

Intellectual Property and Trademarks in Bankruptcy

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Intellectual Property Licensing in the Shadow of Bankruptcy

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Intellectual property (patent, trademark and copyright) licenses are essential assets of many businesses. Licenses are often long term contracts with substantial upfront investment. This article considers insolvency risks related to intellectual property licenses, from the point of view of the licensor as well as the licensee, with a focus on contract drafting and transactional solutions to manage risk. Topics include the limitations of protection for licensees under Bankruptcy Code §365(n), structural and drafting techniques to protect trademark licensees, and methods for licensors to maintain control of licenses in the event of a licensee's bankruptcy.

1. Overview of Executory Contracts in Bankruptcy

1.1. Defining an Executory Contract. The term “executory contract” is not defined in the Bankruptcy Code, although the Senate Report on Bankruptcy Code §365 states that the definition “generally includes contracts on which performance remains due to some extent on both sides.” *See* Senate Report 95-989. Many courts cite the Countryman definition, that an executory contract is a contract where the obligations of both parties “are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other.” *See, e.g. In re Sunterra Corp.*, 361 F.3d 257, 264 (4th Cir. 2004); *Benvioles v.*

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Alexander (In re Alexander), 670 F. 2d 885, 887 (9th Cir. 1982). Intellectual property licenses, even pre-paid licenses, are generally considered to be executory contracts. *See Everex Sys. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 877-78 (9th Cir. 1996) (pre-paid non-exclusive patent license is an executory contract because licensor must refrain from suing for infringement and licensee must mark products with statutory patent notice); *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1045-46 (4th Cir. 1985), *cert. denied sub nom. Lubrizol Enters. Inc. v. Camfield*, 475 U.S. 1057 (1986) (technology license requiring delivery of sales reports and account records to licensor is an executory contract); *Institut Pasteur et al. v. Cambridge Biotech Corp. (In re Cambridge Biotech Corp.)*, 104 F. 3d 489, 490 n.2 (1st Cir.), *cert. denied*, 521 U.S. 1120 (1997); *In re Valley Media, Inc.*, 279 B.R. 105, 135 (Bankr. D. Del. 2002) (“The Third Circuit follows the general rule that intellectual property licenses, including copyright licenses, are executory contracts within the meaning of 11 U.S.C. § 365(c) under the Countryman test.”); *In re Access Beyond Tech.*, 237 B.R. 32, 43-44 (Bankr. D. Del. 1999) (collecting cases). *But see In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010) (holding that a perpetual, exclusive, royalty-free trademark license is not an executory contract); *In re Interstate Bakeries Corp.*, 751 F.3d 955 (8th Cir. 2014) (*en banc*) (same). A contract that has expired or been terminated prior to bankruptcy is not an executory contract. *See, e.g., Guaranty Nat’l Ins. Co. v. Greater Kansas City Transp., Inc.*, 90 B.R. 461, 463 (D. Kansas 1988) (insurance contracts expiring pre-petition not executory contracts); *In re Office Prods. of Am., Inc.*, 136 B.R. 675, 685 (Bankr. W. D. Tex. 1992) (finding that agreement between investment banking firm

and debtor was not executory contract, where contract expired prepetition by its own terms).

1.2. Rejection of Executory Contracts. The Bankruptcy Code contemplates that a debtor, with Bankruptcy Court approval, will either assume or reject an executory contract during the course of the case. *See* Bankruptcy Code §365(a). Rejection of an executory contract is deemed to be a breach of the contract immediately before the date of the filing of the petition in bankruptcy. *See* Bankruptcy Code §365(g)(1). In other words, in the event of a contract rejection, the non-debtor party to the contract is entitled to a pre-petition damage claim for breach of the contract but generally is not entitled either to a first priority administrative expense claim or to specific performance² of the contract.

1.3. Assumption of Executory Contracts. With certain significant exceptions, a debtor can assume an executory contract if the debtor can cure defaults under the contract (other than defaults related to the bankruptcy filing itself, the insolvency or financial condition of the debtor or the appointment of a trustee, all of which need not be cured), and provide adequate assurance of future performance of the contract. *See* Bankruptcy Code §365(b). Assumption of a contract constitutes the debtor's agreement to perform the contract and entitles the non-debtor party to a first priority administrative claim in the event of a later default under the contract.

² The Bankruptcy Code vitiates most state law remedies of specific performance because a plan of reorganization is binding on creditors holding claims, *see* Bankruptcy Code § 1141(a), and, under Bankruptcy Code § 363(f) a sale of property may be free and clear of claims. The definition of "claim" under the Bankruptcy Code includes a right to an

- 1.4. Assumption and Assignment of Executory Contracts. With certain significant exceptions, a debtor may assume and assign an executory contract to a third party. *See* Bankruptcy Code §365(f). Assignment is generally authorized even if the contract itself restricts or conditions assignment. *Id.* Assumption and assignment, as with assumption alone, requires that existing monetary defaults must be cured and that adequate assurance of future performance, in this case based on the financial ability of the assignee, be demonstrated.
- 1.5. Cure of Non-Monetary Defaults. In the past, courts were divided over the issue of whether non-monetary defaults must be “cured” in connection with assumption or assumption and assignment of an executory contract. Non-monetary defaults, such as covenants related to quality of performance, delivery deadlines, performance milestones and notice provisions may result from historical events that are not subject to cure. Amendments to Bankruptcy Code § 365(b) in 2005 clarified ambiguous statutory language³ and strengthened arguments that executory contracts with material non-monetary defaults may not be assumed or assumed and assigned. *See* Bankruptcy Code § 365(b)(1)(A).
- 1.6. Contracts in “Limbo” Prior to Assumption or Rejection. A non-debtor party to an executory contract can be subjected to a lengthy period of uncertainty until the debtor

equitable remedy for breach of performance if such breach also gives rise to a right of payment. *See* Bankruptcy Code § 101(5).

