INTELLECTUAL PROPERTY AND TECHNOLOGY DUE DILIGENCE

Chapter 14

Intellectual Property Acquired Through Bankruptcy

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I. Introduction

Imagine a chief in-house counsel for a company that licenses a patent that is crucial to its business. Imagine further that one day this in-house counsel receives in the mail a notice that the owner of the patent has just filed a bankruptcy petition. Our in-house counsel has had little experience with bankruptcy. In fact, counsel's only involvement in a bankruptcy has been to prepare and file a proof of claim for the company. What does counsel tell the company regarding the potential impact that the bankruptcy may have on the patent? Is the company's business toast? Does the company need to start looking for a new way to make money? Or does the U.S. Bankruptcy Code give the company the ability to protect itself and its rights in the patent?

This hypothetical scenario is not that uncommon. Corporate bankruptcy cases are filed every day, and many of these debtors

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own intellectual property (IP) that is being licensed to other companies. Therefore, it is imperative for counsel to have at least a basic understanding of how intellectual property is treated under the Bankruptcy Code, and the rights and obligations of parties to intellectual property licenses.

II. Background on Bankruptcy

Like intellectual property, bankruptcy is a niche area of law with its own court system and its own set of laws and rules. The most common types of bankruptcy cases are filed under Chapter 7, Chapter 11, or Chapter 13 of the Bankruptcy Code. Petitions to recognize foreign insolvency proceedings—unique cases that are becoming more prevalent—are filed under Chapter 15 and are discussed in subsection G.

The major concerns associated with intellectual property occur in Chapter 11 cases in which the debtor is either a licensor or licensee of intellectual property. Given the value of intellectual property, especially when the company's profitability is based upon the use or ownership of the intellectual property, it is very important that in-house counsel have at least a basic understanding of how intellectual property is treated in bankruptcy cases.

A. Intellectual Property under the Bankruptcy Code

Not all intellectual property is created equal in bankruptcy. Although the Bankruptcy Code gives special rights to licensees of "intellectual property," the Bankruptcy Code's definition of *intellectual property* is actually limited to the following categories:

- A trade secret;
- An invention, process, design, or plant protected under Title 35;
- A patent application;
- A plant variety;

- A work of authorship protected under Title 17; and
- A mask work protected under Chapter 9 of Title 17.[1]

Significantly, under the Bankruptcy Code intellectual property does *not* include trademarks, trade names, or service marks. This exclusion is unfortunate for licensees of trademarks, trade names, or service marks, as it means that the Bankruptcy Code does not afford them any special protections. Therefore, if a company is the licensee of one of these three excluded categories, and the licensor has filed for bankruptcy, then the company may be out of luck in the eyes of the Bankruptcy Code.

B. Treatment of Intellectual Property Licenses under the Bankruptcy Code

As noted in the introduction to this chapter, many companies enter into license agreements to secure access to someone else's intellectual property as a means of achieving business goals, such as starting or expanding a business. What happens to one of those license agreements if the owner of the intellectual property files a bankruptcy petition?

It is important to recognize that a license for intellectual property is typically considered, in bankruptcy parlance, to be an "executory contract." An *executory contract* is a contract that requires some future or ongoing performance by both parties, where the outstanding obligations for the parties are *material*. Another formulation, as defined in the often-cited *Countryman* test, provides that 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 performance would constitute a material breach excusing the performance of the other."[2] If one party has fully performed

1. 11 U.S.C. § 101(35A).

2. Vern Countryman, *Executory Contracts in Bankruptcy, Part I,* 57 Minn. Law Review 439, 460 (1973).

its obligations, but the other party has not, then the agreement is not an executory contract.

Whether material obligations or incomplete performance remain for both parties of a license is a fact-specific inquiry for the court in which the bankruptcy petition is filed. Some examples of what might constitute a material obligation include:

- The obligation of the intellectual property owner to refrain from suing the licensee[3]
- The obligation of the licensee to account for and pay royalties to the licensor[4]
- The duty to maintain confidentiality on the part of the licensee[5]
- The duty on the part of the licensor to indemnify and defend the licensee from infringement claims[6]

3. *E.g.,* Everex Sys., Inc. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 677 (9th Cir. 1996) (holding that the licensor's continuing obligation to refrain from suing the licensee for infringement was a material unperformed obligation, and that an exclusive license agreement was therefore executory); *In re* Access Beyond Techs., Inc., 237 B.R. 32, 44 (Bankr. D. Del. 1999) (holding that an exclusive patent license agreement was executory because the licensor's duty to forbear from suing the licensee for infringement was, in and of itself, a material ongoing performance obligation).

4. *E.g.*, *In re* Petur U.S.A. Instr. Co., 35 B.R. 561, 563 (Bankr. W.D. Wash. 1983) ("In this instance, the Court concludes that the license agreement is an executory contract. The debtor is under a number of continuing obligations, including providing product, information and know-how, and consulting services. Conversely, Petur of Canada is obligated to pay royalties on sales for the remaining term of the agreement. The failure to perform by either party would constitute a material breach excusing performance by the other.").

5. *E.g.*, RCI Tech. Corp. v. Sunterra Corp. (*In re* Sunterra), 361 F.3d 257, 264 (4th Cir. 2004) ("On this point, we agree with the district court that the Agreement was executory when Sunterra petitioned for bankruptcy. When the bankruptcy petition was filed, each party owed at least one continuing material duty to the other under the Agreement—they each possessed an ongoing obligation to maintain the confidentiality of the source code of the software developed by the other.").

