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Intellectual Property

Assigning Intellectual Property in a Bankruptcy: Is the Licensor's Consent Necessary?

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When a party to an intellectual property license agreement files for bankruptcy protection, the implications can be daunting. The uncertainty and risk associated with the prospect of valuable intellectual property rights being freely assigned to a third party without consent is never more clear than when viewed through the eyes of a non-debtor licensor - despite the fact that the terms of the agreement expressly prohibit assignment. As with other areas of federal jurisprudence, the intersection of bankruptcy law and intellectual property law often boils down to an uneasy balancing of conflicting interests. The goal of bankruptcy reorganization is to rehabilitate debtors and maximize the value of the debtor's assets for the benefit of interested parties. This aim requires vesting a debtor with broad flexibility to market and monetize its intellectual property assets. On the other hand, the objective of parties entering into intellectual property licenses is to provide protection against erosion of value that would result from an owner of intellectual property being forced into license agreements with undesirable business partners.

The discussion of the article focuses on the scenario in which a debtor-licensee intends to assume and assign an intellectual property license agreement. Although well-settled bankruptcy law permits a debtor to assume and assign an executory contract over the objection of the contract counterparty, intellectual property licenses may be subject to a distinct carve-out that limits the debtor's authority to assign a license absent consent. As a general matter, courts have recognized a limitation on a debtor's authority to assume and assign a non-exclusive patent license, copyright license, or a trademark license absent consent where the agreement expressly prohibits assignment or provides no express authorization for assignment. A more unsettled area concerns whether an exclusive patent license, copyright license, or trademark license may be assigned without consent when assignment is not otherwise provided for by the terms of the agreement. Given the ever-burgeoning presence of intellectual property in our technology-driven economy, coupled with the lagging economic recovery, it is imperative for companies across all sectors to understand how a debtor-licensee's bankruptcy could cause significant reverberations to their bottom lines.

Assumption and Assignment of Executory Contracts Under the Bankruptcy Code

Bankruptcy Code § 365(a) provides that a debtor "subject to the court's approval, may assume or reject any executory contract or unexpired lease," and vests a debtor with the authority to continue or shed contracts for the benefit of the bankruptcy estate. 11 U.S.C. § 365(a). In conjunction, 11 U.S.C. § 365(f) allows a debtor to assign a contract to a third party despite the existence of a non-assignment provision in the agreement. Although the decision to assume an executory contract must be approved by the bankruptcy court, absent compelling circumstances courts generally defer to the business judgment of the debtor

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as to whether assumption and assignment is appropriate. 3 *Collier on Bankruptcy*, ¶ 365.03[2], 365-25 (16th ed. 2010). Since the applicable business judgment standard is relatively lax, a contract counterparty often faces an uphill battle in arguing that assumption and assignment is unwarranted under the circumstances.

Pursuant to 11 U.S.C. § 365, a debtor must assume an agreement as a whole and is not permitted to shed unwanted obligations while retaining the benefits of the respective contract. *Collier*, ¶ 365.03[3], 365-27 (explaining that an executory contract may not be assumed in part and rejected in part). Furthermore, during the gap period, after a bankruptcy petition has been filed and prior to the debtor's election to assume or reject an agreement, the debtor generally is obligated to compensate the counterparty for the reasonable value of the benefits received under the respective contract. *Collier*, ¶ 365.04[4], 365-41 (citing *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984)).

In order to assume a contract, § 365 requires that the debtor satisfy the following three requirements: (1) cure any existing defaults (or provide adequate assurance that they will be cured promptly), (2) provide compensation or adequate assurance to the counterparty for pecuniary loss resulting from any existing default, and (3) provide some form of adequate assurance to the counterparty that the contract will be performed on a going-forward basis. 11 U.S.C. § 365(b)(1). The concept of adequate assurance of future performance is flexible and varies depending on the circumstances, but it requires a showing that the debtor (or third party assignee) has the ability to perform the obligations under the agreement after assumption. *See Collier*, ¶ 365.06[2], 365-52.

"Applicable Law" Exception to Assumption and Assignment of Executory Contracts

Bankruptcy Code § 365(c) provides a critical limitation on the power of a debtor to assume and assign an executory contract and provides that a debtor "may not assume or assign any executory contract . . . if applicable law excuses a party, other than the debtor . . . from accepting performance from or rendering performance to an entity other than the debtor . . . ." 11 U.S.C. § 365(c). The purpose of the "applicable law" restriction on assumption and assignment is to protect a counterparty from being forced to accept performance from a third party where otherwise "applicable law" would excuse the obligation to adhere to such an arrangement. *Collier*, ¶ 365.07[1][d], 365-64. Courts have interpreted the reference to "applicable law" in § 365(c) to include both relevant federal and state law relating to restrictions on assignment. *See Collier*, ¶ 365.07[1][a], 365-62, n.9; *see, e.g.*, *RCI Tech. Corp. v. Sunterrra Corp. (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004). Courts have seized on the phrase "applicable law" in determining whether intellectual property licenses may be assumed and assigned absent consent of the non-debtor counterparty.