³ Bankruptcy Code § 365(b) formerly provided that a default that is a breach of a provision relating to “the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform non monetary obligations” need not be cured in connection with assumption of a contract. The 2005 amendments to the Bankruptcy Code added the word “penalty” before the word “provision”, eliminating arguments that this exception to the cure requirement applies expansively to non-penalty related non-monetary defaults.

determines whether to assume or reject the contract. The non-debtor party will generally not be able unilaterally to terminate the contract post-petition without moving for relief from the automatic stay under Bankruptcy Code §362. Violation of the automatic stay can result in substantial damages to the non-debtor party, including punitive as well as actual damages. *See* Bankruptcy Code §362(h); *In re Computer Communications, Inc.*, 824 F.2d 725, 731 (9th Cir. 1987) (upholding award of \$4,750,000 actual damages and \$250,000 punitive damages for violation of automatic stay in terminating contract post-petition). A non-debtor party can, however, seek relief from stay to terminate a contract that is non-assumable. *See In re Trump Entertainment Resorts, Inc.*, 526 B.R. 116 (Bankr. D. Del. 2015) A non-debtor party can also move to compel the debtor to determine within a specified time whether to assume or reject the contract. *See* Bankruptcy Code §365(d)(2). In cases where the non-debtor party is incurring post-petition expense under a contract (such as expense for maintenance and upgrades of a software license) or suffering loss as a result of the debtor's delay in assuming a contract (as, for example, where licensed intellectual property or leased equipment is declining in value), the non-debtor party can seek adequate protection payments as compensation for the delay in the debtor's assumption or rejection of the contract. *See, e.g., In re Reice*, 88 B.R. 676, 685-86 (Bankr. E.D.Pa.1988) (denying motion for relief from stay to terminate equipment leases based upon adequate protection payments equal to decline in value of equipment).

1.7. Bankruptcy Practice Tips for Documentation of Executory Contracts. Generally, in entering into any executory contract where there is insolvency risk, certain bankruptcy considerations should be addressed in the documentation. The following are recommendations that will enhance the rights of the non-debtor, solvent party to a contract.

1.7.1. Consider Every Long Term Contract as an Extension of Credit. Long term contracts, particularly contracts with substantial upfront payments and deferred benefits, involve credit risk. The party making the upfront investment should assess the risk of insolvency and bankruptcy by understanding the financial condition of the party rendering performance.

1.7.2. In More Complex Transactions, Consider Using a Single Contract or, If Separate Contracts Are Used, Incorporating Explicit Cross Default Provisions.

A debtor in bankruptcy generally must assume all obligations under a contract and cannot modify the contract without the consent of the non-debtor party. The existence of separate, stand alone contracts may afford a debtor an opportunity to “cherry pick” among contracts, assuming favorable contracts while rejecting contracts with burdensome obligations. Therefore, it will generally be to the advantage of the more solvent party to use a single, integrated contract or, at least, to provide for cross defaults among related contracts.

- 1.7.3. Consider Using a Short Term Contract With Discretionary Extensions Rather Than a Long Term Contract. Use of a short term contract with renewal options will afford a non-debtor greater control over assumption and assignment in the event of a bankruptcy. Attention should be paid to the mechanics of contract extensions. So-called “evergreen” contracts renew automatically unless affirmative notice of non-renewal is given in advance of the renewal date. However, if a contract counterparty is in bankruptcy, the automatic stay may prevent delivery of notice of non-renewal. If bankruptcy is a significant risk, the more financially stable party to the contract should consider a contract extension mechanism that requires affirmative notice by the solvent party to extend the contract.
- 1.7.4. If the Likely Debtor is a Licensee, Incorporate Clear, Non-Insolvency Related Default Provisions. The Bankruptcy Code renders unenforceable so-called “ipso facto” clauses that terminate or modify a contract based on the insolvency or financial condition of a debtor or the filing of a bankruptcy case. While “ipso facto” clauses can still be included in contracts and may have some utility outside of bankruptcy, it is important to include specific events of default in licenses that are triggered by objective, non-insolvency related events. For example, license defaults based on non-payment, failure to meet sales targets or sales force layoffs or other work force reductions, can afford termination rights that are not “ipso facto” clauses conditioned solely on the financial condition of a debtor.