6. *E.g.*, *In re* Chipwich, Inc., 54 B.R. 427, 430 (Bankr. S.D.N.Y. 1985) ("Additionally, Farmland is required to protect the debtor's rights in the licensed trademarks. Manifestly, the licenses in the instant case are executory as to both the debtor and Farmland and, therefore, they are executory contracts within the meaning of 11 U.S.C. § 365(a).").

The typical nonexclusive license agreement often contains provisions constituting sufficiently material obligations for both parties to qualify the license as an executory contract.

In contrast, some courts have concluded that *exclusive* intellectual property license agreements are nonexecutory. These courts have focused on the lack of the licensor's continuing obligations under these agreements, as well as the court's view that the exclusive license is analogous to a sale, in holding that an exclusive license agreement was not an executory contract.[7] However, other courts have reached the opposite conclusion.[8] Therefore, a party to an exclusive license agreement should not assume that the agreement is nonexecutory just because the agreement is exclusive.

Can a nondebtor party to an executory contract terminate the contract during the bankruptcy? The short answer is no, at least not without court approval. The debtor's rights under the executory contract become part of the bankruptcy estate.[9] Upon the filing of the bankruptcy case, an automatic stay is put in place, and this automatic stay prevents creditors from taking many different types of actions against the debtor or its property, including obtaining possession of, or exercising control over, property of the bankruptcy estate.[10] A creditor can ask the court to grant it relief

7. *E.g.*, *In re* Kmart Corp., 290 B.R. 614, 619 (Bankr. N.D. Ill. 2003) ("Accordingly, an exclusive intellectual property license would be more likely to constitute a sale because an exclusive license confers upon the licensee (and divests the licensor of) all or some portion of the ownership rights and interests associated with the intellectual property pursuant to well-established principles of patent[,] copyright and trademark law." (citations omitted)).

8. *See In re* Access Beyond, *supra* n. 3, 237 B.R. at 44.

9. *See* 11 U.S.C. § 541(a)(1) (the commencement of a bankruptcy case creates an estate, which is comprised of, among other things, "all legal or equitable interests of the debtor in property as of the commencement of the case"); *see also* Cinicola v. Scharffenberger, 248 F.3d 110, 121 (3d Cir. 2001) (explaining that a debtor's interest in an executory contract is included in the property of the bankruptcy estate, as defined by 11 U.S.C. § 541(a)(1)).

10. *See* 11 U.S.C. § 362(a).

from the automatic stay.[11] However, such relief is rarely granted to allow a nondebtor party to terminate an executory contract, especially when that contract is valuable to the estate. Therefore, the nondebtor party to an intellectual property license agreement should presume that it will not be able to terminate the agreement during the bankruptcy, even if the agreement provides that insolvency or the filing of a bankruptcy petition is an event of default.[12]

C. License Agreements as Executory Contracts

Let us return to the introductory hypothetical concerning the in-house counsel looking at a bankruptcy filing by the patent owner. The in-house counsel has now reviewed the license agreement and sees multiple material obligations existing on both sides of the contract, so counsel is on alert that the agreement is almost certainly an executory contract. But what does that mean for purposes of bankruptcy?

At the heart of the answer is § 365 of the Bankruptcy Code. Section 365 gives the debtor three options regarding its executory contracts.[13] First, the debtor may *reject* an executory contract that the debtor determines is not beneficial to its estate.

11. *See* 11 U.S.C. § 362(d) (permitting relief from the automatic stay (1) for "cause"; or (2) with respect to the stay of an act against property, if the debtor does not have equity in the property and the property is not necessary to an effective reorganization).

12. On a related note, the bankruptcy filing will stay any litigation brought against the debtor, including, for instance, patent or other intellectual property-related litigation. In such cases, it is not unusual for the party bringing claims against the debtor to seek relief from the automatic stay so that it may continue with the litigation. Often such relief is granted, on the condition that the party asserting the claims does not take steps to enforce any judgment obtained against the debtor, except through the bankruptcy case.

13. Section 365 also addresses unexpired leases, but such leases are not pertinent to the analysis of intellectual property license agreements. Accordingly, this chapter addresses only executory contracts, although many of the rules regarding unexpired leases are the same.

Rejection constitutes a breach of the contract and relieves the debtor from any future obligations under that contract.[14]

Second, the debtor may *assume* an executory contract, meaning that the debtor will continue to perform under the contract. An executory contract must be assumed in whole, meaning that the debtor cannot assume those portions of the contract that it likes, and reject those portions it finds burdensome.[15] In order to assume an executory contract, the debtor must:

- cure, or provide adequate assurance that it will promptly cure, defaults (subject to certain exceptions not pertinent to this discussion) under the contract;
- compensate, or provide adequate assurance that it will promptly compensate, the other party to the contract for any actual pecuniary losses resulting from prior defaults; and
- provide adequate assurance of the debtor's ability to fully perform all of its future obligations under the contract.[16]

Third, the debtor may *assume and then assign* an executory contract.[17] Upon assumption and assignment, the assignee would, in essence, take the debtor's place as a party to the contract and would assume the debtor's obligations (and receive the benefits that would have accrued to the debtor). The assignee of the contract must therefore provide adequate assurance of its ability to fully perform all of its future obligations under the contract.[18]

In a Chapter 11 case, the debtor may assume or reject (or assume and assign) an executory contract any time up until

14. 3 Collier on Bankruptcy ¶ 365.03[1] (15th ed. rev., 2003).

15. *E.g.*, Schlumberger Res. Mgmt. Servs. v. Cellnet Data Sys. (*In re* Cellnet Data Sys.), 327 F.3d 242, 249 (3d Cir. 2003) ("Under the Bankruptcy Code, a trustee may elect to reject or assume its obligations under an executory contract. This election is an all-or-nothing proposition—either the whole contract is assumed or the entire contract is rejected.").

