulk of the debtor's assets in a § 363 sale. The court began by applying the standard Countryman definition of an executory contract and looking to see whether there were mutual unperformed obligations under the license that would render it executory. As in most licenses, the licensor/patentee's obligation was to refrain from suing the licensee for infringement, while the licensee/debtor's counter-obligations were to provide quarterly reports on use of the licensed product and pay a one-time licensing fee for each new licensed product placed into service. Based on those standard license provisions, the Fifth Circuit fell in line with other courts nationwide and stated that "typically" a patent license is executory.[57]

Undaunted, RPD, the putative assignee of the debtor's license, claimed that a unique feature of this license made it non-executory. RPD argued that, because the license was "perpetual," the licensor couldn't sue for infringement even if the licensee breached the license; thus, the licensee's performance wasn't material to the licensor's continuing obligation to not sue for patent infringement and the license was therefore non-executory. The court rejected that argument, based on a critical distinction between a license that is merely "perpetual," as opposed to one that is "perpetual and irrevocable."[58] A "perpetual" license may not be revoked at will by the licensor, but the licensor's continued performance may be excused (*i.e.*, the licensor may sue for infringement) upon the licensee's material breach. But a license that is "irrevocable" cannot be terminated even upon the licensee's material breach. As a practice tip, then, a licensor will want to avoid making an "irrevocable" grant, while a licensee will try to include that term, thereby converting the license from Bankruptcy Code § 365 property to § 363 property.

Once the *RPD Holdings* court reached its decision on "executoriness" of the patent license, it still had one more bridge to cross before holding that the license had been rejected. Certainly, following conversion of the debtor's bankruptcy case to Chapter 7, the trustee failed to assume the license within 60 days, which is a 'bright line" that would normally result in automatic rejection of the license by operation of § 365(d)(1) of the Bankruptcy Code. RPD contended, however, that the 60-day deadline shouldn't apply equitably where the debtor failed to schedule the license among its executory contracts and the trustee was unaware of it. The court slammed this final door on RPD by holding that the only potential equitable exception to the 60-day rule under § 365(d)(1) is where a debtor intentionally concealed the existence of a

[56] RPD Holdings, LLC v. Tech Pharmacy Services (*In re* Provider Meds, LLC), 2018 WL 5317445 at *7 (5th Cir. Oct. 29, 2018).
[57] *Id*. at *4.
[58] *Id*. at **6-7.

contract.[59] That exception couldn't apply in this case, where there was no suggestion of intentional concealment and the license was a matter of public record from the debtor's earlier settlement of infringement litigation with Tech Pharmacy. Ultimately, the court found that automatic rejection of the license placed it outside of the debtor's bankruptcy estate, so neither the trustee nor the bankruptcy court could administer it and it couldn't have been part of the debtor's asset sale to RPD.[60]

3. **Exception for Licensee as Co-Owner of Patent.** In the unique situation where a debtor-patent licensee is also a co-owner of the patent, the debtor can reject the license and still retain its co-ownership rights under the patent.[61] In *Diomed*, the debtor was granted an exclusive license (which gave debtor the right to sue for infringement) from the co-owners of the patent, sued others for infringement, later purchased the rights of another co-owner of the patent, rejected the license, settled with the alleged infringers, and sought to keep all settlement proceeds for itself. The Court emphasized that 35 U.S.C. § 262 differs from "ordinary" rules governing co-ownership of personal property, by allowing each co-owner of a patent to make, use or sell the patented invention, without the consent of and without accounting to any co-owners. This means, "With co-ownership comes the power to use the patent in its entirety, even if the circumstances suggest that the use results in the abuse of the rights of the remaining co-owners."[62]

Before rejection of the license, the debtor might have been bound by its terms, including an obligation to turn over to co-owners settlement proceeds from infringement claims. After rejection, however, the debtor was free from its license obligations; thus, it could use, market, and license the patented technology on a non-exclusive basis without any obligation to co-owners.[63] The debtor's rights as co-owner of the patent were sufficient to invoke the maxim that "joint owners in [a patent] are at the mercy of each other."[64]

B. Assumption Generally.

Assumption of an executory contract is a significant transaction for a bankruptcy estate, because, once assumed, the contract becomes effectively a new post-petition obligation of the estate. If a contract, once assumed, is later breached or rejected, the non-debtor counterparty will have a priority post-petition administrative claim against the estate for all damages caused by the breach. The T/DIP must assume the entire contract, with all burdens, and may not reject certain undesirable provisions of the contract while assuming the remainder. An executory contract will only constitute property of the estate and be capable of assumption if it has not been previously terminated. If an agreement was terminated prior to bankruptcy, no remaining contract rights could have accrued to the debtor's bankruptcy estate and there would be nothing left for a T/DIP

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[59] *Id*. at **7-9.
[60] *Id*. at 9.
[61] *In re* Diomed, Inc. 394 B.R. 260, 268 (Bankr. D. Mass. 2008).
[62] *Id.* at 266.
[63] *Id.* at 267.
[64] *Id.* at 266 (quoting Gibbs v. Emerson Elec. Mfg. Co., 29 F.Supp. 810, 811-12 (D. Mo. 1939)).

to assume once the case was filed.[65] The prerequisites to assumption of an executory contract are set forth in Section 365(b)(l):

> [I]f there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee –
>
> > (A) cures, or provides adequate assurance that the trustee will *promptly cure*, such default . . .;
> >
> > (B) compensates, or provides *adequate assurance that the trustee will promptly compensate*, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
> >
> > (C) provides adequate assurance of future performance under such contract or lease.[66]

Whether a debtor has satisfied the statutory conditions for assuming a contract will depend on the unique facts or circumstances of each case.[67] The requirements for curing any default in order to assume a contract will be governed by state contract law.[68] Courts have held that debtors' proposals to cure arrearages over two years[69] or three years[70] in certain cases were reasonably "prompt," in light of the business relationships between the particular parties. In contrast, another court determined that a debtor's proposal to cure contract arrearages over a seven-month period did not constitute a "prompt cure."[71] Clauses providing for default or automatic termination either "ipso facto" upon the filing of bankruptcy or due to a debtor's insolvency or poor financial condition are rendered unenforceable and need not be cured as a condition of assumption, under Section 365(b)(2) and (e)(l). As a prerequisite to the T/DIP's assumption, the non-debtor counterparty to an executory contract is entitled to a cure of arrearages, and adequate assurance of future performance, through the payment of cash or cash collateral "that is non-speculative, positive and sufficiently substantial so as to assure the non-breaching party that it will realize the amount of the default."[72]