- 1.7.5. If the Likely Debtor is a Licensee, Consider Shortening Cure Periods and Simplifying Notice Provisions. The automatic stay under Bankruptcy Code §362 will prevent a non-debtor party from terminating an executory contract after a bankruptcy has been filed. Complex termination provisions with long cure periods, arbitration rights or other conditions can make it difficult or impossible to terminate a contract prior to bankruptcy. Obviously, the business needs of the licensor and licensee must be taken into account in negotiating these types of provisions. However, at least for material defaults such as payment defaults, brief cure periods and clear and simple termination rights can eliminate substantial uncertainty by allowing termination of a contract prior to bankruptcy.
- 1.7.6. If the Likely Debtor is a Licensee Paying Royalties, Consider Providing for Default Interest. Bankruptcy can result in significant delays in receiving payment due under software licenses or other contracts. If a contract is eventually assumed, the debtor will be obligated to cure defaults under the terms of the contract. Lack of appropriate default interest provisions can result in an inability to recover more than the principal amount of payments due under the contract, notwithstanding significant delay between the date of the breach and the cure.

2. The Debtor As Licensor: Intellectual Property Licenses and Bankruptcy Code §365(n)

2.1. Bankruptcy Code §365(n). Bankruptcy Code §365(n)⁴ was enacted in 1988 in response to a Fourth Circuit decision *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043 (4th Cir. 1985). In the *Lubrizol* case, the Fourth Circuit Court of Appeals permitted a debtor licensor to reject a non-exclusive patent license for a metal coating process technology. Although the rejection afforded the non-debtor licensee a damage claim in the bankruptcy, the *Lubrizol* court held that the licensee had no enforceable rights of specific performance and must be denied access to the technology for which it had contracted. Bankruptcy Code §365(n) affords intellectual property licensees a choice in the event of a debtor/licensor's rejection of a license: the licensee can (i) treat the license as terminated and assert a damage claim, or (ii) continue to use the licensed technology, waive administrative claims against the debtor for breach of the license and continue to pay any royalties due to the debtor under the terms of the contract without any right of setoff for monetary damages arising from rejection of the license.

2.2. Section 365(n) Not Applicable to Trademark Licenses. The Bankruptcy Code definition of "intellectual property" excludes trademarks. See Bankruptcy Code §101(35A). As the legislative history of §365(n) makes clear, the omission of trademark licenses from statutory protections was intentional. *See* S. Rep. No. 100-505, at 5-6 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3200, 3204 ("[T]he bill does not address the rejection of executory trademark, trade name, or service mark licenses by

debtor-licensors.”). As a result, courts have held that trademark licenses are not entitled to the protections of Bankruptcy Code §365(n) in the event that a trademark license is rejected. *See, e.g., In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009). The bankruptcy risk for a licensee of trademarks is greatest in circumstances where the licensed trademarks have independent market value and where the license is either prepaid or where the royalty payable to the licensor is below market value. In these circumstances, the debtor has a very strong incentive to reject the trademark license and to sell or re-license the trademarks.

In situations where a prepaid license is entered into in connection with a broader transaction involving acquisition of a product line or business unit, two recent Circuit level decisions support arguments that the license should be viewed as an integrated contract with the fully performed asset purchase agreement rather than as an executory contract that is subject to rejection. *See In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010); *In re Interstate Bakeries Corp.*, 751 F.3d 955 (8th Cir. 2014) (*en banc*).

The Seventh Circuit Court of Appeals recently held that the *Lubrizol* case was wrongly decided and that a non-debtor trademark licensee is permitted to continue to use licensed trademarks following rejection of a license. *See Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012); *see also In re Crumbs Bake Shop, Inc.*, 522 B.R.766 (Bankr. D. N. J. 2014).

⁴ The full text of Bankruptcy Code § 365(n) is set forth in Exhibit A hereto.

On April 29, 2015, a bill was filed in the U.S. Senate incorporating amendments to Bankruptcy Code §365(n) proposed by the International Trademark Association (“INTA”). *See* Senate 1137, 114th Cong., 1st Sess. At 43-44 (“Senate Bill 1137”).⁵ Senate Bill 1137, if enacted, will amend the Bankruptcy Code’s definition of “intellectual property” to include “a trademark, service mark, or trade name, as those terms are defined in section 45 of the Act of July 5, 1946 (commonly referred to as the ‘Trademark Act of 1946’ (15 U.S.C. 1127)).” The proposed legislation also provides that a trademark licensee electing to retain use of trademarks, service marks or trade names “shall not be relieved of any of its obligations to maintain the quality of products and services” and that the trustee shall retain the right to oversee and enforce quality control for licensed products and services notwithstanding rejection of a license.

- 2.3. Section 365(n) Provides No Explicit Protection for Licenses of Non-U.S. Patents and Copyrights. The Bankruptcy Code defines “intellectual property” with reference to the U.S. Code; patents are defined as an “invention, process, design or plant protected under title 35” and copyrights are defined as a “work of authorship protected under title 17.” As a result, Section 365(n) provides no explicit protection for intellectual property registered in non-U.S. jurisdictions. U.S. treaties may provide some arguments that foreign intellectual property is entitled to protections under section 365(n).⁶ If a license covering world wide rights is rejected in a U.S. bankruptcy case,

⁵ Excerpts of the sections of Senate Bill 1137 proposing to amend the Bankruptcy Code are attached as Exhibit B.

⁶ For example, section 3(a)(1) of The Berne Convention Implementation Act of 1988 provides that the provisions of the Berne Convention “shall be given effect under title 17.”

rights to continue to use licensed intellectual property registered in foreign jurisdictions may depend upon the degree to which a foreign jurisdiction will afford a licensee continued rights in licensed intellectual property registered in that jurisdiction following a breach of the license by the licensor.

