Licensing Intellectual Property and Technology from the Financially-Troubled or Startup Company: *Prebankruptcy Strategies to Minimize the Risk in a Licensee's Intellectual Property and Technology Investment*

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INTRODUCTION

Intellectual property and technology are big business in today's new economy. In recent years, intellectual property and technology industries have grown at twice the annual rate of the economy,[1] and there is no indication that this trend will slow any time soon. As the importance of intellectual property and technology in the business community continues to grow, so too does the need for entities to protect their investments in such property. In no scenario is the need for this protection greater than where an entity desires to license or invest in intellectual property and technology owned by a financially-troubled or startup company—and this scenario is not unusual.

Intellectual property and technology often are owned by a small business or an individual who is financially unstable for one reason or another (whether as a result of significant cash outlays relating to the development of the intellectual property and technology or, simply, poor management) or by a startup company lacking profits prior to the commercialization of its product. These entities typically are in need of financial investors, business partners, or entities willing to pay for the use (or the anticipated use)

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1. *See, e.g.*, David Franecki, *Up Up and Away! Techs Lead Mutual Funds to Rousing Gains*, BARRON'S, Jan. 10, 2000, at F26 (noting that the average return for technology based mutual funds was five times that of the average U.S. diversified mutual fund throughout 1999); *Fortune's One Hundred Fastest-Growing Companies*, FORTUNE, Sept. 6, 1999, at 90 (noting that 32 of the top 100 fastest growing companies are technology companies); Darren McDermott, *Profits Beat Forecasts in Rebound*, WALL ST. J., Aug. 2, 1999, at C1 (estimating a growth in operating income for the technology-based industry at twice the rate of the overall economy for 1999).

of the intellectual property and technology. Before entering into an intellectual property and technology investment with such an entity, however, it is important to consider the financial risks in the transaction—i.e., the insolvency of the intellectual property and technology owner—and how you can protect your investment or continued use of the intellectual property and technology.

Intellectual property and technology typically are not sold outright because it divests the owner of all rights in the property, including the right to receive a portion of the income generated by the property.[2] Thus, an entity desiring to use the intellectual property and technology of a financially-troubled or startup company usually enters into a license agreement with the company, which makes the entity's access to and use of the intellectual property and technology dependent upon the survival of the intellectual property and technology owner as an on-going business. A license agreement, in turn, basically is a waiver of the owner's (i.e., the licensor's) right to sue the entity (i.e., the licensee) for infringement of the intellectual property and technology;[3] a license authorizes the licensee to use the licensor's intellectual property and technology in exchange for a license fee or royalties. If the licensor's financial condition remains healthy, the license agreement may be a win-win situation for both the licensor and the licensee, allowing the licensee to use the intellectual property and technology in its business operations and allowing both parties to profit from such use. Nevertheless, if the licensor's financial condition deteriorates, the licensee may quickly find itself in a no-win situation, i.e., the licensor's bankruptcy case.

An entity choosing to license intellectual property and technology from a financially-troubled or startup company faces the risk that the company will file for bankruptcy, which may change, if not terminate, the parties' prebankruptcy license agreement. In bankruptcy, the license agreement most likely will be characterized as an "executory contract," because both the licensor and the licensee will have unperformed obligations under the agreement. The licensor thus may reject the agreement and purge itself of all obligations thereunder.[4] In many circumstances, the licensee may be helpless—its only options under the Bankruptcy Code[5] are either to continue performing its obligations under the license agreement (which option provides the licensee uninterrupted use of the intellectual property and

2. *See, e.g.*, S. Rep. No. 100-505, at 3-4 (1988) (explaining that the industry relies upon licenses to distribute the use of intellectual property because an outright sale of such intellectual property divests the innovator of its rights in the intellectual property and restricts the number of parties that can utilize the technology).

3. *See* 6 ERNEST B. LIPSCOMB, WALKER ON PATENTS § 20:3, at 9 (3d ed. 1987).

4. 11 U.S.C. § 365(a) (1994). For a detailed discussion of section 365(a), *see infra* notes 51-64 and accompanying text.

5. *Id.* §§ 101-1330 (the Bankruptcy Code).

technology in exchange for a waiver of all claims against the licensor)[6] or to terminate the agreement.[7] Neither option provides the licensee with the full benefit of its prebankruptcy bargain.

So what should an entity desiring to use the intellectual property and technology of a financially-troubled or startup company do to protect its investment in the intellectual property and technology? Unfortunately, there is no simple answer to this question. Rather, the best that an entity can do is to assess the risks inherent in entering into such a transaction with such a company and take steps during the initial stages of the transaction to minimize such risks. Accordingly, this Article addresses the risks inherent in licensing intellectual property and technology from a financially-troubled or startup company, explains the protections provided such a licensee by law, and then explores various options that a licensee may have prebankruptcy to enhance these protections. Such options include structuring the transaction as something other than a license (i.e., a sale or an absolute assignment), transferring title to the intellectual property and technology to a trust or bankruptcy-remote entity, placing portions of the intellectual property and technology in escrow, or taking a security interest in the intellectual property and technology. Although none of these options are perfect solutions, prebankruptcy planning may minimize an entity's risk of loss in using the intellectual property and technology of a financially-troubled or startup company and increase its bargaining position if the owner of the intellectual property and technology ultimately files for bankruptcy protection.

A LICENSEE'S PROTECTION OF ITS INTELLECTUAL PROPERTY AND TECHNOLOGY INVESTMENT UNDER APPLICABLE LAW: A GOOD BUT NOT COMPLETE ANSWER

As previously noted, the risk in entering into a license agreement to use the intellectual property and technology of a financially-troubled or startup company is that the company's financial condition will not improve, and bankruptcy will be the end result. Prior to the Intellectual Property Bankruptcy Protection Act of 1988 (Intellectual Property Act),[8] such a result, i.e., the filing of a bankruptcy petition by the licensor, had a potentially devastating effect on the licensee's business because some courts held that a debtor/licensor's rejection of a license under section 365 of the Bankruptcy Code terminated the license agreement and all of the li-

6. *Id.* § 365(n)(1), (2). For a detailed discussion of section 365(n), *see infra* notes 65-69, 88-113 and accompanying text.

7. *Id.* § 365(n)(1).

8. Pub. L. No. 100-506, 102 Stat. 2538 (1988) (codified as amended as 11 U.S.C. §§ 101(52)-(53), 365(n)(1994)) (the Intellectual Property Act).

censee's rights thereunder.[9] Thus, upon rejection of the license agreement, these courts required the licensee to return the licensed property to the debtor/licensor's estate and only gave the licensee the right to assert a general, unsecured claim against the debtor/licensor's estate for damages arising from the court-authorized breach of the license.[10] In those instances where the licensed property was essential to the operation of the licensee's business, a court's determination that the rejection of the license terminated the licensee's rights thereunder could possibly cripple the licensee's business operations.[11]

Recognizing the detrimental impact that the courts' restrictive application of section 365 of the Bankruptcy Code in the context of intellectual property and technology licenses could have on the technology industry,[12] Congress enacted the Intellectual Property Act. In particular, the Intellectual Property Act amended section 365 to add a new subsection, section 365(n), which grants a licensee limited protections during the postpetition, pre-rejection period and upon the rejection of a license agreement by a debtor/licensor. As the legislative history to the Intellectual Property Act explains, section 365(n) "corrects the perception of some courts that Section 365 was ever intended to be a mechanism for stripping innocent

9. *See, e.g.*, Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1048 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986). *See also* S. REP. NO. 100-505, at 2 (1988) (explaining that several courts, including the Fourth Circuit in *Lubrizol*, interpreted section 365 "as providing a basis for permitting a licensor of intellectual property to strip its licensee of any continuing right to use the licensed intellectual property under the auspices of rejecting the license as an executory contract"). *But see* Fenix Cattle Co. v. Silver (*In re* Select-A-Seat Corp.), 625 F.2d 290, 292 (9th Cir. 1980) (stating *in dicta* that the rejection of a license agreement only relieves the debtor/licensor of performing its obligations thereunder but does not terminate the license with respect to the licensee).

10. *See Lubrizol*, 756 F.2d at 1048 (relying upon NLRB v. Bildisco & Bildisco, 465 U.S. 513, 519-27 (1984), for the proposition that the licensee only holds a prepetition general unsecured claim against the debtor/licensor upon rejection of the license agreement); S. REP. NO. 100-505, at 2 (1988) (explaining that allowing a licensor/debtor to reject an intellectual property license under section 365 of the Bankruptcy Code basically "results in valuable rights apparently reverting to the bankruptcy estate—rights which the bankruptcy estate otherwise would have to share with the licensee").

11. *See, e.g.*, Licensing by Paola, Inc. v. Sinatra (*In re* Gucci), 126 F.3d 380, 393-94 (2d Cir. 1997) (explaining that section 365(a) of the Bankruptcy Code, prior to the Intellectual Property Act, "was perceived as having a chilling effect on intellectual property licensing because it authorized the stripping of an innocent licensee's rights—rights which are central to the licensee's ongoing business"); S. Rep. No. 100-505, at 2-4 (1988) (explaining that Congress never anticipated that section 365 would "subject the licensee to the risk that, upon bankruptcy of the licensor, the licensee would lose not only any future affirmative performance required of the licensor under the license, but also any right of the licensee to continue to use the intellectual property as originally agreed in the license agreement").

12. The legislative history to section 365(n) notes that the subsection was enacted to overrule *Lubrizol* and its prodigy. *See* S. REP. NO. 100-505, at 4-5 (1988) (explaining that the "bill is intended to respond to a particular problem arising out of recent court decisions under Section 365").

licensee[s] of rights central to the operations of their ongoing business and stripping the American licensing system of its dependability and flexibility."[13]

This section of the Article first explains the basic protections provided by the Bankruptcy Code to any nondebtor party, including a licensee, to a prebankruptcy executory contract with a debtor. The section then analyzes the special protection provided by the Bankruptcy Code to a nondebtor licensee to a prebankruptcy license agreement with the debtor/licensor. Finally, this section summarizes the risks still facing a licensee despite section 365(n) of the Bankruptcy Code.

THE BASIC PROTECTIONS PROVIDED BY THE BANKRUPTCY CODE TO ANY NONDEBTOR PARTY TO A PREBANKRUPTCY EXECUTORY CONTRACT WITH A DEBTOR

Upon filing a petition for relief under the Bankruptcy Code, "all legal or equitable interests of the debtor in property"[14] become property of the debtor's bankruptcy estate.[15] As a result, to the extent that a debtor has a prebankruptcy interest, legal or equitable, in an intellectual property and technology license, that license becomes property of the debtor's bankruptcy estate under section 541 of the Bankruptcy Code.[16] A trustee or

13. S. Rep. No. 100-505, at 4 (1988). *See also Gucci*, 126 F.3d at 393-94 (explaining that section 365(n) was enacted, in part, to ameliorate the adverse impact of the rejection of a prepetition license on a nondebtor licensee's business); Encino Bus. Management, Inc. v. Prize Frize, Inc. (*In re* Prize Frize, Inc.), 32 F.3d 426, 428 (9th Cir. 1994) (same); *In re* EI Int'l, 123 B.R. 64-66 (Bankr. D. Idaho 1991) (same).

14. 11 U.S.C. § 541(a)(1)(1994). Courts generally interpret section 541(a) of the Bankruptcy Code broadly to encompass any and all interests of a debtor, irrespective of the location or party in possession of the property. *See, e.g.*, United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983); 5 COLLIER ON BANKRUPTCY ¶ 541.01, at 541-7 (Lawrence P. King ed., 15th ed. 2000) ("Congress' intent to define property of the estate in the broadest possible sense is evident from the language of the statute, which initially defines the scope of estate property to be all legal or equitable interests of the debtor in property as of the commencement of the case, wherever located and by whomever held").

15. To determine whether a debtor's estate has an interest in property under the Bankruptcy Code, the courts generally consider the following three factors: (i) whether the property is "property" within the meaning of section 541 of the Bankruptcy Code, (ii) whether the debtor has an interest in such property under applicable state law, and (iii) whether the debtor had the property interest on the bankruptcy petition date. *See, e.g.*, Snyder v. Dewoskin (*In re* Mahendra), 131 F.3d 750, 755 (8th Cir. 1997), *cert. denied*, 523 U.S. 1107 (1998); C.T. Dev. Corp. v. Barnes (*In re* Oxford Dev., Ltd.), 67 F.3d 683, 685 (8th Cir. 1995); Davis v. Moon (*In re* Usery), 158 B.R. 470, 472 (Bankr. W.D. Mo. 1993).

16. *See, e.g.*, Krebs Chrysler-Plymouth, Inc., v. Valley Motors, Inc., 141 F.3d 490, 498 (3d Cir. 1998) (characterizing a franchise as a license to use the subject trademarks and noting that such franchises represent interests in the trademarks and thus, are property of a debtor's estate under section 541) (citing 5 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 541.06[5] (explaining that interests in executory contracts are estate property)).

debtor in possession may, in turn, assume, assume and assign, or reject this intellectual property and technology license as an executory contract under section 365(a) of the Bankruptcy Code.[17]

An Intellectual Property and Technology License as Property of a Debtor's Estate

As with most forms of property,[18] an owner of intellectual property and technology holds a "bundle" of rights in the property and may transfer[19] the entire bundle of rights through a sale or an assignment or transfer a limited interest in the bundle of rights through a license.[20] If the owner sells or assigns its rights in the intellectual property and technology, the transaction divests the owner of all rights in the intellectual property and technology, including title (but, unless otherwise provided in the agreement, not including the right to sue for past infringement). The transferee thus obtains all rights in that portion of the intellectual property and technology transferred through a sale or an assignment. Subject to a debtor's avoidance powers,[21] a sale or an assignment removes the intellectual prop-

17. 11 U.S.C. § 365(a).

18. United States patents are deemed to have the attributes of personal property. *See* 35 U.S.C. § 261 (1994); Robert L. Tamietti, *Technology Licenses Under the Bankruptcy Code: A Licensee's Mine Field*, 62 AM. BANKR. L.J. 295, 303 (1988). With respect to trade secrets, courts and commentators alike initially rejected the notion that the owner of a trade secret held a property interest in the secret. *See, e.g.*, E.I. duPont de Nemours Powder Co. v. Masland, 244 U.S. 100, 102 (1917). The U.S. Supreme Court, however, disposed of this notion in *Ruckelshaus v. Monsanto Co.*, holding that the owner of a trade secret possesses a property interest in that a trade secret is protected by the Takings Clause of the Fifth Amendment. 467 U.S. 986, 1002-04 (1984). Consequently, an owner of a trade secret, like the owner of a patent or copyright, may sell, assign, or license its interest in the trade secret to another. *See, e.g.*, United States v. Wise, 550 F.2d 1180 (9th Cir. 1977), *cert. denied*, 434 U.S. 929 (1977); Vault Corp. v. Quaid Software Ltd., 655 F. Supp. 750 (E.D. La. 1987), *aff'd*, 847 F.2d 255 (5th Cir. 1988).

19. The Copyright Act, 17 U.S.C. §§ 101-1101 (1994) (the Copyright Act), explains that the "[o]wnership of a copyright, or of any of the exclusive rights under a copyright, is distinct from ownership of any material object in which the work is embodied," 17 U.S.C. § 202, and defines a "transfer of copyright ownership" 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." 17 U.S.C. § 101. Accordingly, a copyright owner may effect an absolute transfer of its rights in the copyright separate and apart from the sale of a product incorporating the copyrighted work.

20. *See, e.g.*, Vaupel Textilmaschinen KG v. Meccanica Euro Italia S.P.A, 944 F.2d 870, 875 (Fed. Cir. 1991) (explaining that a patent owner has "in effect, a bundle of rights which may be divided and assigned, or retained in whole or part").

21. Under sections 544, 545, 546, 547, 548, and 549 of the Bankruptcy Code, a trustee in bankruptcy or a debtor in possession has the power to avoid certain pre- and postpetition transfers of property of the debtor's estate. Generally, under these sections, a transfer of estate property may be avoided as, among other things, a fraudulent transfer, a preferential transfer, or a postpetition transfer in contravention of the Bankruptcy Code and without the

erty and technology (other than, perhaps, the right to sue for past infringement) from the debtor/owner's bankruptcy estate. This result occurs because, as of the date that the owner/debtor files its bankruptcy petition, the owner/debtor no longer has a legal or equitable interest in the intellectual property and technology. If, on the other hand, the transaction is structured as something less than a sale or an assignment, i.e., a license, the owner retains title to the intellectual property and technology and such property (and the owner's interest in the license itself) becomes property of the owner/debtor's bankruptcy estate.

A Sale of Intellectual Property and Technology

An outright sale of intellectual property and technology typically entails the transfer of all of the owners' exclusive rights in the intellectual property and technology. Such a complete transfer divests the original owner of *all rights* in, including the right to sue for future infringement of the intellectual property and technology,[22] *and title to* the intellectual property and technology.[23] Whether a transfer of intellectual property and technology constitutes a sale sufficient to remove the property from the owner/debtor's bankruptcy estate or something less than a sale, i.e., a license, depends upon the intent of the parties and the substance of the transaction.[24] As a result, if the owner of the intellectual property and technology retains any substantial rights in the property, such as the right to receive royalties or to sue for future infringement, the sale may be viewed as a disguised

approval of the Bankruptcy Court. As a result, an entity entering into a prepetition sale or assignment of intellectual property with a financially-troubled or startup company must be careful to ensure that the transfer is an arms-length transaction, for reasonably equivalent value and that it satisfies one of the exceptions to preference avoidance set forth in section 547(c) of the Bankruptcy Code.

22. *See, e.g.*, Waterman v. Mackenzie, 138 U.S. 252, 255-56 (1891) (explaining that a sale or an assignment of a patent must include the right to sue for infringement). A sale or assignment of intellectual property, however, does not necessarily transfer the right to sue for past infringement. *See infra* note 31 and accompanying text.

23. *See, e.g.*, Minco, Inc. v. Combustion Eng'g, Inc., 95 F.3d 1109, 1116-17 (Fed. Cir. 1996) (quoting *Waterman*, 138 U.S. at 255); Everex Sys., Inc. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 676 n.2 (9th Cir. 1996); SAPC, Inc. v. Lotus Dev. Corp., 921 F.2d 360, 361 (1st Cir. 1990). *See also* MacLean Assocs., Inc. v. William M. Mercer-Meidinger-Hansen, Inc., 952 F.2d 769, 778-79 (3d Cir. 1991) (explaining that, in the copyright context, a sale involves the conveyance of the absolute right of distribution and, perhaps, the absolute right to display and use the copyrighted work); 5 LIPSCOMB, *supra* note 3, § 19-12, at 366 (explaining that a sale of a patent occurs when there is a transfer of "all substantial rights of value in the patent").

