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INTELLECTUAL PROPERTY LICENSE ISSUES IN BANKRUPTCY

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Most bankruptcy attorneys will confess that they delight in telling the non-bankruptcy attorney for the other side that a bankruptcy case has been filed and that a contractual termination provision or other right governed by state law is suddenly superseded and rendered superfluous by the Bankruptcy Code, 11 U.S.C. § 101 et seq., which is federal law. In other words, my law trumps your law.

When bankruptcy law and the policy considerations underlying it intersect (or collide) with intellectual property law, which is also primarily federal law and is based on its own compelling (and often competing) set of policy considerations, the analysis becomes much more complex. This article explores the attempts by Congress and the courts to resolve the issues that arise when intellectual property license agreements become part of a bankruptcy estate and describes the protections that may be available to, and the pitfalls that should be avoided by, licensors and licensees.

Two Key Definitions

Any discussion of intellectual property license issues in bankruptcy requires an understanding of (1) the Bankruptcy Code's definition of intellectual property and (2) the concept of an "executory contract" under bankruptcy law.

Section 101(35)(A) of the Bankruptcy Code defines intellectual property as: (1) a trade secret; (2) a patent; (3) a patent application; (4) a plant variety; (5) a copyright; or (6) a mask work. Conspicuously absent from the definition are trademarks, trade names, and service marks, which Congress believed were more appropriately addressed on a case by case basis. (We will revisit this exclusion shortly).

An "executory contract," which is a bankruptcy term of art, is a contract under which performance remains due by both parties or, more precisely, the obligations of each party are so underperformed that the failure of one party to complete performance would constitute a material breach excusing performance of the other party. If a license agreement is not an executory contract then the assumption, assignment, rejection, and other provisions in Bankruptcy Code section 365 (discussed below) do not apply. License agreements *are* generally executory contracts because the licensor is agreeing not to sue the licensee, the licensee is paying royalties, and each party has confidentiality and/or other ongoing obligations. In other words, performance remains due by both parties. This is not a foregone conclusion, however, especially if the licensee has pre-paid for the license, and whether a particular license agreement is an executory contract should always be considered.

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Licensee's Rights and Protections if Licensor Files for Bankruptcy

What preemptive measures can a licensee take to protect itself in the event of a licensor's bankruptcy, and what recourse does it have once the bankruptcy case is filed?

Bankruptcy Code section 365(a) allows a debtor, including a licensor, to reject an executory contract. The debtor's ability to reject an executory contract is subject to a business judgment standard that can be satisfied with relative ease. Rejection of the contract is treated as a breach, and the non-debtor's damages from that deemed breach give rise to a general, unsecured claim. A general, unsecured claim that may garner twenty cents on the dollar is of little solace to a licensee whose entire business may hinge on the rejected license agreement. Congress had this in mind when it enacted legislation in 1988 that is now codified in Bankruptcy Code section 365(n).

That section of the Bankruptcy Code provides that where a debtor is the licensor of intellectual property, the licensee has the option of either (1) treating the debtor's rejection of the license agreement as a termination of the agreement or (2) retaining its rights to use the intellectual property for the duration of the agreement and any renewal period. If the licensee chooses to retain its rights, upon its written request, the licensor may not interfere with the licensee's rights under related agreements and must turn over any intellectual property to which the licensee is entitled. In return, the licensee has to continue to make royalty payments, to waive its priority administrative claims in the bankruptcy case, and to waive its set-off rights against future royalty payments.

The practical effect of Bankruptcy Code section 365(n) is that the licensor will be relieved from any affirmative obligations under the license agreement (such as to provide indemnification or maintain the intellectual property), and the licensee will be excused from making payments to the licensor on account thereof. Moreover, since it only retains rights as of the bankruptcy filing date, the licensee is not entitled to any modifications of the intellectual property and cannot force the licensor to update the intellectual property, which can be a problem for software licensees in particular. On the other hand, while the licensee relinquishes its set-off rights, it may retain recoupment rights. Finally, there is an argument, based on the language of the statute, that the licensee has the option of retaining its rights for less than the remaining term of the license agreement if it so desires.

Bankruptcy Code section 365(n) only applies if the debtor is a licensor, and only with respect to intellectual property, which, as we have seen, does not expressly include trademark licenses. Some courts have found, however, that 365(n) applies if the licensed trademark is inextricably linked, for example, to copyrighted material that is the subject of the same license agreement.