2.4. Section 365(n) is Likely Inapplicable in a Non-U.S. Bankruptcy. If a licensor is organized or has principal operations in a foreign jurisdiction, a bankruptcy proceeding may be filed outside of the United States. In that event, a licensee's right to control use of U.S. intellectual property following the licensor's breach or termination of the license will depend upon the extent to which a licensee's equitable remedies in the applicable jurisdiction survive breach or termination of the license and application of U.S. legal principles of comity. *See Jaffe v. Samsung Electronics Company, Ltd.*, 737 F.3d 14, 32 (4th Cir. 2013) (holding that a bankruptcy court granting discretionary relief under § 1521 to a foreign bankruptcy administrator must ensure sufficient protections of creditors and may condition relief on creditors receiving the protection of § 365(n) of the Bankruptcy Code).

Pending legislation in the U.S. Senate, if enacted, will codify and extend the holding of the Samsung case so that licensees of U.S. patents are protected in a foreign non-main proceeding in the U.S. under chapter 15 of the Bankruptcy Code if a licensor files bankruptcy in a foreign jurisdiction and rejects or repudiates an intellectual property license. See Senate Bill 1137 at 43; § 2.2 above.

- 2.5. Other Limitations on the Scope of Protections Under Section 365(n). Section 365(n) permits a licensee continued use of licensed intellectual property “as such rights existed immediately before the [bankruptcy] case commenced.” As a result, §365(n) provides useful protection for licensees if the license deals with mature, static intellectual property rights. If licensed rights relate to intellectual property that is under development, as may be the case with regard to licenses pursuant to a joint venture or collaboration agreement, the protection is much less complete. Similarly, with regard to licenses that provide for product upgrades such as software licenses, the licensee may experience significant business disruption as a result of a bankruptcy of the licensor and rejection of the license. Finally, under §365(n) ancillary rights, such as rights of reference to clinical data for government approvals, may not be considered “embodiments” of intellectual property and the licensee may not be able to prevent rejection of the contract and termination of such rights.
- 2.6. Split Among U.S. Circuit Courts Concerning the Effect of Rejection on Intellectual Property Licenses: *Lubrizol Enterprises* and *Sunbeam Products*. Twenty-five years after Congress enacted §365(n) in response to the Fourth Circuit’s decision in *Lubrizol Enterprises v. Richmond Metal Finishers (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043 (4th Cir. 1985), the U.S. Court of Appeals for the Seventh Circuit considered the effect of a debtor-licensor’s rejection of a trademark license, holding that the *Lubrizol* case was wrongly decided and that a licensor’s rejection of a trademark license does not divest a licensee of its right to continue to use licensed trademarks. See *Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC*, 686 F.3d 372 (7th

Cir. 2012); *see also In re Exide Technologies*, 607 F.3d 957, 964-69 (3d Cir. 2010) (Ambro, J., concurring) (discussing legislative history of Bankruptcy Code §365(n) and opining that Congress did not necessarily intend rejection to terminate rights in a licensed trademark). The *Lubrizol / Sunbeam* circuit split enhances arguments for vindicating rights of licensees on rejection of intellectual property licenses in bankruptcy but also creates substantial uncertainty as to the effect of rejection on intellectual property licenses, primarily trademark licenses, that are not entitled to protection under §365(n). *See* James M. Wilton and Andrew G. Devore, *Trademark Licensing in the Shadow of Bankruptcy*, 68 Bus. Law. 739 (May 2013). The *Sunbeam Products* case should not affect the protections of §365(n) for licensees in situations where the statute is applicable.

2.7. Bankruptcy Practice Tips for Licensees of Intellectual Property. In licensing intellectual property from a licensor that may be in financial difficulty, a licensee should take certain bankruptcy considerations into account in the course of documenting the license. The following are suggestions for documentation and structural changes that can enhance the rights of non-debtor licensees.

2.7.1 Refer to Section 365(n) in Documentation of the License.⁷ Although Bankruptcy Code §365(n) will be applicable to any executory license of intellectual property, it is good practice to include an express agreement between the parties that the license is entitled to the benefits of Bankruptcy

Code §365(n). The license should also contain a recital or acknowledgment to the effect that the licensed technology is “intellectual property” as defined in 11 U.S.C §101(35A).

2.7.2. Specify Licensee’s Right to “Embodiments” of Intellectual Property.

Bankruptcy Code §365(n) requires the debtor/licensor to provide the licensee with access to any “embodiments” of the licensed intellectual property to the extent required by contract. It is good practice to specify the information that the parties agree are embodiments of intellectual property under Bankruptcy Code §365(n), for example, computer source code, drawings, tooling, designs, cell lines, and other tangible materials. The license should give the licensee unequivocal rights to access embodiments of its licensed technology either prior or after default.

2.7.3. Specifically Refer to Supplementary Agreements. Bankruptcy Code

§ 365(n) affords a licensee rights specified in any agreement “supplementary” to an intellectual property license. It is good practice to identify all supplementary agreements, such as source code escrow agreements, third party marketing or development agreements, etc. and to

⁷ License provisions referencing Bankruptcy Code Section 365(n) vary considerably and should be tailored to the particular situation. An example of provisions from a pharmaceutical collaboration agreement is attached as Exhibit C.

indicate the intent of the parties that the licensee's rights under these agreements are entitled to protection under Bankruptcy Code §365(n).