C. <u>Assignability of Assumed Licenses</u>.

If an executory contract represents a beneficial economic deal for the bankruptcy estate, a T/DIP may desire to assume the contract and then assign it to a third party to obtain value that

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[65] Moody v. Amoco Oil Co., 734 F.2d 1200, 1212 (7th Cir. 1984), *cert. denied*, 469 U.S. 982 (1984).
[66] 11 U.S.C. § 365(b)(l) (emphasis added).
[67] *In re* Valley View Shopping Ctr., L.P., 260 B.R. 10, 26 (Bankr. D. Kan. 2001).
[68] J. W. Fortune v. McLean Square Assoc. (*In re* J. W. Fortune, Inc.), 173 F.3d 424 (4th Cir. 1999).
[69] *In re* Valley View Shopping Ctr., L.P., 260 B.R. at 26.
[70] *In re* Coors of North Mississippi, Inc., 27 B.R. 918, (N.D. Miss. 1983).
[71] Cole v. Kramer Suburban Car Wash Enters. 1992 WL 62144 (D. Md. 1992).
[72] *In re* Bronx-Westchester Mack Corp., 4 B.R. 730, 734-35 (Bankr. S.D.N.Y. 1980).

will augment the estate for the benefit of creditors. Section 365(f) generally allows a T/DIP to assign any executory contract, even if the contract contains a restriction on assignment:

> (f) Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection . . . .[73]

However, as referenced in Section 365(f), above, a critical exception to the general assignability of executory contracts is contained in Section 365(c).

D. <u>Restrictions on Assumption or Assignment</u>.

The inextricable relationship between the issues of whether an intellectual property license may be, first, assumed and, second, assigned rests on Congress's (unfortunate) use of the word "or" in Section 365(c); as we shall see, those two letters can make all the difference between whether a debtor company lives or dies:

> (c) 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.[74]

Accordingly, a T/DIP[75] that is a licensee of intellectual property is not only prohibited from *assigning*, but may not in the first instance *assume* such a license if "applicable law" excuses the non-debtor from accepting performance from or rendering performance to a party other than the debtor.

1. **<u>"Applicable Law" Restricting Assignment</u>.** It has been held that "applicable law" referred to in Section 365(c) includes federal trademark, copyright, and patent

[73] 11 U.S.C. § 365(f) (emphasis added).
[74] 11 U.S.C. § 365(c) (emphasis added).
[75] As discussed in subsection 2, and specifically subsection 2-c, *infra*, some restrictions on a trustee's assignment of an intellectual property license may not be applicable to a debtor-in-possession; restated, this may be a relatively unique area where the rights of a trustee are not coextensive with those of a debtor-in-possession under 11 U.S.C. § 1107(a).

law, and corresponding common law. If such laws excuse a non-debtor from accepting performance from or rendering performance to a party other than the debtor, the license cannot be assigned by the T/DIP. Unfortunately, "applicable law" is unsettled and there appears to be a split between the circuits, particularly with respect to the assignability of exclusive licenses.

The rationale behind federal common law, although generally reaching the same conclusion regarding non-assignability, depends on the type of intellectual property involved. The fundamental policy of intellectual property law with respect to patents and copyrights is to encourage invention and creation, and courts hold that allowing free assignability of non-exclusive licenses would undermine the reward that encourages invention and creation.[76] With respect to trademarks, courts emphasize that the purpose of a trademark is to identify a particular good or service to consumers, and such specification requires consistency, including a duty by the licensor to ensure quality, which requires the licensor to monitor the abilities of potential licensees and control the identity of licensees.[77] Whether a license is assignable further depends on whether the license could be classified as an outright sale (in which event Section 365(c) is not applicable), a non-exclusive license (in which event it is generally thought that a license is not assignable) or an exclusive license (in which event it is generally thought that a license is assignable, though a few courts hold otherwise).

a. Copyrights. Under copyright law there appears to be a presumption that non-exclusive copyright licenses are generally held to be non-assignable.[78] In contrast, exclusive copyright licenses are usually assignable.[79] Several decisions from the Ninth Circuit, however, have held that even exclusive licenses are not assignable,[80] though those decisions have been criticized.[81]

b. Patents. Unlike copyright law, patent law applies a blanket and long-standing rule of non-assignability with respect to all licenses, whether non-exclusive or exclusive. Patent licenses are viewed as personal and not assignable under federal common law and, consequently, cannot be assigned under Section 365(c).[82]

c. Marks. Similar to patents, trademark licenses are generally viewed as non-assignable in bankruptcy, regardless of their exclusive nature. According to the Seventh Circuit in *XMH*, "[T]he universal rule is that trademark licenses are not assignable in the absence

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[76] Everex Sys. v. Cadtrak Corp. (*In re* CFLC Inc.), 89 F.3d 673, 679 (9th Cir. 1996).
[77] *See generally In re* Trump Entertainment Resorts, Inc., 526 B.R. 116, 124 (Bankr. D. Del. 2015).
[78] *See* RCI Tech. Corp. v. Sunterra Corp., (*In re* Sunterra Corp.), 361 F.3d 257 (4th Cir. 2004); *In re* Patient Educ. Media, Inc., 210 B.R. 237 (Bankr. S.D.N.Y. 1997); *In re* Golden Books Family Entm't Inc., 269 B.R. 311 (Bankr. D. Del. 2001).
[79] Golden Books, 269 B.R. at 314; Traicoff v. Digital Media, Inc., 439 F. Supp. 2d 872, 877 (S.D. Ind. 2006).
[80] Gardner v. Nike, Inc., 110 F. Supp. 2d 1282 (C.D. Cal 2000), *aff'd*, 279 F. 3d 774 (9th Cir. 2002). *Accord* Sapiano v. Millennium Entm't, LLC, 2013 WL 12122435, at *4 (C.D. Cal. Mar. 15, 2013).
[81] *See* Golden Books, 269 B.R. at 317-19 (and authorities discussed therein); *and see* Traicoff, 439 F. Supp. 2d at 877.
[82] *See* Perlman v. Catapult Entm't (*In re* Catapult Entm't), 165 F.3d 747 (9th Cir. 1999); Everex, 89 F.3d at 673; *In re* LGX, LLC, 336 B.R. 601 at *3 (B.A.P. 10th Cir. 2006); *In re* Alltech Plastics Inc., 71 B.R. 686 (Bankr. W.D. Tenn. 1987); *In re* Access Beyond Techs. Inc., 237 B.R. 32 (Bankr. D. Del. 1999); *In re* Hernandez, 285 B.R. 435 (Bankr. D. Ariz. 2002); ProteoTech, Inc. v. Unicity Intern., Inc., 542 F. Supp. 2d 1216 (W.D. Wash. 2008); Unarco Indus., Inc. v. Kelley Co., 465 F.2d 1303 (7th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973); Troy Iron & Nail Factory v. Coming, 55 U.S. 193 (1852).