16. 11 U.S.C. § 365(b)(1)(A)(C).

17. 11 U.S.C. § 365(f).

18. 11 U.S.C. § 365(f)(2).

confirmation of a plan of reorganization or liquidation.[19] However, the nondebtor party to the contract can request that the court compel the debtor to make an earlier election.[20] The decision of whether to assume or reject is subject to the court's approval.[21] The court will apply what is known as the *business judgment test*, wherein the debtor's decision will be approved as long as the decision is within the debtor's sound exercise of business judgment.[22] This is a relatively low standard that is easy for the debtor to meet.

D. Debtor Rejection of the Intellectual Property License

Let us take a worst-case scenario. After reviewing the license, counsel is of the opinion that the intellectual property license agreement is an executory contract, and the debtor has given notice that it intends to reject the agreement. To make matters worse, the licensed patent is crucial to the company's business. Without the patent, the company cannot continue to operate. Meanwhile, the company president is asking in-house counsel what to do, and is impatiently waiting for an answer.

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19. In a Chapter 11 case, the court may confirm a plan of reorganization or plan of liquidation. In the case of a plan of reorganization for a corporate or partnership debtor (the typical debtor with intellectual property interests), the debtor's business is restructured and a process is approved for paying the debtor's debts. In contrast, under a plan of liquidation the debtor's assets are liquidated and the proceeds are used to pay the debtor's debts.

20. 11 U.S.C. § 365(d)(2).

21. 11 U.S.C. § 365(a).

22. *E.g.*, Orion Pictures Corp. v. Showtime Networks, 4 F.3d 1095, 1099 (2d Cir. 1993) ("In *In re Minges* we held that a bankruptcy court reviewing a trustee's or debtor-in-possession's decision to assume or reject an executory contract should examine a 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 it."); *In re* Minges, 602 F.2d 38, 43 (2d Cir. 1979) (explaining that a number of courts have relied on the substance of the business judgment test and that its flexibility makes the test the most appropriate for determining when an executory contract may be rejected); *In re* GP Express Airlines, 200 B.R. 222, 230 (Bankr. D. Neb. 1996) ("The best business judgment test generally requires a showing that assumption of an executory contract benefits and is in the best interests of the bankruptcy estate, and is the result of the exercise of reasonable business judgment"); 3 Collier on Bankruptcy ¶ 365.03[2] (15th ed. rev., 2003).

The company is in luck: Section 365(n) of the Bankruptcy Code was drafted for just this situation and will allow the company to retain its rights to the patent. Under § 365(n), if a debtor rejects an executory contract under which the debtor is a licensor of intellectual property, the licensee may either (a) elect to treat the contract as terminated (i.e., breached), and file a proof of claim for damages flowing from the debtor's termination of the contract;[23] or (b) retain its rights to use the intellectual property under the contract for the duration of the contract and for any extension periods provided for by the contract.[24] If it elects to retain its rights to the intellectual property, the licensee must continue to make all royalty payments due under the original term of the contract, and any term extensions that the licensee elects to exercise.[25] The debtor-licensor must, upon written request of the licensee, (1) comply with any contractual requirement to provide the intellectual property to the licensee, and (2) refrain from interfering with the rights of the licensee to the intellectual property.[26] The licensee should not wait for the debtor-licensor's rejection of the contract if it has already decided that it wants to retain its rights in the intellectual property. Instead, the licensee should be proactive and provide written notice to the debtor-licensor, as the debtor is, upon receipt of the notice, required to either (1) continue to perform under the contract or (2) comply with any contractual requirement to provide the intellectual property to the licensee, as well as (3) refrain from interfering with the rights of the licensee to the intellectual property.[27]

This is plainly great news for the company because it can continue to utilize the intellectual property notwithstanding the

23. Section 365(g) of the Bankruptcy Code provides that the rejection of an executory contract constitutes a breach of the contract occurring immediately prior to the filing of the bankruptcy. In the case of an intellectual property license agreement rejected by the debtor-licensor, the licensee would have a claim for damages arising by virtue of the debtor's prepetition breach of the agreement.

24. 11 U.S.C. § 365(n)(1).

25. 11 U.S.C. § 365(n)(2)(B).

26. 11 U.S.C. § 365(n)(3).

27. 11 U.S.C. § 365(n)(4).

debtor's rejection of the license agreement. However, there are still some shortcomings for licensees under § 365(n). First, the licensee waives any right of setoff that it may have with respect to the license agreement and also waives its right to assert an administrative expense claim arising from the performance of the contract.[28] Second, the rights granted to the licensee under § 365(n) are restricted to the intellectual property: they do not extend to other benefits it was receiving under the agreement, such as the debtor's assistance.[29]

Nonetheless, § 365(n) puts the nondebtor party to an intellectual property license agreement (the licensee) in a significantly better position than a nondebtor party to a run-of-the-mill executory contract. Whereas the former can continue to enforce certain rights under the contract, the latter is out of luck and is limited to an unsecured rejection damages claim that will, in the vast majority of cases, be paid pennies on the dollar. For checklists and charts summarizing this discussion, see Appendix 14.1.

E. Trademark Licensee Protection

As noted in I.A, trademarks are not included within the definition of intellectual property set forth in § 101(35A), and therefore the licensee is not afforded any protection under the Bankruptcy Code if it has only a license to a trademark. If, however, the agreement grants a trademark license in addition to a patent license, may the licensee retain its right to the trademark as well under the Bankruptcy Code? Unfortunately—and clients hate to hear this—it depends.

The combination of § 101(35A) and § 365(n) can be read to create the inference that Congress did not intend to protect a trademark licensee in the same way in which an intellectual

28. 11 U.S.C. § 365(n)(2)(C).