2.7.4. Licensee's Rights to Sue for Infringement. In the case of exclusive licenses, even if the licensor is obligated or has the right to sue third parties for infringement in the first instance, the license should give the licensee the same right following default.

2.7.5 Clearly Define Payments Constituting "Royalties". If under Bankruptcy Code §365(n) a licensee elects to retain use of intellectual property, it is obligated to continue to make "royalty payments" to the trustee as provided under the license. The license should clearly distinguish royalty payments from other payments (such as payments for software maintenance or upgrades) which the licensee would not be required to make following default under the license.

2.7.6 Draft Prepaid Trademark Licenses to Allow Argument that Contract is Not Executory. As noted above, two Circuit level decisions support arguments that a prepaid trademark license may not be an executory contract in certain situations. *See In re Exide Technologies*, 607 F.3d 957 (3^d Cir. 2010); *In re Interstate Bakeries Corp.*, 751 F.3d 955 (8th Cir. 2014) (*en banc*). Drafting a prepaid trademark license to minimize or eliminate a licensee's obligations or to provide that a licensee's breach does not permit

termination of the license will enhance a licensee's arguments that the license conveys an ownership interest and is not subject to rejection.

2.7.7. Grant Licensee a Security Interest in Licensed Trademarks. As noted above, trademarks are not included within the Bankruptcy Code definition of "intellectual property" and, as a result, trademark licenses are not entitled to protection under Bankruptcy Code §365(n). As an alternative means of protection some commentators have suggested that, exclusive licensees of trademarks consider securing any claims for breach of the trademark license agreement with a security interest in the licensed trademarks. A security interest will allow the licensee potentially to foreclose and obtain title to the licensed trademarks in the event of rejection of the license. A security interest will also create a strong economic disincentive against a debtor's rejection of a trademark license in bankruptcy because the licensee under the rejected license would have a claim secured by proceeds of any subsequent sale or license of the trademarks. The grant of a security interest can create serious business issues for the licensor, particularly in situations where the trademarks are already pledged as collateral to other entities or where the trademarks are licensed for different purposes, in different markets or to more than one licensee.

2.7.8. Consider using a "Bankruptcy Remote" Vehicle as a Holding Company for

Licensed Trademarks. In circumstances in which bankruptcy of a licensor of trademarks is a significant risk and the licensor as a business matter is unable or unwilling to assign its trademarks outright to the licensee, it may be possible to minimize bankruptcy risks through use of a so called “bankruptcy remote” special purpose vehicle as owner and licensor of the trademarks. A bankruptcy remote special purpose vehicle is a corporation, trust or other entity that serves as a holding company for intellectual property with business purposes limited to the ownership and license of the intellectual property. Charter provisions typically provide for voting representation by licensees through independent directors or through issuance of special classes of stock, with the affirmative vote of licensees required to initiate a bankruptcy case.

Transactions involving special purpose vehicles are complex, often difficult to negotiate and cumbersome to document and administer. As a result, this structure is not recommended for all transactions. Nevertheless, in situations where insolvency of the licensor is a significant risk and where the trademark license is prepaid or has significant value in excess of the associated royalty stream payable to the licensor, a bankruptcy remote holding company structure may be an alternative for minimizing insolvency risk.

2.7.9 Evaluate Risks of a Non-U.S. Bankruptcy of Licensor or Potential Loss of

Non-U.S. Intellectual Property. Section 365(n) may be inapplicable in a non-U.S. bankruptcy, at least in situations where a U.S. court grants comity to a foreign insolvency court. If a non-U.S. based licensor is financially unstable, a licensee may want to consider transaction structures that provide protection. Such structures can include a sale and license back of intellectual property, formation of a U.S. based intellectual property holding company, or grant of a security interest in intellectual property.

Section 365(n) provides no explicit protections for non-U.S. intellectual property. If bankruptcy is a significant risk and these rights are important, the licensee may want to consider alternative transaction structures such as formation of a bankruptcy remote holding company or the grant of a security interest to the licensee.

In many cases, alternative transaction structures to enhance a licensee's rights in the event of a licensor's bankruptcy are impractical or difficult to implement. The sale and license back of core intellectual property or the grant of a security interest to a licensee can inhibit a licensor from later obtaining debt or equity financing. In addition, if the licensed intellectual property is "platform" technology that is licensed broadly to multiple licensees, the sale or grant of a security interest may be impractical. Similarly, transaction structures involving bankruptcy remote holding companies are cumbersome and difficult to implement.

As a result, alternative transaction structures should normally be reserved for situations where (i) a licensor's financial circumstances indicate that bankruptcy is a serious risk, (ii) Bankruptcy Code §365(n) provides little or no protection, and (iii) the licensor's incentives to reject or terminate the license are high, for example, where the license is prepaid and maintaining the license has few ongoing benefits for the licensor.