Thus, there is already some protection for licensees built into the Bankruptcy Code. There are other measures, however, that a licensee can take, both before and after the licensor files bankruptcy, to further protect itself.

For instance, pre-bankruptcy, the licensee can request that key intellectual property elements (such as source codes) be placed in escrow to facilitate their transfer to the licensee in the event it elects to retain its rights under Bankruptcy Code section 365(n). Ideally, the licensor would not be a party to the escrow agreement, so it could not be rejected in bankruptcy. The licensee can also insist that the license agreement be described as an executory contract, in an effort to ensure that it is subject to Bankruptcy Code section 365 and the protections thereunder. In addition, it can clearly and narrowly defined royalty payments, since those are the payments it would have to make if it were to elect under Bankruptcy Code section 365(n). Finally, if the costs are warranted, it can require the licensor to create a bankruptcy remote vehicle to license the intellectual property.

After the licensor files for bankruptcy protection, the licensee can and generally should exercise its right under Bankruptcy Code section 365(n)(4) to require the licensor to continue to perform under the license agreement, to provide the licensee with the relevant intellectual property, and to refrain from interfering with the licensee's rights pending any rejection of the agreement. The licensee can also move the bankruptcy court to compel the licensor to assume (i.e., accept) or reject the license agreement by a certain date or, in the alternative, to allow the licensee to terminate the agreement. The court's decision on such a motion will depend, in large part, on the extent of the harm being suffered by the licensee, as a result of the deterioration in the value of the intellectual property or otherwise.

Licensor's Rights and Protections if Licensee Files for Bankruptcy

If a licensee files for bankrupt protection, is the licensor's intellectual property suddenly "up for grabs"?

We have seen that the Bankruptcy Code allows a debtor to reject a burdensome executory contract. It also allows a debtor to assume (i.e., accept) an executory contract, including an intellectual property license agreement, if the debtor cures or provides assurance that it will cure all outstanding monetary defaults. Moreover, Bankruptcy Code section 365(f) allows the debtor to assign an agreement to a third party as long as that third party provides

adequate assurance of performance under the agreement, notwithstanding any provision in the agreement or applicable law prohibiting assignment. Thus, as a general matter, the Bankruptcy Code ignores contractual restrictions on assignment and anti-assignment laws.

Bankruptcy Code section 365(c), however, provides that a debtor may not assume or assign an executory contract if (1) applicable law excuses the non-debtor from accepting performance from or rendering performance to the potential assignee and (2) the non-debtor does not consent to the assignment. Courts and scholars have struggled with the relationship between 365(c) and (f), which both refer to "applicable law" and seem, on their face, to be in conflict. Most courts have reconciled those sections of the Bankruptcy Code by interpreting 365(f) as addressing provisions and laws that restrict assignment as a general matter and 365(c) as creating an exception where a law specifically relieves a party from performance-- that is, if it prohibits assignment because the identity of the contracting party is material to the agreement.

Courts have found that copyright, patent, and, in most cases, trademark laws constitute laws where the identity of the licensee is material. Thus, if those laws prohibit assignment they will be honored in a bankruptcy context.

Drawing from relevant statutory law and citing intellectual property case law, bankruptcy courts differentiate between exclusive and non-exclusive licenses of intellectual property. The theory, to which most but not all courts subscribe, is that the licensee of an exclusive license is entitled to all rights of the licensor, including transfer rights, such that the licensee effectively has an ownership interest in the intellectual property, the assignment of which cannot or should not be restricted. Thus, a licensee with an exclusive license agreement will be able to assign that agreement in bankruptcy if it otherwise satisfies the requirements of Bankruptcy Code section 365.

On the other hand, most bankruptcy courts have found that non-exclusive licenses are personal to the licensee, do not give rise to a property interest, and therefore are not assignable over the licensor's objection. If they were assignable, the argument goes, the licensor would have no control over its intellectual property.

Once again, trademarks may be treated differently. Some courts distinguish trademarks from copyrights and patents on the theory that trademarks protect unfair competition and confusion among consumers, but do not confer a monopoly. They find that non-exclusive trademark license agreements may be assumed and assigned if the assignee is in a position to comply with the restrictions in the agreement, even if the licensor has not consented to the assignment. Other courts have come out the other way.