of a clause expressly authorizing assignment."[83] That is because the identity of the licensee and the relationship between the licensor and licensee is critical in maintaining consistent quality of a good or service that is identified to consumers through the trademark.[84] The parties are free, however, to contract around this "default rule" of non-assignability through a provision in the license expressly authorizing assignment, which will be given effect in bankruptcy.[85]

A minority of courts will look beyond the "default rule" by analyzing trademark licenses as akin to personal services contracts, and ignore federal trademark law. These courts will conduct a fact-intensive inquiry whether there is any "special personal relationship, knowledge, unique skill or talent" with respect to the parties.[86] Thus, to protect against an aberrant application of law by a particular bankruptcy court and prevent assumption and assignment without the licensor's consent, it may be advisable to express in the license that the rights are personal and that performance is unique and personal to the parties.

Further protecting the rights of trademark licensors, the Delaware Bankruptcy Court emphatically limited the holding and discredited the analysis of *Rooster, Inc.*, and upheld the generally prevailing state of the law that trademark licenses are *not* assignable without the consent of the licensor. In *In re Trump Entertainment Resorts, Inc.*,[87] the debtors managed the Trump Taj Mahal in Atlantic City, New Jersey, using Donald and Ivanka Trump's names and likenesses throughout the casino under a license agreement with a Trump corporation. Debtors sought to assume the license agreement as part of their Chapter 11 restructuring. Based on the "hypothetical test" for assumption (discussed below) that prevails in the Third Circuit, if the license couldn't be assigned, then it couldn't be assumed either.[88] The Court held that not only did the license agreement "expressly prohibit[ ] the Debtors from sublicensing or assigning their rights thereunder absent Trump AC's consent," but that "federal trademark law prohibits assignment of trademark licenses under circumstances where it is clear that the identity of the licensee is crucial to the agreement."[89]

In so doing, the Court dismissed the distinctions between exclusive/non-exclusive licenses drawn by *Golden Books*. In the Court's view, unlike for copyrights, "[a] trademark licensor would have the same concerns with respect to the identity of the licensee and the quality of products bearing its trademark whether the trademark license is exclusive or non-exclusive. Thus, a rule distinguishing between exclusive and non-exclusive licenses for purposes of assignability makes little sense in the trademark context."[90] Because a trademark, unlike other species of intellectual property, can amount to a tacit endorsement in the marketplace of the

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[83] *In re* XMH Corp., 674 F.3d 690, 695 (7th Cir. 2011). *Accord* Miller v. Glenn Miller Prods., Inc., 454 F.3d 975, 988 (9th Cir. 2006); *In re* Trump Entertainment Resorts, Inc., 526 B.R. 116, 123 (Bankr. D. Del. 2015).
[84] XMH, 647 F.3d at 695.
[85] *Id*. at 696.
[86] *In re* Rooster, Inc., 100 B.R. 228, 233 (Bankr. E.D. Pa. 1999) (concluding that exclusive sublicensing agreement to use trade name and trademark was not "personal services contract" that could not be assumed or assigned under § 365(c)); *compare In re* Planet Hollywood Int'l, Inc., 2000 WL 36118317 (D. Del. Nov. 21, 2000) (distinguishing *Rooster* and denying assumption by finding that debtor had greater creative control over uses of athletes' memorabilia and likenesses, even though it did not have exclusive control).
[87] 526 B.R. 116 (Bankr. D. Del. 2015).
[88] *Id*. at 122.
[89] *Id.* at 125.
[90] *Id.* at 127.

licensee's products and their quality, the Court concluded that consent was determinative in evaluating assignability of a trademark under §365.[91]

The same Court later reached a similar conclusion in *In re Rupari Holding Corp.*, regarding a license agreement allowing debtors to use the trademarked name "Tony Roma" for a line of frozen meats.[92] Again, the Court held that the trademark was not assignable under federal trademark law absent the licensor's express consent.

However, debtors challenged this holding by claiming that the licensors had withheld their consent unreasonably, thereby violating the license. Licensor responded by pointing out that the applicable provision in the license agreement allowed debtor to request licensor's consent only "if the assignment is (i) by operation of law, or (ii) pursuant to a sale of all or substantially all of Debtors' assets."[93] Unfortunately for the debtor, it closed on the sale of all of its assets after the buyer removed (following vigorous resistance by licensor to transfer of the license to buyer as part of the sale) assignment of the license as a closing condition and reduced the purchase price by $2 million, pending resolution of the trademark assignment in a separate proceeding. The Court agreed that closing the sale without assignment of the license meant that clause (ii), above, couldn't apply and mooted the issue of the licensor's reasonable consent.[94] While the Court admitted that the debtors may have separate claims in state court against licensor based on the latter's efforts to frustrate a sale that included the license agreement, it refused to rewrite the license agreement. As in *Trump Entertainment*, the rule in Delaware Bankruptcy Courts is that a licensor's withholding of consent to assignment will control for trademark assignability unless the license agreement expressly allows assignment without such consent.

d. Trade Secrets. Trade secrets are a function of state law, and there is no underlying federal common law as to whether licenses of trade secrets are or are not assignable. Accordingly, "applicable law" should be state, not federal, contract law on assignability. State law appears to be fact sensitive and depends on the relationship of the parties. There appears to be no presumption as to assignability or non-assignability, and the courts look to whether there is a special relationship of trust and an analysis of the specific terms of the license.[95] It is advisable that, in addition to non-assignability provisions, licenses of trade secrets (including any designs, concepts or inventions for which patents have not been applied) should include language indicating that the license is personal to the parties and is founded on a special relationship of trust. This includes nondisclosure and confidentiality agreements.