29. *E.g.*, Biosafe Int'l v. Controlled Shredders (*In re* Szombathy), Case Nos. 94 B 15536, 95 A 01035, 1996 Bankr. LEXIS 888, at *31 (Bankr. N.D. Ill. July 9, 1986), *rev'd on other grounds*, 1997 U.S. Dist. LEXIS 5168 (N.D. Ill. Apr. 10, 1997) ("Moreover, the licensee cannot compel the debtor to perform any affirmative obligations under the agreement once it has been rejected.").

property licensee is protected.[30] Some courts have rejected this so-called negative inference and have held that bankruptcy courts have the authority to permit a nondebtor to retain a trademark license based upon the equities of the case.[31] The Seventh Circuit also rejected the negative inference but held that a nondebtor's right to continue to use a trademark license is based upon § 365(g). As noted earlier,[32] § 365(g) provides that a rejection of an executory contract simply constitutes a prepetition breach of that contract: it acts as neither a contract rescission nor a termination. Therefore, the licensee can continue to utilize the licensed trademark notwithstanding the rejection of the contract.[33] Nonetheless, these cases should be seen as outliers to the general rule that a nondebtor is not able to continue to utilize a trademark license once the debtor has rejected that license agreement.

F. Debtor/Licensee Assignment of Licensed Rights

More and more bankruptcy cases are filed with the ultimate goal of selling the debtor's operating business under § 363 of the Bankruptcy Code, which permits the sale of a debtor's assets free and clear of claims, liens, and encumbrances.[34] Executory contracts

30. *E.g., Mission Prod. Holdings, Inc. v. Tempnology, LLC (In re Tempnology, LLC)*, No. 16-9016, 2018 U.S. App. LEXIS 870, at *34 (1st Cir. Jan. 12, 2018) ("For these reasons, we favor the categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise." (citations omitted)).

31. *E.g.*, *In re* Crumbs Bake Shop, Inc., 522 B.R. 766, 77172 (Bankr. D.N.J. 2014) ("Congress intended the bankruptcy courts to exercise their equitable powers to decide, on a case by case basis, whether trademark licensees may retain the rights listed under § 365(n). Here, the Court finds that it would be inequitable to strip the [] Licensees of their rights in the event of a rejection, as those rights had been bargained away by Debtors.").

32. *Supra* n. 23.

33. Sunbeam Prods. v. Chicago Am. Mfg., LLC, 686 F.3d 372, 37778 (7th Cir. 2012) ("What § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance . . . [. N]othing about this process implies that any rights of the other contracting party have been vaporized").

34. From 2012 through 2015, the percentage of large, public company bankruptcies utilizing a § 363 sale of substantially all of the debtor's assets increased from 21 percent to 38 percent. *See* UCLA-LoPucki Bankruptcy Research Database,

are often included among the assets being sold. Specifically, if a debtor wants to sell its operating business through its bankruptcy case, the proposed purchaser will identify those executory contracts that it wants to acquire. The debtor will file a motion to assume those contracts and to assign the contracts to the purchaser as part of the sale.

What about executory contracts that contain a provision prohibiting assignment? Section 365(f) actually renders ineffective most provisions in executory contracts that prohibit, restrict, or condition the assignment of such contract.[35] However, § 365(c)(1) provides one exception to this general rule of assignability, by providing that a debtor "may not assume or assign" an executory contract or unexpired lease, whether or not the contract or lease prohibits or restricts assignment of rights or delegation of duties, if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor" and "such party does not consent to such assumption or assignment."[36] "Applicable law," as used in § 365(c)(1), includes patent laws—and under U.S. patent law, a nonexclusive license is considered to be personal and not assignable without the patent owner's consent.[37]

Let us revisit the hypothetical in-house counsel, but this time let us reverse the scenario so that the debtor is a licensee of

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363 Sales of All or Substantially All Assets in Large, Public Company Bankruptcies as a Percentage of All Cases Disposed by Year of Case Disposition, http://lopucki.law.ucla.edu/tables_and_graphs/363_sale_percentage.pdf. The rate of § 363 sales decreased in 2016, although it remains to be seen whether the dropoff in 2016 is an anomaly.

35. *See* 11 U.S.C. § 365(f)(1) (providing that a trustee may assign an executory contract or unexpired lease "notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts or conditions the assignment of such contract or lease").

36. 11 U.S.C. § 365(c)(1).

37. *E.g.*, Cargill, Inc. v. Nelson (*In re* LGX, LLC), 2006 Bankr. LEXIS 635, at *11 (B.A.P. 10th Cir. Jan. 13, 2006) ("Bankruptcy courts have held that federal common law preventing the non-consensual assignment of patent licenses constitutes 'applicable law' that prohibits a debtor's assumption and assignment of the license over a patent owner's objection under § 365(c)(1)"); Everex Sys., Inc. v. Cadtrak Corp. (*In re* CFLC, Inc.), 89 F.3d 673, 679 (9th Cir. 1996) (under federal law, a nonexclusive patent license that is silent as to assignability is presumed not to be assignable).

intellectual property owned by in-house counsel's company. In the previous scenario, the company was the licensee and the debtor was seeking to reject the executory contract under which the company was licensing the intellectual property. Under this new scenario, the debtor is the party licensing the company's intellectual property under a nonexclusive license agreement, and the debtor now wants to assign those nonexclusive rights to its purchaser. Is there anything in-house counsel can do on behalf of the company to stop the debtor from assigning the licensed rights?

The short answer to this question is, once again, it depends. Specifically, it depends on where the bankruptcy case is filed. There is a strong split among the federal circuits concerning the interpretation and impact of the applicable statute, § 365(c)(1). The split is primarily between those courts utilizing the "hypothetical test" and those courts utilizing the "actual test." To further complicate matters, some courts have even chosen to deviate from the split and apply yet another test, known as the "*Footstar* test."