24. "Whether a transfer constitutes a sale or license is determined by the substance of the transaction and a transfer will suffice as a sale if it appears from the agreement and surrounding circumstances that the parties intended that the patentee surrender all his substantial rights to the invention." Bell Intercontinental Corp. v. United States, 381 F.2d 1004, 1011, 152 U.S.P.Q. 182, 184 (Ct. Cl. 1967) (citations omitted).

license agreement, and both the intellectual property and technology, and the parties' agreement, may become property of the owner/debtor's bankruptcy estate (making the parties' agreement subject to rejection under section 365 of the Bankruptcy Code).

An Assignment of Intellectual Property and Technology

An assignment of intellectual property and technology typically is defined as an immediate and irrevocable transfer of all of the owner's rights in the property.[25] An assignment, however, is not limited to a transfer of all of the owner's rights in the intellectual property as a whole. Rather, it may include a transfer of only certain identified rights in the intellectual property and technology, such as the exclusive rights under a patent in a particular geographical region or any one of a copyright owner's exclusive rights under section 106 of the Copyright Act.[26] As in the sale context, the critical inquiry in this determination is the intent of the parties to the transfer and, more importantly, the legal effect of the transfer on the

25. *See, e.g.,* Artoc Bank & Trust, Ltd. v. Apex Oil Co. (*In re* Apex Oil Co.), 975 F.2d 1365, 1369 (8th Cir. 1992); Sarf v. Leff (*In re* Candy Lane Corp.), 38 B.R. 571, 575 (Bankr. S.D.N.Y. 1984). For purposes of this Article, the term "assignment" refers to an absolute assignment that transfers title to the assigned property. *See* discussion *infra* notes 26-27, 32-34 and accompanying text. As previously noted, property assigned through an assignment to another prior to the debtor's bankruptcy petition date does not become property of the debtor's estate under section 541(a) of the Bankruptcy Code. *See* discussion *supra* notes 18-21 and accompanying text.

26. Whether a particular assignment of intellectual property is an absolute assignment of the owner's rights in that property should be determined under applicable nonbankruptcy law. For example, a patentee may assign, grant, or convey either: (i) the whole patent, including the exclusive right to make, use and sell/distribute the invention throughout the United States; (ii) an undivided part of that exclusive right; or (iii) the exclusive right under the patent within and throughout a specified part of the United States. *See, e.g., Waterman,* 138 U.S. at 255 (explaining that an assignment may be accomplished by a transfer of the "whole of the patent right, or of an undivided part of the right, or of all rights in a specified geographical region"), *quoted in Vaupel Textilmaschinen KG,* 944 F.2d at 873-74. *See also* 8 DONALD S. CHISUM, CHISUM ON PATENTS: A TREATISE ON THE LAW OF PATENTABILITY AND INFRINGEMENT § 21.03[2], at 21-263 (2000) (explaining the three categories of patent rights that may be assigned) [hereinafter CHISUM ON PATENTS]. The Patent Act, 35 U.S.C. §§ 1-376 (1994) (the Patent Act), expressly provides that a patent, or any interest therein, is assignable. 35 U.S.C. § 261 (1994). Likewise, the Copyright Act provides that an ownership interest in a copyright is assignable. 17 U.S.C. §§ 101, 201, 204 (1994). A copyright owner generally may transfer by assignment any one or all of its exclusive rights in the copyright set forth in section 106 of the Copyright Act. *See, e.g.,* MacLean Assocs. v. William M. Mercer-Meidinger-Hansen, Inc., 952 F.2d 769, 778 (3d Cir. 1991). Finally, an owner of a trade secret, as any owner of personal property, may assign its ownership interests in the trade secret. *See, e.g.,* Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1002 (1984) (citing Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373, 401-02 (1911) and Painton & Co. v. Bourns, Inc., 442 F.2d 216, 225 (2d Cir. 1971)). *See also supra* note 18.

parties' respective rights in the property.[27] If the owner is relinquishing all of its rights in and title to the intellectual property and technology or all of its rights in and title to an identified portion thereof, the transfer is an assignment.[28]

An assignment generally grants the assignee all of the rights associated with ownership of the intellectual property and technology.[29] This bundle

27. *See* discussion *supra* notes 24, 26 and *infra* notes 32-34 and accompanying text. As noted above, a transfer of something less than all of the owner's rights in the intellectual property and technology through a sale or an assignment generally constitutes a license. *See generally* CHISUM ON PATENTS, *supra* note 26, § 21.03[3][1][c], at 21-247 (citing Gayler v. Wilder, 51 U.S. 477 (1850), for the proposition that a transfer of anything less than the owner's "entire and unqualified" rights in the assigned property (or portion thereof) is simply a license). Such a limited transfer also is sometimes referred to as a limited assignment. Regardless of whether it is labeled a license or a limited assignment, the critical inquiry is whether the owner has relinquished all of its rights in the property transferred. *See* discussion *supra* notes 24, 26 and *infra* notes 32-34 and accompanying text; *Vaupel Textilmaschinen KG*, 944 F.2d at 875 (explaining that an assignment of a patent "'may be either absolute, or by way of mortgage and liable to be defeated by non-performance of a condition subsequent'") (quoting *Waterman*, 138 U.S. at 256); Tamietti, *supra* note 18, at 303-304 (explaining that the distinction between an absolute assignment that transfers ownership of the intellectual property and an assignment that only transfers the particular rights to the assignee for a limited period of time; also suggesting that such a limited assignment is akin to a lease of personal property and, therefore, may be assumed or rejected as an unexpired lease by a debtor under section 365(a) of the Bankruptcy Code); *cf.* Endico Potatoes, Inc. v. CIT Group/Factoring, Inc., 67 F.3d 1063, 1068-69 (2d Cir. 1995) (explaining that among the factors to be considered in distinguishing an absolute assignment from a limited assignment for purposes of security is the intent of the parties at the time that the assignment was executed); Luker v. Reeves, (*In re* Reeves), 65 F.3d 670, 674 (8th Cir. 1995) (same); Flanders & Medeiros, Inc. v. Bogosian, 65 F.3d 198, 203-04 (1st Cir. 1995) (same); Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 543-46 (3d Cir. 1979) (same); United States v. Poling, 73 F. Supp. 2d 882, 893 (S.D. Ohio 1999) (same); *In re* Carolina Utils. Supply Co., Inc., 118 B.R. 412, 415 (Bankr. D. S.C. 1990) (same); *In re* Evergreen Valley Resort, Inc., 23 B.R. 659, 661 (Bankr. D. Me. 1982) (same) (and cases cited therein). For purposes of determining whether a transfer of intellectual property and technology amounts to a sale, assignment, or license, the retention of the right to receive a share of the royalties generated by the intellectual property as consideration for the assignment does not in and of itself prevent the assignment from constituting an absolute assignment. *See, e.g.*, *Vaupel Textilmaschinen KG*, 944 F.2d at 875 (citing Rude v. Westcott, 130 U.S. 152, 162-63 (1889)); Larry Spier, Inc. v. Bourne Co., 953 F.2d 774, 778 (2d Cir. 1992) (and cases cited therein). *See also* CHISUM ON PATENTS, *supra* note 26, § 21.03[2], at 21-261 (assignor retaining any rights in portion of patent "assigned" essentially is treated as a grantor of an exclusive license).

28. *See* cases cited *supra* note 26.

29. *See, e.g.*, *Waterman*, 138 U.S. at 255 (explaining that an absolute assignment of a patent, as opposed to a license, transfers title to the patent and the right to sue for infringement thereof to the assignee); Minco, Inc. v. Cobustion Eng'g, Inc., 95 F.3d 1109, 1116 (Fed. Cir. 1996) (explaining that "[a]n assignment of patent rights operates to transfer title to the patent"); Rite-Hite Corp. v. Kelley Co., 56 F.3d 1538, 1551 (Fed. Cir. 1995) ("A transfer of any of these [referring to the three categories of assignable rights identified in *Waterman*, 138 U.S. at 255] is an assignment and vests the assignee with title in the patent, and a right to sue infringers."), *cert. denied*, 516 U.S. 867 (1995). *See also* CHISUM ON PATENTS, *supra* note 26, § 21.03 (explaining rights transferred through a patent assignment); HOWARD B. ABRAMS,

of rights includes the right to sue for future infringement of the intellectual property and technology.[30] It does not, however, include the right to sue for past infringement because infringement "harms only the owner of the patent at the time of the infringing acts."[31]

A License of Intellectual Property and Technology

Any transfer of intellectual property and technology short of a sale or an assignment constitutes a license.[32] A license does not transfer any property interests in the intellectual property and technology to the licensee;[33] rather, a license essentially allows the licensee to use the intellectual property and technology for the purposes specified in the license agreement and protects the licensee from an infringement suit [34] by the licensor for

THE LAW OF COPYRIGHT § 13.02[A], at 13-3 through 13-5 (West 1999) (explaining that ownership of a copyright may be transferred through, among other means, an assignment, pursuant to section 101 of the Copyright Act (set forth *supra* note 19)).

30. *See, e.g.,* Abbott Lab. v. Diamedix Corp., 47 F.3d 1128, 1131 (Fed. Cir. 1995) (citing *Waterman* for the proposition that an assignee has standing to sue for future infringement); CMS Indus. v. L.P.S. Int'l Ltd., 643 F.2d 289, 294 (5th Cir. 1981) (explaining that "[w]here an agreement effectively transfers the entire bundle of rights residing in a patent, that agreement is an assignment, not a license"). *See also* ABRAMS, *supra* note 29, § 13.02[A], at 13-3 through 13-5 (legal or beneficial owner of a copyright is entitled to sue for future infringement).

31. *Minco,* 95 F.3d at 1117 (explaining that an assignment does not automatically transfer the right to sue for past infringement). *See also* CHISUM ON PATENTS, *supra* note 26, § 21.03[2], at 21-262 (explaining that an assignee of the title to a patent obtains rights to sue for future infringement, but only obtains rights to sue for past infringement if specifically granted by the assignor).

32. *See, e.g., Waterman,* 138 U.S. at 255. In *Waterman,* the Supreme Court further explained that "[w]hether a transfer of a particular right or interest under a patent is an assignment or a license does not depend upon the name by which it calls itself, but upon the legal effect of its provisions." *Id.* at 256. *See also* Eickmeyer v. United States, 231 U.S.P.Q. 820, 821 (Ct. Cl. 1986) ("[A] basic distinction between the transfer of a license and the transfer of a patent is whether the transferee has received the right to sue for infringement"); Relational Design and Tech., Inc. v. Brock, No. 91-2452-EEO, 1993 WL 191323 (D. Kan. May 25, 1993) (explaining that, in the copyright context, a license is distinguishable from the sale or an assignment of the copyright because a license does not transfer title to the copyrighted work); Control Components, Inc. v. Atlantic Richfield Co., 439 F. Supp. 654, 656 (C.D. Cal. 1977) ("[A]n agreement which purports to give only an exclusive license may in fact be an assignment if its legal effect is to transfer substantially all of the rights under the patent."). *See also* discussion *supra* note 27 and accompanying text.

33. *See, e.g., Waterman,* 138 U.S. at 255.

34. A license agreement that completely transfers any or all of the exclusive rights of the owner of the intellectual property (i.e., an exclusive license) is, for all practical purposes, equivalent to a sale because such a license divests the owner of those particular rights (including the right to sue for future infringement of the exclusive rights transferred). *See, e.g., Waterman,* 138 U.S. at 255 (noting that a patentee may assign, grant, or convey "the exclusive right under the patent within and throughout a specified part of the United States"); United

such use. Indeed, licenses commonly are described as mere covenants by the licensor not to sue for infringement.[35]

There is no standard form for intellectual property and technology licenses. Rather, the form and substance of a particular license typically is driven by and tailored to fit the particular needs of the underlying business transaction.[36] The only essential elements of a license are: (i) that the licensor have an ownership interest in the intellectual property and technology; (ii) that the intellectual property and technology be of a type protected by law; and (iii) that the license specifically identify the interest in the intellectual property and technology transferred to the licensee.[37] Additionally, a license should specifically reserve to the owner/licensor those interests in the intellectual property and technology not transferred to the licensee.[38]

An Intellectual Property and Technology License Agreement as an "Executory Contract" for Purposes of the Bankruptcy Code

Executory Contracts in General

The Bankruptcy Code does not define the term "executory contract;" however, the legislative history to section 365 suggests that a contract is "executory" if "performance remains due to some extent on both sides" to the contract.[39] In light of this legislative history, the vast majority of courts employ the following definition of the term "executory contract" developed by Professor Countryman: "[An executory contract is a] contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete

States Naval Inst. v. Charter Communications, Inc., 936 F.2d 692, 695 (2d Cir. 1991) (explaining that "[a]n exclusive license granted by the copyright owner constitutes a transfer of ownership of the copyright rights conveyed in the license"); *In re* Patient Educ. Media, Inc., 210 B.R. 237, 240-41 (Bankr. S.D.N.Y. 1997) (explaining the distinction between an exclusive and nonexclusive license agreement). To the extent, however, that an exclusive license agreement imposes obligations on the licensor (such as the obligation to defend the licensee in infringement suits relating to the licensed property), an exclusive license most likely will be characterized as an executory contract subject to rejection by a licensor/debtor under section 365 of the Bankruptcy Code. *See* discussion *infra* note 47 and accompanying text. As a result, although an exclusive license possesses traits similar to a sale of the intellectual property, an exclusive license will not provide an intellectual property user the same degree of protection as a sale under the Bankruptcy Code.

35. *See, e.g.*, 6 LIPSCOMB, *supra* note 3, at 9.

36. *See, e.g.*, JAY DRATLER, JR., LICENSING OF INTELLECTUAL PROPERTY § 1.01, at 1-4 (1997).

37. *See, e.g.*, *id.*

38. *See, e.g.*, *id.*

39. H.R. REP. NO. 95-595, at 347 (1977); S. REP. NO. 95-989, at 58 (1978); 3 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 365.02[1], at 365-17.

performance would constitute a material breach excusing performance of the other."[40]

Additionally, several courts have expanded the concept of what is "executory" under section 365(a) of the Bankruptcy Code, recognizing that the power bestowed upon a debtor by this section "is based on the trustee's long-standing power to abandon obligations burdensome to the estate."[41] As a result, these courts follow a functional approach that focuses the section 365(a) analysis on the estate and the course of action most beneficial to the estate and its creditors. This functional approach allows a debtor to reject any contract if such rejection produces a net benefit for the debtor's estate and creditors.[42] The court in *Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, supported its application of this functional approach by noting: "Rejection's limited effect renders unnecessary any definition of 'executoriness' as a pre-condition to rejection. . . . Every contract may, without harm, be made subject to rejection; at worst, rejection will be superfluous."[43]

The critical date for determining whether a contract is executory for purposes of the Bankruptcy Code is the date that the debtor filed its

40. Vern Countryman, *Executory Contracts in Bankruptcy Part I*, 57 MINN. L. REV. 439, 440 (1973). *See also* Enterprise Energy Corp. v. United States (*In re* Columbia Gas Sys. Inc.), 50 F.3d 233, 239 (3d Cir. 1995) (quoting Sharon Steel Corp. v. National Fuel Gas Distrib. Corp., 872 F.2d 36, 39 (3d Cir. 1989)); Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1045 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986); Carlson v. Farmers Home Admin. (*In re* Newcomb), 744 F.2d 621, 624 (8th Cir. 1984); Fenix Cattle Co. v. Silver (*In re* Select-a-Seat Corp.), 625 F.2d 290, 292 (9th Cir. 1980); Butler v. Resident Care Innovation Corp., 241 B.R. 37, 42 (D.R.I. 1999); 3 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 365.02[1], at 365-17. *But see* Chattanooga Mem'l Park v. Still (*In re* Jolly), 574 F.2d 349, 351 (6th Cir. 1978) (criticizing a rigid application of the above-quoted Countryman executory contract definition and proposing a functional approach to determining whether contracts are executory: "If those objectives [i.e., the purposes behind allowing a debtor to assume or reject the contract] have already been accomplished, or if they can't be accomplished through rejection, then the contract is not executory within the meaning of the Bankruptcy Act"), *cert. denied*, 439 U.S. 929 (1978). Similar to the Countryman definition, the legislative history to section 365 explains that the term "executory contract" generally "includes contracts on which performance remains due to some extent on both sides." H.R. Rep. No. 95-595, at 347 (1977); S. REP. NO. 95-989, at 58 (1978); 3 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 365.02[1], at 365-17.

41. Sipes v. General Dev. Corp. (*In re* General Dev. Corp.), 177 B.R. 1000, 1013 (S.D. Fla. 1995) (quoting *In re* Martin Brothers Toolmakers, Inc., 796 F.2d 1435, 1439 (11th Cir. 1986)), *aff'd sub nom.* Sipes v. Atlantic Gulf Communities Corp. (*In re* General Dev. Corp.), 84 F.3d 1364 (11th Cir. 1996). *See also* Cohen v. Drexel Burnham Lambert Group, Inc. (*In re* Drexel Burnham Lambert Group, Inc.), 138 B.R. 687, 706-08 (Bankr. S.D.N.Y. 1992).

42. *See, e.g., General Dev.*, 177 B.R. at 1011-13. *See also Jolly*, 574 F.2d at 351; Procter & Gamble, Co. v. Paragon Trade Brands, Inc. (*In re* Paragon Trade Brands, Inc.), No. 98-60390, at 5-6 (Bankr. N.D. Ga. June 3, 1998); *Drexel*, 138 B.R. at 708-09; Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989).

43. 138 B.R. at 708-09 (quoting Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1, 16-17 (1991)).

bankruptcy petition.[44] Nevertheless, if a contract terminates by its terms after the debtor files its bankruptcy petition but before the debtor makes its assumption or rejection decision, the contract is no longer "executory."[45] As a result, if one of the parties has completely performed its obligations under the contract as of the date of the debtor's bankruptcy petition or the contract terminates by its terms postpetition, the contract arguably is not subject to assumption or rejection by the debtor under section 365 of the Bankruptcy Code.

Intellectual Property and Technology License Agreements as Executory Contracts

"The usual patent license, by which the patentee-licensor authorizes the licensee to exercise some part of the patentee's exclusive right to make, use, and vend the patented item in return for payment of royalties, ordinarily takes the form of an executory contract."[46] Based upon this characterization of a patent license as an executory contract by Professor Countryman, courts generally characterize intellectual property and technology licenses as executory contracts for purposes of section 365 of the Bankruptcy Code.[47] These courts recognize that in the typical intellectual

44. *See, e.g., Columbia Gas*, 50 F.3d at 240; Collingwood Grain, Inc. v. Coast Trading Co. (*In re* Coast Trading Co.), 744 F.2d 686, 692 (9th Cir. 1984); *Newcomb*, 744 F.2d at 624. *But see In re* Riodizio, 204 B.R. 417 (Bankr. S.D.N.Y. 1997) (holding that if the contract is set to expire by its terms postpetition, the critical date for determining whether the contract is executory for purposes of section 365 of the Bankruptcy Code is the date that the motion to assume or reject is filed).