2. **The Three Tests for Assumption of a License.** As described above, where parties to an intellectual property license agree that the license is non-transferable, that restriction on assignment under non-bankruptcy contract and intellectual property law will often be enforced in bankruptcy, under Section 365(c). However, as indicated above, in addition to restricting *assignment*, that subsection further restricts a T/DIP – licensee's ability to obtain value for the estate through the mere *assumption* of a non-transferable intellectual property

[91] *Id.*
[92] 573 B.R. 111 (Bankr. D. Del. 2017).
[93] *Id.* at 118-19.
[94] *Id.* at 118.
[95] *See In re* Sentry Data, Inc., 87 B.R. 943 (Bankr. N.D. Ill. 1988); Bronx-Westchester Mack Corp., 20 B.R. at 139.

license, through Congress's use of the word "or" in Section 365(c): "the trustee may not assume or assign any executory contract . . ." Thus, under one reading of the plain statutory language, if the T/DIP cannot assign a non-transferable license, it cannot assume it either, without the licensee's consent. This statutory language potentially stifles debtors' efforts to reorganize their businesses around valuable intellectual property licenses, and gives massive leverage to licensors, enabling them to extract additional payments or other concessions from T/DIP's as a condition of the licensor's consent to assumption. Whether such harsh restrictions will govern the mere assumption of intellectual property licenses depends on whether a court adopts one of the three tests that courts have adopted to determine whether licenses may be assumed under Section 365(c): the "hypothetical" test; the "actual" test; or the "*Footstar*" test.

a. The "Hypothetical Test". The majority of federal circuit courts that have addressed the issue have denied a T/DIP's ability to assume a non-transferable intellectual property license by applying the "hypothetical test": under the plain language of Section 365(c), a debtor-in-possession, which is equated to a trustee under Section1107(a), may not assume an executory contract over the non-debtor's objection if applicable law would bar assignment to any *hypothetical* third party, even where a debtor-in-possession has no intention of assigning the contract in question to any such third party.[96] Courts that have applied this test have barred the assumption of non-transferable intellectual property licenses, because federal intellectual property law usually makes such licenses assignable only with the consent of the licensor and, under the text of Section 365(c), if the license cannot not be assigned, then it cannot be assumed. One federal court reasoned that to decide otherwise would rewrite Section 365(c) to prohibit "assumption *and* assignment, rather than assumption *or* assignment."[97] In sum, the "hypothetical test" applies rigidly the plain language of Section 365(c) and equates a trustee to a debtor-in-possession, to yield the result that where a contract is not assignable under applicable nonbankruptcy law, neither is it assumable by a debtor-in-possession.

b. The "Actual Test". To avoid the harsh result of a literal application of Section 365(c), two federal circuit courts and the majority of lower bankruptcy courts have developed what has been known as the "actual test" for assumption: Section 365(c) bars assumption of a non-transferable license only where the proposed action will result in a non-debtor actually having to accept performance from a third party other than the party with whom the non-debtor contracted.[98]

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[96] Catapult Entm't, 165 F.3d at 750. Accord Sunterra, 361 F.3d at 264; City of Jamestown v. James Cable Partners, L.P. (*In re* James Cable Partners), 27 F.3d 534, 537 (11th Cir. 1994); *In re* West Electronics, Inc., 852 F.2d 79, 83 (3d Cir. 1988).

[97] Catapult Entm't, 165 F.3d at 751 (emphasis in original).

[98] *See id*. The "actual test" has been applied to permit assumption of non-transferable contracts, in *In re* Mirant Corp., 440 F.3d 238, 251 (5th Cir. 2006); Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir. 1997); Summit Invest. & Dev. Corp. v. Leroux, 69 F.3d 608, 612 (1st Cir. 1995); Texaco, Inc. v. Louisiana Land & Exploration. Co., 136 B.R. 658, 668-71 (M.D. La. 1992); *In re* GP Express Airlines, 200 B.R. 222, 231-33 (Bankr. D. Neb. 1996); *In re* Hartec Enters., Inc., 117 B.R. 865, 871-73 (Bankr. W.D. Tex. 1990), *vacated on other grounds*, 130 B.R. 929 (W.D. Tex. 1991); *In re* Aerobox Composite Structures, 373 B.R. 135, (Bankr. D.N.M. 2007); *In re* Footstar, Inc, 323 B.R. 566 (Bankr. S.D.N.Y. 2005). The "actual test" has also been applied to permit assumption of contracts outside the intellectual property sphere that have restrictions on their transferability, in *In re* Adelphia Comm. Corp., 359 B.R. 65 (Bankr. S.D.N.Y. 2007) (holding that where the ability to assign a franchise agreement is restricted by applicable law, sufficient to bring it within the ambit of 1 1 U.S.C. § 365(c)(l), that

The theory behind the "actual" test is that Congress could not have intended to bar debtors-in-possession from assuming their own contracts where no assignment is contemplated; thus, to avoid a supposedly absurd interpretation of Section 365(c), as long as a license is not *actually* being assigned to a third party, the court will permit a T/DIP to assume a non-transferable license.[99] Moreover, allowing the T/DIP to assume an advantageous contract under the "actual test" aligns with the fundamental goal in bankruptcy of maximizing the value of the debtor's estate.[100]

Despite the seeming reasonableness of the "actual test," the case in which that test received its most famous application resulted in what might arguably be an unjust result to the licensor and precisely the outcome that the licensor intended to prevent when it bargained for non-transferability of its license. In *Institut Pasteur v. Cambridge Biotech Corp.*,[101] Cambridge Biotech ("CBC") was the debtor-in-possession and licensee, while Pasteur was the licensor that sought to enforce a non-transferability provision of its patent license. CBC's reorganization plan provided for its assumption of all licenses, the continuation of its business and the transfer of all of its stock to another company that was Pasteur's primary competitor in precisely the segment of business covered by Pasteur's patent licenses to CBC. The court held that, because the license was being assumed by CBC, the same "actual" entity with whom Pasteur had initially contracted (notwithstanding the transfer of ownership of CBC to Pasteur's direct competitor), the license was not being assigned and Pasteur was not "actually" being "forced to accept performance under the executory contract from someone other than the debtor party with whom it originally contracted."[102] Ultimately, Pasteur wound up licensing its intellectual property for the benefit of its primary competitor, by virtue of the First Circuit's application of the "actual test" for assumption.[103]

c. <u>The "Footstar Test"</u>. The *Footstar* court attempted to reconcile the practical (and arguably result-oriented) perspective of the "actual test" with the plain meaning approach of the "hypothetical test."[104] That court placed primary emphasis on the fact that Section 365(c) plainly says "the *trustee* may not assume or assign any executory contract . . . ." and since a trustee is distinct from a debtor-in-possession[105] and the text of the section does not restrict the debtor-in-possession, the fact that a contract is not assignable does not mean that it is

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restriction does not also apply to the debtor-in-possession's ability to assume that contract).