The key to understanding the primary split is the phrase "assume or assign" used in § 365(c)(1). Does "or" mean only "or," or does it also include "and"? In other words, what happens when the debtor seeks *only to assume* the nonexclusive license agreement and does not intend to assign those rights? Does § 365(c)(1) nonetheless bar the assumption on behalf of the objecting licensor?

Those courts utilizing the actual test hold that § 365(c)(1) bars the assumption of a nonexclusive intellectual property license agreement on behalf of the objecting licensor *only if* the debtor actually intends to also assign the agreement. These courts read "or" to include "and," and have held that unless the debtor actually intends to assume *and* assign, § 365(c)(1) does not bar assumption. Under the actual test, licensors cannot use § 365(c)(1) to prevent assumption of their license agreements, and may have to continue to permit the debtor to perform under the agreements. The circuit courts applying the actual test include the First[38] and

38. Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir. 1997) (rejecting the hypothetical test and explaining that §§ 365(c) and (e) call for a case-by-case inquiry as to whether the nondebtor party is *actually* being forced to accept

Fifth[39] Circuits, although lower courts in the Seventh,[40] Eighth,[41] and Tenth[42] Circuits appear to follow the actual test as well.

In contrast, those courts utilizing the hypothetical test hold that § 365(c)(1) bars the assumption of a nonexclusive intellectual property license agreement on behalf of the objecting licensor, *even if* the debtor has no intention of assigning the agreement.

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performance under its executory contract from someone other than the debtor party with whom it originally contracted); *see also In re* Leroux, Case No. 92-20404-WCH, 1997 Bankr. LEXIS 971, at *2829 (Bankr. D. Mass. June 30, 1997) ("[I]t appears that for motions to assume or reject that implicate 11 U.S.C. § 365(c) and (e), the standard is the 'actual performance' test, as coined by the First Circuit.").

39. *In re* Mirant Corp., 440 F.3d 238, 24950 (5th Cir. 2006) (adopting the actual test to determine the "applicable law" for an executory contract); *see also In re* Jacobsen, 465 B.R. 102, 10708 (Bankr. N.D. Miss. 2011) (noting that the court "rejects the 'hypothetical test' approach when there is a clear absence of an intent to assign the executory contract or the unexpired lease"); *In re* Virgin Offshore United States, Case No. 11-13028, 2012 Bankr. LEXIS 5642, at *13 (Bankr. E.D. La. Dec. 6, 2012) ("In *Mirant*, the Fifth Circuit adopted the 'actual or as applied[ʻ] test. . . . The actual test provides that if no assignment has taken place or will take place, the exception for non-assignable contracts does not apply.").

40. *In re* Edison Mission Energy, Case No. 12-49219, 2013 Bankr. LEXIS 3872, at *3032 (Bankr. N.D. Ill. Sept. 16, 2013) ("The Court also finds that the actual test is more congruous with fundamental bankruptcy policy: the maximization of the value of the debtor's estate. . . . The hypothetical test, by contrast, would preclude the assumption of an advantageous contract to the detriment of the entire creditor body and the debtor's reorganizing efforts. This is so even when the debtor has no plans to assign the contract. Thus, this Court rejects the hypothetical test approach and will apply the actual test herein.").

41. *In re* GP Expl. Airlines, Inc., 200 B.R. 222, 23133 (Bankr. D. Neb. 1996) ("On facts like those before this court, where a debtor in possession simply wants to retain its prepetition executory contracts and to perform thereunder, the better reasoned result is to permit assumption, regardless of whether the contract can be assumed and assigned to a third party under applicable law.").

42. *In re* Aerobox Composite Structures, 373 B.R. 135, 142 (Bankr. D.N.M. 2007) ("Thus, where the debtor-in-possession seeks to assume, or, as is the situation in the instant case, where the debtor-in-possession has neither sought to assume nor reject the executory contract but simply continues to operate post-petition under its terms, 11 U.S.C. § 365(c)(1) does not prohibit assumption of the contract by the debtor-in-possession and cannot operate to allow the non-debtor party to the executory contract to compel the Debtor to reject the contract. In reaching this conclusion, the Court finds that the 'actual test' articulated in *Cambridge Biotech*, and the reasoning of the court in *Footstar*, is the better approach to § 365(c)(1) when determining whether a debtor-in-possession is precluded from assuming an executory contract.").

These courts ask whether, under § 365(c)(1), a debtor could *hypothetically* assign the agreement over the objection of the licensor. The hypothetical test provides enormous power to the licensor, which can prevent the assumption of the license agreement even if the debtor places its proverbial hand on a Bible and swears that it will not seek to assign the agreement. The circuit courts applying the hypothetical test include the Third,[43] Fourth,[44] Ninth,[45] and Eleventh[46] Circuits.

43. *In re* West Elecs., 852 F.2d 79, 83 (3d Cir. 1988) (applying the hypothetical test and holding that because the government military contract could not be assigned to a third party under applicable law, the debtor in possession could not assume the contract); *see also* Huron Consulting Servs., LLC v. Physiotherapy Holdings, Inc. (*In re* Physiotherapy Holdings, Inc.), 538 B.R. 225, 231233 (D. Del. 2015) ("Because the License Agreement is assignable under 11 U.S.C. § 365(c), the Third Circuit's 'hypothetical test' dictates that it is also assumable"); *In re* Trump Entm't Resorts, Inc., 526 B.R. 116, 125 (Bankr. D. Del. 2015) (holding that under the hypothetical test "the Debtors are prohibited from assuming or assigning the Trademark License Agreement, despite the fact that the Debtors have no immediate plans to assign the agreement to a third party.").