45. *See, e.g.*, Aetna Cas. & Surety Co. v. Gamel, 45 B.R. 345, 348-49 (N.D.N.Y. 1984) (finding that, where an insurance policy terminated by its terms pending the debtor's assumption or rejection decision, the debtor could not assume the policy under section 365); *In re* El Paso Ref., L.P., 220 B.R. 37, 40 n.6 (Bankr. W.D. Tex. 1998) (same); Hertzberg v. Loyal Am. Life Ins. Co. (*In re* B & K Hydraulic Co.), 106 B.R. 131, 134-36 (Bankr. E.D. Mich. 1989) (same); Lauderdale Motorcar Corp. v. Rolls Royce Motors, Inc. (*In re* Lauderdale Motorcar Corp.), 35 B.R. 544, 548 (Bankr. S.D. Fla. 1983) (same).

46. Vern Countryman, *Executory Contracts in Bankruptcy Part II*, 58 MINN. L. REV. 479, 501 (1974). Professor Countryman also recognized in this article that "[w]here there is no express undertaking by the licensor, the agreement with the licensee may not be executory because the licensor may have fully performed merely by executing the license agreement." *Id.* at 502. Nevertheless, Professor Countryman ultimately concludes that even in such a close case, a license should be classified as an executory contract because in every license, the licensor impliedly warrants the validity of its patent and this undertaking continues over the life of the license. *Id.*

47. *See, e.g.*, Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 490 n.2 (1st Cir. 1997) (recognizing, without discussion, that the cross-licenses of patents at issue were "executory" for purposes of section 365), *cert. denied*, 521 U.S. 1120 (1997); Perlman v. Catapult Entertainment, Inc. (*In re* Catapult Entertainment, Inc.), 165 F.3d 747, 749 (9th Cir. 1999) (assuming that nonexclusive licenses were executory contracts without discussion), *cert. dismissed*, __ U.S. __, 120 S.Ct. 369 (1999); Everex Sys., Inc. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 677 (9th Cir. 1996) (holding that a patent license was an executory contract where the licensee had the continuing obligation of marking its products with the proper statutory patent notice and the licensor had the obligation to refrain from suing the licensee for patent

property and technology license scenario both the licensor and the licensee have obligations that continue until the termination of the license agree-

infringement); *In re* Superior Toy & Mfg. Co., Inc., 78 F.3d 1169, 1175-76 (7th Cir. 1996) (disregarding the trustee's argument that a license was not executory where the trustee's predecessor had assumed the license under section 365 with court approval); Encino Business Management, Inc. v. Prize Frize, Inc. (*In re* Prize Frize, Inc.), 32 F.3d 426, 428 (9th Cir. 1994) (concluding that the license of technology, patents and proprietary rights in certain machinery was an executory contract for purposes of section 365 of the Bankruptcy Code because "there were obligations on both sides which to some extent were unperformed"); Otto Preminger Films, Ltd. v. Qintex Entertainment, Inc. (*In re* Qintex Entertainment, Inc.), 950 F.2d 1492, 1494-96 (9th Cir. 1991) (finding an exclusive film license to be an executory contract because the licensor had the continuing obligation not to license the film to third parties and the licensee had the continuing obligation to pay royalties); Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1045-46 (4th Cir. 1985) (holding that licensing agreement was an executory contract where the licensor had continuing notice and forbearance obligations under the license and the licensee had the continuing obligation to pay royalties and submit quarterly accounting to the licensor), *cert. denied*, 475 U.S. 1057 (1986) (superseded by 11 U.S.C. § 365(n) on other grounds); *In re* Access Beyond Techs., 237 B.R. 32, 43-44 (Bankr. D. Del. 1999) (finding that patent cross license was executory due to various obligations remaining outstanding on both sides); *In re* Ehrenfried Tech., Inc., No. 97-24936, 1998 Bankr. LEXIS 804, at *11-*15 (Bankr. E.D. Va. June 1, 1998) (treating a patent license as an executory contract under section 365 of the Bankruptcy Code and approving the licensee/debtor's assumption of the license under its plan of reorganization); *In re* Patient Educ. Media, Inc., 210 B.R. 237, 241 (Bankr. S.D.N.Y. 1997) (noting that courts "have generally treated nonexclusive copyright and patent licenses as executory contracts"); Biosafe Int'l, Inc. v. Controlled Shredders, Inc. (*In re* Szombathy), Nos. 94B15536, 95A01035, 1996 Bankr. LEXIS 888, at *18 (Bankr. N.D. Ill. July 9, 1996) (finding that a license was executory because of the licensor's on-going promise to grant the licensee the exclusive rights to manufacture, use and sell the licensed property), *rev'd in part (on other grounds) sub nom.* Szombathy v. Controlled Shredders, Inc., No. 97C481, 1997 WL 189314 (N.D. Ill. Apr. 14, 1997); University of Connecticut Research & Dev. Corp. v. Germain (*In re* Biopolymers, Inc.), 136 B.R. 28, 29-30 (Bankr. D. Conn. 1992) (holding that an exclusive licensing agreement was an executory contract because obligations remained outstanding on both sides where the licensor had to forebear from granting licenses to others and to not unreasonably withhold its consent to the licensee's sublicensing decisions); *In re* Three Star Telecast, Inc., 93 B.R. 310, 312 (Bankr. D.P.R. 1988) (characterizing a television program licensing agreement as executory for purposes of section 365); *In re* New York Shoes, Inc., 84 B.R. 947, 960 (Bankr. E.D. Pa. 1988) (same with respect to trademark contract); *In re* Best Film & Video Corp., 46 B.R. 861, 869 (Bankr. E.D.N.Y. 1985) (same with respect to movie distribution contract). *See also* Procter & Gamble, Co. v. Paragon Trade Brands, Inc. (*In re* Paragon Trade Brands, Inc.) No. 98-60390, at 7-9 (Bankr. N.D. Ga. June 3, 1998) (finding that an agreement allowing an infringing party a certain period of time to convert its infringing product into a noninfringing product (the "Conversion Agreement") akin to a license and "executory" for purposes of section 365 under both the Countryman executory contract definition and the functional approach (because "rejection presented a possibly significant benefit for Debtor")). *But see In re* Learning Publications, Inc., 94 B.R. 763, 765 (Bankr. M.D. Fla. 1988) (holding that a publication agreement was not executory for purposes of section 365); *In re* Stein and Day, Inc., 81 B.R. 263, 267 (Bankr. S.D.N.Y. 1988) (same). Although *Learning Publications* and *Stein and Day* often are cited to support the proposition that "[l]icensing agreements are not . . . universally considered executory contracts," *Quintex Entertainment*, 950 F.2d at 1495, both cases involved publication agreements under which the respective authors sold and/or assigned substantially all of their rights, title and interest in their respective works to the debtor publishing companies. Thus, the only unperformed obligation under these agreements was the debtor's obligation to pay royalties. Such an obligation typically does not render a contract executory. *See infra* note 50.

ment. Such obligations include the licensor's duty to forebear from prosecuting the licensee for infringement[48] and to defend and indemnify the licensee in infringement suits relating to the licensed property,[49] and the licensee's duty to pay royalties and provide an accounting to the licensor.[50]

48. A contract may be executory for purposes of section 365 of the Bankruptcy Code notwithstanding the fact that the debtor's or nondebtor party's "continuing obligation [is] only one of forbearance." *Lubrizol*, 756 F.2d at 1045-46 (citing with approval the Ninth Circuit's holding in Fenix Cattle Co. v. Silver (*In re* Select-A-Seat Corp.), 625 F.2d 290, 292 (9th Cir. 1980)). For example, the contract at issue in *Select-A-Seat* was a software licensing agreement that the Ninth Circuit determined to be an executory contract based upon the following two obligations: (a) the nondebtor party was obligated to pay the debtor a royalty and (b) the debtor was under a continuing obligation not to sell the software to a third party. 625 F.2d at 292. Similarly, in *Lubrizol*, the Fourth Circuit determined that the debtor's obligation under the parties' agreement to restrict its right to license its process at a certain royalty rate was sufficient to make the contract executory for purposes of section 365 of the Bankruptcy Code. 756 F.2d at 1045-46. *See also, e.g.*, *CFLC*, 89 F.3d at 677 (finding that the nondebtor party's obligation under the parties' agreement to refrain from suing the debtor for infringement was sufficient to make the contract executory for purposes of section 365 of the Bankruptcy Code); *Access Beyond*, 237 B.R. at 44 (finding that parties' duties to refrain from suing each other under patent cross license made contract executory); *Paragon Trade Brands, Inc.*, No. 98-60390, at 7-8 (finding that a patent owner's promise not to enforce an injunction against the patent infringer/debtor's customers was sufficient forbearance to render the Conversion Agreement executed between the parties executory in the debtor's chapter 11 case); *Biopolymers*, 136 B.R. at 29-30 n.2 ("The trustee's contentions, that [the nondebtor party's] obligation to forbear from granting licenses to others and not to unreasonably withhold permission for sublicensing do not suffice to make the license agreement executory, are not sustainable."). In a similar vein, courts have determined that a covenant not to compete with the licensee contained in the license agreement is sufficient to render the license an executory contract. *See, e.g.*, *In re* Golconda, Inc., 56 B.R. 136, 137 (Bankr. M.D. Fla. 1985); *In re* Rovine Corp., 6 B.R. 661, 666 (Bankr. W.D. Tenn. 1980). *But see, e.g.*, *In re* Schneeweiss, 233 B.R. 28, 32 (Bankr. N.D.N.Y. 1999) (finding that an obligation not to compete did not render the underlying contract executory); *In re* Hughes, 166 B.R. 103, 105 (Bankr. S.D. Ohio 1994) (same) (not involving license); *In re* Drake, 136 B.R. 325, 327-28 (Bankr. D. Mass. 1992) (same); *In re* Oseen, 133 B.R. 527, 529 (Bankr. D. Idaho 1991) (same).

49. *See, e.g.*, *In re* Chipwich, Inc., 54 B.R. 427, 430 (Bankr. S.D.N.Y. 1985) (explaining that the contingency of a debtor/licensor's obligation to defend the licensee in infringement suits and indemnify the licensee for certain losses relating to the licensed property did not prevent these obligations from being an unperformed obligation of the debtor/licensor sufficient to render the license executory). *See also Lubrizol*, 756 F.2d at 1046.

50. *See, e.g.*, *Lubrizol*, 756 F.2d at 1046; *Chipwich*, 54 B.R. at 430; *In re* Petur U.S.A. Instrument Co., Inc., 35 B.R. 561, 563 (Bankr. W.D. Wash. 1983). It is generally recognized that one party's obligation to pay and the other party's obligation to accept such payments are not sufficient to render a contract executory under section 365 of the Bankruptcy Code. *See, e.g.*, *Lubrizol*, 756 F.2d at 1046 (and cases cited therein); *In re* Seabrook Island Ocean Club, Inc., 118 B.R. 410, 412 (Bankr. D.S.C. 1990). Nonetheless, because a licensor typically has obligations above and beyond the mere duty to accept the payment of royalties under the license agreement, this proposition does not prevent a license from qualifying as an executory contract under section 365 of the Bankruptcy Code. *See, e.g.*, *Lubrizol*, 756 F.2d at 1046; *Chipwich*, 54 B.R. at 430.

General Application of Section 365 of the Bankruptcy Code

A Debtor's Decision to Assume or Reject an Executory Contract

Section 365 of the Bankruptcy Code provides in pertinent part that "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[51] A court generally evaluates a trustee's or a debtor's request for authority to assume or reject an executory contract under the "business judgment" standard.[52] This

51. 11 U.S.C. § 365(a) (1994). To the extent that an intellectual property license agreement constitutes an executory contract, a debtor may assume the license agreement under section 365(a) of the Bankruptcy Code, provided that the other requirements of that section are satisfied. Nonetheless, if applicable nonbankruptcy law excuses the nondebtor party to the license agreement from accepting performance from or rendering performance to an entity other than the debtor, the debtor may not assume or assign that agreement *unless the nondebtor party to the agreement consents. See* 11 U.S.C. § 365(c). The United States Court of Appeals for the Third Circuit has held that section 365(c)(1) "creates a hypothetical test—i.e., under applicable law, could the [nondebtor party] refuse performance from 'an entity other than the debtor or the debtor in possession.'" *In re* West Electronics Inc., 852 F.2d 79, 83 (3d Cir. 1988). *See also, e.g.*, Perlman v. Catapult Entertainment, Inc. (*In re* Catapult Entertainment, Inc.), 165 F.3d 747, 750 (9th Cir. 1999) (adopting the hypothetical test pronounced by the Third Circuit in *West Electronics*), *cert. dismissed*, __ U.S. __, 120 S.Ct. 369 (1999); *In re* James Cable Partners, 27 F.3d 534, 537 (11th Cir. 1994) (same); Access Beyond Technologies, 237 B.R. 32, 48-49 (Bankr. D. Del. 1999) (same). Several courts applying the Third Circuit's hypothetical test under section 365(c)(1) have determined that a debtor may not assume or assign a patent license agreement, unless the nondebtor party to the agreement consents. *See, e.g.*, *Perlman*, 165 F.3d at 750; *Access Beyond*, 237 B.R. at 48-49. These courts support their decisions by noting that "'the long-standing federal rule of law with respect to the assignability of patent license agreements provides that these agreements are personal to the licensee and not assignable unless expressly made so in the agreement.'" *Access Beyond*, 237 B.R. at 45 (quoting Unarco Indus., Inc. v. Kelley Co., 465 F.2d 1303, 1306 (7th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973)). Other courts, however, have rejected the hypothetical test pronounced by the Third Circuit. These courts generally hold that, even if applicable nonbankruptcy law prohibits the assignment of the particular contract, so long as the debtor is not seeking to assign the contract to a third party, the debtor may assume the contract notwithstanding section 365(c)(1) of the Bankruptcy Code. *See, e.g.*, Summit Inv. and Dev. Corp. v. Leroux, 69 F.3d 608, 612-13 (1st Cir. 1995). To the extent that a debtor may not assume the license under section 365(c), it arguably may not assign it either under sections 365(c) and 365(f) of the Bankruptcy Code.

52. *See, e.g.*, NLRB v. Bildisco & Bildisco, 465 U.S. 513, 523 (1984) (explaining that the business judgment test is the traditional standard by which to evaluate a debtor's decision under section 365) (citing Group of Institutional Invs. v. Chicago, Milwaukee, St. Paul & Pacific R.R., 318 U.S. 523, 549-51 (1943) (explaining that the decision to assume or reject a lease is one of business judgment)); *Lubrizol*, 756 F.2d at 1047 (explaining that a debtor's decision to assume or reject an executory contract under section 365 must be evaluated under the business judgment standard); Control Data Corp. v. Zelman (*In re* Minges), 602 F.2d 38, 43 (2d Cir. 1979) (same). *See also In re* G.I. Indus., Inc., 204 F.3d 1276, 1282 (9th Cir. 2000) (stating that "a bankruptcy court applies the business judgment rule to evaluate a trustee's rejection decision"); Four B. Corp. v. Food Barn Stores, Inc. (*In re* Food Barn Stores, Inc.), 107 F.3d 558, 567 n.16 (8th Cir. 1997) (recognizing that a "court uses a business judgment test in deciding whether to approve a trustee's motion to assume, reject, or assign an unexpired lease or executory contract"); Orion Pictures Corp. v. Showtime Networks, Inc. (*In re* Orion Pictures Corp.), 4 F.3d 1095, 1099 (2d Cir. 1993) (explaining that "a bank-

standard focuses on the benefit derived by the debtor's bankruptcy estate and its creditors from the proposed treatment of the executory contract under section 365 of the Bankruptcy Code.[53] For the most part, courts

ruptcy court reviewing a trustee's or debtor-in-possession's decision to assume or reject an executory contract should examine [the] contract and the surrounding circumstances and apply its best 'business judgment' to determine if it would be beneficial or burdensome to the estate to assume"), *cert. dismissed*, 511 U.S. 1026 (1994); *In re* Market Square Inn, Inc., 978 F.2d 116, 121 (3d Cir. 1992) (stating that "[t]he resolution of this issue of assumption or rejection will be a matter of business judgment by the bankruptcy court"); Sharon Steel Corp. v. National Fuel Gas Distr. Corp., 872 F.2d 36, 39-40 (3d Cir. 1989) (approving the bankruptcy court's application of the business judgment test); Control Data Corp v. Zelman (*In re* Minges), 602 F.2d 38, 43 (2d Cir. 1979) (stating that the business judgment test is a flexible test for determining when an executory contract may be rejected); *In re* Steaks To Go, Inc., 226 B.R. 35, 38 (Bankr. E.D. Mo. 1998) (finding that the Debtors "business judgment and the best interests of the estate" supported rejection of the agreements); Phar-Mor, Inc. v. Strouss Bldg. Assocs., 204 B.R. 948, 951-52 (N.D. Ohio 1997) (stating that "[w]hether an executory contract is 'favorable' or 'unfavorable' is left to the sound business judgment of the debtor," and that "[c]ourts should generally defer to a debtor's decision whether to reject an executory contract"); *In re* Spectrum Info. Techs., Inc., 190 B.R. 741, 745-46 (Bankr. E.D.N.Y. 1996) (noting that "[a]pproval of a debtor's assumption or rejection of an executory contract is contingent upon the exercise of the debtor's business judgment"); Software Customizer, Inc. v. Bullet Jet Charter, Inc. (*In re* Bullet Jet Charter, Inc.), 177 B.R. 593, 601 (Bankr. N.D. Ill. 1995) (stating that the "bankruptcy judge should have a deferential view of the debtor's business judgment" when determining whether to approve a debtor's decision to reject an executory contract); Glenstone Lodge, Inc. v. Buckhead Am. Corp. (*In re* Buckhead Am. Corp.), 180 B.R. 83, 88 (D. Del. 1995) (approving the bankruptcy court's application of the business judgment test to evaluate the debtor's assumption of an agreement); *In re* Stable Mews Assocs., Inc., 41 B.R. 594, 596 (Bankr. S.D.N.Y. 1984) (applying the business judgment test and noting that the "great weight of modern authority applies . . . [and] virtually all recent Bankruptcy Court decisions apply this test"); 3 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 365.03[2], at 365-22 through 365-24. *But see, e.g.*, Robertson v. Pierce (*In re* Chi-Feng Huang), 23 B.R. 798, 801-03 (B.A.P. 9th Cir. 1982) (applying, in the rejection context, a "balancing of the equities" standard that weighed the benefit generated for the debtor's unsecured creditors by rejection against the harm caused to the nondebtor party by the same); *In re* Matusalem, 158 B.R. 514, 522 (Bankr. S.D. Fla. 1993) (denying the debtor/licensor's request to reject the license agreement because the debtor did not exercise good business judgment in reaching its decision to reject, but rather, the decision appeared to be one driven primarily by the desire to injure the licensee's business); Infosystems Tech., Inc. v. Logical Software, Inc. (*In re* Logical Software, Inc.), Bankr. L. Rep. (CCH) ¶ 71,899, 1987 U.S. Dist. LEXIS 6285, at *3 (D. Mass. June 25, 1987) (same); Bregman v. Meehan (*In re* Meehan), 59 B.R. 380, 385 (E.D.N.Y. 1986) (same); *Petur U.S.A.*, 35 B.R. at 563 (same).