3. The Debtor As Licensee: Assumption of Intellectual Property Licenses Under *Catapult Entertainment* and *Cambridge Biotech*

3.1. Overview: How a drafting glitch in Bankruptcy Code §365(c) can prevent a debtor from assuming its own contracts. As noted above, Bankruptcy Code §365(f) permits a debtor to assign many types of executory contracts notwithstanding contractual or other prohibitions on assignment. This statutory provision, however, expressly does not override restrictions on assignment that are enforceable under Bankruptcy Code §365(c). Bankruptcy Code 365(c) provides that:

- (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.

Traditionally, Bankruptcy Code §365(c) has been applied to render enforceable restrictions on contract assignments under applicable non-bankruptcy law; for example, common law restrictions on assignment of personal services contracts. The

statute, however, if read literally, goes further than restricting assignment by providing that a debtor “may not assume or assign” a contract that is not assignable under applicable non-bankruptcy law (emphasis added). Furthermore, courts have applied the statute in the context of non-exclusive patent licenses, which are non-assignable as a matter of federal common law. As a result, in cases where a debtor is the licensee under patent or other intellectual property licenses that are non-assignable as a matter of law, the debtor may not be able to assume these licenses. In the case of a debtor with a business dependent upon intellectual property licenses, the debtor may not be able to reorganize without the consent of licensors of its intellectual property.

- 3.2. Split Among U.S. Circuit Courts: The “Actual” versus the “Hypothetical” Test for Assumption Under Bankruptcy Code §365(c). U.S. Courts of Appeals have differing interpretations as to whether the language of Bankruptcy Code §365(c) should be read literally to prevent a debtor’s assumption of its own contracts. In *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), the U.S. Court of Appeals for the First Circuit adopted a test that looks at the actual transaction involved in assessing whether Bankruptcy Code §365(c) will prevent assumption of a non-assignable patent license. Under this approach, a court will determine on a case by case basis whether the non-debtor party actually is being “forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.” *Id.* at 493 (*quoting Summit Inv. & Dev. Corp. v. Leroux (In re Leroux)*, 69 F.3d 608, 612 (1st Cir. 1995)). If the non-debtor party is receiving performance from the party with whom it originally contracted, the contract

may be assumed.⁸ The Fifth Circuit Court of Appeals has adopted the First Circuit's approach in the *Cambridge Biotech* case. *See Bonneville Power Admin. v. Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006).

Other U.S. Courts of Appeal have adopted a more literal reading of Bankruptcy Code 365(c), holding that the statute establishes a “hypothetical” test: if an executory contract cannot be assigned to a third party under applicable law, then it cannot be assumed by the debtor, whether or not the transaction at issue contemplates assignment. *See In re Sunterra Corp.*, 361 F.3d at 266-67; *In re Catapult Entertainment, Inc.*, 165 F.3d 747, 750 (9th Cir. 1999); *In re James Cable Partners, L.P.*, 27 F. 3d. 534, 537 (11th Cir. 1994); *See also In re CFLC*, 89 F.3d 673, 679 (9th Cir. 1996).

At least one Justice of the U.S. Supreme Court has noted the circuit split and has indicated that the court is waiting for a "suitable" case before addressing it. *N.C.P. Marketing Group, Inc. v. BG Star Prods., Inc.*, 129 S.Ct. 1577 (2009) (memorandum denying certiorari)

- 3.3. Expansion of Literal Reading of Bankruptcy Code §365(c). The literal rule of *Catapult Entertainment* has been adopted by the U.S. Bankruptcy Court for the District of Delaware. *See In re Access Beyond Tech.*, 237 B.R. 32, 49 (Bankr. D. Del. 1999) (Walrath, J.) Given that the Delaware bankruptcy court has become a forum of

⁸ The issue in *Cambridge Biotech* centered upon the assumption of a patent license in the context of a reorganization plan that contemplated sale of a controlling interest of the debtor to a competitor of the non-debtor patent licensor. The *Cambridge Biotech* court reached its decision, in part, based on the fact that the license at issue failed to provide for termination or other remedies upon change of control. *See id.* at 494.

choice in large Chapter 11 reorganization cases, the negative implications of the literal “hypothetical” test in the Third Circuit cannot be overstated. In addition, the rule of *Catapult Entertainment* has been held to apply to copyright licenses as well as to patent licenses. See *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 243 (Bankr. S.D.N.Y. 1997) (Bernstein, J.); Primoff & Weinberger, *E-Commerce and Dot-Com. Bankruptcies: Assumption and Assignment of Executory Contracts*, 8 AM. BANKR. INSTIT. L. REV. 307 (2000). A number of cases have also held that the rule articulated in *Catapult Entertainment* would preclude assumption of a trademark license.⁹ *In re Trump Entertainment Resorts, Inc.*, 526 B.R. 116 (Bankr. D. Del. 2015); *In re XMH Corp.*, 647 F.3d 690 (7th Cir. 2011); *In re N.C.P. Marketing Group, Inc.*, 337 B.R. 230 235-36 (D. Nev. 2005); see also *In re Travelot Company*, 286 B.R. 447, 455 (S.D. Ga. 2002). In a non-bankruptcy case, the U.S. Court of Appeals for the Ninth Circuit has held that under the Copyright Act a holder of an exclusive copyright license may not assign the license without explicit contract language in the license providing for consent of the licensor to assignment. *Gardner v. Nike, Inc.*, 279 F.3d 774, 781 (9th Cir. 2002). In a bankruptcy context, the *Nike* case provides support for an argument that an exclusive copyright license, even if the license does not prohibit assignment, cannot be assumed by a debtor licensee in bankruptcy absent express consent of the licensor. Finally, certain lower courts have concluded that the *Catapult* doctrine