[99] *See* Catapult Entm't, 165 F.3d at 751.

[100] *See In re* Edison Mission Energy, 2013 WL 5220139, at *10 (Bankr. N.D. Ill. Sept. 16, 2013).

[101] Institut Pasteur, 104 F.3d at 489.

[102] *Id*. at 493.

[103] In *dicta*, the Court suggested that the harm Institut Pasteur suffered as a result of the Court's decision might have been avoided had the parties included in their license agreement a provision for termination upon a change in control of the licensee through a stock sale. *See id.* at 493, 494 n.11; *see also* White v. Hitachi, Ltd., 2007 WL 2725888, at *6-7 (E.D. Tenn. Sept. 17, 2007) (gathering cases reaching the same result as *Institut Pasteur* and finding that a change in stock ownership does not constitute an assignment to a new entity absent a change-in-control clause in the license). However, no court yet has reached the issue of the effectiveness of a license's change-in-control provision to bar assumption, under the "actual test," of a license in bankruptcy by a debtor that is under new control.

[104] *In re* Footstar, Inc., 323 B.R. 566, 570 (Bankr. S.D.N.Y. 2005); *Accord In re* Aerobox Composite Structures, LLC, 373 B.R. 135, 142 (Bankr. D.N.M. 2007).

[105] *See* Bankruptcy Code § 1104(a) (providing for the appointment of a Chapter 11 trustee).

not assumable by the debtor-in-possession.[106] The *Footstar* court emphasized its point as follows:

> The statute does not say that the debtor or debtor in possession may not assume or assign -- the prohibition applies on its face to the "trustee." In this case there is no trustee. Here, it is the debtors who seek to assume the Agreements. Nothing in the Bankruptcy Code prohibits the debtors from assuming the Agreements. To construe "trustee" in Section 365(c)(l) to mean "debtors" or "debtors in possession" would defy the "plain meaning" of the statute as written by Congress and could be characterized as . . . judicial legislation . . . .[107]

The primary obstacle to the *Footstar* court's test is found in Section 1107(a), which pertains to the rights, powers, and duties of a debtor-in-possession and states:

> Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights...and powers, and shall perform all the functions and duties...of a trustee serving in a case under this chapter.[108]

Section 1107(a) is normally invoked to equate a debtor-in-possession with a trustee, including by the Second Circuit, which has emphasized that Section 1107(a) "places a debtor in possession in the shoes of a trustee in every way."[109] The *Footstar* court surmounted the seeming obstacle of Section 1107(a) by noting that the linkage between a trustee and debtor-in-possession in that section is "subject to any limitations on a trustee," and invoking Section 365(c)(1) as precisely one of those limitations.[110] The court then undermined the persuasive power of its rationale by mislabeling as an "oxymoron" a construction of the statute as saying that "the debtor in possession may not assume . . . any contract if . . . applicable law excuses [the counterparty] . . . from accepting performance from or rendering performance to an entity *other than the debtor in possession* . . . ."[111] Not only is the Court's proposed interpretation *not* an oxymoron, but it is a reasonable allocation of the risks of bankruptcy that Congress could have intended. In light of the potentially dramatic effects of bankruptcy upon a company's business, and the metamorphosis that a company may experience once in bankruptcy (e.g., changes in ownership and corporate structure; redirection of business strategies; and loss, gain, or restructuring of corporate affiliates, divisions, or business segments), Congress certainly could have concluded that, because a debtor- in-possession presented a greater credit risk than the prepetition debtor, and was more likely to turn into a different type of entity from the prepetition debtor, the trustee

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[106] *Id*. at 570-71 (emphasis added).
[107] *Id*. (emphasis in original).
[108] 11 U.S.C. § 1107(a).
[109] *In re* Century Brass Products, Inc., 22 F.3d 37, 40 (2d Cir. 1994) (emphasis in original) (quoting S. Rep. No. 989, 95th Cong., 2d Sess. 116 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5902).
[110] *Footstar*, 323 B.R. at 572-73.
[111] *Id*. at 573 (emphasis in original).

or debtor- in-possession could not assume or assign an otherwise unassignable contract.[112] This would leave the parties to negotiate the terms of any such assumption or assignment on a consensual basis, under the new facts as they presented themselves.

The *Footstar* court then rebounded from a possible lapse in reasoning to make what might be its most persuasive point, based on legislative history. The court noted that, as originally passed in 1978, Section (c)(1)(A) had, in place of the current phrase "an entity other than the debtor or the debtor in possession," the phrase "to the trustee or an assignee of such contract or lease."[113] A 1980 bill to amend the Bankruptcy Code contained a proposed amendment to Section 365(c)(l)(A) that would have changed the statute to its current form. Although that amendment was not enacted in 1980 (though it was in 1984), the House Judiciary Committee report on the proposed amendment stated:

> This amendment makes it clear that the prohibition against a trustee's power to assume an executory contract does not apply where it is the debtor that is in possession and the performance to be given or received under a personal service contract will be the same as if no petition had been filed because of the personal nature of the contract.[114]

This legislative history supports the *Footstar* court's reasoning that, because Congress listed in Section 365(c)(l)(A) all three potential entities that might be in control of bankruptcy estate property -- namely, the "trustee," "debtor in possession" and "debtor" -- Congress intended to invest the three terms with "quite different meanings."[115] The thrust of *Footstar's* reasoning is that, when Congress meant to distinguish between a trustee and debtor-in-possession -- with Section 365(c)(l)(A) being a prime example -- it knew how to do so; thus, the restriction in that Section that is applicable to the "trustee" should be limited to the "trustee."

Footstar ultimately puts the sharpest and most persuasive point on the actual test and focuses most clearly the distinction between the actual and hypothetical tests. There is no doubt that, as a matter of course in bankruptcy law, and as emphasized by the Second Circuit in *Century Brass*,[116] under the Bankruptcy Code a debtor-in-possession is typically equated to a trustee under Section 1107(a), so the *Footstar* court's attempt to draw a distinction between the two is somewhat strained. The decision for any court dealing with the issue of assumption of a nontransferable intellectual property license comes down to which part of the Congressional language it wants to ignore to reach a result that it feels comfortable with: (i) the "subject to any limitations on a trustee" language of Section 1107(a) (the hypothetical test); (ii) the "or" versus "and" language of Section 365(c)(1)(A) (the actual test); or (iii) the general congruence between

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[112] Indeed, exactly this type of risk of corporate metamorphosis of a debtor occurred, in Institut Pasteur, 104 F.3d at 489.