53. *See, e.g., Group of Institutional Invs.*, 318 U.S. at 550 (explaining that, under the business judgment test, the provisions of a lease must be attractive to the debtor and its creditors in order for the debtor to assume the lease); *Lubrizol*, 756 F.2d at 1047 (explaining that, under the business judgment test, a court only is reviewing the debtor's decision to either assume or reject the executory contract to determine whether such a decision is advantageous to the debtor and its estate). *See also In re* Federated Dep't Stores, Inc., 131 B.R. 808, 812 (S.D. Ohio 1991) (explaining that the business judgment test "requires the bankruptcy court to examine the impact of the decision to reject on the debtors, not the general unsecured creditors"); Wheeling-Pittsburgh Steel Corp. v. West Penn Power Co. (*In re* Wheeling-Pittsburgh Steel Corp.), 72 B.R. 845, 847 (Bankr. W.D. Pa. 1987) ("Once the debtor establishes that rejection will benefit the estate, our inquiry ends.").

are reluctant to interfere with a debtor's decision under the business judgment standard absent a showing of bad faith or abuse of discretion.[54]

In deciding whether to assume or reject an executory contract, a debtor must consider the contract as a whole because the Bankruptcy Code does not permit a debtor to rewrite the terms of an executory contract. Rather, a debtor must either assume or reject an executory contract in its entirety.[55] Additionally, if a default exists under the executory contract and a debtor desires to assume the contract, the debtor must cure the default (or provide adequate assurance thereof), compensate the nondebtor party to the contract for any actual pecuniary loss relating to such default (or provide adequate assurance thereof), and provide adequate assurance of future performance under the contract.[56]

A Nondebtor Party's Rights Prior to Assumption or Rejection

Prior to a debtor's decision to assume or reject an executory contract, the nondebtor party to the contract must continue to perform its obligations thereunder.[57] This duty to perform, however, is not reciprocal and,

54. *See, e.g.*, *Lubrizol*, 756 F.2d at 1047 (explaining that, under the business judgment test, "courts should defer to—should not interfere with—decisions of corporate directors upon matters entrusted to their business judgment except upon a finding of bad faith or gross abuse of their 'business discretion'"); *see also Market Square Inn*, 978 F.2d at 121 (same); *Sharon Steel*, 872 F.2d at 39-40 (same); *In re* Southern Cal. Sound Sys., Inc., 69 B.R. 893, 896-99 (Bankr. S.D. Cal. 1987) (same); cases cited *supra* note 52.

55. *See* 3 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 365.03[1], at 365-22. *See also Bildisco & Bildisco*, 465 U.S. at 531 (a debtor must assume an executory contract "*cum onere*"); Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co., 83 F.3d 735, 741 (5th Cir. 1996); City of Covington v. Covington Landing Ltd. Partnership, 71 F.3d 1221 (6th Cir. 1995); Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1311 (5th Cir. 1985); *In re* Lovitt, 757 F.2d 1035, 1040-41 (9th Cir. 1985), *cert. denied sub nom.* Cheadle v. Appleatchee Riders Assoc., 474 U.S. 849 (1985); Cottman Transmissions, Inc. v. Holland Enters., Inc. (*In re* Holland Enters., Inc.), 25 B.R. 301, 303 (E.D.N.C. 1982); *In re* Village Rathskeller, Inc., 147 B.R. 665, 671 (Bankr. S.D.N.Y. 1992).

56. 11 U.S.C. § 365(b)(1) (1994). A debtor is not required to cure any default relating to: (i) the insolvency or financial condition of the debtor; (ii) the commencement of the bankruptcy case; (iii) the appointment of a trustee in bankruptcy or custodian prior to bankruptcy; or (iv) the payment of penalties arising from the debtor's failure to perform nonmonetary obligations under the contract. 11 U.S.C. § 365(b)(2) (A-D).

57. *See, e.g.*, Krafsur v. UOP (In re El Paso Refinery, L.P.), 196 B.R. 58, 72 (Bankr. W.D. Tex. 1996) ("The [Bankruptcy] Code places an independent duty on the non-debtor to continue the performance of an executory contract until it is assumed or rejected. . . . Whether the debtor performs or not, the non-debtor must perform until assumption or rejection."). *See also, e.g.*, Data-Link Sys., Inc. v. Whitcomb & Keller Mortgage Co. (*In re* Whitcomb & Keller Mortgage Co.), 715 F.2d 375, 378-79 (7th Cir. 1983); Seacost Prods., Inc. v. Spring Valley Farms, Inc., 34 B.R. 379 (M.D.N.C. 1983); Continental Energy Assocs. Ltd. Partnership v. Hazelton Fuel Management Co. (*In re* Continental Energy Assocs. Ltd. Partnership), 178 B.R. 405 (Bankr. M.D. Pa. 1995); McLean Indus., Inc. v. Medical Lab. Automation, Inc. (*In re* McLean Indus., Inc.), 96 B.R. 440, 447-50 (Bankr. S.D.N.Y. 1989); Skeen v. Denver Coca-Cola Bottling Co. (*In re* Feyline Presents, Inc.), 81 B.R. 623 (Bankr. D. Colo. 1988); *In re* Chick Smith Ford, 46 B.R. 515 (Bankr. M.D. Fla. 1985).

consequently, a debtor is not required to perform its contractual obligations until it has elected to assume the contract under section 365 of the Bankruptcy Code.[58] Indeed, during this interim period, the nondebtor party's only rights against the debtor are for payment of its postpetition services to the debtor as an administrative expense claim under section 503(b) of the Bankruptcy Code[59] and to request that the court compel the debtor to make its decision to either assume or reject the contract.[60] Otherwise, a debtor is not required to assume or reject an executory contract (and, therefore, is not required to perform its obligations under such contract) until the confirmation of a plan of reorganization in the debtor's bankruptcy case.[61]

58. *See, e.g., Bildisco & Bildisco*, 465 U.S. at 532 (holding that an executory contract is not enforceable against the bankruptcy estate until the contract is assumed by the debtor under section 365 of the Bankruptcy Code).

59. 11 U.S.C. § 503(b) (1994).

60. *Id.*, § 365(d)(2). Courts generally allow a debtor a "reasonable time" within which to make its assumption or rejection decision. *See, e.g., Data-Link,* 715 F.2d at 379; South Street Seaport Ltd. Partnership v. Burger Boys, Inc. (*In re* Burger Boys, Inc.), 94 F.3d 755, 761 (2d Cir. 1996) (citing Theatre Holding Corp. v. Mauro, 681 F.2d 102, 105-06 (2d Cir. 1982)); In re Dunes Casino Hotel, 63 B.R. 939, 949-50 (D.N.J. 1986); *In re* Mayer Pollock Steel Corp., 157 B.R. 952, 964 (Bankr. E.D. Pa. 1993). The reasonableness of the time allotted a debtor to make its assumption or rejection decision is based upon a totality of the circumstances analysis and determined on a case-by-case basis. *See, e.g., Burger Boys,* 94 F.3d at 761; *In re* Lionel Corp., 23 B.R. 224, 225 (Bankr. S.D.N.Y. 1982) (citing the following factors as relevant in a court's decision regarding whether a debtor has had a reasonable time to evaluate an executory contract or lease: (i) "the nature of the interests at stake;" (ii) "balance of hurt to the litigants;"(iii) "the good to be achieved;" (iv) "safeguards afforded to the litigants;" and (v) whether the action is in derogation of a statutory scheme) (citation omitted). The legislative history to section 365(d)(2) indicates that it was intended to "prevent parties in contractual or lease relationships with the debtor from being left in doubt concerning their status vis-a-vis the estate." H.R. Rep. No. 95-595, at 348 (1977); S. Rep. No. 95-989, at 57 (1978). Nevertheless, in spite of this legislative history, courts are often times reluctant to force a debtor to make an early assumption or rejection decision. *See, e.g., Data-Link,* 715 F.2d at 379 (affirming the bankruptcy court's decision preserving the debtor's "reasonable time" to assume or reject an unexpired computer lease even though it was evident that the lease was necessary to the debtor's reorganization); Procter & Gamble, Co. v. Paragon Trade Brands, Inc. (*In re* Paragon Trade Brands, Inc.), No. 98-60390, at 9-11 (Bankr. N.D. Ga. June 3, 1998) (denying the creditor's motion to compel assumption or rejection of an executory contract because forcing the debtor to assume or reject the contract could prejudice the debtor's estate by binding the estate to the terms of the contract or subjecting the estate to a large rejection damages claim, respectively, depending upon the resolution of the underlying patent infringement lawsuit); *In re* Wheeling-Pittsburgh Steel Corp., 54 B.R. 385, 388-89 (Bankr. W.D. Pa. 1985) (denying the creditor's motion to compel assumption or rejection where the debtor was timely performing its obligations under the contract).

61. 11 U.S.C. § 365(d)(2). It is important to note that in the chapter 7 context, if the trustee does not assume or reject an executory contract within 60 days after the date that the case was commenced (as may be extended by the court for cause), the contract is deemed rejected. 11 U.S.C. § 365(d)(1).

A Nondebtor Party's Rights Upon Rejection of an Executory Contract

Rejection of an executory contract is not equivalent to termination of the contract.[62] Rather, upon rejection of an executory contract, the debtor is deemed to be in breach of the contract immediately prior to the bankruptcy petition date.[63] As a result, the nondebtor party to the rejected contract is entitled to assert a prebankruptcy claim for any damages that it sustains as a result of the debtor's breach of the executory contract.[64]

THE ENHANCED PROTECTION PROVIDED BY THE BANKRUPTCY CODE TO A NONDEBTOR LICENSEE TO A PREBANKRUPTCY INTELLECTUAL PROPERTY AND TECHNOLOGY LICENSE WITH A DEBTOR

In addition to the general rights provided a nondebtor party to a prebankruptcy executory contract under section 365 of the Bankruptcy Code discussed above, Congress saw it necessary to grant a nondebtor licensee additional protection because of the detrimental impact that rejection of

62. *See, e.g.,* Medical Malpractice Ins. Assn v. Hirsch (*In re* Lavigne), 114 F.3d 379, 386-87 (2d Cir. 1997); Eastover Bank for Savs. v. Sowashee Venture (*In re* Austin Dev. Co.), 19 F.3d 1077, 1082-83 (5th Cir. 1994); *In re* Bergt, 241 B.R. 17, 30-32 (Bankr. D. Alaska 1999); CASC Corp. v. Milner II (*In re* Locke), 180 B.R. 245, 259 (Bankr. C.D. Cal. 1995); *In re* Giles Assoc., Ltd., 92 B.R. 695 (Bankr. W.D. Tex. 1988). *But see* Commercial Fin., Ltd. v. Hawaii Dimensions, Inc. (*In re* Hawaii Dimensions, Inc.), 47 B.R. 425, 427-28 (Bankr. D. Haw. 1985) (holding that rejection of a lease operates to terminate the lease); Hassett v. Sprague Elec. Co. (*In re* O.P.M. Leasing Serv., Inc.), 30 B.R. 642 (Bankr. S.D.N.Y. 1983) (same). For a general discussion of the theories supporting rejection as a form of breach and those supporting rejection as a form of termination, *see In re* Bergt, 241 B.R. 17 (Bankr. D. Alaska 1999).

63. Section 365(g) provides in pertinent part:

> [T]he 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.

11 U.S.C. § 365(g)(1). *See also* Aslan v. Sycamore Inv. Co. (*In re* Aslan), 909 F.2d 367, 371-72 (9th Cir. 1990) (explaining that the date of breach is the date immediately preceding the petition date and not some earlier or different date); *In re* O.P.M. Leasing Svcs., Inc., 79 B.R. 161, 167 (Bankr. S.D.N.Y. 1987) (explaining that a nondebtor party's damages must be discounted to the petition date).

64. Section 502(g) of the Bankruptcy Code provides in pertinent part:

> A claim arising from the rejection, under section 365 of this title or under a plan under chapter 9, 11, 12, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

11 U.S.C. § 502(g).

an intellectual property and technology license agreement can have on a licensee's business.[65]

In General

There are three basic points to keep in mind with respect to section 365(n) of the Bankruptcy Code. First and foremost, section 365(n) applies *only* where (i) the debtor is the licensor under the license agreement[66] and (ii) the license is one for "intellectual property" as such term is defined in section 101(35A) of the Bankruptcy Code.[67] Second, section 365(n) applies to any intellectual property license executed prepetition, even if the term of the license had not yet begun on the bankruptcy petition date.[68] Finally, the basic principles underlying section 365, such as evaluating a debtor's assumption or rejection decision under the business judgment standard, apply to intellectual property licenses.[69]

Definition of "Intellectual Property" for Purposes of Section 365(n)

The Bankruptcy Code defines intellectual property to include: (i) a trade secret; (ii) an invention, process, design, or plant protected under title 35 of the U.S. Code; (iii) a patent application; (iv) a plant variety; (v) a work

65. *See* discussion of the legislative purpose underlying section 365(n) *supra* notes 8-13 and accompanying text. The rights granted a licensee under section 365(n) of the Bankruptcy Code are available only during the period prior to the debtor's assumption or rejection of the license and, after that period, only upon rejection of the license by the debtor. *See, e.g.*, Novon Int'l, Inc. v. Novamont S.p.A. (*In re* Novon Int'l, Inc.), Nos. 98-CV-0677E(F), 96-BK-15463B, 2000 U.S. Dist. LEXIS 5169, at *14 (W.D.N.Y. Mar. 31, 2000).

66. *See* 11 U.S.C. § 365(n)(1) (1994); *Prize Frize*, 32 F.3d at 428. As previously noted, a license need take no particular form and basically is a covenant not to sue for infringement. *See supra* note 35. Based upon this broad concept of a license, at least one court has determined that a franchise agreement giving the franchisee exclusive rights in copyrighted works was a "license of intellectual property" for purposes of section 365(n) of the Bankruptcy Code. *See Matusalem*, 158 B.R. 514, 521-22 (Bankr. S.D. Fla. 1993).

67. *See* 11 U.S.C. §§ 365(n)(1), 101(35A); *Gucci*, 126 F.3d at 394 (noting that the definition of "intellectual property" set forth in section 101(35A) of the Bankruptcy Code does not include trademarks); *Prize Frize*, 32 F.3d at 428; *Matusalem*, 158 B.R. at 521-22. *See also infra* notes 70-72 and accompanying text.

68. *See* 3 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 365.14[1][a], at 365-87 (noting that, unlike its counterpart section 365(h) (which governs the rights of a real property lessee upon rejection of an unexpired lease of real property by a debtor/lessor), section 365(n) does not require the term of a license to have commenced prepetition in order for the license to fall within the protections of the section). *See also* S. Rep. No. 100-505, at 8 (1988) ("It is important to note that the amendment, when referring to retention of rights under 'such contract,' deliberately omits the phrase 'the term of which has commenced' appearing in the somewhat parallel subsection 365(h) . . . .").

69. *See* 3 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 365.14[1][a], 365-87. *See supra* notes 52-54 and accompanying text.

of authorship protected under title 17 of the U.S. Code; or (vi) a mask work protected under chapter 9 of title 17 of the U.S. Code.[70] Most notably, this definition of intellectual property does not encompass trademarks,[71] which Congress specifically excluded from the Intellectual Property Act. The legislative history to section 101(35A) indicates that because trademark, trade name, and service mark license agreements "depend to a large extent on control of the quality of the products or service" licensed, Congress found such license agreements to be beyond the scope of the Intellectual Property Act.[72]

Section 101(35A) identifies certain categories of property that may constitute intellectual property and relies upon nonbankruptcy law to define the scope of the particular category. As a result, to understand fully the scope of the definition of intellectual property set forth in section 101(35A) of the Bankruptcy Code, it is necessary to have a general understanding of the Patent Act, the Copyright Act, and trade secret laws.[73]

70. 11 U.S.C. § 101(35A). In other contexts, the term "intellectual property" typically includes "utility patents, trade secrets, copyrights, trademarks, design patents, plant patents, plant variety protection, semiconductor mask work protection, false advertising remedies, misappropriation, and public rights." DONALD S. CHISUM & MICHAEL A. JACOBS, UNDERSTANDING INTELLECTUAL PROPERTY LAW § 1E, at 1-3 (1992) [hereinafter UNDERSTANDING INTELLECTUAL PROPERTY LAW]. This general definition of intellectual property varies from that set forth in the Bankruptcy Code in that section 101(35A) of the Bankruptcy Code is focused on the actual type of property in which an intellectual property proprietor obtains rights (e.g., invention, process, design) and the legal mechanism for protecting such property rights (e.g., trade secret, patents, and copyrights). *See* S. REP. NO. 100-505, at 7 (1988). Thus, section 101(35A) does not include false advertising remedies, misappropriation, public rights and, as explained above, trademarks, trade names, or service marks. Likewise, sections 101(35A) and 365(n) have been interpreted to exclude "licenses of technology or content that are not protected by federal copyright or patent law [and] licenses for the use of some database compilations." WARREN E. AGIN, BANKRUPTCY AND SECURED LENDING IN CYBERSPACE § 10, at 10-9 (Bowne 2000) [hereinafter AGIN]. Throughout the remainder of this Article, references to "intellectual property" encompass intellectual property and technology within the definition of section 101(35A) of the Bankruptcy Code.

71. *See, e.g., Gucci*, 126 F.3d at 394; Richard Lieb, *The Interrelationship of Trademark Law and Bankruptcy Law*, 64 AM. BANK. L.J. 1, 4 (1990).

72. S. Rep. No. 100-505, at 5 (explaining that "[s]ince these matters [i.e., trademark, trade name, and service mark license agreements] could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts").

73. Unlike patent and copyright law, trade secret law is a creature of state, and not federal, law. As a result, a party's rights with respect to trade secrets may vary depending upon the laws of the particular state governing the transaction. Despite the absence of a uniform federal law, most states derive their trade secret law from one of two sources and thus, in practice, there is little variance in trade secret law from state to state. These two sources are (a) the Uniform Trade Secrets Act, first promulgated in 1979 and subsequently amended in 1985 and (b) the RESTATEMENT OF TORTS § 757 (1939) (RESTATEMENT). *See generally* DRATLER, *supra* note 36, at 1-4 n.8 (explaining the two sources of trade secret law and setting forth the twenty states that have adopted the Uniform Trade Secrets Act).

The Patent Act

The definition of intellectual property set forth in the Bankruptcy Code includes inventions, processes, designs, and plants protected under the Patent Act. The Patent Act, in turn, applies to any new and useful process, machine, manufacture, or composition of matter, or any "new and useful improvement thereof."[74] Consequently, if any entity invents or discovers a new and useful process, machine, manufacturer, or composition of matter, it may apply to the U.S. Patent and Trademark Office (PTO) for a patent covering its invention or discovery.[75] Such a patent, if granted, conveys, among other things, the right to exclude others from "making, using, offering for sale, or selling" the product or process subject to the patent in the United States.[76] A patent generally bestows the exclusive right to make, use, or sell the invention upon the patentee for a period of twenty years.[77]

The Copyright Act

Copyright law protects[78] various modes of "idea expression," including works of authorship embodied in a tangible medium of expression and

74. 35 U.S.C. § 101 (1994).