⁹ Cases involving trademark licenses are potentially distinguishable from the holding of *Catapult Entertainment*, given that enabling clauses of the U.S. Constitution create a Federal common law applicable to patents and copyrights that are not applicable to trademarks. Nevertheless, trademark licenses are, in some sense, quintessential personal services contracts that are non-assignable under state law. As a result, Bankruptcy Code §365(c) likely prevents assumption of trademark licenses because the contracts are non-assignable under applicable non-bankruptcy law, other than Federal common law.

applies to transfers of exclusive patent licenses. *See Proteotech, Inc. v. Unicity Int'l, Inc.*, 542 F. Supp. 1216 (W.D. Wash. 2008); *In re Hernandez*, 285 B.R. 435 (Bankr. D. Ariz. 2002). Under these circumstances, financially troubled licensees of intellectual property may have considerable difficulty reorganizing under Chapter 11 of the Bankruptcy Code without the cooperation of non-debtor licensors of their assets.

3.4. Bankruptcy Practice Tips for Licensees and Licensors of Intellectual Property. In

licensing intellectual property, a licensee can take certain steps to ensure that its license will not be lost in the event of bankruptcy. Similarly, a licensor can take steps to preserve opportunities to terminate intellectual property licenses if its licensee files for bankruptcy.

3.4.1. To Protect a Licensee's Rights in Bankruptcy, Incorporate the Licensor's

Express Consent to Assumption but not Assignment of the License in

Bankruptcy. Bankruptcy Code §365(c) would permit assumption of an

intellectual property license even under the literal, “hypothetical” test if the

licensor has consented to assumption or assignment. *See* Bankruptcy Code

§365(c)(1)(B). As a result, a licensee should be able to protect itself in the

event of a later bankruptcy by drafting language in the assignment clause of a

license expressly authorizing assumption of the contract in a bankruptcy of the

licensee. To assure effectiveness, this language should provide that the licensor

expressly consents to the licensee's assumption of the license pursuant to

Bankruptcy Code §365(c)(1)(B). *See In re Sunterra Corp.*, 361 F.3d at 271

(provisions in a license permitting assignment of the license held insufficient to constitute consent to assumption of the license in bankruptcy because the terms “assumption” and “assignment” describe two conceptually distinct events).¹⁰

3.4.2. To Enhance a Licensors’ Ability to Terminate a License in a Bankruptcy of the Licensee, Specify Non-Monetary Obligations That Afford a Termination Right.

Many intellectual property licenses contain non-monetary performance obligations such as developmental milestones, delivery obligations and the like. In order to preserve and enhance a termination right for breach of non-monetary defaults in the event of a bankruptcy of the licensee, the license should provide for an express termination right in the event of non-monetary defaults and contract language specifying the “time is of the essence” with respect to date specific delivery and performance obligations.

3.4.3. To Prevent Assumption of a License in a Bankruptcy of the Licensee, Licensors Should Eliminate License Provisions That Could Imply Licensors Consent to Assumption or Assignment. Common license provisions providing that a licensee may assign a license “with consent of the licensor, such consent not to be unreasonably withheld or delayed” or “in connection with a sale of all or substantially all of the assets related to the license” will create arguments that

¹⁰ An example of contract language effecting a licensor’s consent to a licensee’s assumption of a license in bankruptcy would be: “Conditioned upon satisfaction of the requirements of §365(b) of Title II, United States Code (the “Bankruptcy Code”), licensor hereby consents to assumption of this license in a case filed by or against Licensee under the Bankruptcy Code.”

the licensor has consented to assumption and assignment of the license in a licensee's bankruptcy. To avoid implied consent, a license should prohibit assumption and assignment or, at least, be silent as to the licensee's right to assume and assign the license.

3.4.4. To Prevent Potential Access to Technology by Competitors, Licensors Should Incorporate Change in Control Provisions in Anti-Assignment Clauses of

Licenses. In the *Cambridge Biotech* case, a bankrupt patent licensee circumvented the anti-assignment clause of a patent license by transferring the license pursuant to a sale of stock of the debtor in a reorganization plan. This result might well have been avoided if the patent licensor had incorporated change-in-control termination rights in the license. Change-in-control provisions, which can impair the marketability of a licensee's securities, may be difficult for a licensee to accept. However, a more palatable provision could limit change in control restrictions to strategic acquisitions by competitors. Alternatively, change in control restrictions could permit changes in control subject to the licensor's consent, not to be unreasonably withheld. These limited provisions may afford protection without unduly limiting a licensee's options for sales to strategic investors.

EXHIBIT A

(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 entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or

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

(i) the duration of such contract; and

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

(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract—

(A) the trustee shall allow the licensee to exercise such rights;

(B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract; and

(C) the licensee shall be deemed to waive—

(i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and

(ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.

(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity.

(4) Unless and until the trustee rejects such contract, on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract or any agreement supplementary to such contract—

(i) perform such contract; or

(ii) provide to the licensee such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment), including any right to obtain such intellectual property (or such embodiment) from another entity.