44. RCI Tech. Corp. v. Sunterra Corp. (*In re* Sunterra), 361 F.3d 257, at 26667, 271—72 (4th Cir. 2004) (determining that under § 365(c), the debtor in possession was precluded from assuming a nonexclusive software license because the licensee's consent to assignment did not constitute the necessary consent to assumption); *see also Warner v. Warner,* 480 B.R. 641, 64950 (Bankr. N.D. W. Va. 2012) ("Section 365(c)(1) allows non-debtor parties to prevent the trustee from assuming or assigning the rights of the debtor as long as the contract is an agreement where substitute performance is not permitted.").

45. Pearlman v. Catapult Entm't (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 74950 (9th Cir. 1999) ("In other words, the statute by its terms bars a debtor in possession from assuming an executory contract without the nondebtor's consent where applicable law precludes assignment of the contract to a third party. The literal language of § 365(c)(1) is thus said to establish a 'hypothetical test': a debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession has no intention of assigning the contract in question to any such third party."); *see also* Maunakea v. Hu (*In re* Maunakea), 448 B.R. 252, 264 (D. Haw. 2011) (discussing the Ninth Circuit's adoption of the hypothetical test to determine whether an intellectual property license can be assumed by a debtor in possession under § 365(c)(1)).

46. City of Jamestown v. James Cable Partners, Ltd. P'ship (*In re* James Cable Partners), 27 F.3d 534, 53738 (11th Cir. 1994) (affirming the holding that a cable operator franchisee, as the debtor in possession, could assume a cable franchise without franchising authority consent, despite a local cable ordinance that prohibited assignment, which was insufficient to constitute applicable law under § 365(c (1));

Finally, one bankruptcy court in the Southern District of New York held that the debtor in possession may assume an executory contract over the objections of the nondebtor party.[47] The *Footstar* court based its holding on the lead-in language in § 365(c)(1), which provides that the "*trustee* may not assume or assign…" [emphasis added]. Thus, as long as the debtor seeks to assume an intellectual property license agreement, rather than a trustee, the *Footstar* approach would permit the assumption.

In 2009, Justices Kennedy and Breyer indicated that they were interested in determining whether the hypothetical or actual test should be used when deciding whether intellectual property license agreements can be assumed.[48] To date, however, the Supreme Court has not taken up a case in order to resolve the circuit split.

So, where do all of these tests leave our in-house counsel? It all depends on where the bankruptcy case is filed. If in-house counsel is lucky, the case will be filed in a circuit bound by the hypothetical test, as this approach provides a licensor with maximum ability to prevent the assumption of the license agreement. However, two circuit courts have adopted the actual test, and the

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see also Moe's Franchisor, LLC v. Taylor Inv. Partners II, LLC (*In re* Taylor Inv. Partners II, LLC), 533 B.R. 837, 84243 (Bankr. N.D. Ga. 2015) ("The 11th Circuit's pronouncement—that § 365(c)(1) would prevent a debtor in possession from assuming an executory contract if applicable law would excuse the other party to the contract from accepting performance from a party other than the debtor in possession—is not *dicta*").

47. *In re* Footstar, Inc., 323 B.R. 566, 570 (Bankr. S.D.N.Y. 2005) ("Section 365(c)(1) states that 'the *trustee* may not assume or assign . . .' (emphasis supplied). The key word is 'trustee.' The statute does not say that the debtor or debtor in possession may not assume or assign—the prohibition applies on its face to the 'trustee' . . . . Nothing in the Bankruptcy Code prohibits the debtors from assuming the Agreements.").

48. N.C.P. Mktg. Grp. v. BG Star Prods., 129 S. Ct. 1577, 1578 (2009) ("The division in the courts over the meaning of § 365(c)(1) is an important one to resolve for Bankruptcy Courts and for businesses that seek reorganization. This petition for certiorari, however, is not the most suitable case for our resolution of the conflict. Addressing the issue here might first require us to resolve issues that may turn on the correct interpretation of antecedent questions under state law and trademark-protection principles. For those and other reasons, I reluctantly agree with the Court's decision to deny certiorari. In a different case the Court should consider granting certiorari on this significant question.").

weight of the lower courts favors the actual test, and it is therefore certainly possible, if not probable, that the company's ability to prevent the assumption of the license agreement will depend upon whether the debtor intends to assign the agreement after assumption.[49]

G. Recognition of Foreign Insolvency Proceedings

To make matters more confusing, let us assume that our in-house counsel receives a copy of a Chapter 15 bankruptcy petition. Chapter 15 of the Bankruptcy Code permits a foreign representative of a non-U.S. insolvency proceeding to seek recognition of the foreign proceeding in the United States. With recognition, the foreign representative can, among other things, marshal the foreign debtor's U.S.-based assets and distribute the assets, or proceeds thereof, in accordance with the foreign proceeding.

What happens if the foreign debtor is the licensor of intellectual property to a U.S.-based company, and the laws of the foreign proceeding do not protect intellectual property licensees as § 365(n) does? Is the U.S.-based licensee at risk of losing its license?

In 2013, the Fourth Circuit Court of Appeals held that the protections of § 365(n) should be applied in Chapter 15 cases to protect a licensee from a foreign debtor-licensor seeking to reject an intellectual property license.[50] In its decision, the court cited § 1522(a), which allows the court to grant certain relief upon recognition of a foreign proceeding, but "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."[51] The court rejected the debtor-licensor's

49. *See Pearlman, supra* n. 45, 165 F.3d at 749 (adopting the hypothetical test, but noting decisions adopting the actual test).