75. *See generally* 37 C.F.R. § 1.10 (1994).

76. UNDERSTANDING INTELLECTUAL PROPERTY LAW, *supra* note 70, at 1-3 through 1-4. Specifically, section 154(a) provides in pertinent part:

> [A patent grants] to the patentee, his heirs or assigns, . . . the right to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention into the United States, and, if the invention is a process, . . . the right to exclude others from using, offering for sale or selling throughout the United States, or importing into the United States, products made by that process, referring to the specification for the particulars thereof.

35 U.S.C. § 154(a)(1) (1994).

77. *Id.* § 154(a)(2) (this 20-year term is calculated from the date that the patent application is filed in the PTO).

78. Copyright protection is automatic; it arises upon the work's creation, which the Copyright Act defines as a point in time at which a work is fixed in a copy or phonorecord for the first time. 17 U.S.C. § 101. *See also* UNDERSTANDING INTELLECTUAL PROPERTY LAW, *supra* note 70, at 4-97. The Copyright Act no longer requires that a copyright notice (i.e., a "c" in a circle or the word "copyright" accompanied by the year of publication and the name of the copyright owner) be attached to the work. *See* Berne Convention Implementation Act of 1988, P.L. 100-568, 102 Stat. 2853 (Oct. 31, 1988) (making the copyright notice optional for works published on or after March 1, 1989). Notwithstanding the fact that the Copyright Act no longer requires a copyright notice, a copyright owner may obtain greater protection by including such a notice on publicly distributed copies of the copyrighted work because, in an infringement action with respect thereto, the alleged infringer may be estopped from asserting an innocent infringement defense under 17 U.S.C. § 401(d) (1994). The Copyright Act does, however, require the owner of the copyright to deposit "two complete copies of the best edition" of the work (or, if the work is a sound recording, "two complete phonorecords of the best edition") in the copyright office within three months after the date of publication of the work. *See* 17 U.S.C. § 407 (such copies or phonographs are for the use or

mask works fixed in a semiconductor chip product.[79] A "work of authorship" for purposes of the Copyright Act includes: (i) literary works; (ii) musical works, including any accompanying works; (iii) dramatic works, including any accompanying music; (iv) pantomimes and choreograph works; (v) pictorial, graphic and sculptural works; (vi) motion pictures and other audio visual works; (vii) sound recordings; and (viii) architectural works.[80] Copyright protection[81] generally extends over the subject work from the date of the work's creation until seventy years after the author's death.[82]

Trade Secret Law

Information constitutes a trade secret if it "derives 'economic value . . . from not being generally known to, and not being readily ascertainable by proper means by, [*sic*] other persons' and it 'is the subject of efforts that are reasonable under the circumstances to maintain se-

disposition of the Library of Congress). Additionally, the Copyright Act provides for the registration of copyrighted works. *See* 17 U.S.C. §§ 408-410. Although this registration requirement is optional, an action for infringement of the copyrighted work generally may not be commenced unless the work is registered within three months after its first publication. *See* 17 U.S.C. §§ 411-412. The exceptions to the general prohibition on infringement actions absent a copyright being registered with the Copyright Office are set forth in section 411(a) of the Copyright Act and include actions for infringement of "Berne Convention works" whose country of origin is not the United States in actions for infringement based upon section 106A(a) of the Copyright Act (relating to the rights of an author of a work of visual art to attribution and integrity). *See* 17 U.S.C. § 411(a).

79. 17 U.S.C. § 902. Additionally, a mask work is "fixed" in a semiconductor chip product if "its embodiment in the product is sufficiently permanent or stable to permit the mask work to be perceived or reproduced from the product for a period of more than transitory duration." 17 U.S.C. § 901.

80. 17 U.S.C. § 102(a)(1-8).

81. Subject to certain exceptions, a copyright conveys the following exclusive rights on the copyright owner: (i) the right to reproduce the work; (ii) the right to prepare derivative works; (iii) the right to distribute reproductions of the work; (iv) the right to perform the work publicly; and (v) the right to display the work publicly. *See* 17 U.S.C. § 106. The primary exceptions to the broad rights granted a copyright owner under 17 U.S.C. § 106 include: (i) fair use, *see* 17 U.S.C. § 107; (ii) reproduction by libraries or archives, *see* 17 U.S.C. § 108; (iii) subsequent sale, transfer or disposal of the copyrighted work, *see* 17 U.S.C. § 109; and (iv) performances or displays of the copyrighted work for educational purposes, *see* 17 U.S.C. § 110. A copyright owner generally may commence an infringement action against any entity performing an unauthorized act within the scope of the owner's exclusive rights. *See* 17 U.S.C. § 501(a). If an authorized use of the work does not fall within the owner's exclusive rights, an infringement action may not be sustained. *See, e.g.,* Twentieth Century Music Corp. v. Aiken, 422 U.S. 151, 155 (1975).

82. *See* 17 U.S.C. § 302(a). With respect to joint works, the duration of the copyright generally is 70 years after the death of the last surviving author, and with respect to anonymous works and works for hire, the duration of the copyright is 95 years from the year of its first publication or 120 years from the year of its creation, whichever expires first. *See* 17 U.S.C. § 302(b), (c).

crecy.'"[83] The type of information typically considered to be a trade secret includes formulae, data compilations, programs, devices, processes, and customer lists.[84] Likewise, the Restatement defines a trade secret as "any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it."[85] The owner of a trade secret need take no special action to establish its ownership interest in the trade secret; however, this ownership interest is only protected for so long as the trade secret is withheld from the public domain.[86] "Information that is public knowledge or that is generally known in an industry cannot be a trade secret."[87]

Protection During the Postpetition, Pre-Rejection Period

Although a debtor typically is not required to perform its obligations under an executory contract pending its decision to assume or reject the contract,[88] section 365(n)(4) modifies this principle slightly in the context of intellectual property licenses.[89] Upon the filing of a bankruptcy petition by a debtor/licensor (and until such time as the debtor/licensor rejects the license), section 365(n) gives a licensee the ability to request that the trustee or debtor in possession continue to perform under an intellectual property

83. UNDERSTANDING INTELLECTUAL PROPERTY LAW, *supra* note 70, at 1-3 through 1-4 (quoting Uniform Trade Secrets Act § 1(4)).

84. UNDERSTANDING INTELLECTUAL PROPERTY LAW, *supra* note 70, at 1-3 through 1-4 (quoting Uniform Trade Secrets Act § 1(4)).

85. RESTATEMENT § 757 cmt. b.

86. *See, e.g.*, UNDERSTANDING INTELLECTUAL PROPERTY LAW, *supra* note 70, at 3-27 (citing RESTATEMENT, cmt. a for the proposition that "protection . . . [is] not limited to a fixed number of years."). *See also* Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1002 (1983) ("If an individual discloses his trade secret to others who are under no obligation to protect the confidentiality of the information, or otherwise publicly discloses the secret, his property right is extinguished.") (citations omitted).

87. *Ruckelshaus*, 467 U.S. at 1002.

88. *See* discussion *supra* note 58 and accompanying text.

89. Section 365(n)(4) provides in pertinent part:

> 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.

11 U.S.C. § 365(n)(4) (1994).

license.[90] Once a licensee makes such a request in writing, the trustee or debtor in possession must, to the extent provided in the license or a supplementary agreement thereto, either (i) continue to perform its obligations under the license[91] or (ii) turn over to the licensee the licensed property, including any embodiment thereof.[92] Additionally, the trustee or debtor in possession may not interfere with the rights of the licensee under the intellectual property license or any supplementary agreement thereto.[93]

Protection Upon Rejection of an Intellectual Property License

If a debtor/licensor elects to reject an intellectual property license, the licensee may either (i) treat the intellectual property license as terminated (if the debtor/licensor's rejection would constitute a breach under the intellectual property license allowing the licensee to terminate the license)[94] or (ii) retain its rights under the license for the initial term of the license and any lawful extensions thereof.[95]

90. *Id.*

91. *See id.* § 365(n)(4)(A)(i).

92. *See id.* § 365(n)(4)(A)(ii). A trustee's or debtor in possession's obligation to turn over property subject to an intellectual property license applies *only* to property in existence as of the date that the debtor filed its bankruptcy petition. *See* S. REP. NO. 505, 100th Cong., 2d Sess. 10 (1988). In light of this legislative history, section 365(n) arguably does not give the licensee any rights in postpetition property—i.e., any postpetition improvements or variations of the intellectual property. *Id. See also infra* notes 104 and 105.

93. *See* 11 U.S.C. § 365(n)(4)(B). This subsection does not shield a licensee from the trustee's or debtor in possession's avoiding powers under sections 544, 545, 546, 547, 548, and 549 of the Bankruptcy Code. *See* S. Rep. No. 100-505, at 10-11. *See also supra* note 21.

94. Section 365(n)(1)(A) provides in pertinent part:

> 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;

11 U.S.C. § 365(n)(1)(A).

95. Section 365(n)(1)(B) provides in pertinent part:

> 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—
> (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

Treating the License as Terminated

Section 365(n)(1)(A) essentially preserves the rights of a licensee upon rejection of an intellectual property license as they existed prior to the enactment of the Intellectual Property Act,[96] i.e., the licensee may treat the contract as terminated, cease performing its obligations under the license, and file a general unsecured claim against the debtor/licensor for damages arising from the debtor/licensor's breach of the license agreement under section 502(g) of the Bankruptcy Code.[97] The shortcoming of this option for most intellectual property licensees is twofold. First, it is often difficult to measure the monetary damage caused by a debtor/licensor's rejection of the license agreement.[98] Unlike the situation where, if a debtor/licensee rejects an intellectual property license, the licensor may file a general unsecured claim for the estimated royalties that it would have received from the licensee during the life of the license, a debtor/licensor has no monetary obligations to the licensee. Second, even if a licensee can estimate the damage caused to its business by the debtor/licensor's rejection of the license, a damage award typically does not give the licensee what it really needs, i.e., the licensed property to continue the operation of its business.

Retaining Rights Under the License

The major revision to section 365 implemented by the Intellectual Property Act is that, upon rejection of a license agreement by a debtor/licensor, a licensee may elect to retain its rights under the license agreement for the initial term of the license and any lawful extensions thereof. This revision mirrors the relief provided to a lessee of real property under an unexpired lease with a lessor/debtor and to a purchaser of real property under an executory contract with a seller/debtor under sections 365(h) and 365(i), respectively, of the Bankruptcy Code.[99]

Rights Protected by Section 365(n)(1)(B)

Section 365(n)(1)(B) allows a licensee to retain and exercise any right held by the licensee under the license, or any supplementary agreement thereto, as of the bankruptcy petition date.[100] Thus, if the licensee was

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

11 U.S.C. § 365(n)(1)(B).

96. *See* S. Rep. No. 100-505, at 8 (explaining that the relief provided by section 365(n)(1)(A) "would be available to the licensee without this bill [i.e., the Intellectual Property Act]").

97. 11 U.S.C. § 502(g). The text of section 502(g) of the Bankruptcy Code is set forth *supra* note 64.

98. *See infra* notes 122 and 148 and accompanying text for a discussion of liquidated damage provisions, which may assist in the calculation of damages.

99. *See* 11 U.S.C. §§ 365(h), (i). *See also* S. REP. NO. 100-505, at 5-6.

100. *See* 11 U.S.C. § 365(n)(1)(B).

granted an exclusive right in the intellectual property (and this right existed on the bankruptcy petition date),[101] a trustee or debtor in possession may not take any action (such as the licensing of the intellectual property to a third party) that interferes with this right.[102]

Rights Excluded from Section 365(n)

Most notably, section 365(n)(1)(B) does not protect a licensee's right to future performance by the debtor/licensor—i.e., other than the enforcement of an exclusivity clause, a licensee may not exercise any rights under applicable nonbankruptcy law to specific enforcement of the contract.[103] Likewise, a licensee has no rights in the licensed property except for those that existed on the bankruptcy petition date.[104] Thus, to the extent that the licensed property is modified or enhanced by the postpetition efforts of the debtor/licensor, the licensee arguably has no rights in such post-petition property.[105] In certain circumstances, this exception may undercut

101. *See id.* § 365(n)(1)(B) (noting that the section includes a licensee's right to enforce any exclusivity provision contained in the license).

102. *See* S. Rep. No. 100-505, at 9 (explaining that, with respect to exclusivity provisions, "the licensee is given the right to compel specific performance, i.e., to enjoin the licensing to another of the rights granted by the contract to the licensee. Retention of contractual rights, both in extent and quality, is a central aim of the bill.")

103. *See* 11 U.S.C. § 365(n)(2), (3) (noting that a trustee or debtor in possession need only allow the licensee to exercise its rights under the license and provide the licensee with the intellectual property and any embodiment thereof to which it is entitled under the license). *See also* S. Rep. No. 100-505, at 9 ("If the trustee has chosen to reject the license, the licensee, although entitled to elect to retain the use of the existing intellectual property without interference, cannot otherwise compel affirmative post-petition performance under the license."). Thus, arguably, the licensee could not exercise an option to purchase the intellectual property included in the license agreement after the debtor/licensor commenced its bankruptcy case.

104. *See* 11 U.S.C. § 365(n)(1)(B). *See also* S. Rep. No. 100-505, at 9 (explaining that a licensee under a rejected license "is entitled to use the underlying intellectual property *in the state that it existed on the day of the bankruptcy filing* as provided in the license") (emphasis added).

105. *See* Szombathy v. Controlled Shredders, Inc., No. 97C481, 1997 WL 189314, at *2-*3 (N.D. Ill. Apr. 14, 1997) (noting with approval the bankruptcy court's decision that a licensee electing to retain its rights under a rejected license agreement has no interest in postpetition improvements or modifications to the licensed patent). *But see* C Tek Software, Inc. v. New York State Bus. Venture Partnership (*In re* C Tek Software), 127 B.R. 501, 507-508 (Bankr. D.N.H. 1991) (applying the doctrine of accession (*i.e.*, where articles attached to personal property become so closely incorporated with the principle article, the attachments become part of the principle article) to grant the nondebtor licensee ownership rights in postpetition improvements to intellectual property owned by the debtor/licensor where the nondebtor licensee's efforts procured the improved property). Given the dearth of case law on this issue, it simply is not clear how courts will reconcile section 365(n) and its legislative history with intellectual property improvement clauses and intellectual property law doctrines such as the Rule of Addition and the Doctrine of Equivalents. For a general discussion of the interplay between section 365(n) and intellectual property law in this respect, see Robert T. Canavan, *Unsolved Mysteries of Section 365(n)—When a Bankrupt Technology Licensor Rejects an Agreement Granting Rights to Future Improvements*, 21 SETON HALL L. REV. 800, 816-830 (1991) (explaining the arguments for and against allowing a licensee to retain its rights in future

the protection afforded a licensee by section 365(n) because, theoretically, a debtor/licensor may develop an advanced version of the licensed property postpetition and license this property to a third party, notwithstanding an exclusivity provision in a prepetition, rejected license.

Obligations of a Licensee Electing to Retain Its Rights

If a licensee elects to retain its rights under the license agreement, the licensee must continue to pay to the trustee or debtor in possession any and all royalties due under the license for the initial term of the license and any lawful extensions thereof.[106] A payment need not be labeled a "royalty" payment to fall within a licensee's obligation under section 365(n)(2). Some courts have interpreted the term "royalties" broadly to include any fee or payment due from the licensee under the license agreement, including the initial licensing fee.[107]

Waiver of Licensee's Rights to Certain Damages

In addition to having to pay for the use of the intellectual property under the license, a licensee desiring to retain its rights under a rejected license also must waive any claim that it has (or may have) against the debtor/licensor under the license agreement, other than a general unsecured claim. Once a licensee elects to retain its rights, the licensee is *deemed* to waive (i) any right that it may have to setoff under section 553 of the Bankruptcy Code or applicable nonbankruptcy law,[108] and (ii) any right

improvements of intellectual property under section 365(n) of the Bankruptcy Code and the use of intellectual property law by such a licensee to prevent others from using the improvements).

106. *See* 11 U.S.C. § 365(n)(2)(B); Encino Business Management, Inc. v. Prize Frize, Inc. (*In re* Prize Frize, Inc.), 32 F.3d 426, 428 (9th Cir. 1994).

107. *See infra* note 124 and accompanying text. *See also, e.g., Prize Frize*, 32 F.3d at 428-29 (holding that a licensee's obligation to pay royalties under section 365(n)(2) of the Bankruptcy Code encompasses all "payments by [a] licensee to [a] licensor for the use of intellectual property," including a license fee). *See also* Microsoft Corp. v. DAK Indus., Inc. (*In re* DAK Indus., Inc.), 66 F.3d 1091, 1096 n.3 (9th Cir. 1995) ("'Royalty payments' owed to the debtor under § 365(n) are interpreted broadly in order to insure that the estate receives full payment when a licensee takes advantage of the debtor's intellectual property.") (citing *Prize Frize*, 32 F.3d at 428).

108. *See* 11 U.S.C. § 365(n)(2)(C)(i). Section 553 of the Bankruptcy Code provides in pertinent part:

> Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . .

11 U.S.C. § 553(a). A right of setoff essentially gives a creditor a secured claim against the debtor because it allows the creditor to collect its prepetition claim against the debtor from prepetition amounts that it owes to the debtor. Thus, the amount of the creditor's prepetition debt to the debtor basically becomes security for its prepetition claim against the debtor.

that it may have to assert an administrative expense claim relating to the postpetition performance of the license under section 503(b) of the Bankruptcy Code.[109] As a result, any claim for damages that the licensee may hold against the licensor, whether pre- or postpetition, is relegated to a general unsecured claim against the debtor/licensor's estate.