EXHIBIT B

**SEC. 11. PROTECTION OF INTELLECTUAL PROPERTY LICENSES
IN BANKRUPTCY**

(a) IN GENERAL.- Section 1522 of title 11, United States Code, is amended by adding at the end the following:

“(e) Section 365(n) shall apply to cases under this chapter. If the foreign representative rejects or repudiates a contract under which the debtor is a licensor of intellectual property, the licensee under such contract shall be entitled to make the election and exercise the rights described in section 365(n).”.

(b) TRADEMARKS.-

(1) AMENDMENT.-Section 101(35A) of title 11, United State Code, is amended-

(A) in subparagraph (E), by striking “or”;

(B) in subparagraph (F), by adding “or” at the end; and

(C) by adding after subparagraph (F) the following new subparagraph:

“(G) a trademark, service mark, or trade name, as those terms are defined in section 45 of Act of July 5, 1946 (commonly referred to as the ‘Trademark Act of 1946’ (15 U.S.C. 1127));”.

(2) CONFORMING AMENDMENT.-Section 365(n) (2) of title 11, United States Code, is amended-

(A) in subparagraph (B)-

(i) by striking “royalty payments” and inserting “royalty or other payments”; and

(ii) by striking “and” after the semicolon;

(B) in subparagraph (C), by striking the period at the end of clause (ii) and inserting “; and”; and

(C) by adding at the end the following new subparagraph:

“(D) in the case of a trademark, service mark, or trade name, the licensee shall not be relieved of any of its obligations to maintain the quality of the products and services offered under or in connection with the licensed trademark, service mark or trade name, and the trustee shall retain the right to oversee and enforce quality control for said products and/or services.”.

(c) EFFECTIVE DATE.-The amendments made by this section shall take effect on the date of enactment of this Act and shall apply to any case that is pending on, or for which a petition or complaint is filed on or after, such date of enactment.

EXHIBIT C**8.03 Provisions for Insolvency.**

- (a) All rights and licenses now or hereafter granted by Licensor to Licensee under or pursuant to this Agreement, including, for the avoidance of doubt, the licenses granted to Licensee pursuant to Section ____ and Section ____, are, for all purposes of Section 365(n) of the Bankruptcy Code, licenses of rights to "intellectual property" as defined in the Bankruptcy Code. Upon the occurrence of any Insolvency Event with respect to Licensor, Licensor agrees that Licensee, as Licensee of such rights under this Agreement, shall retain and may fully exercise all of its rights and elections under the Bankruptcy Code. Further, each Party agrees and acknowledges that all payments by Licensee to Licensor hereunder, other than the License and Option Fee pursuant to Section ____, royalty payments pursuant to Section ____ and Section ____, and the sales milestones pursuant to Section ____, do not constitute royalties within the meaning of Section 365(n) of the Bankruptcy Code or relate to licenses of intellectual property hereunder. Licensor shall, during the term of this Agreement, create and maintain current copies or, if not amenable to copying, detailed descriptions or other appropriate embodiments, to the extent feasible, of all such intellectual property. Licensor and Licensee acknowledge and agree that "embodiments" of intellectual property within the meaning of Section 365(n) include, without limitation, **[laboratory notebooks, cell lines, product samples and inventory, research studies and data, regulatory approvals][list other embodiments]**. If (i) a case under the Bankruptcy Code is commenced by or against Licensor, (ii) this Agreement is rejected as provided in the Bankruptcy Code, and (iii) Licensee elects to retain its rights hereunder as provided in Section 365(n) of the Bankruptcy Code, Licensor (in any capacity, including debtor-in-possession) and its successors and assigns (including a trustee) shall:
- (i) provide to Licensee all such intellectual property (including all embodiments thereof) held by Licensor and such successors and assigns, or otherwise available to them, immediately upon Licensee's written request. Whenever Licensor or any of its successors or assigns provides to Licensee any of the intellectual property licensed hereunder (or any embodiment thereof) pursuant to this Section 8.03(b), Licensee shall have the right to perform Licensor's obligations hereunder with respect to such intellectual property, but neither such provision nor such performance by Licensee shall release Licensor from liability resulting from rejection of the license or the failure to perform such obligations; and
- (ii) not interfere with Licensee's rights under this Agreement, or any agreement supplemental hereto, to such intellectual property (including such embodiments), including any right to obtain such intellectual property (or such embodiments) from another entity, to the extent provided in Section 365(n) of the Bankruptcy Code.
- (b) All rights, powers and remedies of Licensee provided herein are in addition to and not in substitution for any and all other rights, powers and remedies now or hereafter existing at law or in equity (including the Bankruptcy Code) in the event of the commencement of a case under the Bankruptcy Code with respect to Licensor. The Parties agree that they intend the following rights

to extend to the maximum extent permitted by law, and to be enforceable under Bankrupt Code Section 365(n):

- (i) the right of access to any intellectual property (including all embodiments thereof) of Licensee or any Third Party with whom Licensor contracts to perform an obligation of Licensor under Agreement, and, in the case of the Third Party, which is necessary for the manufacture, use, import or export of Licensed Products; and
- (ii) the right to contract directly with any Third Party to complete the contracted work.