[113] *Id*. at 574.

[114] *Id*., (quoting H.R. Rep. No. 1195, 96th Cong., 2d Sess., § 27(b) (1980)). *See also* Summit Invest., 69 F.3d at 613 (relying on above-quoted legislative history to support the actual test). *But see* Sunterra, 361 F.3d at 270 (rejecting persuasive force of above-quoted legislative history because it (a) suggests an interpretation contrary to the statute's plain meaning, (b) relates to a 1980 proposal that was never enacted (despite the enactment of the identical 1980 proposal in 1984), and (c) reflects the view of only a single House committee).

[115] Footstar, 323 B.R. at 571.

[116] 22 F.3d at 39-40.

a debtor-in-possession and a trustee under Section 1107(a) (the *Footstar* test). Given Congress' naming of all three potential estate-controlling entities in Section 365(c)(l)(A) and the 1980 legislative history, it would appear that Congress did intend -- though inartfully -- to distinguish between the trustee and debtor-in-possession in that Section and that the *Footstar* court has the better side of the argument.

Despite its advantages, however, *Footstar* has failed to make a substantial mark in the debate, outside the Southern District of New York. Courts that have addressed *Footstar* as an alternative to the hypothetical and actual tests in other circuits have stuck with their precedents and declined to follow *Footstar*.[117] Others have downplayed the significance of *Footstar* as a genuine alternative to the hypothetical or actual tests, treating it instead as a subtype of the actual test.[118] The end result is that, for the pragmatic advantages *Footstar* offers in attempting to reconcile the inconsistencies in Section 365(c), the debate continues unabated.[119]

IV. CONCLUSION

As the foregoing demonstrates, there is little certainty with respect to security interests in intellectual property or how licenses of intellectual property are dealt with in bankruptcy. The statutes are not specific, and the case law is inconsistent and, at best, confusing. In addition, most of the decisions are at the bankruptcy court or district court level, with a few inconsistent federal circuit court decisions -- and there are no governing U.S. Supreme Court decisions. This does not give much comfort and creates uncertainty rather than consistency and predictability. The result is that with respect to perfecting security interests, it is generally advisable to file twice: once under the UCC, and once in the applicable federal office. With respect to the assumability or assignability of intellectual property licenses in bankruptcy, the uncertainty will typically not be resolved until hearings are held and a court issues its decision, depending on which circuit the court is in and the line of reasoning that a particular court finds persuasive.

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[117] *See In re* Taylor Investment Partners II, LLC, 533 B.R. 837, 841 (Bankr. N.D. Ga. 2015). In that case, the court examined *Footstar*'s results and noted its pragmatism "certainly has appeal." However, the court concluded it was bound to the hypothetical test by the precedent of *In re* James Cable Partners. *Id.*

[118] *See In re* Jacobsen, 465 B.R. 102, 106 (Bankr. N.D. Miss. 2011) (favoring the actual test); *In re* Kazi Foods of Mich., Inc., 473 B.R. 887, 889-90 (Bankr. E.D. Mich. 2011) (favoring the hypothetical test).

[119] In 2009, the U.S. Supreme Court denied certiorari on a case raising the conflict between the hypothetical and actual test, with Justice Kennedy noting the importance of resolving the division but concluding that the case in question raised antecedent questions, which might interfere with that resolution. N.C.P. Mktg. Gp., Inc. v. BG Star Prod., Inc., 556 U.S. 1145 (2009). It stands to reason that the Supreme Court may accept an invitation to address this dispute in the future should a better test case arise.

Historical Overview and Current Status of Judicial Interpretation of 11 U.S.C. § 365 (n)

I. Relevant Statutory Provisions

A. **11 U.S.C. § 365** provides in relevant part:

(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to court's approval, may assume or reject any executory contract or unexpired lease of the debtor.

***

(g) Except as provided in subsections (h) (2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease—

(1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition [.]

***

(n) (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 entitled 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.

***

B. **11 U.S.C. § 101 (35A)** provides:

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

to the extent protected by applicable nonbankruptcy law.

II. Basic Statutory Construction.

A. Section 365 (a) of the Bankruptcy Code allows trustees or debtors, with court approval, to "assume or reject any executory contract or unexpired lease" thereby allowing the debtor/lessor to assess if the contract is a net benefit or net detriment to the bankruptcy estate. 11 U.S.C. § 365 (a).

B. If the debtor/lessor assumes the contract, the obligations under the contract are treated as administrative expenses of the estate. 11 U.S.C. § 503(b)(1).

C. If the debtor/lessor rejects the contract, the rejection constitutes a breach of the contract…immediately before the petition date. 11 U.S.C. § 365(g)(1).

D. The creditor/lessee has a prepetition unsecured claim for the damages resulting from the breach. 11 U.S.C. § 502(g)(1).

III. Historical Judicial Interpretation of Section 365.

A. *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.,* 756 F.2d 1043 (4th Cir. 1985)("Lubrizol").

1. In *Lubrizol*, the Fourth Circuit applied the rejection provisions of Section 365 to an intellectual property license agreement. The Fourth Circuit held that rejection of an intellectual property license agreement relieved the debtor from future performance and stripped the licensee of its right to continue using the licensed intellectual property, thereby allowing the debtor to remarket and sell or lease the license to a third party. 756 F. 2d at 1047-1048. The *Lubrizol* court defined "rejection" as a rescission or termination of the contract. Consequently, the Court found that rejection of a contract cuts off the rights of both parties under the contract and leaves the licensee with nothing but a prepetition claim for money damages with no claim for specific performance for those contractual rights available under non-bankruptcy law.

2. In response to *Lubrizol*, Congress quickly enacted Section 365 (n) and Section 101 (35A) to protect the rights of intellectual property licensees. In Section 365 (n) Congress provided that when a debtor/licensor rejects a contract involving intellectual property, the licensee may elect to either treat the contract as terminated or to retain its rights under the contract. 11 U.S.C. §365(n)(1)(B). The types of intellectual property contracts that were addressed by Section 365(n)(1)(B) where defined in Section 101 (35A). Trademarks were not included in the definition of "intellectual property" in Section 101 (35A).