Obligations of the Trustee or Debtor in Possession

Upon rejection of a license agreement under section 365 of the Bankruptcy Code, the trustee or debtor in possession no longer has an affirmative duty to perform its obligations under such license. Nevertheless, section 365(n) does impose certain "ministerial" obligations on the trustee or debtor in possession if the licensee elects to retain its rights under the

Similar in some respects to setoff is the doctrine of recoupment, which arguably does not fall within the scope of section 365(n)(2)(c)(i). Under the doctrine of recoupment, a nondebtor party may satisfy its claim against the debtor from a debt that it owes to the debtor if "'both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations.'" Megafoods Stores, Inc. v. Flagstaff Realty Assocs. (*In re* Flagstaff Realty Assocs.), 60 F.3d 1031, 1035 (3d Cir. 1995) (quoting University Med. Ctr. v. Sullivan (*In re* University Med. Ctr.), 973 F.2d 1065, 1081 (3d Cir. 1992)). Although related to the concept of setoff, the majority of courts hold that neither section 553 nor the automatic stay imposed by section 362 of the Bankruptcy Code apply to a party's right of recoupment and thus, a nondebtor party may exercise its right of recoupment under nonbankruptcy law against a debtor, despite the debtor's pending bankruptcy case. *See, e.g.*, New York State Elec. & Gas Co. v. McMahon (*In re* McMahon), 129 F.3d 93, 96-97 (2d Cir. 1997); Conoco, Inc. v. Styler (*In re* Peterson Distributing, Inc.), 82 F.3d 956, 959 (10th Cir. 1996); Security Pac. Nat'l Bank v. Enstar Petroleum Co. (*In re* Buttes Resources Co.), 89 B.R. 613 (S.D. Tex. 1988); United States v. Midwest Serv. & Supply Co., Inc. (*In re* Midwest Serv. & Supply Co.), 44 B.R. 262 (D. Utah 1983); Waldschmidt v. CBS, Inc., 14 B.R. 309 (M.D. Tenn. 1981). *But see* Wilson v. TXO Prod. Corp. (*In re* Wilson), 69 B.R. 960, 963 (Bankr. N.D. Tex. 1987) (refusing to allow a nondebtor party to exercise its right of recoupment because such an exercise would contravene the Supreme Court's holding in *NLRB v. Bildisco & Bildisco* that an executory contract or unexpired lease is unenforceable until assumed by the debtor). To date, no reported decisions have addressed the doctrine of recoupment in the context of section 365(n) of the Bankruptcy Code. Nevertheless, given the distinction between setoff and recoupment recognized by the courts and the failure of section 365(n)(2)(C)(i) to identify recoupment, a nondebtor licensee could argue that it retains the right to recoup a claim that it has against the licensor/debtor under the license agreement from a debt that it owes to the licensor/debtor under the license agreement even if it elects to retain its rights under the license agreement under section 365(n)(1)(B).

109. *See* 11 U.S.C. § 365(n)(2)(C)(ii). Section 503(b) provides in pertinent part:

> After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—
>
> (1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case;

11 U.S.C. § 503(b)(1)(A).

rejected license.[110] These obligations include: (i) allowing the licensee to exercise its rights under the rejected license;[111] (ii) upon written request from the licensee, turning over to the licensee any intellectual property or embodiment thereof to which the licensee is entitled under the license or any supplementary agreement thereto;[112] and (iii) upon written request from the licensee, refraining from interfering with the licensee's rights under the license or any supplementary agreement thereto.[113]

Escrow Agreements

As noted above, section 365(n) obligates a trustee in bankruptcy, upon the request of a licensee, to turn over to the licensee not only the intellectual property, but any embodiments thereof to which the licensee is entitled under the license or any supplementary agreements. Thus, to take full advantage of the rights granted a licensee under section 365(n), a licensee should request that the licensor transfer key elements, such as source codes for computer software or the embodiment of the licensed intellectual property, to an escrow agent pursuant to an escrow agreement.[114] The escrow

110. *See* S. Rep. No. 100-505, at 10-11 (1988).

111. *See* 11 U.S.C. § 365(n)(2)(A). *See also infra* notes 119-24 and accompanying text for prebankruptcy drafting tips relating to this provision.

112. *See id.* § 365(n)(3)(A). *See also infra* notes 119-24 and accompanying text for prebankruptcy drafting tips relating to this provision.

113. *See id.* § 365(n)(3)(B). Section 365(n)(3)(B) specifically states that a trustee or debtor in possession may not interfere with any right that a licensee may have under the license or any supplementary agreement thereto to obtain the licensed property or an embodiment thereof from a third party. The language of this subsection is intended to encompass those instances where property has been placed in escrow, only to be released by the third party escrow agent upon the occurrence of a specific event. *See* S. Rep. No. 100-505, at 9 (1988). *See also infra* notes 119-24 and accompanying text for prebankruptcy drafting tips relating to this provision.

114. Generally, property placed in escrow to assure the performance of a debtor's obligations is not considered property of the debtor's estate. *See, e.g.*, Dickerson v. Central Florida Radiation Oncology Group, 225 B.R. 241, 245 (M.D. Fla. 1998) (where purpose of escrow agreement is to assure the debtor's performance under settlement agreement, escrowed funds were not property of debtor's estate); *In re* Cedar Rapid Meats, Inc., 121 B.R. 562, 567-70 (Bankr. N.D. Iowa 1990) (where escrow agreement revealed that its underlying purpose was to assure the debtor's performance of its workers' compensation obligations, the escrowed property was not property of the debtor's estate); *In re* Palm Beach Heights Dev. & Sales Corp., 52 B.R. 181, 182-83 (Bankr. S.D. Fla. 1985) (same with respect to the debtor's construction obligations). *See also In re* Carousel Int'l Corp., 89 F.3d 359, 361 (7th Cir. 1996) (affirming the district court's decision that the escrowed funds were not property of the estate); Affiliated Computer Sys., Inc. v. Sherman (*In re* Kemp), 52 F.3d 546, 550-51 (5th Cir. 1995) ("In determining whether [funds held in escrow are] property of the debtors' estates, the bankruptcy courts in those cases [look] to the nature and circumstances of the underlying escrow agreements.") (and cases cited therein); TTS, Inc. v. Citibank, N.A. (*In re* TTS, Inc.), 158 B.R. 583, 584, 587 (D. Del. 1993) (affirming the bankruptcy court's holding that the escrow funds were not property of the debtor's estate, but noting that any prepetition interest of the debtor in the escrow did become part of the debtor's estate); *In re* All Chem. Isotope

agreement should be structured as two separate agreements—one between the licensor and escrow agent and one between the licensee and escrow agent—to prevent the debtor/licensor from attempting to reject the escrow agreement, as to the licensee, as an executory contract under section 365 of the Bankruptcy Code.[115] The net effect of these two escrow agreements basically should be that the licensor is obligated to transfer those elements of the intellectual property that are necessary to the licensee's continued use of such property to the escrow agent and the escrow agent is authorized to release the escrowed property to the licensee upon notification of the licensor's breach or failure to perform its license agreement with the licensee.[116] Under section 365(n) of the Bankruptcy Code, such an escrow agreement would qualify as a supplementary agreement.[117] Consequently, if the licensee elects to retain its rights under a rejected license, section 365(n)(3) authorizes the licensee to obtain the escrowed property upon

Enrichment, Inc., 127 B.R. 829, 837-38 (Bankr. E.D. Tenn. 1991) (where escrow agreement conditioned debtor's right to the escrowed property upon the occurrence of a certain event, such property was not property of the debtor's estate); *In re* Dolphin Titan Int'l, Inc., 93 B.R. 508, 512 (Bankr. S.D. Tex. 1988) (same). *But see, e.g., Kemp*, 52 F.3d at 553 (where debtor retained title to property in escrow, escrow account was property of the debtor's estate); Wilson v. United Sav. of Texas (*In re* Missionary Baptist Found. of Am., Inc.), 792 F.2d 502, 506 (5th Cir. 1986) (concluding that "[w]here the contingency of the escrow was not fulfilled prior to bankruptcy, the debtor holds an interest in the property."); Tully v. Taxel (*In re* Tully), 202 B.R. 481, 482 (B.A.P. 9th Cir. 1996) (affirming the bankruptcy court's holding that real estate commission held in escrow at the time the petition was filed constituted property of the estate); World Communications, Inc. v. Direct Mktg. Guar. Trust (*In re* World Communications, Inc.), 72 B.R. 498, 501 (D. Utah 1987) (concluding that the escrow account constituted property of the estate pursuant to section 541(a)(1)); *In re* Rosenshein, 136 B.R. 368, 374 (Bankr. S.D.N.Y. 1992) (holding that the funds deposited in escrow to induce title company to issue mortgage title policy with respect to lender's construction loan to debtors was property of the estate within the meaning of section 541(a)); Rotman Elec. Co., Inc. v. Cullen (*In re* Vappi & Co., Inc.), 145 B.R. 719, 723-724 (Bankr. D. Mass. 1992) (rejecting creditor's argument that funds held in escrow are not property of the debtor's estate); Gassen v. Universal Bldg. Materials, Inc. (*In re* Berkley Multi-Units, Inc.), 69 B.R. 638, 642 (Bankr. M.D. Fla. 1987) (holding that the funds in escrow "remained properties of the estate and were properties of the estate at the time of the commencement of the case."). Thus, the escrow agreement should specifically acknowledge that its purpose is to assure the debtor's performance of its obligations under the license and any related agreements. In addition, the parties to the escrow agreement should recognize that a bankruptcy court could determine that the escrowed property is property of the debtor's estate.

115. *See* Scott A. Steinberg and Michael A. Gurber, *Software Licensing: Protecting Intellectual Property in Bankruptcy*, 6 J. BANKR. L. & P. 535, 546-47 (1996-97).

116. The escrow agreement also should provide that the licensor is given a specified period of time within which to cure or dispute the existence of any breach or failure to perform. If the licensor cures or disputes the alleged breach or failure to perform, the escrow agent would then be obligated to retain possession of the intellectual property until the licensee and licensor agree, or a predetermined dispute resolution mechanism decides, whether a breach or failure to perform has occurred.

117. *See supra* note 113 and accompanying text.

written request to the trustee.[118] Thus, a licensee may gain access to property that otherwise would be property of the debtor's estate by executing a prebankruptcy escrow agreement.

Practice Points for Invoking Section 365(n)

Prebankruptcy Drafting Tips

Agreement as Executory

To ensure that the protections of section 365(n) are available to a licensee, the license agreement specifically should provide that, to the extent that the license agreement is determined to be an executory contract under section 365 of the Bankruptcy Code, it is an intellectual property license within the meaning of section 365(n) of the Bankruptcy Code.[119] Parties desiring to avoid the uncertainty surrounding a determination that the intellectual property license is not an executory contract also may want to identify the ongoing obligations of each of the parties to the license and provide that the failure to perform any of these obligations constitutes a material breach of the license.[120]

118. *See* 11 U.S.C. § 365(n)(3)(B). *See also* notes 112-13 and accompanying text. Likewise, pending the debtor/licensor's decision to assume or reject the license, a licensee may request the turnover of the escrowed property under section 365(n)(4)(B). *See id.* § 365(n)(4)(B). *See also* note 89 and accompanying text.

119. A bankruptcy filing does not nullify the debtor's prebankruptcy nonexecutory contracts. Thus, to the extent that a license agreement is determined to be nonexecutory, the licensee would be entitled to continue to use the intellectual property in accordance with the terms and subject to the conditions of the license agreement. *See, e.g.,* Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149, 1153 (3d Cir. 1989) (recognizing the principle that "a trustee is generally bound by the debtor's non-executory contracts."); Jenson v. Continental Fin. Corp., 591 F.2d 477, 482 (8th Cir. 1979) (stating that a nonexecutory security agreement could not be rejected under the Bankruptcy Act and that it therefore remained valid to secure any recovery by the plaintiffs); Kendall Grove Joint Venture v. Martinez-Esteve, 59 B.R. 407, 409 (S.D. Fla. 1986) (recognizing that after a contract has been executed, it may not be rejected).

Nonetheless, as discussed above, the majority of courts have determined that license agreements (particularly in the nonexclusive license context) are executory contracts. *See supra* notes 47-50 and accompanying text. Moreover, a bankruptcy court could determine that a prepetition nonexecutory contract only gives the nondebtor party to the contract a prepetition claim for breach against the debtor and not the right to compel the debtor's postpetition performance under the contract. *See* Stewart Foods, Inc. v. Broecker (*In re* Stewart Foods, Inc.), 64 F.3d 141, 143 (4th Cir. 1995) (reversing lower courts and holding that a "debtor's obligation under a non-executory contract created [only] a claim to be handled as part of the bankruptcy proceedings"); *In re* Wheeling-Pittsburgh Steel Corp., 59 B.R. 129, 135 (Bankr. W.D. Pa. 1986) (stating same general proposition). Accordingly, providing that the agreement is an "intellectual property license" will assist a licensee in obtaining section 365(n) protection.

120. *See* discussion of the definition of "executory contract" *supra* notes 39-50 and accompanying text.

Right to Terminate

As noted above, section 365(n)(1)(A) of the Bankruptcy Code provides that, upon rejection of a license agreement by the debtor, a licensee may treat the license agreement as terminated *if* the rejection of the license agreement constitutes a breach that would entitle the licensee to terminate the agreement under the terms of the agreement, applicable nonbankruptcy law or an agreement between the licensee and another entity.[121] To preserve a licensee's right to terminate the license agreement under section 365(n)(1)(A) of the Bankruptcy Code, the license agreement should define the term "event of default" to include among other things: (i) the licensor's rejection of the license agreement under section 365(n) of the Bankruptcy Code; and (ii) the licensor's breach or failure to perform or observe any of its obligations, covenants, or agreements under the license agreement. The license agreement also should specifically recognize the licensee's right to terminate the license agreement upon the licensor's default thereunder. By documenting the parties' agreement that the licensee may terminate the license agreement upon rejection of the license agreement or the licensor's failure to perform under the agreement (whether as the result of rejection or otherwise), there should be little question that the license agreement can be terminated under section 365(n)(1)(A).

Liquidated Damages Clause

Because it would be difficult to ascertain the amount of the licensee's damages upon the licensor's default under the license agreement, the license agreement should contain a liquidated damages clause.[122] Such a clause actually serves two purposes. First, a liquidated damages clause would assist the parties in determining the licensee's damages upon rejection of the license agreement. Second, a potentially large liquidated damages award in favor of the licensee may discourage the debtor from rejecting the license agreement.[123] In particular, the license agreement

121. *See supra* notes 94 and 96 and accompanying text.

122. Because a debtor must assume or reject an executory contract *in toto*, some courts have determined that rejection of an executory contract under section 365 of the Bankruptcy Code forecloses the enforcement of a liquidated damages clause contained in the rejected contract. *See, e.g., In re* EI Int'l, 123 B.R. 64 (Bankr. D. Idaho 1991); *In re* Transamerican Natural Gas Corp., 79 B.R. 663 (Bankr. S.D. Tex. 1987); *In re* Davies, 27 B.R. 898 (Bankr. E.D.N.Y. 1983). *See also* Steinberg and Gerber, *supra* note 115, at 539, 545. *But see In re* Independent Am. Real Estate, Inc., 146 B.R. 546 (Bankr. N.D. Tex. 1992) (enforcing a liquidated damages provision after rejection of executory contract). Thus, although there is no harm in including a liquidated damages provision in the license, such provision may not be enforceable if the license ultimately is rejected by the debtor. In addition, to be enforceable, the liquidated damages provision must comply with and be enforceable under applicable nonbankruptcy law. Generally, a liquidated damages provision is enforceable if it provides for "reasonable" damages in light of the anticipated or actual loss caused by the breach and the difficulties of establishing the loss. *See* RESTATEMENT (SECOND) OF CONTRACTS § 356.

123. *See infra* notes 148 and 149 and accompanying text.

should contain two liquidated damage calculations: (i) first, the license agreement should set forth the licensee's damages upon termination of the agreement; and (ii) second, the license agreement should set forth the licensee's damages upon the licensor's failure to perform its servicing and/or research/development obligations under the license agreement. The latter calculation would assist the licensee in asserting a rejection damage claim under section 502(g) of the Bankruptcy Code where the licensor has rejected the license agreement, but the licensor has retained its rights thereunder.

Royalty Payments: Less is Better

Because a licensee must continue to make all royalty payments to a licensor/debtor if the licensee retains its rights under the license agreement, the licensee should avoid characterizing its monetary obligations (other than its percentage payments for use and/or sale of the intellectual property) under the agreement as "royalty payments." Given the courts' broad interpretation of the term "royalty payments" as used in section 365(n) of the Bankruptcy Code, a licensee should identify the nature and purpose of each of its monetary obligations under the agreement. Indeed, a licensee should make licensing/service fees directly contingent upon the licensor fulfilling its servicing and/or research/development obligations so that if the licensor rejects the license agreement and stops performing its obligations thereunder, the condition precedent to the licensor receiving those fees fails and the licensee arguably is released from that monetary obligation. Alternatively, the servicing and/or research/development obligations of the licensor could be set forth in a separate agreement to prevent the lumping together of any service fees with the royalty fees set forth in the license agreement.

In a similar vein, a licensee may want to structure the royalty provision of the license so that any royalty fees are discounted if the licensee loses it rights to future improvements of the licensed property. The justification for such a reduction would be that the intellectual property is worth less to the licensee without the improvements. Thus, if the licensor files for bankruptcy and rejects the license (thereby, potentially eliminating the licensee's rights to improvements), the licensee's royalty obligations should it elect to retain its rights under the agreement would be arguably reduced. The downside to including such a provision in a license is that a bankruptcy court may characterize the reduction as an unenforceable *ipso facto* clause under section 365(e) of the Bankruptcy Code.[124]

124. Section 365(e) provides in pertinent part:

> Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated *or modified*, and any right or obligation under such contract or lease may not be termi-

Right to Improvements

Because a licensee only is entitled to retain its rights under the license agreement as they existed on the bankruptcy petition date under section 365(n) of the Bankruptcy Code, a licensee should include a provision in the license agreement that grants it the right to use all improvements of and enhancements to the intellectual property developed by the licensor during the term of the license agreement. Although it is not certain whether such a provision would be enforced by a bankruptcy court, there is no harm in including the provision if it is acceptable to the licensor.

Escrow Agreement

Finally, a licensee should request that the licensor transfer the embodiment of, source codes to, or other key information relating to the licensed intellectual property into an escrow account. The escrow agreement should (i) acknowledge that the agreement is a "supplement" (as that term is used in section 365(n) of the Bankruptcy Code) to the license agreement; and (ii) direct the escrow agent to release the escrowed property to the licensee upon an event of default by the licensor under the license agreement.

Postbankruptcy Tips

Request Upon Bankruptcy Filing

Immediately upon receiving notice of the licensor/debtor's bankruptcy petition, the licensee should serve a written request upon the trustee or

> nated *or modified*, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
> (B) the commencement of a case under this title; or
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

11 U.S.C. § 365(e) (1994). Courts generally interpret section 365(e)(1) broadly to facilitate the rehabilitative purposes of the Bankruptcy Code and thus, generally do not enforce contract provisions conditioned upon or triggered by the debtor's insolvency or commencement of a bankruptcy case. *See, e.g., In re* Chedick, No. 95-01096, 1996 Bankr. LEXIS 1716, at *9-*12 (Bankr. D.D.C. Mar. 22, 1996) ("The courts have not hesitated to invalidate [*ipso facto*] provisions as penalizing the debtor's efforts to obtain a fresh start even in the absence of an express statutory provision against the particular ipso fact [*sic*] clause."). *See also* Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608, 609 (1st Cir. 1995) (affirming the bankruptcy court's decision that "section 365(e) preempted certain provisions in the limited partnership agreement which purported to convert the general partnership interests . . . into limited partnership interests immediately upon the filing of [the general partners'] respective chapter 11 petitions."); *Chedick*, 1996 Bankr. LEXIS 1716, at *9-*12 (holding that a provision in a prepetition promissory note assessing a fee of five percent of the amount necessary to pay off the note upon the filing of a bankruptcy petition was an unenforceable *ipso facto* provision); *In re* Texaco, Inc., 73 B.R. 960, 965 (Bankr. S.D.N.Y. 1987) (same).

debtor in possession for (i) performance of the license agreement; (ii) turn over of the intellectual property licensed and any related escrowed property; and (iii) compliance with its duty not to interfere with the licensee's rights under the license agreement.