Intellectual Property Licenses and Classification As Executory Contracts

The market for intellectual property thrives on the use of licenses. The ability to license one's intellectual property encourages the development of creative technology and innovation by the owner while facilitating broad utilization of the technology and further development by the licensee. Intellectual property often represents highly sensitive proprietary information that can be "mission critical" to a company's operations. Courts have consistently recognized that patents, copyrights and trademarks represent forms of "property" that are entitled to protections as such. Accordingly, intellectual property law generally fosters freedom of contract in licensing to allow a licensor the ability to carefully monitor the dissemination of its technology. Based on these considerations, intellectual property licenses require unique analyses when determining whether a debtor may freely assume and assign such agreements.

A threshold issue in determining whether a debtor-licensee is empowered to assume and assign a license is whether it meets the definition of an "executory contract." There is no express definition for the term "executory contract" contained in the Bankruptcy Code. Most courts, however, have adopted the "Countryman" test, which provides that a contract is executory only if the obligations "of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." *See, e.g.*, *Sharon Steel Corp. v. National Fuel Gas Distribution Corp.*, 872 F.2d 36, 39 (3d Cir. 1989); *see also* Countryman, Executory Contracts in Bankruptcy; Part I, 57 Minn. L. Rev. 439, 460 (1973). Irrespective of the parties' characterization of an agreement as a "license," courts examine whether at least one continuing material duty exists for each counterparty in determining whether the license constitutes an executory contract capable of being assumed and assigned.

While intellectual property license agreements are not automatically characterized as executory contracts, courts frequently find that the ongoing duties attendant to such licenses (i.e., the duty of confidentiality) satisfy the Countryman test. *See, e.g.*, *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't)*, 165 F.3d 747, 750 (9th Cir. 1999); *In re Golden Books Family Entm't, Inc.*, 269 B.R. 300, 308-09 (Bankr. D. Del. 2001). It is important to note that a court may be more likely to view an exclusive license as non-executory given that it represents a transfer of a greater portion of the subject intellectual property. *See In re DAK Indus., Inc.*, 66 F.3d 1091, 1096 (9th Cir. 1995). The defining characteristic of an executory contract is ongoing performance by both parties to the contract. To the extent that a debtor-licen*see* can demonstrate some form of remaining obligation a court will likely find that such a license falls within the purview of § 365.

Exclusive Versus Non-Exclusive Licenses and the Role of Consent

Since, in most instances, an intellectual property license will be recognized as an executory contract, the ability of a non-debtor licensor to control the disposition of its licensed intellectual property boils down to whether "applicable non-bankruptcy law" would prohibit the proposed assignment under § 365(c). The most critical distinction drawn by courts is whether the license at issue is exclusive or non-exclusive in nature. An exclusive license, akin to a property right, confers more rights and generally may be freely transferable by the licen*see* even though the license agreement may restrict assignment. By contrast, a non-exclusive license grants a more limited personal interest that does not convey the same bundle of rights and, therefore, typically cannot be assigned absent the licensor's consent. What follows is a discussion addressing the most prominent forms of intellectual property licenses and the effect that the exclusivity distinction has on the debtor-licensee's ability to assign.

– A. Copyright Licenses

Federal copyright law is not completely settled on the issue of contract assignment, and this uncertainty has trickled into bankruptcy decisions addressing the ability of a debtor to assume and assign an agreement under § 365. By and large, whether § 365(c) prevents assignment based on applicable copyright law is dictated by whether the license is exclusive or non-exclusive. *See Golden Books*, 269 B.R. at 309 (citing cases).

The weight of the case law provides that a non-exclusive license confers only a personal interest which cannot be assigned absent authorization from the counterparty *See Golden Books*, 269 B.R. at 309; *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 242-43 (S.D.N.Y. 1997). This line of cases recognizes that assignment is generally disallowed for non-exclusive licenses absent consent or express provisions to the contrary.