ARTICLES

The Association welcomes articles of interest to the IP bar. Please direct all submissions by e-mail to: Ashe P. Puri, Bulletin Editor, at apuri@sidley.com

For instance, in the recent N.C.P. Marketing Group decision involving Billy Blanks' Tae Bo trademark, the Nevada District Court found that trademarks are designed to protect owners and preserve the value of their business name and products, that the licensor in that case had an interest in the party to whom the trademark license agreement would be assigned, and that the trademark in question was personal to the licensee. It concluded that the license agreement could not be assigned without the licensor's consent. One interesting issue that has not yet been addressed in any written decisions involves the treatment of a non-exclusive license agreement that (1) would *not* be assignable as a separate contract but (2) is part of a franchise agreement that *would* otherwise be assumable and assignable.

Obviously, a licensor will want to keep the exclusive/non-exclusive distinction in mind if it is negotiating a license agreement with a financially distressed licensee. Moreover, there is an argument that non-exclusive licenses may be assignable by a licensee in bankruptcy if the license agreement provides that consent to assignment may not unreasonably be withheld, so licensors should think twice before incorporating such language.

Finally, after the licensee's bankruptcy case has been filed, the licensor can move the bankruptcy court to compel the licensee to assume or reject the agreement by a certain date or, in the alternative, to allow the licensor to terminate the agreement. In addition, because a debtor is under no statutory obligation to continue to make payments under the license agreement, at some point in the case the licensor may need to move to compel the licensee to make post-petition payments.

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Pitfalls for Licensees in Bankruptcy

What should every licensee know before it files for bankruptcy protection?

We have observed that assignment of a non-exclusive intellectual property license agreement generally requires the licensor's consent. But that is not the end of the story for a licensee in bankruptcy. It is often said that a debtor should not have greater rights inside of bankruptcy than it has outside of bankruptcy. Of course, there are exceptions to that general rule. There are very few instances, however, where a bankruptcy filing may actually strip a debtor of assets or rights that it has outside of bankruptcy. The treatment of non-exclusive intellectual property licenses is one of those rare instances.

As described above, Bankruptcy Code section 365(c)87provides that a debtor may not assume *or* assign an executory contract if (1) applicable law excuses the non-debtor from accepting performance from or rendering performance to the potential assignee and (2) the non-debtor does not consent to the assignment. Does this mean that if intellectual property law prevents the assignment of a non-exclusive license agreement to a third party the licensee cannot assume it either? Indeed, the Courts of Appeal for the 3rd, 4th, 5th, 9th, and 11th Circuits have held that, under the so-called hypothetical test, if an executory contract cannot be assigned it cannot be assumed either. It does not matter whether the licensee was actually seeking to assign the agreement. A number of courts take this a step further and hold that if the agreement cannot be assumed then it must be rejected or terminated. Thus, a licensee that files for Chapter 11 to protect its assets may, in the wrong jurisdiction and under the wrong circumstances, suddenly find itself deprived of a valuable license agreement.

Some lower courts, however, have employed creative analyses to prevent such a harsh result. For instance, they have adopted the "ride through" doctrine, under which a debtor can retain the benefits of an agreement without either assuming or rejecting it in bankruptcy, but rather by allowing it to "ride through" the case.

Conclusion

Whether Congress and the courts have struck the right balance between intellectual property law and bankruptcy law is a matter of (often strong) opinion. What is clear, however, is that licensors, licensees, and their counsel should be familiar with both sets of laws, where they intersect, and how they or their clients, as the case may be, can protect themselves under such circumstances.

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"Famous Marks" Doctrine Denied by Second Circuit ITC Limited v. Punchgini, Inc.

2007 WL 914742 March 28, 2007 Judge Reena Raggi

Since 1977, ITC Limited ("ITC") has operated a restaurant under the mark Bukhara in New Delhi, India. Over the course of the three decades since the New Delhi restaurant opened, ITC has opened or authorized the opening of other Bukhara restaurants around the world, including in Hong Kong, Bangkok, Montreal, and Kathmandu, and as a result, the restaurant has garnered "a measure of international renown."

In the mid-1980's, ITC opened Bukhara restaurants in New York City and Chicago. It also obtained a federal registration for the mark Bukhara for "restaurant services." By the summer of 1997, however, ITC had closed both restaurants.

In 1999, the defendants, many of whom were former employees of the Bukhara restaurant, opened two restaurants in New York City under the names Bukhara Grill and Bukhara Grill II. There were numerous striking similarities between the Bukhara Grill restaurants and ITC's Bukhara restaurants.

In 2003, ITC began to sell packaged food products in the U.S. under the Bukhara trademark. That same year, ITC filed a lawsuit against the Bukhara Grill owners in