Request Upon Rejection

Immediately upon receiving notice of the licensor/debtor's motion to reject the license agreement, if the licensee desires to retain its rights under the agreement, the licensee should serve a written request upon the trustee or debtor in possession for (i) performance of the license agreement; (ii) turn over of the intellectual property licensed and any related escrowed property; and (iii) compliance with its duty not to interfere with the licensee's rights under the license agreement.

Shortcomings of Section 365(n)

Although section 365(n) of the Bankruptcy Code provides a licensee dealing with a financially-troubled or startup licensor certain protections if bankruptcy ensues, it neither preserves in full the licensee's prepetition rights under the license agreement nor eliminates all adverse effects of the rejection of the license on the licensee's business. For example, once the debtor/licensor rejects the license agreement, it no longer is obligated to perform any research or development services with respect to the intellectual property set forth in the license.[125] Rather, the debtor/licensor may be able to undertake such research or development efforts postpetition on its own behalf and license the resulting product to a third party. Likewise, if the intellectual property is licensed to the licensee as part of a servicing, marketing, or production agreement, a court may find the debtor's licensing obligations *de minimus* to the contract as a whole and characterize the contract as something other than an intellectual property license. In such a scenario, a licensee receives no protection from section 365(n) of the Bankruptcy Code. Moreover, the scope of licenses subject to the protections of section 365(n) of the Bankruptcy Code is expressly limited by the definition of "intellectual property" set forth in section 101(35A) of the Bankruptcy Code.[126] Consequently, at least one commentator has opined that section 365(n) of the Bankruptcy Code does not accomplish its goal of protecting and promoting the development of intellectual property because the section encourages certain types of "rejection abuse" (such as the use of escrow agreements, third-party assignments, outright sales, and improvements) and also arms a nondebtor party with the ability to override nonabusive rejections by a debtor.[127]

125. *See* discussion *supra* notes 103-04 and accompanying text.

126. *See* discussion *supra* notes 70-73 and accompanying text.

127. *See* John P. Musone, *Crystallizing the Intellectual Property Licenses in Bankruptcy Act: A Proposed Solution to Achieve Congress' Intent*, 13 BANKR. DEV. J. 509 (1997).

ENHANCING A LICENSEE'S PROTECTION OF ITS INTELLECTUAL PROPERTY INVESTMENT: FILLING THE GAPS LEFT BY SECTION 365(n) OF THE BANKRUPTCY CODE

To avoid (or at least lessen the impact of) the problems often faced by a licensee in a licensor's bankruptcy case, there are a number of steps that the licensee may take prepetition. These steps generally fall within one of the following two strategies: (i) structuring the transaction to prevent the intellectual property and any related agreements from becoming property of the debtor/licensor's estate under section 541 of the Bankruptcy Code and (ii) structuring the transaction to include disincentives to the licensor/debtor rejecting the license under section 365 of the Bankruptcy Code.

EXCLUDING THE INTELLECTUAL PROPERTY FROM THE BANKRUPTCY ESTATE

Section 365, as most provisions of the Bankruptcy Code, applies only to property in which the debtor's estate has an interest on the bankruptcy petition date. As previously noted, section 541 of the Bankruptcy Code defines "property of the estate" as "all legal or equitable interests of the debtor in property as of the commencement of the case."[128] Courts generally interpret section 541(a) broadly to encompass any and all property interests of a debtor as of the commencement of the bankruptcy case, irrespective of the location or party currently in possession of the property.[129] Notwithstanding the courts' broad interpretation of section 541, property sold or absolutely assigned by a debtor to another prior to the bankruptcy petition date does not constitute property of the debtor's estate because such a sale or an assignment divests a debtor of *all* interest in the assigned property.[130]

Sale or Absolute Assignment

The greatest protection to be afforded a party that desires to use the intellectual property of a financially-troubled or startup company is to structure the transaction as either a sale or an absolute assignment.[131] Because such a complete transfer of the original owner's bundle of rights in the intellectual property divests the owner of title to the intellectual property, a prebankruptcy sale or absolute assignment of the intellectual property effectively removes the intellectual property from the original owner's potential bankruptcy estate. Moreover, because once the sale is closed or the absolute assignment is consummated, the owner would have no unexecuted obligations to the would-be licensee, the sale or the absolute

128. 11 U.S.C. § 541(a)(1) (1994). *See supra* notes 18-20 and accompanying text.
129. *See supra* notes 18-20 and accompanying text.
130. *See supra* notes 18-29 and accompanying text.
131. *See supra* notes 18-29 and accompanying text.

assignment of the intellectual property no longer would leave the transaction subject to rejection as an executory contract.[132]

Unfortunately, the original owner may not be willing to part with ownership of the intellectual property given all of the benefits, such as the right to receive royalty payments, that accompany such ownership. Structuring a sale may be particularly difficult where the original owner is a new start-up enterprise and the intellectual property is the owner's most, if not only, valuable asset. Considering this obstacle, the most practical way to structure a sale or an absolute assignment (in order to induce the original owner to part with ownership) may be to sell or absolutely assign the intellectual property to the would-be licensee and then have the would-be licensee license back to the original owner the right to use such intellectual property. The primary advantage to this structure is that it accomplishes the would-be licensee's main goal (i.e., obtaining use of the intellectual property while divesting the original owner of title to such property). Yet, it allows the original owner to continue to use and extract some value from the intellectual property in its business operations. Additionally, under this structure, the original owner could be granted an option to repurchase the intellectual property upon a default by the would-be licensee of its license obligations to the seller. The risk, however, in including such a provision in the sale, license-back transaction is that a court could determine that the transaction in substance was merely a license to the would-be licensee and that the original owner retained a sufficient property interest in the intellectual property to bring it into the owner's bankruptcy estate under section 541 of the Bankruptcy Code.[133]

Intellectual Property Trusts

If the owner of the intellectual property balks at making an outright sale or absolute assignment, an alternative would be for the intellectual property owner to transfer the ownership of the intellectual property to a trust; the trust would, thereafter, license the intellectual property to the licensee. The trustee would possess legal title to the intellectual property,[134] and the original owner would have a continuing beneficial interest in the

132. *See* Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp., 143 B.R. 360, 375 (Bankr. D. Md. 1992) (finding that because the parties' agreement transferred title to the subject patent, the transfer was an outright grant of the patent (as opposed to a license to use the patent) and therefore, was not an executory contract for purposes of section 365 of the Bankruptcy Code), *aff'd*, 8 F.3d 817 (4th Cir. 1993); *In re* Access Beyond, 237 B.R. 32, 44-45 (Bankr. D. Del. 1999) (concluding that agreement at issue was a patent license but noting that agreement could not be an executory contract if it were a sale). *See also supra* notes 18-29 and accompanying text.

133. *See* discussion *supra* notes 21-24 and accompanying text.

134. *See* discussion *supra* notes 18-21 and accompanying text. If the intellectual property that was transferred to the trust was divisible (i.e., a patent that contains various fields of use), the trustee could also be granted the authority to enter into other license agreements of the intellectual property.

intellectual property, including the proceeds of any license agreement.[135] While the beneficial interest would still be considered property of the owner's potential bankruptcy estate,[136] this transaction could not cause the trustee's rejection of the license agreement with the licensee because the agreement between the trustee and debtor/owner would be a completed transfer and no longer executory.[137] Moreover, the trust agreement could be structured to prohibit the trustee of the intellectual property trust from filing a bankruptcy petition or incurring any obligations other than the license agreement.[138] As in the sale/assignment context, however, an

135. Because the intellectual property would in some circumstances need maintenance (particularly, in the case of computer software), income could be guaranteed to the beneficiary by having the licensee enter into a direct maintenance agreement with the beneficiary or the trustee that could subcontract such maintenance work to the beneficiary. Such an agreement would, of course, remain subject to rejection under section 365 of the Bankruptcy Code in the event of a bankruptcy filing by the beneficiary.

136. *See* 11 U.S.C. § 541(a) and discussion *supra* notes 14-16 and accompanying text.

137. *See* discussion *supra* notes 39-40 and accompanying text. In this respect, it is imperative that the original owner completely transfer title to the intellectual property (and all rights associated therewith) to the trust on the effective date of the trust agreement and have no further obligations to the trust thereafter. *See, e.g., In re* Structurlite Plastics Corp., 86 B.R. 922, 926-28 (Bankr. S.D. Ohio 1988) (holding that where debtor's only obligation under trust agreement was to fund the trust, trust agreement was not an executory contract for purposes of section 365 of the Bankruptcy Code). The limited obligation of the trustee to pay and the original owner to receive income generated by the trust res (i.e., the intellectual property) generally is not sufficient to render the trust agreement executory. *See, e.g., id.* at 926-27.

Nevertheless, if the trust agreement requires the original owner to do or not to do any act other than transferring the trust res, the trust agreement may be characterized as an executory contract subject to rejection under section 365 of the Bankruptcy Code. *See, e.g., In re* Bellamah Community Dev., 107 B.R. 337, 342 (Bankr. D. N.M. 1989) (comparing the real property trust agreement to a land installment contract and concluding that, because both the seller and buyer of the real property had unperformed obligations, the trust agreement was an executory contract under the Countryman definition); *In re* Texaco, Inc., 73 B.R. 960, 964-65 (Bankr. S.D.N.Y. 1987) (same with respect to an indenture trust agreement).

138. Section 101(9) of the Bankruptcy Code defines the term "corporation" to include a business trust. Although the legislative history to section 101(9) notes that the only type of trust eligible for protection under the Bankruptcy Code is a business trust, it does not define the term "business trust." *See* 2 COLLIER ON BANKRUPTCY, *supra* note 14, ¶ 101.09, at 101-49 through 101-50. As a result, the courts have developed a number of tests to determine whether a trust is a business trust for purposes of the Bankruptcy Code. *See In re* Eagle Trust, No. Civ. A. 98-2531, 1998 WL 635845, at *5 (E.D. Pa. Sept. 16, 1998) (stating that the factors to be considered by a bankruptcy court in determining whether a trust is a business trust for purposes of section 101(9) of the Bankruptcy Code are whether "(1) the trust was formed for the primary purpose of transacting business or commercial activity, as opposed to preserving assets; (2) the trust was formed by a group of investors who contribute capital to the enterprise with the expectation of receiving a return on their investment; (3) the trust was created in compliance with state law; and (4) the beneficial interests in the trust must be freely transferable"); *In re* Gurney's Inn Corp. Liquidating Trust, 215 B.R. 659, 661-64 (Bankr. E.D.N.Y. 1997) (explaining the various tests developed by the courts). Each of these

owner of intellectual property may not be willing to transfer control of its intellectual property to a trustee or otherwise limit its ability to deal with the intellectual property as required by a trust transaction.

Bankruptcy Remote Entities

Another means by which a licensee may keep intellectual property out of the owner's potential bankruptcy estate would be to have the owner transfer title to the intellectual property to a new corporation established specifically (and solely) for the purpose of owning the intellectual property and licensing it to others.[139] This simple transfer, however, is not all that

tests focuses on the facts of the particular transaction and whether the trust is created to conduct business (i.e., whether the trust has the attributes of a corporation) or to preserve and protect the trust res. *See Gurney's Inn*, 215 B.R. at 662-64 (and cases cited therein). Nevertheless, the fact that a trust conducts business, without more, does not compel the conclusion that the trust is a business trust. *See also* Shawmut Bank Conn., Nat'l Ass'n LNC Invs., Inc. v. First Fidelity Bank, (*In re* Secured Equip. Trust of Eastern Airlines), 38 F.3d 86, 90-91 (2d Cir. 1994) (explaining that the "inquiry must focus on the trust documents and the totality of the circumstances, not solely on whether the trust engages in a business").

Given the courts' approach to the definition of a business trust under section 101(9), there are two means by which an intellectual property trust *may* be kept out of bankruptcy (the word "may" is emphasized because neither means is guaranteed effective; rather each is subject to the interpretation of the particular bankruptcy court). The first means is to include language in the intellectual property trust that recognizes its purpose as the protection and preservation of the trust res (i.e, the intellectual property). *See Gurney's Inn*, 215 B.R. at 665-68 (relying upon the language of the trust agreement to characterize the trust at issue for purposes of the Bankruptcy Code). *But see In re* Gonic Realty Trust, 50 B.R. 710, 713-14 (Bankr. D.N.H. 1985) (explaining that a court's inquiry should focus on whether the trust conducts any substantial business activity, irrespective of the terms of the trust agreement). As a corollary duty to this purpose, the trust agreement also should give the trustee the limited authority to license the intellectual property and to collect and distribute the royalties therefrom, so that the trust is authorized to license the intellectual property to the licensee. The trustee, however, should have no other authority under the trust agreement. The second means is to set up the intellectual property trust similar to a sole purpose corporation and again place restrictions on the trustee's authority to conduct business, including its authority to place the trust in bankruptcy, under the trust agreement. For further discussion on the second means, *see infra* "Bankruptcy Remote Entities," notes 139-45 and accompanying text.

139. In structuring a bankruptcy-remote entity, it is imperative that the transfer of assets to the bankruptcy-remote entity be a "true sale." *See, e.g.*, The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW 527, 542-43 (1995) [hereinafter *Structured Financing*]. Factors typically considered in analyzing whether a transfer is a true sale or one for purposes of security include: (i) whether the "risk of loss" is transferred to the purchaser; (ii) whether the seller retains any benefits of ownership; (iii) whether the seller retains any post-transfer control over the assets; (iv) whether the seller treated the transfer as a sale on its books and records; and (v) whether the parties intended the transfer to be a true sale. *Id. See also* cases cited *supra* notes 22-24 and accompanying text. Additionally, the transfer must be for adequate consideration or it may be challenged (and, if successful, avoided) as a fraudulent

would be required to protect the licensee's rights in the intellectual property; rather, the parties would need to take additional steps to ensure the solvency of the corporation or, in other words, make the corporation a bankruptcy-remote entity.

First, the articles of incorporation and by-laws of this corporation should (i) limit the corporation's authority to engage in any business (other than licensing the intellectual property);[140] (ii) give the corporation no authority to incur debt or otherwise encumber its assets;[141] and (iii) prevent the corporation from filing a voluntary petition for bankruptcy.[142] Second, mechanisms should be implemented to limit the corporation's ability to amend its articles of incorporation or by-laws.[143] Third, the corporation should have different classes of stock that would allow the licensee to have some control over its corporate governance, but would allow the original owner of the intellectual property to receive the economic benefits of such property. Finally, internal mechanisms should be implemented by the bankruptcy-remote entity to ensure its separateness from the original owner of the intellectual property.[144] Otherwise, the bankruptcy-remote entity faces the risk that it will be substantively consolidated with the original owner in any bankruptcy case filed by or against the original owner.[145]

transfer under sections 544 and 548 of the Bankruptcy Code. *See* 11 U.S.C. §§544, 548 (1994). *See also* discussion *supra* note 21; *Structured Financing* at 548.

140. *See Structured Financing, supra* note 139, at 554.

141. *See id.* at 554-55.

142. *See id.* at 556-58. A specific prohibition on a corporation's ability to file for bankruptcy protection may be deemed void as against public policy. *See id.* Nevertheless, this same result may be accomplished by requiring that one or more directors of the bankruptcy remote entity be independent and that a voluntary petition for bankruptcy by the bankruptcy remote entity be approved by a super-majority vote of the directors. *See id.* Additionally, to provide a disincentive to rejection of the license agreement if the bankruptcy remote entity does file for bankruptcy, the stock of the bankruptcy remote entity could be utilized to secure its performance of the license agreement with the licensee.

143. One way to accomplish this result is to have the licensee hold a certain amount of voting stock and to place super-majority requirements upon the corporation taking certain types of actions, including filing a voluntary petition for bankruptcy and ordinary course actions (i.e., entering into other license agreements). There is, however, no guarantee that a licensee would be able to control the governance of this corporation in this manner or that such a super-majority voting requirement as it relates to the corporation's right to file for bankruptcy would be enforceable. *See id.*, at 556-57.

144. *See id.* at 558-60. Specifically, the bankruptcy-remote entity should have separate offices, financial statements, assets, management, and decision-making processes. Additionally, the bankruptcy-remote entity should make sure that all transactions with the original owner are arms-length transactions. *See id.*

145. *See id.* at 558-60 ("[A] bankruptcy court's equitable powers include the power to substantially consolidate entities. In a substantive consolidation, the assets of two or more entities are pooled, intercompany claims are eliminated, and, with certain exceptions, claims of outside creditors are treated as claims against the common fund.") (citations omitted). *See also, e.g.*, Fishell v. United States Trustee *(In re* Fishell*)*, 111 F.3d 131, 1997 WL 188458, **2 (6th Cir. 1997) (unpublished disposition) (citations omitted); Eastgroup Properties v. Southern Motel Assoc., Ltd., 935 F.2d 245, 248 (11th Cir. 1991); Union Savings Bank v. Augie/Restivo

DISINCENTIVES TO REJECTION: CREATION OF SECURED REJECTION CLAIMS

If the owner of the intellectual property is reluctant to part with its ownership interests in the property through one of the transactional structures described above, the licensee could structure the license agreement with an eye towards the future, i.e., the owner's potential bankruptcy case. First, as previously discussed, a licensee should seek to protect its interests in the license should the licensor's bankruptcy ensue by including specific language in the license regarding section 365(n) and liquidated damages and by executing a separate escrow agreement and maintenance agreement with the licensor.[146] Second, a licensee should take steps to make the rejection of the license under section 365 less attractive to the debtor/licensor. Perhaps the most effective means to achieve this goal is to execute a security agreement in conjunction with the license transaction.

Specifically, a licensee could secure a licensor's performance of a license agreement by having the licensor grant the licensee a security interest in the licensed intellectual property and the other property necessary to the utilization of such intellectual property.[147] The security agreement does not insure continued performance of a license agreement, but it does have the effect of converting what would otherwise be a prebankruptcy general unsecured damage claim to a secured claim upon the rejection of a license agreement.[148] As a result of the security agreement, there is an economic

Baking Co., Ltd. *(In re* Augie/Restivo Baking Co., Ltd.), 860 F.2d 515, 518 (2d Cir. 1988); *In re* Molnar Bros., 200 B.R. 555, 560 (Bankr. D.N.J. 1996) (substantive consolidation results in "the merger of assets and liabilities of two or more estates, creating a common fund of assets and a single body of creditors"). Substantive consolidation typically results where the one entity (e.g., the bankruptcy-remote entity) is a "mere instrumentality" or "alter ego" of the other (e.g., the original owner). *See id. See also, e.g.,* Eastgroup Properties, 935 F.2d at 249-50; Soviero v. Franklin Nat'l Bank of Long Island, 328 F.2d 446, 448 (2d Cir. 1964) (affiliates "were but instrumentalities of the bankrupt with no separate existence of their own"); *In re* Eagle-Picher Indus., Inc., 192 B.R. 903, 906 (Bankr. S.D. Ohio 1996) (subsidiaries' corporate minutes and meetings of the board of directors were merely pro forma); *In re* Vecco Constr. Indus., Inc., 4 B.R. 407, 411 (Bankr. E.D. Va. 1980) (subsidiaries were wholly-owned by the parent, shared same directors and officers and conducted same business).