50. Jaffé v. Samsung Elecs. Co., 737 F.3d 14, 17 (4th Cir. 2013) (ruling that the bankruptcy court had (1) properly construed § 1522(a) as requiring the application of a balancing test to weigh the interests of the licensees against the interests of the debtor, and (2) reasonably exercised its discretion in finding that the application of § 365(n) was necessary to ensure that the licensees under the foreign debtor's U.S. patents were sufficiently protected).

51. *See* 11 U.S.C. § 1522(a).

argument that § 1522(a) was merely a procedural safeguard that was designed to ensure that U.S.-based parties-in-interest would be on "equal footing" with the debtor's other creditors.[52] Instead, as the court recognized, § 1522(a) requires that the court balance the interests of the creditors and the debtor "based on the relative harms and benefits in light of the circumstances presented."[53] Consequently, the Fourth Circuit court ruled that the bankruptcy court did not abuse its discretion in applying the balancing analysis and finding that the application of § 365(n) was appropriate.[54]

Jaffé v. Samsung Electronics Co. should provide our in-house counsel with a measure of relief, because at least one circuit-level court has refused to permit a foreign debtor-licensor to reject a license agreement without also giving the U.S.-based licensee the right, under § 365(n), to continue to enforce and perform under the license agreement.

H. Strategies

With all of the intricacies in the treatment of intellectual property in the bankruptcy context, how is our in-house counsel supposed to best protect his or her company? The easiest answer, especially if in-house counsel has no bankruptcy experience, would be to retain outside bankruptcy counsel (1) as soon as a bankruptcy case is filed by a counterparty to an intellectual property license agreement; or, better yet, (2) prior to a bankruptcy filing, to review the company's existing agreements to ensure that the company is protected. However, the company may not want to incur the additional legal expense, and the job will then fall on in-house counsel.

If the company is a licensee under an intellectual property license agreement, and if the licensor files a bankruptcy petition, our in-house counsel should take the following steps:

52. *Jaffé*, *supra* n. 50, 737 F.3d at 27.
53. *Id.* at 2728.
54. *Id.* at 31.

- Counsel should review the agreement and make a determination as to whether the agreement is executory.
- If the agreement is executory, the company must decide whether it wants to retain its rights under the agreement. The company needs to weigh the benefits of continuing the contract (e.g., the importance of the intellectual property; the remaining term of the agreement and any extensions) versus the costs of the contract (e.g., the amount of the royalty payment that will have to be paid).
- If the company decides to retain its rights under the agreement in accordance with § 365(n), notice should be sent to the debtor of the company's decision. This notice should be sent to the debtor even before a motion to reject the agreement is filed by the debtor, as the debtor is, upon receipt of the notice, required to continue to provide the intellectual property to the company and cannot interfere with the company's rights under the agreement.
- If a motion to reject the agreement is filed, counsel should file a response to the motion stating that the company had elected to retain its rights under the agreement in accordance with § 365(n).

Alternatively, if the company is a licensor under an intellectual property license agreement and the debtor-licensee files a bankruptcy case, counsel should take the following steps:

- Counsel should review the agreement and make a determination as to whether the agreement is executory.
- Counsel must determine whether the company has an interest in objecting to either an assumption of the agreement by the debtor, or an assumption and subsequent assignment by the debtor.
- If the company has such an interest, counsel should review the prevailing case law in the circuit in which the bankruptcy case is filed and understand whether the hypothetical test, the actual test, or the *Footstar* test will be applied.

- Once counsel determines which test is likely to apply, counsel should advise the company on the likelihood of success in objecting to a licensee assuming the agreement or assuming and subsequently assigning the agreement.

Looking prospectively, the company may want to license intellectual property (or even something that questionably falls within the definition of *intellectual property* in § 101(35A) of the Bankruptcy Code, such as trademarks) from a licensor. In this circumstance, counsel's main goal in negotiating the agreement should be to ensure that the company is entitled to protection under § 365(n) if the licensor files for bankruptcy. In this instance, counsel should take the following steps:

- Counsel should ensure that the license agreement specifically provides that the subject of the license agreement is "intellectual property" as defined by § 101(35A). The license agreement should also specifically provide that the company, as licensee, is entitled to all of the protections afforded licensees under § 365(n). The licensor should specifically acknowledge both of these points in the license agreement.
- Because § 365(n)(2)(B) requires a licensee to make "all royalty payments" for the duration of the agreement, counsel should negotiate narrowly defined royalty payments and differentiate the royalty payments from other monetary obligations under the agreement.
- If the license agreement involves licensing software, counsel should negotiate a separate escrow agreement for the software source code. The escrow agreement would specify that the escrow agent is permitted to release the source code to the licensee upon certain conditions, including the filing of a bankruptcy petition by the licensor, an event of default under the license agreement, or the rejection of the license agreement by the licensor.
- Counsel should advise the company to take a security interest in the intellectual property. This would permit the

company to foreclose on the intellectual property upon the occurrence of a specified default.

- Counsel should negotiate separate agreements for separate aspects of the transaction. This would prevent the licensor from arguing that the license is part of a larger, integrated transaction, and would minimize the risk that the license agreement will be rejected without the company being afforded the protections under § 365(n).[55]
- Counsel should have the company consider the benefits of negotiating a perpetual, exclusive license, because these are often treated as a sale and conveyance of a property interest, and therefore not subject to rejection.
- Finally, counsel should negotiate to have a bankruptcy remote entity hold the intellectual property and be the licensor under the lease agreement. This will make it more difficult for the intellectual property to become subject to a bankruptcy proceeding in the first instance.