On the other hand, it can be gleaned from the case law that assignment under § 365 of an exclusive copyright license is generally appropriate, even if the copyright license explicitly prohibits assignment. However, not all case law on the issue has been consistent. For example, a leading decision from the Ninth Circuit Court of Appeals, *Gardner v. Nike, Inc.*, 279 F.3d 774 (9th Cir. 2002), adopts a different approach. In *Gardner*, the court upheld a licensor's right to require consent even where the copyright license was exclusive and was silent on the issue of assignment. The court in *Gardner* concluded that § 201 of the Copyright Act of 1976 did not grant exclusive licensees the right to freely transfer the license, and therefore found that an exclusive copyright cannot be transferred absent the licensor's consent pursuant to § 365(c) of the Bankruptcy Code. The view espoused in *Gardner* is favorable to non-debtor licensors who seek continued exercise of control over the future disposition of their copyright even where the license is exclusive.

– B. Patent Licenses

Courts addressing non-exclusive patent licenses have recognized the same general rule applicable to non-exclusive copyright licenses. Almost uniformly, courts have held that non-exclusive patent licenses may not be assigned pursuant to § 365 absent consent by the licensor. *See, e.g., In re Access Beyond Technologies*, 237 B.R. at 45-47; *In re Catapult Entm't*, 165 F.3d at 750-55. The rationale underlying these decisions is that federal patent law renders non-exclusive patents personal in nature and non-delegable absent consent or express authorization contained in the license agreement. These outcomes are in line with the underlying purpose of federal patent law which is to encourage investment in developing new technology by allowing the patent holder pervasive control over which parties, particularly potential competitors, may gain access to its technology. *See In re CFLC, Inc.*, 89 F.3d 673, 679 (9th Cir. 1996).

The number of decisions addressing exclusive patent licenses is more limited and thus more unpredictable. By way of illustration, the bankruptcy court in *In re Hernandez*, 285 B.R. 435, 439-40 (Bankr. D. Ariz. 2002), squarely addressed the "assignability" of an exclusive patent license, and concluded that federal patent law requires the licensor's consent prior to assignment to an unrelated third party. In so finding, the court reasoned that an assignment would vitiate a licensor's right to control the dissemination of the licensed technology upon the grant of an exclusive license and that such a result ignored the distinction between the grant of an exclusive license and an outright assignment of the patent. Of note, the license agreement at issue in *Hernandez* contained an express non-assignment provision. It is questionable whether the courts would extend this decision to a license agreement that is silent as to assignment. Based on the outcome in *Hernandez*, the existence of an anti-assignment clause, and even the exact language used in granting the license, may be outcome determinative.

– C. Trademark Licenses

In most cases, a trademark license is similar to a non-exclusive patent or copyright license in that it is personal to the licensee. The policy underlying federal trademark law is to protect the goodwill associated with a particular mark. This policy supports the rationale that a trademark owner retains the right to prevent assignment unless the agreement expressly provides otherwise. As such, "applicable" trademark law may support a licensor's attempt to block a debtor-licensee's assumption and assignment of a trademark regardless of whether the license is characterized as exclusive or non-exclusive.

The dearth of published decisions addressing the ability to assign a trademark license is even more pronounced than the limited number of cases addressing copyrights and patents. The bankruptcy court in *In re N.C.P. Marketing Group, Inc.*, 337 B.R. 230, 233 (D. Nev. 2005), addressed a situation where a debtor-licen*see* sought to assume and assign a non-exclusive trademark license. Relying on patent and copyright decisions, the court

concluded that applicable law dictated that trademarks were personal and non-assignable absent consent from the licensor. The proposition that a trademark license is not subject to assignment is bolstered where there is no express authorization in the license agreement itself. Moreover, as with both copyrights and patents, a licensor's attempts to preclude assumption and assignment are likely to be more successful in dealing with a non-exclusive rather than an exclusive license. *See In re Travelot Co.*, 286 B.R. 447, 454-55 (Bankr. S.D. Ga. 2002).

Assumption Versus Assumption and Assignment

Another interesting wrinkle in assessing a debtor-licensee's ability to assume or ratify an intellectual property license under the Bankruptcy Code is whether the debtor seeks to both assume and assign the license versus simply assume the license. For example, a debtor seeking to emerge from a chapter 11 bankruptcy as a reorganized entity may seek to simply assume the license and continue to use the license post-bankruptcy. Based on the "applicable law" limitation found in § 365(c), courts addressing this question are split as to whether a limitation on a debtor's ability to assume and assign a license is tantamount to a limit to assume in the first instance. Two separate tests have emerged to address this issue. As set forth below, the conflicting approaches adopted by courts often dictate the venue a debtor elects to file chapter 11 and, necessarily, could have a significant impact on a non-debtor licensor's ability to exert leverage with respect to the intellectual property license.