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

1. In *Sunbeam*, the Seventh Circuit expressly rejected the reasoning adopted by *Lubrizol* and held that a trademark license survives the rejection by the debtor/licensor of a license agreement. In reaching its decision, the Seventh Circuit reasoned that since §365(g) defines rejection as a breach of the contract, licensees are entitled to a claim for damages from the debtor's nonperformance and are entitled to retain any contractual rights not requiring affirmative performance by the debtor to the extent allowed by nonbankruptcy law. *Id.* at 377. In *Sunbeam*, Judge Easterbrook reasoned that since § 365 (g) provides that "the rejection of an executory contract…constitutes a breach of such contract" the contract was not terminated by the rejection and the licensee retained the rights it had under nonbankruptcy law. *Id*. Under nonbankruptcy law, a breach of the license by the licensor does not terminate the licensee's rights to the license; therefore, the licensee could continue to use the trademark as allowed by the contract's terms and nonbankruptcy law. *Id.* In addition to the forgoing, rejection of the contract also allows the licensee to assert a prepetition claim for damages caused by the debtor's non-performance of the contract. After *Sunbeam* was decided, the majority of legal opinion and cases agreed with its interpretation of § 365.

C. *Tenth Circuit Opinions*

1. The Tenth Circuit has not specifically addressed a rejection of a trademark license agreement. However, the Tenth Circuit has held that a rejection of an executory contract constitutes a "breach" of a contract. *See, In re Western Real Estate*

Fund, Inc., 922 F.2d 592 (10th Cir. 1990), and *Intern. Broth. Of Teamsters v. IML Freight, Inc.,* 789 F.2d 1460 (10th Cir. 1986).

2. Judge Tallman, in the case of *The Banning Lewis Ranch Company LLC v. City of Colorado Springs, Colorado, In re The Banning Lewis Ranch*, 532 B.R. 335 (Bankr.D.Colo 2015) cited *Sunbeam* for the proposition that "rejection of a contract does not work a rescission of the contract and is not, itself, an avoiding power" and that when a Debtor rejects under §365 to "free itself from any obligation…the Agreements themselves remain valid and enforceable." This opinion adopts the *Sunbeam* holding that rejection constitutes a breach and not a termination of the contract. This is persuasive authority for bankruptcy courts in the Tenth Circuit to hold that rejection allows licensee's to maintain their nonbankruptcy rights.

D. *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)* 879 F.3d 389 (1st Cir. 2018) ("Mission Product").

1. In January 2018, the First Circuit rejected *Sunbeam,* and sided with the Fourth Circuit in *Lubrizol* when it held that rejection of a trademark contract confines trademark licensees to a prepetition damage claim. *Id.* at 402. The First Circuit reasoned that since trademarks where not defined as "intellectual property" by § 101 (35A), rejection of a contract terminated all rights granted under the contract to both the debtor/licensor and the licensee. *Id.* at 401. In its analysis of *Sunbeam,* the First Circuit criticized *Sunbeam* because it effectively forces a debtor to "choose between performing executory obligations arising from continuance of the license or risking the permanent loss of its trademarks." *Id.* at 403. The First Circuit stated that the "plain meaning" of the

Bankruptcy Code precluded the Court from altering the defined terms set forth in § 101 (35A). Therefore, since trademarks are not included as intellectual property in §101 (35A), the rejection provisions of §365 (n) do not apply to the rejection of trademark license agreements. *Id.*

2. Mission Product Holdings, Inc. appealed the First Circuit's decision to the U.S. Supreme Court. The Supreme Court granted certiorari on October 26, 2018. The Court only granted certiorari to decide the following question:

> Whether, under §363 of the Bankruptcy Code, a debtor-licensor's "rejection" of a license agreement—which "constitutes a breach of such contract," 11 U.S.C. § 365 (g)—terminates rights of the licensee that would survive the licensor's breach under applicable non-bankruptcy law.

IP Valuation, Marketing, and Sale in Distressed Contexts

Real World Case Study

Rocky Mountain Bankruptcy Conference

January 24, 2019

Weston Anson
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CONSOR IP Consulting and Valuation
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EB Products Company Overview

- Headquartered in New York
- Specialized in the design and distribution of niche products for:
  - Personal fitness
  - Hand-held exercise devices
  - Travel accessories
  - Gift markets
  - Industrial specific products (hand, wrist, and head protection)

- None were truly classified as tier one level brands, however many sold in top tier retail stores

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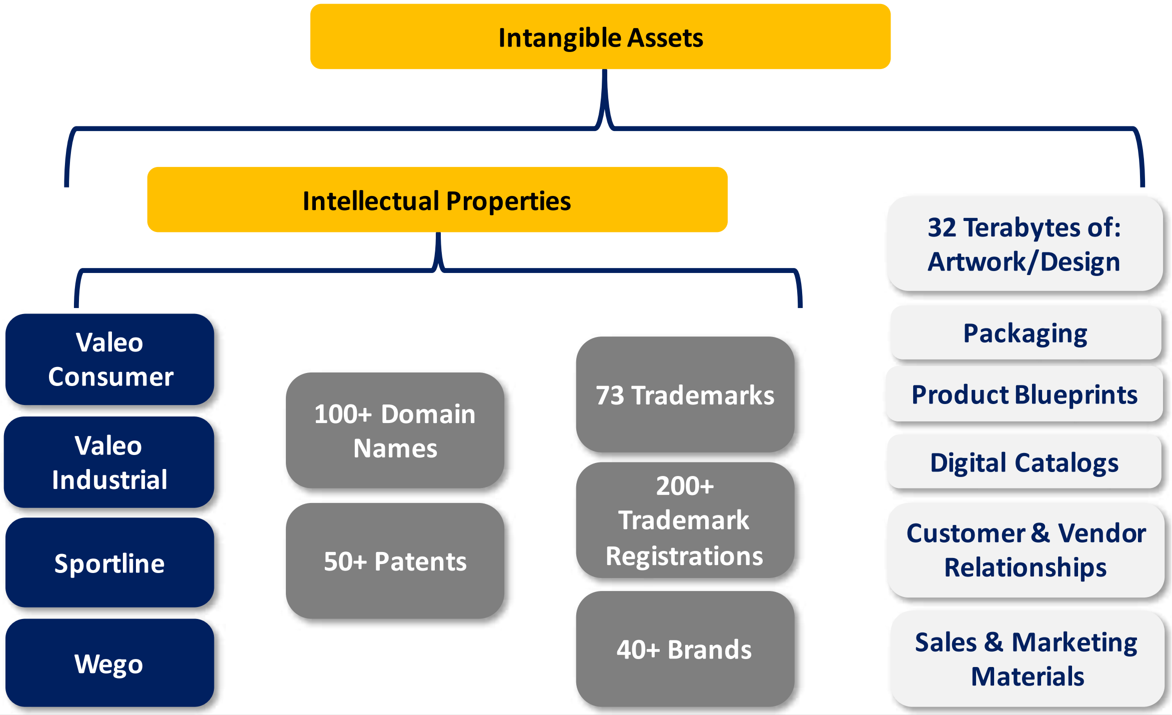
EB Products Company Overview (continued)