146. *See* discussion of prebankruptcy drafting tips *supra* notes 119-21 and accompanying text.

147. For a general discussion of the steps necessary to take and perfect a security interest in intellectual property, *see infra* notes 152-65 and accompanying text.

148. *See, e.g.,* Leasing Serv. Corp. v. First Tenn. Bank Nat'l Ass'n, 826 F.2d 434, 436-37 (6th Cir. 1987) (explaining that "while rejection of a lease obligation does have the effect of a breach of the contract, it does not affect the creditor's secured status" if the parties executed a prepetition security agreement in conjunction with their transaction). Additionally, to establish the amount of its secured claim upon a breach of the license agreement and to exert maximum leverage over the debtor/licensor, the secured party/licensee should consider including a liquidated damage provision in its license agreement because a bankruptcy court may be predisposed to estimate the secured party/licensee's claim at a nominal amount, which estimation would effectively defeat the secured party/licensee's security interest. Such a liquidated damage provision would, in most instances, be consistent with the difficulty of

disincentive upon the debtor/licensor from utilizing its rights under section 365 of the Bankruptcy Code to reject the license agreement with the secured party/licensee.

Enhancing a Licensee's Leverage in Bankruptcy

In a bankruptcy proceeding, a secured party/licensee would be able to exert pressure upon the debtor/licensor by threatening to move for relief from the automatic stay of section 362 of the Bankruptcy Code[149] to foreclose on its security interests in attempting to satisfy its claims arising from a rejection of its license agreement.[150] A secured party/licensee also could, in the event its license agreement is not promptly assumed by the debtor/licensor, place further pressure upon the debtor/licensor by requesting adequate protection for the debtor/licensor's use of the collateral (which cash collateral includes the cash proceeds resulting from the licenses of the intellectual property encompassed in the collateral) pursuant to the provisions of section 361 of the Bankruptcy Code.[151] Moreover, if the secured party/licensee's foreclosure on its security interests makes it impossible for the debtor/licensor to perform the agreements that it entered into with other parties, the debtor/licensor may forego rejecting its license agreement with the secured party/licensee to avoid being forced to breach its agreements with such other parties.

Structuring the Security Agreement

Collateral Description

The description of the collateral that secures the debtor/licensor's obligations to the secured party/licensee should be very specific. Unfortunately, many of the security agreements drafted to date that have involved intellectual property as collateral have relied upon "buzz words" in describing the collateral. These "buzz words" often are incorrectly used and do not accurately describe the intellectual property in which a security interest should be taken (i.e., hardware and software). Failure to describe the collateral properly will result in the secured party/licensee having an

estimating the damages resulting from a rejection of a license of developing technology or an option to acquire future technology. The problem, however, is devising the mechanism to establish such damages. In addition, notwithstanding the difficulty of estimating damages, a liquidation damages provision still may be unenforceable under applicable law. *See supra* note 122 and accompanying text.

149. *See* 11 U.S.C. § 362(d) (1994).

150. Foreclosure by a secured party/licensee may be forestalled by a bankruptcy court permitting the sale of the licensee/secured party's collateral free and clear of all liens pursuant to section 363 of the Bankruptcy Code. *See* 11 U.S.C. § 363(f). Such a sale would cause the secured party/licensee to have to look to the proceeds of the sale of its collateral to satisfy its secured claim. *See* 11 U.S.C. § 363; U.C.C. §9-504(1). Nonetheless, the secured party will be able to bid in the amount of its claim at the sale of such collateral. *See* U.C.C. § 9-504(3).

151. *See* 11 U.S.C. § 361.

uncertain lien priority status once the debtor/licensor files for bankruptcy. The following items should be considered in formulating the collateral description for the security agreement:

- licenses and permits relating to or necessary for use of the intellectual property;
- present and future rights to sue for infringement or misappropriation of intellectual property rights;[152]
- physical property necessary for the creation and use of the intellectual property in which a security interest is taken;[153] and
- rights relating to governmental authorizations and permits and rights arising under foreign laws.[154]

Representations

In structuring the representations to be included in a security agreement, the parties must balance the desires of a debtor/licensor to keep information confidential against the need of a secured party/licensee to acquire information necessary to perfect and to protect its security interests in the intellectual property. As a result, the licensor may be extremely reluctant to disclose information as part of the secured transaction that was not previously disclosed in connection with its licensing agreement. In addition to the usual representations found in a security agreement, the following representations should be included in a security agreement relating to intellectual property:

- title to the intellectual property as being free and clear of all liens and encumbrances;
- extent of the licenses and other rights granted in the intellectual property;
- no affiliate of licensor has (or will have) any interests in the intellectual property;

152. The grant of a security interest in intellectual property in and of itself does not necessarily transfer the right to sue for infringement or misappropriation. *See generally,* Harold R. Weinberg and William J. Woodward, Jr., *Easing Transfer and Security Interest Transactions in Intellectual Property: An Agenda for Reform,* 79 KY. L.J. 61 (1991). *See also,* discussion *supra* note 31 and accompanying text.

153. For example, a security interest should always be taken in the specialized machinery or other tangible property that is necessary to operate the business, which would allow the secured party/licensee to continue in operation in the event of rejection and to utilize the property in which it has been granted a security interest upon the exercise of its remedies as a secured party. Taking a security interest in such equipment will also place additional pressure on the debtor/licensor not to reject its license agreement because the debtor/licensor would lose access to such property to conduct its business.

154. Rights under foreign laws can be extremely valuable, but it may be difficult to perfect and protect such rights.

- licensor not guilty of infringing or misappropriating any other entity's rights in any intellectual property; and
- precautions have been (and will continue to be) taken to keep confidential the intellectual property.

Covenants

In drafting the covenants to be included in the security agreement, the parties must weigh the licensor/bankrupt's desire to conduct its business in the ordinary course against the secured party/licensee's desire to secure performance of the security agreement by restricting the debtor/licensor's use of the collateral. For example, the licensor will usually want to license the intellectual property to others with the understanding that such licenses will continue even in the event of the secured party/licensee's exercise of its remedies resulting from a licensor/bankrupt's breach. In contrast, the secured party/licensee will want to focus upon avoiding the termination of important licenses and permits without notice to the debtor/licensor, which terminations could have the impact of eviscerating the secured party/licensee's security interests. Thus, the debtor/licensor should covenant to give the secured party/licensee notice of breach of any such agreements and an opportunity to cure such breach. Other covenants that should be included in the security agreement are:

- a covenant that debtor/licensor will continue to keep information secret and will enter into appropriate confidentiality agreements with employees;
- a covenant to notify of the need to take any action to perfect and protect rights and security interests granted;
- a covenant that licensor will not create or suffer to exist any mortgage, pledge, lien, or charge on the collateral;
- a covenant to maintain records of proceeds of intangibles and require that such proceeds be held in trust for secured party/licensee;
- a covenant to grant secured party/licensee the right to set off claims arising out of a breach of the security agreement against monies owing the debtor/licensor under other agreements, such as the license agreement;
- a covenant to sign financing statements, filings, applications, assignments, registrations, notices, documents of further assurances, or other documents necessary to perfect or protect rights and security interests;
- a covenant to notify secured party/licensee of the development of other intellectual property encompassed within the collateral; and
- a covenant to allow secured party/licensee, as agent, to execute documents necessary to perfect or protect rights and security interests.

Events of Default

In drafting a security agreement, the exercise of the secured party/licensee's rights and remedies pursuant to the security agreement cannot be conditioned upon the debtor/licensor's commencement of a bankruptcy case or its insolvency. Otherwise, such event of default will constitute an unenforceable *ipso facto* clause under section 365(e) of the Bankruptcy Code or otherwise unenforceable as violative of public policy.[155] As a result, the secured party/licensee should strive to include in the security agreement very broad events of default, which events of default are linked to the licensor's performance of the license agreement and security agreement. In contrast, the debtor/licensor will seek a very narrow default clause to assure its financiers and other licensees that it will not be limited in operating its business by the security agreement except in the event of its bankruptcy filing. To respond to the debtor/licensor's concerns, the secured party/licensee should consider events of default based only upon those provisions of the license agreement and security agreement that are most important to it (i.e., the actual license of the intellectual property).

Non-Disturbance upon Foreclosure

In order to allow a licensor to continue to license the intellectual property by enabling it to ensure its other licensees that their licenses will not be disturbed upon the occurrence of an event of default under the security agreement,[156] the parties should consider including a non-disturbance clause in the security agreement.[157] This non-disturbance clause or agreement would be analogous to a mortgagee's agreement not to disturb a leasehold estate upon a mortgagee's foreclosure on a parcel of real estate. The non-disturbance agreement would allow the licensor to enter into license agreements with others with the understanding that such license agreement will not be disturbed in the event the secured party/licensee exercises its remedies against its security upon the occurrence of an event of default.[158] To some extent, a non-disturbance agreement diminishes a

155. *See* 11 U.S.C. § 365(e). For a detailed discussion of section 365(e), *see supra* note 124.

156. A non-disturbance agreement is most effective if the secured party/licensee also takes a security interest in the proceeds of any other license relating to the intellectual property so that the secured party/licensee can demand adequate protection for the monies generated by such third-party license agreements.

157. Such a non-disturbance agreement basically should provide that the secured party/licensee agrees not to sue for infringement or misappropriation any person that has received license rights to any of the security pursuant to a license agreement that is *not inconsistent* with the license agreement existing between the secured party/licensee and the debtor/licensor.

158. A non-disturbance agreement should continue only so long as the debtor/licensor would have no right to terminate the license with the third party and such license has not been rejected by the debtor/licensor and terminated by the respective licensee under section 365 of the Bankruptcy Code.

licensor/bankrupt's disincentive to reject a license agreement with a secured party/licensee because claims from the breach of the other license agreements will not occur upon the exercise of the secured party/licensee's foreclosure rights. Nonetheless, if the secured party/licensee includes the proceeds of such license agreements that are not to be disturbed within its collateral description, in the event of the licensor's bankruptcy filing, the proceeds of such licenses would be "cash collateral" entitled to adequate protection under section 361 of the Bankruptcy Code.[159]

Perfecting the Security Interest

An unperfected security interest in a debtor's property may be extinguished by the debtor or the bankruptcy trustee, pursuant to section 544 of the Bankruptcy Code.[160] Thus, it is not enough for a licensee simply to take a security interest in the licensor/debtor's intellectual property. Rather, the licensee must take any and all steps necessary under applicable law to perfect that security interest as against third parties. Unfortunately, perfecting a security interest in intellectual property may be a trap for the unwary. The primary reason is that, in most instances, it is unclear whether such a security interest must be perfected under applicable state law (i.e., the applicable state's version of the Uniform Commercial Code) or applicable federal law (e.g., the Patent Act, the Copyright Act, or the Lanham Act[161]).[162]

Under Article 9 of the Uniform Commercial Code, a party may perfect a security interest in "general intangibles," which has been interpreted to include computer programs, software, trade names, trademarks, trade secrets, goodwill, and licenses to use the same.[163] The scope of Article 9,

159. *See* 11 U.S.C. §§ 361, 363. *See also supra* note 156.

160. 11 U.S.C. § 544. Section 544(a) of the Bankruptcy Code grants a debtor in possession or the bankruptcy trustee the rights and powers of a judgment lien creditor and bona fide purchaser of real property and allows the debtor or the bankruptcy trustee to extinguish any interest in the debtor's property that is voidable by such creditor.

161. *See* 15 U.S.C. §§ 1051-1127 (1994) (the Lanham Act). The Lanham Act generally governs the enforcement of parties' rights in trademarks.

162. For a detailed discussion of the complex issues relating to the perfection of security interests in intellectual property, *see, e.g.*, AGIN, *supra* note 70, § 12; 3 ASSET-BASED FINANCING: A TRANSACTIONAL GUIDE, ch. 31 (Intellectual Property Financing) (Howard Ruda, ed., Matthew Bender 1999); 3 RAYMOND T. NIMMER, COMMERCIAL ASSET-BASED FINANCING, ch. 22 (Intellectual Property Rights Financing) (West 1998); Steven O. Weise, *The Financing of Intellectual Property Under Revised UCC Article 9*, 74 CHI.-KENT. L. REV. 1077 (1999); Alice Haemmerli, *Insecurity Interests: Where Intellectual Property and Commercial Law Collide*, 96 COLUM. L. REV. 1645 (1996).

163. *See* AGIN, *supra* note 70, at 12-4 through 12-5 and cases cited therein. It should be noted that the National Conference of Commissioners on Uniform State Laws (NCCUSL) has recommended revisions to Article 9 of the Uniform Commercial Code (Revised Article 9) that are designed to make Article 9 more user-friendly with respect to intellectual property and technology. The NCCUSL also has created a committee to draft the Uniform Computer Information Transactions Act (UCITA), which is a new statute designed to address issues

however, is limited and may be preempted by federal law.[164] Consequently, filing a financing statement in accordance with Article 9 of the Uniform Commercial Code may not be sufficient to perfect a party's security interest in patents, copyrights, or trademarks.[165] A licensee taking a security interest in a licensor/debtor's intellectual property thus should consider the requirements for perfecting that security interest under state *and* federal law and may be best served by complying with the requirements of *both*.

raised in the context of the sale and licensing of information. For a general summary of Revised Article 9 and the UCITA, *see* AGIN, *supra* note 70, § 19.

164. UCC §§ 9-104(a), 9-302(3)(a) (1995). *See also* AGIN, *supra* note 70, at 12-7 through 12-8.

165. *See, e.g.*, Moldo v. Matsco, Inc. (*In re* Cybernetic Servs., Inc.), 239 B.R. 917, 922-23 (B.A.P. 9th Cir. 1999) (affirming bankruptcy court's holding that the perfection of a security interest in a patent does not require a filing with the PTO and that a properly filed UCC-1 financing statement covering all of the debtor's "general intangibles" was sufficient to perfect a security interest in the patents owned by the debtors); T.S. Note Co. v. United Kan. Bank and Trust (*In re* Topsy's Shoppes, Inc. of Kan.), 131 B.R. 886, 888 (D. Kan. 1991) (affirming bankruptcy court's decision that a financing statement that covered all of the debtor's "general intangibles" was sufficient to perfect a security interest in the debtor's franchise agreements, trademarks and copyrights, without the enumeration of each type of intellectual property covered); National Peregrine, Inc. v. Capitol Fed. Sav. And Loan Ass'n of Denver (*In re* Peregrine Entertainment, Ltd.), 116 B.R. 194, 198-204 (C.D. Cal. 1990) (holding that a security interest in a copyright and receivables from that copyright may be perfected only by the filing of a financing statement with the U.S. Copyright Office and that the purported security interest created in such copyright by the filing of a UCC-1 financing statement with the secretary of state was without effect); Aerocon Eng'g Inc. v. Silicon Valley Bank (*In re* World Auxiliary Power Co.), 244 B.R. 149, 156 (Bankr. N.D. Cal. 1999) (holding that a security interest in an unregistered copyright may be perfected by the filing of a UCC-1 financing statement in accordance with state law); *In re* Together Dev. Corp., 227 B.R. 439, 442 (Bankr. D. Mass. 1998) (holding that the filing of a financing statement with the PTO was insufficient to perfect an interest in the debtor's trademark and, therefore, the creditor's rights in the trademark were subordinate to those of the debtor in possession); *In re* Avalon Software Inc., 209 B.R. 517, 521 (Bankr. D. Ariz. 1997) (holding that a security interest in copyrighted or copyrightable property, as well as in proceeds from the copyrighted material, is perfected only when such interest is registered with the U.S. Copyright Office); Official Unsecured Creditors' Comm. v. Zenith Prod., Ltd. (*In re* AEG Acquisition Corp.), 127 B.R. 34, 40-41 (Bankr. C.D. Cal. 1991) (holding that the perfection of a security interest in a motion picture film is a two step process that requires (i) the registration of the film with the U.S. Copyright Office and (ii) the recordation of the security interest in that film with that same office), *aff'd*, 161 B.R. 50 (B.A.P. 9th Cir. 1993); *In re* Chattanooga Choo-Choo Co., 98 B.R. 792, 796 (Bankr. E.D. Tenn. 1989) (holding that the filing of a UCC-1 in accordance with Tennessee's version of Article 9 of the Uniform Commercial Code was sufficient to perfect an interest in a service mark); *In re* Transportation Design and Tech., Inc., 48 B.R. 635, 640 (Bankr. S.D. Cal. 1985) (holding that a creditor's filing of a UCC-1 financing statement covering the debtor's general intangibles, including patents, was perfected against the trustee in bankruptcy, even though the creditor did not make any filing with the PTO); Roman Cleanser Co. v. National Acceptance Co. of Am. (*In re* Roman Cleanser Co.), 43 B.R. 940, 943-45 (Bankr. E. D. Mich. 1984) (holding that the manner of perfecting a security interest in trademarks is governed by Article 9 of the Uniform Commercial Code and not by federal trademark law; therefore, the filing of a UCC-1 was sufficient to perfect a security interest in a trademark), *aff'd*, 802 F.2d 207 (6th Cir. 1986).

CONCLUSION

As with any business transaction, there is an inherent risk in an entity's decision to use or invest in the intellectual property and technology of a financially-troubled or startup company. Nevertheless, by taking the proper precautions, an entity may ameliorate the effect of such risks while taking full advantage of the benefits of the transaction. By purchasing the intellectual property and technology outright or entering into a license to use the intellectual property and technology with a trust or entity separate and apart from the financially-troubled or startup company, an entity may be able to eliminate the risk altogether. If the financially-troubled or startup company, however, is reluctant to part with its ownership of the intellectual property and technology, the entity may still enhance the protection of its interests in any license with such company by drafting the license to take full advantage of the protections afforded a nondebtor licensee under section 365(n) of the Bankruptcy Code. Additionally, the entity may take a security interest in the intellectual property and technology not only to secure the financially-troubled or startup company's performance of the license, but also to make the rejection of any such license in a bankruptcy case less attractive. Although such precautions will not enable an entity licensing intellectual property and technology from a financially-troubled or startup company to avoid all of the adverse consequences that may flow from a licensor's bankruptcy case, they may lessen the impact of the bankruptcy case on the entity's business and thus, keep things "business as usual" for the entity and its customers.