If, however, the company owns and is planning to license the intellectual property, the company should negotiate the license agreement with an eye toward increasing its leverage if the licensee should file for bankruptcy. If the licensee files, the licensor's main concern would be to control the licensee's ability to assume, or assume and assign, the license agreement. In light of that concern, counsel should consider including a provision in the agreement that the laws of a certain federal circuit apply. The designated circuit would be one of those applying the hypothetical test, because the hypothetical test maximizes a licensor's ability to prevent assumption of a license agreement.

To hedge against the chance that the licensee will file in a circuit applying the actual test, counsel should consider the specific

55. However, if the license is in fact an integral part of an overall transaction, counsel should have the company aggregate the license and all other terms of the transaction into a single agreement, as opposed to separate agreements. This would prevent the licensor from "cherry picking" those agreements it wants to assume and those it wants to reject in the event of bankruptcy.

assignments that should be prohibited and include the necessary language in the agreement. For instance, the licensor may not want the intellectual property license being assigned to one of its competitors or assigned to a company that would be competing with another licensee operating in a specific geographic area. Although the enforceability of such provisions is debatable, it is best practice to include in the agreement limitations on assignability and then to litigate the enforceability of the limitations if necessary.

Counsel should also include terms in the license agreement that would enhance the licensor's ability to terminate the agreement before a bankruptcy is filed (e.g., licensee's failure to meet financial projections; licensee's failure to bring product to the market by a date certain). If the license agreement is terminated prior to the bankruptcy filing, the agreement cannot be revived. Consequently, it will not be part of the bankruptcy estate and therefore cannot be assumed.

Finally, regardless of whether the company is licensee or licensor of intellectual property, counsel should review the company's existing license agreements to ensure that these agreements adequately address the § 365(n) concerns. If the agreements are lacking, counsel should ensure that all necessary provisions are included in the agreements if and when the agreements are renegotiated.

Appendix 14.1

Checklist for IP License Subject to a Chapter 11 Bankruptcy Filing

1. Check whether the intellectual property (IP) in the license agreement is subject to protection under the Bankruptcy Code.

IP protected under Bankruptcy Code	IP not protected under Bankruptcy Code
• A trade secret • An invention, process, design, or plant protected under Title 35 (patentable subject matter) • A patent application • A plant variety • A work of authorship protected under Title 17 • A mask work	• Trademarks[1] • Trade names • Service marks

2. If subject to protection, then determine whether the IP license agreement is an executory contract. Note that the court in which the bankruptcy petition is filed will make the final determination on whether the license is executory or not.
   - Definition: An executory contract is a contract that requires some future or ongoing performance by *both* parties, where the outstanding obligations for both parties are material. If one party has fully performed its obligations, but the other party has not, then the agreement is not an executory contract.

1. Although trademarks are not IP under the Bankruptcy Code, as noted in the text, a minority of courts may still permit a trademark licensee to utilize the licensed trademark notwithstanding the rejection of the trademark license agreement.

- Nonexclusive license agreements are typically executory.
- Exclusive IP license agreements are typically nonexecutory.

3. If the IP license agreement constitutes an executory contract, then determine which of the following situations applies:
   a. Debtor is the licensee of IP owned by the company and wishes to assume and potentially assign the license; or
   b. Debtor is the licensor of the IP that is being licensed by the company.
4. If 3(a) applies, then the IP licensor must determine whether it is comfortable with the debtor-licensee either assuming the license or assuming and assigning the license to a third party (e.g., its purchaser) after assumption.
   - If the licensor does not want the debtor-licensee to have the option to assume or assume and assign the IP license, then the licensor should file an objection with the bankruptcy court to stop the debtor-licensee from assuming the IP license.
   - Note, however, that the licensor's ability to prevent the debtor-licensee from being able to assign the license will depend in large part on where the bankruptcy case is filed.
     - ❍ If the bankruptcy court resides in a circuit bound by the hypothetical test, then the licensor will have the maximum ability to prevent the assumption (and therefore assignment) of the license agreement.
     - ❍ If the bankruptcy court resides in a circuit that has adopted or favored the actual test, then there must be evidence of the debtor-licensee's actual intent to assign the agreement to a third party. Otherwise, it will be more difficult for the licensor to prevent the debtor-licensee's assumption of the license agreement.

SECTION 365(C)(1)(A) CIRCUIT SUMMARY			
Hypothetical Test	**Actual Test**	**Undecided But Potentially Actual**	**Undecided/Other**
3rd Circuit	1st Circuit	7th (district courts appear to follow actual test)	2nd (district courts appear to follow Footstar approach)
4th Circuit	5th Circuit	8th (district courts appear to follow actual test)	6th (district courts appear to be split)
9th Circuit		10th (district courts appear to follow actual test)	District of Columbia[2]
11th Circuit			

5. If 3(b) applies and the debtor-licensor seeks to reject the IP license agreement, the licensee must determine whether it wants to maintain its rights under the agreement.
   - If the licensee wants to maintain its rights under the IP license agreement, the licensee should proactively serve written notice to the debtor-licensor in accordance with § 365(n). The licensee must also continue paying royalty payments as required by the existing license agreement. The debtor-licensor will then be required to continue performing its contractual obligations (or at least must continue to provide the IP to the licensee) and cannot interfere with the licensee's rights under the agreement.
   - If the licensee wants to maintain its rights under the IP license agreement but the debtor-licensor files a motion to reject the agreement, the licensee should file an objection to the rejection motion. The objection should specifically state that the licensee has invoked its rights under § 365(n) to the IP.

2. There is little guidance from courts within the District of Columbia Circuit as to which test the courts would apply.

- If the licensee does not want to maintain its rights under the IP license agreement, the licensee can treat the rejection of the agreement as a prepetition breach and file a proof of claim for damages.

Section 365(n) Flow Chart