- Between 2013 and 2016, EB Products went through a series of financial reversals
- Placed into a NY court receivership in 2017
- Did not have strong relationships with its vendors in China, Asia, or even the U.S.
- Forced to liquidate

EB Product Asset Types



Key Steps of IP Disposal

1. IP Identification
2. IP Bundling
3. IP Prioritizing and Triage
4. Identifying Potential Buyers
5. Communicating and Negotiating
6. Closing and Transferring Assets

Step 1 – IP Identification

- We were instructed to manage the orderly disposal of EB Products IP portfolio comprising of:

XYZ IP Portfolio Summary	
200+	Trademark Registrations
73	Trademarks
40+	Brands
100+	Domain Names
50+	Patents
32	Terabytes of: Artwork/Designs
	Miscellaneous Promotional Materials
	Vendor Lists
	Retailer Lists and Contents

- The court appointed a receiver, forcing the company to sell its assets in a time frame of under 120 days
- Target liquidation value of $500k

Liquidation Value

- Liquidation value is the price an asset would be expected to receive in a distressed or time critical situation
- Most commonly used in bankruptcy situations, but also a required valuation conclusion for asset based lenders (sometimes labeled as "distressed fair market value" for these purposes)
- It is important to note that as time passes in a liquidation scenario, the value of the IP can decrease rapidly

Step 2 – Bundling of IP

- The 40+ brands and other assets were further condensed down to 15 bundles based on:
  - Trademark registration by country
  - Trademark classes
  - Databases
  - Category of products
  - Intangibles added as appropriate for each trademark group
  - Patents were added to the bundles as appropriate

- **Focused on readily monetized IP**
- Also bundled all data on vendors, retailers, etc. as separate saleable asset
- Most time consuming step - - bundles need to highlight value of all assets

Step 3 – IP Prioritizing and Triage

- Assets needed to be prioritized according to:
  - Historical sales
  - International trademark protection
  - Trademark classes
- This process determined the ranking of the potentially most desirable bundles
- Of the 15 bundles, only a few met the criteria to be considered strong candidates for sale

Step 3 – IP Prioritizing and Triage (continued)

Key asset bundles included the following:

Bundle 1 (Valeo split)

- For **consumer use** in exercise and fitness gear and apparel in North America
- For **industrial use** in exercise and fitness gear and apparel in North America

Bundle 2

- For consumer use in exercise and fitness equipment and health monitoring products

Bundle 3

- Warm weather apparel and gear

Bundle 4

- Misc. brands

Step 4 – Identifying Potential Buyers

- Necessary to identify the *right* buyers for each of the bundles
- Relied on CONSOR's proprietary database and EB Products database
- **Key Target Buyers:**
  - Brand owners
  - Retailers
  - Suppliers
  - Manufacturers
  - Overseas manufacturers/vendors
- Different marketing campaigns were tailored for each type of potential buyer (dependent on industry or country)
- Mailings in both Chinese and English

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Step 5 – Communication and Negotiation

Turn-Key Brands Available For Sale

30+ Brands Generating $50M+ Revenue
Tier 1 Retailer Relationships

CONSOR is assisting in the orderly disposal of a portfolio of well-known trademarks owned by **EB Products**...

Nearly turn-key brand packages include some of the following: Retailer / Vendor / Manufacturer Relationships

Product Designs / Packaging Specifications / Web Assets/Trade Dress / Marketing Materials / Planograms

VALEO™

2016 Sales of **$5 Million**
51% Gross Margin
Retailers:
- Amazon
- Big 5
- Dunham Sports

wego

2016 Sales of **$3.2 Million**
50% Gross Margin
Retailers:
- Wal-Mart
- Stanmar International
- Power Sales & Advertising

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Step 5 – Communication and Negotiation (continued)

- As negotiations continued, it became clear that a move to an auction process would be needed
- The combinations of IP for sale were almost endless
- The IP Portfolio and related intangibles ended up selling in five major groups:
  - Valeo industrial products only
  - Valeo consumer products only
  - Sportline consumer products only
  - Wego consumer products only
  - All other trademarks and intangibles

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Step 6 – Closing and Asset Transfer

- Always a tricky process – and not just from a legal point of view – it is also tricky from a marketing/end-use point of view
- Industrial vs. consumer use
- **Due diligence**
  - For the seller: confirming funding ability of each buyer
  - For the buyer: similar financing terms and a myriad of legal obstacles because EB Products was in receivership
- Coached both parties through each step to ensure no one would get cold feet

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Conclusion

- Five buyers were brought to the table, three were selected
- Roughly $2 million was added to the EB Products estate - - far exceeding $500k target
- Sale of entire IP portfolio to the three buyers was completed in the 120-day time frame

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CONSOR's Services

IP Valuation

- Valuing patents, trademarks, copyrights, trade secrets, celebrity rights, and technology
- Helping businesses understand the value of their IP
- Valuation for transactions, tax purposes, litigation, licensing deals, and more

IP Litigation Support

- Assisting attorneys with damage calculation parameters & case strategy
- Proven success as expert witnesses
- Economic damages in litigation
- Federal, state & international experience
- Arbitration, and mediation

Licensing Consulting

- Assisting clients in maximizing the licensing value of their IP assets
- Develop licensing strategies, execute, negotiate license agreements
- Licensing experts in litigation
- Evaluate financial and economic commitments of a potential transaction

IP Transactions

- Maximize the value of assets
- Identify valuable IP
- Market and sale of bankrupt IP assets
- Value and dispose of intellectual property

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SPORTLINE

2016 Sales of **$4.4 Million**

58% Gross Margin

Retailers:

- Wal-Mart
- BIG 5
- Heart Rate Monitor USA

PERFECT SOLUTIONS

2016 Sales of **$4.5 Million**

36% Gross Margin

Retailers:

- CVS
- Kmart
- Wal-Mart

space navigator

thermaGEAR

2016 Sales of **$1.5 Million**

46% Gross Margin

Retailers:

- Marmaxx Group
- Tuesday Morning
- Wal-Mart