

A General Overview of the Treatment of Intellectual Property Licenses in Bankruptcy

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In a bankruptcy case, a debtor has the ability to assume (i.e., affirm) or reject (i.e., disavow) executory contracts and unexpired leases. A debtor's ability to assume or reject an executory contract or unexpired lease is recognized as one of the primary purposes and essential tools available to a debtor under the Bankruptcy Code. The Bankruptcy Code allows a debtor to keep in place favorable contracts, and discard and relieve it of burdensome contracts, and thus avoid future performance obligations under such contracts. If the debtor assumes a contract, it can compel the non-debtor contract party to continue to perform. Likewise, a debtor has the ability to assume and assign (i.e., sell) the contract to a third party, notwithstanding most provisions in a contract or lease, that would prohibit or restrict the assignment of such lease or contract. In most instances, the assignment of the contract does not require the consent of the non-debtor contract party, although in some instances consent is required, especially when dealing with intellectual property licenses.

The source for the foregoing rights and powers of a debtor in bankruptcy are embodied in section 365 of the Bankruptcy Code. Section 365 of the Bankruptcy Code is not unfettered and, by way of example, debtors cannot assume a personal service contract or a contract to make a loan or extend financial accommodations.

Likewise, section 365 of the Bankruptcy Code provides certain time limitations in which a debtor must exercise its right seeking to assume or reject executory contracts or unexpired leases. In the event the debtor does not act within those time periods, the executory contract or unexpired lease may be deemed rejected.

Determining if a contract or agreement is an "executory contract or unexpired lease" within the meaning of section 365 of the Bankruptcy Code is the initial question. The Bankruptcy Code does not define the term "executory contract," but the majority of courts have followed definition developed by Professor Vern Countryman. Professor Countryman defined an executory contract as a "contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." Thus, section 365 would apply to contracts where performance remains due to some extent on both sides, other than simply the payment of money, where a breach would be deemed material.

In addition, section 365(c) of the Bankruptcy Code provides that when applicable non-bankruptcy law prohibits a contract's assignment, it may not be assumed or assigned by a debtor without the permission of the non-debtor counterparty to the contract. Thus, in connection with licenses of intellectual property, section 365 is fraught with difficulties. Intellectual property contracts can consist of, among other things, technology licenses, patents, copyrights, trademarks and/or trade secrets.

In determining whether an intellectual property agreement is an "executory contract" within the meaning of section 365(c) and, therefore, potentially subject to assumption, many courts make a distinction as to whether the agreement is an exclusive or non-exclusive license or right of use. Courts that hold that this distinction is relevant have then held that the debtor may not assume or assign a non-exclusive license, but may freely assume or assign and assign an exclusive license. These courts make their determination based upon applicable non-bankruptcy law by determining that a non-exclusive license is only a grant of a license of a personal property interest, while an exclusive license gives the debtor complete ownership rights and, therefore, may be assumed and assigned. Conversely, some courts (mostly in the 9th Circuit Court of Appeals) hold that licensees cannot freely transfer rights even under an exclusive license and, therefore, the non-exclusive v. exclusive distinction is irrelevant because neither can be assumed or assumed and assigned without the consent of the non-debtor licensor. In determining whether an agreement is exclusive or non-exclusive, the courts look closely at the terms of the agreement, as well as applicable non-bankruptcy law that may impact it, such as copyright or trademark law.

Alternatively, where the debtor is the licensor of intellectual property, section 365(n) of the Bankruptcy Code grants the non-debtor licensee additional rights in certain circumstances. In the event the debtor is the licensor and it assumes the agreement, there is no issue because by assumption, the debtor has affirmed that it will keep in place that intellectual property agreement. In the event the debtor or licensor rejects the license or right to use certain intellectual property, section 365(n) grants the non-debtor licensee the right to (i) treat the contract as terminated by rejection and assert any damage claim in the bankruptcy, or (ii) retain its rights under the contract, including the right to enforce any exclusivity provision under the contract and to continue using whatever intellectual property rights were granted to the licensee under the agreement for the duration of the contract, as well as

any extensions that may be provided for in such contract, conditioned upon the non-debtor licensee's continued compliance of its obligations under the contract. Thus, when the 365(n) election is taken, the non-debtor licensee is required to continue to make all payments due under the agreement and to comply with all other covenants or obligations it has. Further, the licensee would be deemed to have waived any right of setoff it may have with respect to such contract in connection with its claim or an assertion of an administrative claim for charges that may have accrued during the course of the bankruptcy case.

For instance, under the Copyright Act, a non-exclusive license of a copyright is not considered a transfer of the copyright's ownership. Thus, under the Copyright Act, most non-exclusive license agreements to copyrighted material are considered personal and, therefore, could not be assumed or assigned and assigned to a third party without the consent of the licensor unless the license agreement expressly provides otherwise. Under the Copyright Act, such permission for assignment must be expressly written in the underlying agreement. An exclusive license to a copyright is deemed a transfer of the ownership of the copy and, therefore, freely assignable by the licensee in bankruptcy.

Likewise, trademarks under applicable non-bankruptcy law are generally not assignable to third parties unless the contract expressly permits assignment. Further, because trademarks are used to identify goods, generally a trademark cannot be assigned apart from the goodwill of the underlying business of which it is associated. These non-bankruptcy restrictions on transfers are enforceable in bankruptcy and would limit a debtor's ability to assume or assume and assign a trademark agreement.

Concerning patent licenses, the licensor effectively covenants not to sue the licensee. Thus, under applicable non-bankruptcy federal law, patent licenses are generally personal to the licensee. Therefore, under the Bankruptcy Code, patent licenses are generally not assignable by the licensee

to a third party without the consent of the licensor, unless the license agreement expressly provides otherwise. This would appear to be the case for both exclusive and non-exclusive patent licenses.

As a result of the foregoing, if a licensor of intellectual property became a debtor in a bankruptcy case, the licensor must monitor closely the bankruptcy case in order to preserve its rights. In many instances, the non-debtor licensor is owed money as a creditor and could utilize its effective "veto" over the debtor's attempt to sell (assume and assign) the intellectual property licensed to a third party to require payment of its pre-petition arrearages, as well as to require the assignee (or purchaser) to directly enter into a contract with the licensor, further protecting the licensor's intellectual property rights in the hands of the new licensee. The licensor's failure to monitor and actively participate in a bankruptcy case could result in a bankruptcy court approving the assumption or assumption and assignment of an otherwise non-assignable intellectual property license agreement based upon the non-debtor party's failure to object, and the court viewing that effectively as consent. Active monitoring and participating by the non-debtor party to an intellectual property license, whether they are the licensee or the licensor, is crucial in order to maximize and protect their rights in the license, and to exert as much leverage as they are able to for their own business purposes.



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