– 1. Hypothetical Test

The Third, Fourth, Ninth and Eleventh Circuit Courts of Appeal have adopted what is colloquially termed as the "hypothetical test," which provides that if applicable non-bankruptcy law prohibits a debtor from assigning the license to a third party, the debtor cannot assume the contract itself irrespective of whether it intends to actually assign the license.[1] *See In re West Electronics, Inc.*, 852 F.2d 79, 82 (3d Cir. 1988); *In re Sunterra*, 361 F.3d at 265; *In re James Cable Partners, L.P.*, 27 F.3d 534, 537-38 (11th Cir. 1994). In other words, to determine whether the license can be assumed, these courts would create a "hypothetical" third party to whom the license may be assigned to determine whether an assignment would otherwise be impermissible under § 365(c).

– 2. Actual Test

A more pragmatic approach has been adopted by the First Circuit and numerous lower courts in determining whether a debtor may assume, or assume and assign a license.[2] These courts have adopted what is termed the "actual test," which provides that if applicable non-bankruptcy law precludes a debtor from assigning the license to a third party, the license agreement is assumable unless the debtor actually intends to assign the license. *See Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 490-91 (1st Cir. 1997); *In re Footstar, Inc.*, 323 B.R. 566, 567-68 (Bankr. S.D.N.Y. 2005). In applying this test, courts do not even address the issue of whether assignment to a third party would be permissible where the debtor-licen*see* seeks only to assume the license for its continued use. The rationale for the "actual test" is that if the debtor is merely seeking to continue performing under the license agreement under the terms applicable prior to the bankruptcy filing, the non-debtor licensor cannot be prejudiced by the assumption.

License Agreement Drafting Tips

The uncertainty swirling around a debtor-licensee's ability to assume and assign an intellectual property license makes navigating the chapter 11 process while preserving valuable intellectual property rights a thorny proposition. The exceedingly compressed timelines for chapter 11 cases only adds additional pressure. Truncated auction and sale processes (and the associated designation of licenses to be assumed and assigned) often leave non-debtor licensors scrambling to assess the compatibility of a third party assignee to determine whether to consent or oppose a potential assignment. Giving thought to bankruptcy contingencies in a license agreement can mitigate angst accompanying a debtor-licensee's chapter 11 filing.

In structuring a license agreement, it is important to note that, regardless of the contractual language used, a debtor's right to assume an executory contract likely cannot be waived through a pre-petition agreement. *See Trans World Airlines, Inc.*, 261 B.R. 103, 114 (Bankr. D. Del. 2001). As discussed above, the dichotomy between an exclusive or non-exclusive license can be the deciding factor in whether a licensor's consent is required under § 365(c). Accordingly, where an exclusive license is contemplated, it is prudent to limit the duration to a specified term that is renewable at the discretion of the licensor. This is important, given that § 365 only allows a debtor to assume the terms of a license as they exist pre-petition. As such, a contract expiring by its own terms cannot be assumed and assigned. *See Collier*, ¶ 365.02[2][e], 365-20 (citing *Counties Contracting & Constr. Co. v. Constitution Life Ins. Co.*, 855 F.2d 1054, 1061 (3d Cir. 1988)).

In addition, provisions of the license agreement addressing the terms of adequate assurance of future performance in the event of assignment should also be considered. While such provisions are not binding on the bankruptcy court, evidence of what the parties contemplated at the time of contract formation could influence the bankruptcy court's ultimate decision on what constitutes adequate assurance of future performance. Similarly, a provision of a license agreement addressing the circumstances in which consent to an assignment may be withheld (i.e.,

unreasonableness) could come into play in the event that a debtor-licen*see* argues that a licensor is withholding consent in bad faith.

Negotiating provisions of a license agreement relating to a chapter 11 filing are not always seamless given pressing business considerations and the seeming remoteness of a bankruptcy filing. However, in light of the paramount importance of intellectual property to the value and ultimate survival of many businesses, a licensor that is cognizant of the potential pitfalls of assumption and assignment may be able to craft a license agreement that serves as an ounce of prevention and averts a later-required pound of cure.

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[1] The Third Circuit Court of Appeals presides over the following jurisdictions: Delaware, New Jersey, Pennsylvania and the U.S. Virgin Islands. The Fourth Circuit Court of Appeals presides over the following jurisdictions: Maryland, North Carolina, South Carolina, Virginia and West Virginia. The Ninth Circuit Court of Appeals presides over the following jurisdictions: Alaska, Arizona, California, Guam, Hawaii, Idaho, Montana, Nevada, Northern Mariana Islands, Oregon and Washington. The Eleventh Circuit Court of Appeals presides over the following jurisdictions: Alabama, Florida, and Georgia.

[2] The First Circuit Court of Appeals presides over the following jurisdictions: Maine, Massachusetts, New Hampshire, Puerto Rico and Rhode Island.